Netherlands Scientific Council for
Government Policy

Financing the European Community

Thirty-second Report to the Government

The Hague 1988

Netherlands Scientific Council for Government Policy

To: The Prime Minister/Minister for General Affairs
From: The Scientific Council for Government Policy
Re: 'The Financing of the European Community'

The Hague, 6 November 1987

Herewith the Scientific Council submits its report 'The Financing of the European Community'. The report, which is of an interim nature, is a partial response to the Government's request of 28 November 1986 for a study of economic and monetary policy coordination in the Community and the financing problems facing the Community.

In its report the Council recommends that the institutional framework of the Community budget process should be strengthened with a view to achieving the necessary degree of control, especially in relation to agricultural spending. To this end the European Council should draw up a binding financial framework every five years, within which the tasks and resources of the Community would be mutually coordinated.

In order to offset the decline in revenue from agricultural levies and customs duties, the VAT share in the Community's current revenues should be increased. If the aim of convergence should in due course require a structural increase in the Community's financial resources, the Council considers the EC should be given its own (if limited) powers of taxation.

Under the procedures laid down in the Scientific Council for Government Policy (Establishment) Act, the Council requests that the report be placed on the agenda of the Council of Ministers, and would welcome andy comments it may have.

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PREFACE

In its reaction to report no. 28, 'Unfinished European Integration', the Netherlands Government announced its intention of asking the Scientific Council for Government Policy (WRR) to carry out a follow-up study into the coordination of macro-economic policies and monetary cohesion, and the financing problems of the European Community. This follow-up study has since got under way. In view of the fact that decisions about the financing of the EC are currently being taken at European level, the WRR considered it preferable for this part of the study requested by the Government to be dealt with without delay, rather than waiting with publication until the study as a whole had been completed. The present report is therefore interim in nature, and specific parts may be treated in greater depth and detail at a later stage. Where necessary these aspects will be taken up in the final report.

In carrying out the study the WRR has been assisted by an advisory panel consisting of Messrs. M.H.J.C. Rutten, A. Szász, P. VerLoren van Themaat and J. Zijlstra. The WRR is indebted to them for their contribution towards the formulation of views of which this interim report is based. The responsibility for the report, however, is the WRR's alone.

SUMMARY

This interim report on the financing of the European Community starts with an analysis of the most important structural shortcomings of the present budgetary system. As established in *Chapter 1*, the problems with the Community budget will continue to occur as long as these shortcomings are not corrected. Roughly two-thirds of Community spending - namely expenditure on agriculture - is inherently difficult or impossible to control. Despite recent efforts to limit expenditure on certain products, spending on the Common Agricultural Policy, as structured at present, remains highly sensitive to technological and economic developments over which the Community has little if any control. Even if spending on the Common Agricultural Policy were less of a drain on the Community budget than at present, the Community would still be left grappling with financing problems since the yield from customs duties and agricultural levies continues to fall on the revenue side. There is therefore a structural gap between expenditure and income. In addition, the Single European Act calls for regional disparities in economic development to be reduced. The Treaty legislature has omitted, however, to specify how these additional forms of expenditure are to be financed.

Finally there are institutional shortcoming in the way in which the budget is framed. The horizontal fragmentation of decision-making in the various Councils of Ministers render the preparation, determination and implementation of a sound budgetary policy virtually impossible. The preponderance of special national and sectoral interests makes it difficult to achieve the necassary budgetary discipline. In consequence, the expenditure side of the Community budget is hard to control, while the framework of agreed expenditure tends to be subject to a process of crowding out in which tasks vital for the future of the Community and the economy of Western Europe take second place. The structural budgetary margins determined by revenue - the Community's own resources - is almost permanently under pressure.

The European Commission is handicapped in its budgetary *management* by the shortcomings in budgetary *policy*. It lacks powers vis-a-vis national executive bodies, while its task is further complicated by the susceptibility to fraud of a number of Community regulations.

In *Chapter 2* it is noted that the substantive demands are of the Community budget are in many respects more exacting than the demands imposed on national budgets, while the institutional arrangements for drawing up the budget are considerably weaker at Community than at national level. One complication is the fact that the solutions found at national level to ensure the financial, economic and political viability of a budget cannot be transferred as they stand to the Community. The analysis in this chapter comes down to four conditions with which the Community budget will in future need to comply:

1. The Community budget must reflect to tasks and responsibilities of the Community (and their development) in the short and medium term.
2. The institutional framework for the budgetary process must be such as to permit the maintenance of budgetary equilibrium and the control of *all* categories of spending in the short and medium term.
3. A binding connection needs to be established between budgetary policy and substantive, cost-intensive Community policies by the establishment of hierarchical links between the decision-making process by the budgetary authority and that in the specialist Councils of Ministers.
4. The convergence principle needs to find structural expression in the geopgraphical distribution of Community revenue and expenture.

By way of follow-up to Chapters 1 and 2, *Chapter 3* contains the following recommendations.

a. *Community revenue*

The WRR proceeds from the assumption that the Community must have effective sources of revenue, in which respect continuity of income is particularly important, but that at the same time the principle of material equality must apply, i.e. that proportionality must prevail between the Member States with respects to the revenue they are required to raise. In order to provide the Community with sufficient budgetary freedom to fulfil its tasks, as called for under condition 1, the present sources of revenue - agricultural levies, customs duties and VAT - can best be drawn upon in the *short* term. Over the next five years, a general increase in the VAT share in those revenues is therefore the most logical course, subject to an adjustment on the basis of the differences in the various Member States between the harmonized VAT base and Gross National Product. In the *longer* term, the WRR sees no way round assigning the Community its own taxation powers in addition to existing revenue sources, even though major obstacles of a fundamental, political and technical nature will need to be overcome. At first sight corporation tax would appear the most attractive tax base for a limited fiscal sovereignty of this kind.

b *Community expentiture*

If, in line with condition 2, the full range of expenditure categories is to be allowed to come into its own, the control of agricultural spending is unavoidable. This will require the introduction of financial feedback mechanisms in all the CAP regimes that make demands on the budget. In addition the Treaty could be amended so that there was an obligation to apply these mechanisms when a multiannual ceiling for agricultural spending was in danger of being exceeded.

Such a multiannual ceiling could be determined by the European Council in response to a Commission proposal and in consultation with the European Parliament, as part of a structural financial framework for the budget as a whole, as discussed under c. below. The ceiling would be binding on the budgetary authority and would lay down the margins within which the Council of Agricultural Ministers was permitted to operate. Within that framework it would be possible to provide for buffers in order to absorb cyclical fluctuations in agricultural spending. The management of the Common Agricultural Policy would be delegated to the Commission, with provision for a less developed procedural buffering.

In order to soften the negative impact on farm incomes, the Member States would be permitted to grant national income support, provided this was primarily of a social nature. Such aids would need to comply with Community criteria.

In the case of already weak regions that would be severely affected by a restrictive agricultural policy, the sums in question - which will be considerable - should in the WRR's view be taken out of the agricultural budget and allocated to the structural funds.

In addition the WRR would note that given the evolution of advanced agricultural enterprises into agricultural *industry*, a specific regime for agriculture is becoming increasingly difficult to defend. A trend-based reduction in the share of agricultural spending in the Community budget is therefore desirable.

c. *The institutional context*

To a significant extent, the WRR attributes the continuing inability to solve the Community's financial problems to the lack of coercive rules of decision by which all the parties in the budgetary process are bound. This has made possible a situation under which the Member States demand that spending be controlled on the one hand while on the other they persist with policies that render such expenditure uncontrollable. In order to satisfy *condition 3* the WRR would suggest the following binding rules of decision:

1. In order to ensure that Community responsibilities and the Community budget evolve in parallel, the European Council would draw up a structural financial framework once every five years. This would constitute a set of strategic decisions that was binding on the budgetary authority. To this end the Commission, taking account of the growth in Community responsibilities in the medium-term, would draw up a draft financial framework containing proposals with regard to the overall financial ceiling, the share of convergence expenditure and the share of agricultural spending. These proposals would need to be substantively based on indications of the Community policies likely to be implemented during the planning period. The draft financial framework would be submitted to the European Parliament, whereupon it would be adopted in line with the relevant parliamentary report. *On the basis of these proposals*, the European Council would determine the permitted growth in the expenditure ceiling, together with the shares of agricultural and convergence spending.
2. The European Commission would draw up the annual draft budget. In consultation with the Commission, the Budget Council would finalize the draft budget and submit it to the European Parliament. The Parliament would debate and, after consultation with the Council, adopt the draft budget. In order to maintain budgetary balance and to control spending, the annual growth in the budget would be tied to the financial framework and substantive policies to the budget. In the case of agricultural expenditure a double linkage is envisaged: first of all to the ceiling separately determined in the financial framework and secondly to the annual budget within that ceiling.

Within this decision-making process, the Community budgetary authority would be required to weigh cost-intensive Community tasks and responsibilities against the allocation of the available funds *within* the margins of the structural financial framework by which it was bound. The results of this decision-making process, in the form of the agreed budget, should in turn be binding on the decisions taken within the specialized Councils. The introduction of what at national level is generally a more or less compulsory statutory link between the budget and policies would strengthen the horizontal coordination within the various ministerial Councils as well as the substantive cohesion between the stated intentions of the budgetary authority and the content of material policies. The fragmentation that currently characterizes Community decision-making would thereby be overcome, and greater attention would be devoted to over-arching rather than purely sectoral interests. The decision-making procedure of the budgetary authority could more closely resemble that of a national legislature required to weigh up and authorize the budget, subject to the proviso that it was required to operate within the margins of the structural financial framework.

d. *The financial solidarity within the Community*
To close one's eyes to the need for a reasonable distribution among the Member States of the costs and benefits of the integration process would in the WRR's view be lacking in realism and politically ineffective. For this reason some form of general, objectified system of retrospective compensation is required to cover serious imbalances between Member States' contributions to and receipts from the Community. The relevant mechanism has not been elaborated in specific terms in this report, although the conditions with which an adjustment mechanism would need to comply have been specified. At issue here is a correction mechanism for structural over - or under-payments, to which - in accordance with the convergence principle - prosperous Member States would have greater difficulty in resorting than less prosperous countries.

e. *Practical arrangements for convergence*

Three aspects may be distinguished in relation to the convergence principle specified in *condition 4*: an even geographical distribution of the benefits of the integration process, strengthening of cohesion by the improvement of the economic structure and the solidarity appropriate to a single Community.

The convergence requirement can most appropriately be fulfilled on the expenditure side. To this end the Treaty should be amended to the effect that the European Council, at the Commission's proposal and in consultation with the European Parliament, would, when determining the financial framework every five years, lay down the proportion of Community funds that were to be allocated to regions where per capita income was more than a set percentage below average Community income. This proportion would then have binding force when it came to framing budgetary legislation. For the purposes of disbursing these resources the existing structural funds should be converted into a single new fund, while at the same time simplifying and reducing the numerous financial regulations. The Council of Ministers would lay down the statutes and broad guidelines of the new structural fund, while the Commission would be responsible for its administration. A system of far-reaching territorial decentralization would be in desirable.

Further examination would be required of the European Investment Bank's potential role in the process of convergence and of the way in which the Bank's policy should be coordinated with Community budgetary policy.

1. THE PRICE OF IMBALANCE: THE PROBLEMS OF FINANCIAL MANAGEMENT IN THE EUROPEAN COMMUNITY

1.1 Introduction

1.1.1 *The budget in the modern multi-tier state*

In every modern political entity the budget occupies a central position in the governmental and policy-making processes. In comparison with the situation of less than a century ago the budgetary procedures have evolved radically both *qualitatively* and *quantitatively*.

From a qualitative point of view these budgetary procedures have altered because they have been applied in increasingly important distributive and stabilising roles with the rise of the welfare state, while simultaneously still fulfilling the role of allocating resources for traditional and more modern governmental responsibilities.

The procedures have changed quantitatively because the budgetary allocation has come to comprise an ever increasing proportion of national income. On the one hand this expansion is closely associated with the emergence of the distributive (or redistributive) role of the budget, which can be most clearly demonstrated by the rise in costs of social security payments; on the other hand the expansion can be explained by the increase in governmental responsibilities, which often have to be exercised by means of financial instruments.

The qualitative and quantitative expansion of the budget - the revenue and expenditure of the state - has not been limited to national governments. Since the beginning of the century this expansion has been responsible for considerable constitutional problems in federal and confederal systems (i.e. multi-tier states), which have been solved in various ways. The advent of the welfare state has also resulted in a significant shift towards centralization in federal and confederal political systems, as evident from the increase in federal responsibilities as compared with those of the constituent states. Various modern governmental responsibilities can only be exercised efficiently at a centralised level, such as macro-economic management. This also applies to the measures used to regulate and, if necessary, correct the operation of market forces. In theory, it would be possible to establish certain types of decentralised policy for the (re)distribution of national income, but the experience of socially closely integrated multi-tier states has shown that the principle of material equality requires more or less consistent regulations. Social administration means in effect centralised administration in almost all parts of the world.

The rise of central responsibilities was parallelled in federal or confederal systems by a growth in the financing requirements of the federal government. As a consequence, the question of the distribution of fiscal powers *between* the federation and its component parts became relevant. In allocating fiscal areas the legislature (or framers of the constitution) had to bear in mind the very specific stabilising role played by the central or federal budget. This has been one of the reasons for the relatively large increase in the federal (or central) taxation sector.

The emergence of the welfare state entailed an increased awareness within a given political system of geographical (or inter-state) disparities in prosperity and, correspondingly, in revenue-raising capacity. In those cases where the increasingly prevalent principle of material equality was at variance with the differences between the taxes imposed by the decentralised authorities and the available services, the less prosperous states

were faced with an awkward predicament: the social demands made on them were of similar, if not increased, intensity, yet their financial strength was not comparable.

Two sorts of solution (or a combination of the two) have been applied to this question in federal systems. The first consists of a redistribution of revenue between the federal (or central) government and the states (or lower administrative levels). This *vertical* system of equalisation can be found for instance in the United States and Australia. The second solution consists of direct redistribution between the more prosperous and the less-favoured states. Article 107 of the West German Constitution provides for a solidary or *horizontal* equalisation system of this kind. Indeed, the Federal Republic applies a combined system of horizontal and vertical equalisation.

The various vertical and horizontal equalisation systems differ considerably in content, legal status and form. For each new category of revenue or expenditure, ad hoc arrangements tend to be made with respect to the geographical allocation of costs and benefits. Other, more structural distribution codes are also employed, whether provided for under the constitution or not.

The increasing share of (con)federal revenue and expenditure in a similarly expanding public sector has made policy-making processes with regard to revenue and expenditure subject to ever more intense and extensive regional pressure, which attempts to garner support from all the bodies involved in the decision-making processes. This regional pressure has proved very difficult to contain in federal or confederal systems and had led to expensive compromises, which cause an escalation in expenditure on the one hand and, on the other, are also often less than ideal from the viewpoint of allocation. The less that the vertical and/or horizontal financial equalisation arrangements have been enshrined in the shape of a set of general, mandatory rules of decision, the greater the likelihood that regional particularism will make undesirable inroads.

A second problem with regard to the budget in the modern multi-tier state is not so much connected with the federal or confederal character of the state, but is intimately bound up with the nature of many - especially centralised - social security payments designed to provide citizens with a basic level of welfare. In the welfare state these costs rapidly assume the character of claims or entitlements: a minimum guarantee of security and equality of income, assured by the government. The nature of these costs tends to produce open-ended regulations, expenditure on which can be estimated in a budget but is very difficult to contain. As long as these open-ended arrangements remain restricted in volume and range, and their use can be restrained by other forms of government intervention, the objections to them are not excessive. The objections do become significant when the volume of these regulations reaches a certain critical magnitude, since their absolute and relative size then prevents proper control of public expenditure and, in the long term, undermines the stabilising role of the budgetary process.

In virtually the whole of the Western world the budgetary authorities are grappling with the problem of restricting open-ended regulations and/or reducing the demand made on those regulations. The issue is politically and socially highly charged, since the welfare state owes its inherent nature to the most significant of these regulations. Despite the controversy surrounding this problem, a certain degree of consensus seems to be taking shape in the Netherlands at present, on the basis that, in principle, the only facilities for which open-ended regulations are justified are those based on the right - as a social entitlement - to a minimal individual level of welfare. Each addition to these regulations over and above the basic facilities guaranteed by the welfare state would increase the difficulties of fulfilling the state's basic commitments and would inevitably be at the cost of other high-cost government responsibilities and the stabilising role of the budget.

1.1.2 *The budget in the European Community*

The European Community is a political entity which, institutionally, combines both (pre)federal and inter-governmental characteristics. The range of authority available to the Community is limited, nor do these powers concern the maintenance of external security and traditional foreign policy as customary in conventional federations or confederations. Its powers relate primarily to the economic field.

From a political, socio-economic and cultural point of view the Community is an extremely heterogeneous entity, which has up to the present offered only a limited framework for integration in the field of social consensus. The public spirit within the Community is still mainly focussed on integration within the context of the national state. As a protective body concerned for its own interests the position of the Community is considerably weaker than would be the case with a federation or confederation guarding its federal or confederal concerns.

In comparison with the size of federal government budgets, that of the Community is extremely modest. But even as a percentage of the combined national budgets the Community budget can be considered insignificant. In 1973 the expenditure of the Community amounted to 2% of the combined national budgets; in 1984 this figure was 2.6%[1].

The Community budget has played a primarily allocative role with respect to the gradually expanding responsibilities assigned to the Community; a distinctively distributive role did not emerge until the beginning of the 1970s. Since the repeated enlargements of the Community and the recent adoption of the Single European Act, this redistributive role has, however, grown considerably in significance, at least politically. The limited size of the Community budget for that matter does not enhance the likelihood in the near future of the development of an independent stabilising role for the budget.

Unlike federal and confederal political entities, the Community does *not* possess a separate tax base with associated fiscal sovereignty. The Community's own resources are in effect entitlements arising under the Treaty to certain fiscal and parafiscal taxes imposed by the Member States.

The budgetary decision-making processes has a number of distinctive features as compared with the customary procedures at national level. The institutionally determined fragmentation of the decision-making processes concerned with the Community's expenditure is twofold, the first being the responsibilities of the specialised Councils, divided according to categories of expenditure, and the second the shared responsibility of the Budget Council and Parliament. This division creates a structural tension in the financial frameworks agreed by the budget councils, the results of which are satisfactory neither from the point of view of allocation nor from that of effective redistribution.

As far as the level of prosperity and economic development are concerned, the Community has become more varied over the last decade. The most obvious reason for this development has been the addition in three phases of six states to the Community, bringing the total to twelve. This is not the only reason, however, for the increase in heterogeneity, nor probably in the long term even the most important one. The Member States at the centre of the Community, in particular, have almost systematically ignored the fact that the integration of markets could aggravate geographical disparities in prosperity and development prospects, and that it has indeed done so. Moreover, the tendency for the gap in regional disparities in wealth within the framework of a single geographical market to widen increases at times of slow or declining economic growth.

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[1] *'The Budget of the European Community'*, European Documentation, 1/1986, p. 56.

The Community budget is faced with the problem of the uncontrollability of certain categories of expenditure to a relatively serious degree. Approximately two-thirds of its expenditure derives from price support commitments under the agricultural regimes. The level of these costs is very hard to estimate and even more difficult to control, and it tends to increase structurally with the ever widening structural gap between supply and demand in the most important markets for agricultural produce. Because of the fact that the agreed prices have a direct impact on earnings in the agricultural sector, the Common Agricultural Policy has gradually evolved from the stabilisation of prices and payments into an instrument for redistributing earnings.

As already explained in various reports, this in relative terms extremely large category of expenditure is totally unsuited for distributive purposes and its use for this purpose results in serious distortions in market allocation. In this respect it may be noted that at national level, open-ended financial regulations along the lines of the more far-reaching Community agricultural regimes have been or are being removed as an instrument of *economic policy* on the grounds of their extreme inefficiency. The fact that the Community is lagging behind in this respect affords an illustrative example of its institutional weakness.

These introductory comments may be concluded with a single general observation: in federal and confederal systems which are politically and socially closely integrated and which share a common historical and cultural background, the geographical or regional (re)distribution of the costs and benefits of modern public administration has become one of the key political and constitutional issues. An unsatisfactory solution to this matter imposes a permanent burden on federal (or central) budgetary policy. This aspect of the problems of financial management of the European Community is not unique. The institutional, managerial and socio-political conditions involved in this solution are, however, unique. This brief outline of the specific budgetary problems of the Community as a *unique political entity* shows that a solution to these problems will have to meet various conditions of equality.

The rest of this chapter discusses the nature of the problems that have been noted above; the discussion deals in turn with the budgetary procedures, the implementation of the budget, the stagnating level of revenue and the increasing level of expenditure.

Chapter 2 will consider the conditions required for a new system of financial management within the Community. Chapter 3 contains possible solutions based on those conditions; the income and expenditure of the Community and the institutional aspects of the budget are also dealt with in this chapter.

1.2 The budgetary process

1.2.1 *Introduction*

The budgetary process of the Community is set apart from the national budgetary process by two special features.

The Community has a two-pronged budgetary authority, namely the Council of Ministers and the Parliament, which each have principal responsibility for a part of the expenditure. The Council determines the level of so-called compulsory expenditure, i.e. the spending required under the Treaty. The Parliament determines the level of non-compulsory expenditure and adopts the budget.

The Council's powers with respect to compulsory expenditure are limited, since the volume of this expenditure is ultimately dependent on the content of decisions not taken by the budgetary authority, namely decisions made by the specialised Councils and implementing decisions by the Commission or national executive agencies and also market and monetary developments. As far as these costs are concerned, therefore,

the budget of the Community is inclined to resemble an estimate. If these estimates are exceeded, the requirement to balance the budget means that the overshoot has to be offset in the area of non-compulsory expenditure. Utterances with regard to non-compulsory expenditure made by the European Parliament as one half of the budgetary authority are, however, no more binding in effect. These costs are dependent on the self-discipline of the agencies concerned (i.e. the specialised Councils), the behaviour of which determines the actual volume of compulsory expenditure.

1.2.2 *Preparation and adoption of the budget**

The Commission prepares the budget. The preparatory procedure is initially set in motion by the various decentralised institutions of the Community, which draw up estimates of expenditure.

These estimates are amalgamated by the Commission and if necessary furnished with a recommendation. The Commission then adds an estimate of revenue and all this information is sent to the Council as a draft budget (Art. 203 EEC, paragraph 2). Within the structure of the Commission the budgetary responsibilities reside with the Commissioner for Budgets and the Directorate-General for Budgets (DG XIX). The office of Commissioner is administrative rather than political in nature: decisions involving policies are made by the Council.

Generally speaking reference is made to 'the' Council, as though this were always one and the same body, but the real situation is more complicated. The Council manifests itself, in fact, in several guises. One of these is the General Council, formed by the Ministers of Foreign Affairs, and there are specialised Councils dealing with agriculture, transport, social affairs and the budget. Since the Single European Act came into force on 1 July 1987 the European Council (made up of the heads of government) has under the Treaty been added to the institutions of the Community. All these Councils exert influence on the budgetary process; each specialised Council deliberates upon its particular area of policy and its financial aspects, and the European Council can be called upon to resolve impasses if the specialised Councils are unable to come to an agreement.

The criticism that expenditure programmes are flawed by being set up or continued without attention to the effects on other policy areas has resulted in the initiative of joint meetings of the specialised Councils[2]. Prior to the 1976 budgetary procedure the first meeting took place between the General Council and the Budget Council, but their influence on the budget has remained minimal. The same applies to the joint meetings of the Finance and Economics Councils and the Agriculture and Finance Councils. A joint declaration is issued and - until now - that has been all. The fragmented decision-making in the Council means that the gap between financial/economic policy and material policy in the Community is much more pronounced than in the national states. The financially cautious Budget Council arrives at its decisions without directly confronting the ministers of the specialised Councils who are intent on maximising the budget. Those ministers, meanwhile, meeting in their specialised Councils, do not consider themselves bound by the decisions of the Budget Council, and indeed do not need to as far as compulsory expenditure is concerned.

The *Council* formulates a draft budget. From a formal point of view only the Budget Council plays a part in the adoption procedure. The Budget Council comprises the ministers/secretaries of state with responsibilities for budgetary affairs. The Federal Republic, France and the

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* For a survey of the relevant articles in the EEC Treaty see Annex 1 to this chapter.

[2] G. Edwards, H. Wallace, *The Council of Ministers of the European Community and the Presidention-office*; London, The Federal Trust for Education and Research, 1977, p. 7 ff.

United Kingdom have created the post of secretary of state for budgetary affairs. The Netherlands is represented on this Council by the Secretary of State for Foreign Affairs.

The Budget Council considers the draft submitted by the Commission and in general decides (as the sole Council) by a majority of votes[3]. The Budget Council has no special powers as far as coordination is concerned. The decisions have in fact already been made by the specialised Councils and there is little the Budget Council can do to alter those decisions.

The role of chairman of the Council (in which Member States succeed each other every six months by alphabetical order) has increased in importance in the budgetary process in parallel to the development of the role of Parliament as second budgetary authority. Parliament and the Budget Council actually meet two or three times in formal session prior to discussion of the budget in Council**. Any difference of opinion is referred to the chairman of the Council, Parliament and the Commission. This aspect of arbitration on the part of the chairman can play an important role, both within the Council and between institutions[4].

Parliament determines the budget and has the right of veto. The Decision on Own Resources of 1970 gave Parliament the authority to alter non-compulsory expenditure and to propose adjustments to compulsory spending. The crucial question was the definition of the distinction between compulsory and non-compulsory expenditure and this is still a moot point. In a joint Declaration, Parliament, Council and Commission have agreed to a classification which defines as compulsory expenditure those costs that *have* to be included in the budget for the Community to meet its commitments arising from the Treaties or associated implementing decisions. Parliament disputes the fact, however, that all expenditure involving agricultural guarantees should be designated as compulsory expenditure[5].

The non-compulsory expenditure has given rise to a de facto increase in parliamentary control: the resources of the Regional Fund have been accepted by the Council as non-compulsory spending.

The Treaty contains some scope for control of the volume of non-compulsory expenditure. Every year the Commission decides on a so-called *maximum rate of increase* on the basis of economic indicators. The Council is allowed to make use of this maximum ceiling if it wishes to increase non-compulsory spending. The agreement also enables Parliament to use half of this percentage increase, even if Council has already claimed more than half. This means that Council and Parliament can together permit the budget for non-compulsory spending to rise by up one and a half times the maximum rate of increase without prior formal accord as decreed in Article 203 EEC. Over the course of time, Parliament has consolidated its authority over non-compulsory spending and the areas of decision-making. Ultimately, however, this control remains conditional as long as the growth in compulsory expenditure - which forms over 60% of Community spending - remains able to escape the authority and control of this budgetary body. At Community level there is, therefore, no question of budgetary powers comparable to those of the national parliaments.

**See Annex 2 to this chapter.

[3] H. Wallace, *Budgetary Politics: the finances of the European Communities*, London, George Allen & Unwin Ltd., 1980, p. 83 ff.

[4] Edwards and Wallace, op. cit., p. 18 ff.

[5] H.A.C.M. Notenboom, 'De actuele begrotingsproblematiek van de Gemeenschap' (The current budgetary problem of the Community), *Internationale Spectator*, June 19897, vol. 4 no. 6, p. 323.

1.2.3 *Implementation of the budget*

Article 205 of the Treaty states that implementation of the budget rests with the Commission; there is no reference whatever to any responsibility on the part of the Member States. Significant items of expenditure such as agriculture and the structural funds, however, are administered totally or partly by the Member States, which are obliged to do so under Community regulations and directives. The Commission manages its own budget as well as energy policy and research projects (such as Euratom).

The budget of the Commission itself is dominated by the Common Agricultural Policy (CAP), which is also the source of the greatest difficulties, in that the as yet uncontrollable increase in spending crowds out other Community spending, such as that on structural policy. With the implementation of the European Act the Community will be obliged to pay more attention to structural policy as an instrument for promoting economic cohesion. Both fields are discussed below.

1.2.3.1 Agricultural policy

The implementation of the budget as a *policy process* primarily involves the setting of priorities. In the case of agricultural policy, the allocation of priorities takes place at Council level; the Commission has an administrative role. Particularly in this area, the (political) process in Council reflects to a significant degree the interests of the national (in this case farming) lobbies, as clearly illustrated by the annual fixing of prices. The priorities of the CAP were largely established during the early years of the Community, when the market regimes were fixed. The guaranteed prices are agreed on an annual basis and if necessary quota measures are introduced, but the broad picture is laid down in regulations and guidelines. As a consequence the expenditure on the CAP is spending that *has* to be incurred; the volume of the spending is determined by prices and production, and influenced by world market prices and the dollar exchange rate.

Whereas the Council bears the responsibility for the policy process, the responsibility for *management* is shared between the Commission and the Member States. The Member States implement the agricultural policy and submit a monthly estimate of anticipated costs to the Commission, which then advances payments towards these costs. The definitive account cannot be confirmed until after the end of the financial year and frequently requires adjustments. The final settlement of accounts and the balancing of the books takes place years later: in 1981 the year 1973 had been reached[6]. A second disadvantage of this system of pre-payments is the fact that it does not provide the Commission with a survey of the year's actual spending. Any interim policy changes, however, would not be possible as a consequence of the slow decision-making procedures in the Council, which is responsible for policy.

Two issues connected with the management of the agricultural policy have been particularly in the forefront of late. These are the storage of surpluses and the fact that the rules and regulations in the agricultural sector are susceptible to fraud. On the one hand the problem of the surpluses is concerned with storage: the cereal stocks turn out to have been stored incompetently, so that their value has fallen seriously. On the other hand the problem is focused on the rising costs of storage (between 1983 and 1984 these rose by 35%) and the costs of depreciation of the stocks, for which scarcely any provision is made in the budget. Long-term storage implies depreciation in value. The inclusion of stocks

[6] European Court of Auditors, 'Study of the financial systems of the European Communities (1981)', *Official Journal of the European Communities*, C 342, vol. 24, 31 December 1981, p. 43.

in the budget at book value, however, exaggerates the true level of assets. The depreciation on the book value for 1987 is estimated at 66% (8,1 billion ECU)[7].

The nature of the rules and regulations as well as the multitude of requirements makes them almost impossible to apply and control, thus encouraging fraud. The main powers of control and sanction lie with the Member States, although the Commission too is able to conduct specific inquiries (with which the Member States are obliged to cooperate), to exchange information with the Member States and to take steps to retrieve payments incurred without reason. In practice this does not run smoothly. Parliament presumes that the national bodies (administrative and legal) and Community bodies do not cooperate harmoniously enough[8].

Agricultural spending flows from the Treaty and must therefore be incurred; this then means that other spending may have to be reduced in order to remain within the agreed ceiling. As far as budgetary management is concerned, this leads to transfers from one budgetary item to another, and to transfers within and between budgetary chapters. Transfers between chapters have to obtain approval from Parliament or Council, while those within a budgetary chapter can be effected by the Commission without the need to supply further information. In this manner 10% of the total 1984 budget was used for purposes others than those for which it had originally been approved[9].

1.2.3.2 Structural policy

The leading financial instruments of structural policy consist of the structural funds: the Social Fund, the Regional Fund and the Agricultural Guidance Fund, which all come under the Community budget. The responsibility for these funds rests with the Commission, while the policies are implemented jointly with the Member States.

The chapter proceeds to discuss the modus operandi of the funds and in particular their aims and activities, the response to requests for assistance and finally their budgets and budgetary applications.

When the EEC Treaty was drawn up it was anticipated that the establishment of a common market would require certain adjustments in order to correct imbalances in the labour market resulting from the rearrangement of the factors of production. As a consequence, the *Social Fund* was established, which aimed at boosting employment and hence an increase in the standard of living within the Community.

On account of the altered situation in the labour market the Fund was adapted on a number of occasions and new priorities set. Of these the most important are geographical concentration on less favoured regions and the promotion of employment opportunities for young people; the priority accorded to a particular application depends essentially on the region in question. The priority regions of the Social Fund include Ireland, Greece and Portugal, parts of Spain, southern Italy, the French overseas departments and Northern Ireland. Three-quarters of the available loans have been earmarked for young people.

Apart from encouraging employment opportunities for young people aged under 25, the projects or activities supported by the Social Fund relate to industrial adjustment and restructuring, the development of the labour market, the engagement of certain categories of individuals in social and professional life and specific activities of an innovative nature that are in line with the broad objectives of the Community. In addition

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[7] Commission of the European Communities, *Report from the Commission to the Council and Parliament on the financing of the Community budget*, Brussels, 3 March 1987, COM(87)101 final, p. 7.

[8] European Parliament, *Report on behalf of the Committee on Budgetary Control*, 26 March 1986, PE 103.713 final, p. 32 ff.

[9] European Parliament, op. cit., p. 23.

priority is accorded to activities that enjoy support from more than one Community fund and to activities undertaken jointly by several Member States.

The priorities each constitute a point of decision in the chain of decisions that have to be taken before an application for assistance can be granted. For the purposes of evaluating applications the Commission has a list of 45 headings. In 1985 these were used to evaluate 4785 applications for assistance in 19 different areas of activity[10].

In 1985 the volume of applications to the Social Fund reached 4,985.9 million ECU, i.e. 230% of the available resources. This inadequate budget necessitated a reduction in the assistance that could be provided. This cut was based on the rate of national unemployment and per capita GNP at *national* level, so that assistance was concentrated on Member States with a high level of unemployment and a low GNP per inhabitant instead of on priority regions. The statistics do not specify the actual level of assistance reaching these areas since the figures are classified by Member States and not by region.

Prior to 1985 (i.e. before Spain and Portugal joined the Community) 1,505.5 million ECU were available for payment appropriations, of which 1,413 million ECU were paid out. Italy received 27%, the United Kingdom 20%, France 18% and Ireland 12%. Outstanding financial commitments at the end of 1985 amounted to 2,832.12 million ECU[11].

Apart from the under-utilization of the available resources, the most acute discrepancy faced by the Social Fund consists of the inadequacy of its resources in relation to the requested amounts. The verification of the volume of applications prevents the Commission from supervising or verifying the projects; payments are made on the basis of the reports received from the Member States on project implementation. In 1985 the Commission embarked on the development of a procedure for assessing project effectiveness. This was still being worked on in December 1986.

The *Regional Fund* was established in 1975 with the specific task of supporting the regional policy of the Community. The Fund's terms of reference are to help reduce regional disparities by participating in the development and structural adjustment of regions that have lagged behind economically or of industrial areas that have gone into decline.

Support is given in particular for the improvement of the infrastructure and the promotion of new productive activities in order to eliminate structural employment deficiencies. A new regulation came into effect in 1985, which provides for the coordination of activities at regional level, e.g. by means of programmes. The Regional Fund now has two categories of programmes, drawn up by the Member States, depending on whether they have been initiated by the Member State or by the Commission. In 1985 two programmes were submitted to the Council at the initiative of the Commission, while 17 programme proposals were received from the Member States. Of the latter, three were approved.

The Commission has noted that most Member States experience difficulties in the drafting and submission of programmes. The Commission's procedures for the ex-ante evaluation of applications have been discussed with the Member States, which have indicated considerable disapproval of the procedures; in particular, the information required was seen as excessive.

For each infrastructure project the Commission seeks a cost/benefit analysis, and for each industrial project a detailed calculation of profitability, as well as data on the effect on employment and regional development, is required. Despite the objections, the Commission has decided

[10] Commission of the European Communities, *Fourteenth Report on the activities of the European Social Fund, 1985 Financial Year*, Brussels, 3 March 1987, COM(87) 101 final, p. 7.

[11] Commission of the European Communities, op. cit., p. 28.

to persist with the procedures and to evaluate them in a few years' time. The Commission attributes the difficulties of the Member States partly to the limited experience of the national and regional authorities in dealing with the procedures[12].

The applications are screened on the basis of formal criteria and their contribution towards Community interests, and the applications are also submitted to other agencies of the Commission. The result of this meticulous approach is that 3626 projects out of the 7249 applications submitted in 1985 were still under consideration at the end of the year. The Commission expects that a significant proportion of these projects will be rejected.

For the year 1985 a sum of 1,705.8 million ECU was available for payment appropriations, of which 93.2% was disbursed. At the end of 1985 the outstanding appropriations for commitment amounted to 5,114.2 million ECU[13].

Of the expenditure, 18% was allocated to industry, services and trades; 82% was spent on infrastructure. The geographic concentration of the assistance varies from year to year; in 1985 Southern Italy (Mezzogiorno), Greece (except Athens), Ireland, Northern Ireland and the French overseas departments received 60% of the support.

With respect to assessing the efficacy of the assistance, the Commission observes in its annual report for 1985 that this in fact requires an assessment of the situation as it would be in the absence of aid to these regions; it is not possible to do more than make an estimate. Measuring the effect according to GNP per inhabitant in the various regions would hardly be possible since the assistance provided by the Fund is on such a limited financial scale. The European Court of Auditors notes in this respect that the lack of suitable methods and reliable statistics make it difficult, ten years after the establishment of the Fund, to assess whether Community resources are being properly used[14].

The Regional Fund's most serious problems would appear to be the drafting of applications for assistance and the extremely laborious appraisal procedures. The supervision of project implementation is described in the Court of Auditors' report for 1985 as inadequate. For these reasons the effectiveness of the aid has not been assessed.

The Agricultural Guidance Fund is, on the one hand, an instrument for agricultural policy; it is through the Fund for instance that 40% of the financial arrangements for the conversion of dairy stock is provided. On the other hand, the Fund is an instrument for agricultural-structure policy and it assists activities aimed at improving the social structure, the correction of regional disparities and the improvement of agricultural productivity.

The activities of the Fund are subdivided as follows:

- indirect activities, in which the Member States are reimbursed with a share of the expenditure upon the conclusion of a scheme;
- direct activities, in which assistance is given to the applicant for support for a particular project; this does not necessarily mean a Member State.

  Projects in this context are: the improvement of irrigation in Southern Italy, improving the processing and marketing of animal fodder in Northern Ireland, integrated Mediterranean projects.

[12] Commission of the European Communities, *Fifteenth Annual Report (1985) of the Commission to the Council-European Fund for Regional Development*, Brussels, 31 October 1986, COM (86) 545 final, p. 29 ff.

[13] Commission of the European Communities, ibid., p. 60.

[14] European Court of Auditors, 'Annual report for the year 1985', in *Official Journal*, C 321, 15 December 1986, p. 85.

In total there are at least 46 different activities, divided over a budget of 940.1 million ECU in 1987. Over two-thirds of the budget is destined for contract work, which entails direct financial transfers to the Member States[15].

The use made by the Member States of the available credits differs considerably. In 1985 the average was 89.9%, with Italy as the exception at 50%. This percentage appears slightly inflated; the indirect activities receive assistance in retrospect and as a consequence obtain the total amount (100%) if the conditions are met. The support for direct activities, however, is paid out during the course of the project; if the project comes to a halt or there are bureaucratic delays, nothing is paid out. The percentage of payments to Italy for these activities was 41%. Italy is not the only country experiencing problems in this sphere: the Commission has observed similar difficulties in relation to Greek, Irish and French projects. The Commission suggests in its annual report for 1985 that these countries either submit their requests for payments late or not at all[16]. The national administrations would therefore appear to be at fault in these cases.

The European Court of Auditors in its report of 1985 observes that insufficient checks are carried out to establish where the assistance ends up. Investigations have for example revealed instances in Italy of the funding of production of beef which is subsequently entirely offered for intervention. In the same way assistance is given to insolvent and loss-making companies without prospects of improvement[17].

In the case of the Guidance Fund, the fragmentation of assistance may be attributed to the large number of activities combined with a small budget. The regulations provide little incentive for potential applicants: it takes time for the rules to be incorporated into national legislation, while the Commission delays its final decision until various bodies have been consulted. The (inadequate?) national procedures result in just a fraction of the available credits being used, especially in those Member States that belong to the priority areas.

The Court of Auditors displays considerable criticism in its 1985 report (as in previous reports) towards the operation of the structural funds. It dwells particularly on the inadequate provisions for demarcating certain problem areas as priority regions, since the Commission lacks sufficient information on the socio-economic situation of these areas. Procedures such as the prior allocation of a certain percentage of the assistance for the benefit of these regions (or other targets) mean that assistance can be granted automatically, without substantive evaluation.

The Court of Auditors also draws attention to the danger that inadequate project supervision and control may lead to support for measures that amount to the subsidization of national budgets. Community assistance should be complementary in nature and not take the place of measures which the Members States are themselves obliged to undertake.

As well as transfers within a budgetary year, as described in the case of the CAP, transfers also occur between budgetary years in the case of the Funds (Financial Regulations, article 6). Some items are automatically carried forward to the next budgetary year if they are not used, while other items lapse. This facility is used in order to carry forward certain financial commitments, with the result that on paper the total volume of expenditure is kept within the set limits of the financial year. The commitment continues, however, and increases the pressure on the next bud-

[15] European Parliament, Committee on Budgetary Control, *Draft report on the budget audit of the effectiveness of the structural funds, B. Commentary*; 27 March 1987, PE 112.002/B, p. 6.

[16] Commission of the European Communities, *Fifteenth Financial Report on the European Guidance and Guarantee Fund, Guidance Section, 1985*; Brussels, 24 July 1986, COM (86) 407 final, pp. 12-13.

[17] European Court of Auditors, op. cit., pp. 63 and 60.

get. This 'cost of the past', which arose in the years 1983-1985, relates predominantly to the budgetary resources of the structural funds. According to the European Parliament Committee on Budgetary Control, these deferred payments are just the tip of an iceberg of hopelessly chaotic accounts: some items in the budget date back a number of years and have consequently become notional, and accounting practices have been developed to allow items to remain on the budget which, under the Financial Regulations, should have lapsed many years ago[18].

1.2.3.3 Other financial instruments

Decisions regarding programmes with financial consequences are made not only at the stage of the budgetary discussions, but also outside this sphere of responsibility. Decisions on such programmes, however, do not generally take into account the effect on other policy areas or even on programmes within the same sector. Regional policy within the Community, for instance, is not just pursued with the aid of the Regional Fund; programmes forming part of the Agricultural Guidance Fund, the Social Fund and the European Investment Bank have regional implications as well.

Apart from grants through the structural funds the Community provides loans and interest subsidies, which do not all appear in the budget, such as loans from the own resources of the ECSC and the European Investment Bank (EIB).

Loans under the terms of the new Community instrument (NCI or Ortoli Facility) are granted through the European Investment Bank. The Commission selects the projects on the basis of Council guidelines and the Bank then acts on behalf of the Community. Euratom loans are issued on the basis of a decision by the Commission, within a ceiling determined by the Council. In this instance too, the European Investment Bank takes care of the transaction itself.

The Bank itself also grants loans for projects from its own resources, subject to the aims laid down in the EEC Treaty (Articles 129 and 130). The decision on these loans is made by the Board of Governors, after advisory consultations with the Commission and the Member State where the relevant project is to take place. A negative recommendation of the Member State means that the loan is not granted. Upon a negative recommendation by the Commission, the loan may still be granted, but only if the decision to do so by the Board of Governors is unanimous. Finally the ECSC provides loans from its own resources and with the aid of loans on the capital market; the management and relevant decisions are in the hands of the High Authority/Commission.

The total volume of loans is higher than the subsidies granted through the structural funds.

Table 1.1 Subsidies and loans 1986 (in million ECU)

Subsidies			
Agricultural Fund Guidance Section		884.1	
Social Fund		2625.46	
Regional Fund		2483.88	
Total			5993.44
Loans			
NCI		393.0	
EEG balance of payments		861.8	
ECSC		1069.2	
Euratom		443.2	
EIB from own resources	7059.9		
of wich within the EC		6678.1	
Total			9445.3

Source: *20th General Report on the Activities of the European Communities, 1986.*

[18] European Parliament, op. cit., p. 20.

Within the context of financial coordination Parliament has requested that loans be included in the budget as well. Strasser observes that the European Investment Bank is, as an autonomous body, virtually exempt from any supervisory mechanisms of the Community and that this aspect is giving Parliament growing concern as the Bank increasingly takes on responsibilities that could also be performed by the Commission[19]. It is, however, doubtful whether the Community would be capable of integrating the loan facilities into its economic and financial policies in such a way as to strengthen the existing instruments.

1.2.3.4 Exchange rate variations

A characteristic European budget difficulty is the influence of exchange rate variations. The level of world market prices determines the intervention prices for products regulated under the Common Agricultural Policy. One of the major factors in the world price is the dollar/ECU exchange rate.

Table 1.2 Sensitivity of agricultural guarantee prices to the ECU/dollar exchange rate

Forecast total Agricultural Guarantee Fund at constant 1985/86 prices; billion ECU

	1$ = 1,20 Ecu	1$ = 1, Ecu
1986	19,72	21,14
1987	19,06	20,43
1988	18,70	20,09
1989	18,87	20,28

Source: *"The Future of Community Finance,"* CEPS-papers no. 30, p. 22.

Exchange rate variations also affect the prices received by farmers, since prices are calculated in ECU but paid out in national currencies. Revaluation of the national currencies results in a lower level of ECU. In order to avoid this decline in prices a system of monetary compensatory amounts has been devised, aimed at maintaining the level of Community prices. Over the years the costs of this system have increased considerably and since the introduction of the European Monetary System in 1979 attempts have been made to discontinue the system.

Customs levies - which are Community revenue - are also affected by exchange rate variations. One of the proposals of the Commission with regard to the financing of the Community refers to the establishment of a reserve to offset such variations.

1.2.4 *Control and discharge*

Administrative control has never been a priority within the Commission, and relatively few people are available in this sector. This is an additional handicap in those policy areas in which the Community has little if anything to do with the execution of the budget. In the latter case the Commission is totally dependent on the cooperation of the Member States.

Internal financial control offers more possibilities, in that there are financial inspectors in all the institutions, who can report independently, have access to all relevant documentation and are allowed to undertake 'on the spot checks'.

The auditing of the receipts and expenses of the Community is the responsibility of the European Court of Auditors. The Court investiga-

[19] D. Strasser, *Les Finances de l'Europe*, Fernand Nathan, Paris/Editions Labor, Brussels, 1980, p. 217.

tes the legitimacy of the financial transactions and the financial management. It has powers to inspect financial records, including in the Member States. The Court of Auditors publishes an annual report on its findings and this document, which includes the institutions' reaction, is an important element in the discharge granted by Parliament to the Commission for the administration of the budget.

The discharge procedures are laid down in the Financial Regulations. Parliament gives discharge on recommendation of the Council and after publication of the Court of Auditors' report on the financial year. The discharge is granted provisionally since the audit of the accounts of the Agricultural Fund lags behind and can still produce surprises.

The Commission's political responsibility with regard to Parliament emerges particularly graphically in its power of sanction. Article 144 EEC gives Parliament the authority to force the resignation of the Commission as a whole through a motion of censure. To date Parliament has not exercised this authority. The sanction seem to fulfill a more symbolic role, as Parliament has no control over a new Commission or its appointment.

1.2.5. *Conclusions*

a. *General*

Significant progress in the decision-making processes of the Community is often connected with the budget: decisions on own resources, new programmes and financial instruments and the position and responsibility of Parliament.

It remains to be seen, however, whether the present system of Community finances is efficient enough to allow further developments. The reservations about the present system, which are particularly acute in the European Council, are directed at three aspects. These aspects are also central to the current debate about the financing problem. In the first place there is the problem of budgetary discipline, which defies solution under the present institutional arrangements. This problem is accorded particular significance in the United Kingdom, the Federal Republic and, to a lesser extent, the Netherlands and Denmark. Secondly, there is the distribution problem. The results of the present budgetary processes do not or only marginally reflect the geographical disparities in living standards within the Community. This aspect is emphasized particularly by the less prosperous southern and peripheral Member States. The present budgetary processes offer insufficient prospects for a responsible development of the distributive role of the Community budget. In third place is the problem of the margins of collective solidarity for the individual Member States. The current system of revenues and compulsory expenditure of the Community means that certain Member States can be structurally overpaid or underpaid in relation to their wealth. The structurally underpaid states tend to seek compensation for this anomaly, thereby placing a heavy burden on the Community decision-making processes. The history preceding the so-called Fontainebleau Mechanism is an example of this issue.

These deep-seated reservations about the existing system of Community finances result in reduced support for a 'wasteful' or 'unfair' Community. They place a burden on every discussion of cost-intensive Community responsibilities and hinder the required progress of the integration process as Member States make their support for new initiatives conditional upon a solution to the problems of financial management which would be satisfactory to them.

An additional factor is the new voting procedure in the Council since the Single European Act came in force. To a greater extent than in the past, Member States will be compelled to form coalitions instead of exercising the right of veto if they are intent on directing decisions along the lines they desire. The formation of a bloc along the dividing line be-

tween rich and poor or North and South becomes possible: in a system of weighted votes the poor countries (including Italy and Ireland) can muster sufficient votes to reject an unpopular proposal. Without Italy a 'blocking minority' is not possible, so that in the new system Italy has a floating vote.

b. *The budgetary process*

The budgetary process of the Community is fundamentally deficient in three respects. (i) Budgetary decisions are made in a fragmented way. There is more than one decision-making circuit: the Commission and the specialised Councils deal with the draft budget, while the Budget Council and Parliament are responsible for the adoption of the budget. (ii) The Budget Council has no powers of coordination, so that the decisions taken independently of one another in the various areas of policy are not coordinated in the budgetary process either; and Parliament has authority only over non-compulsory expenditure, a marginal aspect of the budget. (iii) The various items of expenditure are not properly weighed against each other in the light of the priorities and posteriorities of Community policies. In so far as such evaluation does take place, it is dependent on the decisions of bodies which are not involved in the actual budgetary process. The utterances of the Community's budgetary authority therefore have a singularly inadequate binding force on policy.

The division of expenditure between compulsory and non-compulsory spending is a source of discord between the two budgetary authorities, with the result that the dialogue on the budget as an instrument for implementing the Community's responsibilities becomes entangled with the institutional consequences.

c. *Agricultural policy*

Within the framework of the Community Budget, the open-ended nature of agricultural spending makes it a cuckoo in the nest crowding out other, rival items of expenditure. The inflexibility of the policy stems from the CAP regimes and the exclusive responsibility of the Council. Administering the system is enormously expensive due to the system of advance payments and also because of the negligent accumulation of surplus stocks. The failure to provide proper financial depreciation of agricultural stocks is more than just a minor flaw in the system.

The Commission's control over agricultural spending is patchy. Administering the CAP is largely a matter for the individual Member States. The Commission, which under the terms of the Treaty bears the responsibility, should carry out the checks itself. In practice the Commission is involved in three phases: making advance payments at the request of the Member States, registering these sums of money and the final verification of the annual accounts submitted by the individual Member States. In the case of advance payments the Commission relies exclusively on the information supplied by the Member States, which involves a great deal of extra time - and money - for the task of auditing the accounts. The task of checking for possible fraud committed while administering the vast number of regulations is made ever more difficult by the decentralisation of administration.

d. *Structural policy*

The Commission is autonomous in deciding how to make use of the structural funds. However, the vast number of varying regulations each with their own criteria and conditions, conduce towards fragmentation. There is no coordination either of similar activities or of activities directed towards the same aims and/or regions, with the result that the effective yield of the limited resources allocated towards structural policy is questionable. The fact is that there is no evaluation - either because (according to the Regional Fund annual report) it is impossible to establish a procedure or because it has not so far proved possible to formulate one (Social Fund).

What is clear is that the establishment of regional priorities is not working effectively. In the case of the Social Fund this is due to the (forced) cuts that have been applied; in the cases of the Regional Fund and the Guidance Fund to difficulties encountered in the payment procedures.

1.3 Community revenue

1.3.1 *The development of Community revenue*

Initially the Community obtained its revenue in the same way an any international organization, from contributions from the Member States in accordance with a distribution scale laid down in the Treaty. On the basis of the Council's 1970 Decision on Own Resources these contributions were to be gradually replaced by the Community's own revenue, consisting of customs duties, agricultural levies and VAT contributions. Customs duties and agricultural levies on products from outside the EC derive from the provisions laid down by the Community and are described as its traditional own resources.

The agricultural levies are a result of the disparity between the Community price for a given product and its price on the world market. This makes the levies extremely vulnerable to price fluctuations on the world market and also to changes in the US dollar exchange rate.

In contrast to agricultural levies, customs duties are usually expressed in percentage terms. This means that they are hardly likely to be influenced by fluctuations in exchange rates, but they are of course sensitive to differences in price. The level of these two forms of revenue is therefore not determined by budgetary means, but is the result of common trade and agricultural policies and of external factors.

In contrast, the VAT rate payable to the Community is determined annually under the budgetary procedure, within a maximum figure which is agreed to by unanimous decision of the Council. This amount is the balancing figure needed for budgetary balance as required under the terms of the Treaty.

VAT contributions are based on a percentage of the harmonised VAT base, i.e. a percentage calculated for all Member States on the same goods and services.

The table below shows the development of revenue since 1975, the year in which the system of self-financing as laid down by the Decision on Own Resources was meant to take effect.

Table 1.3 Development and composition of Community revenue

Category of	EUR-9		EUR-9		EUR-10		EUR-12	
	1975 Budget		1979 Budget		1983 Budget		1987 Budget	
	Amount (bn. UA)	%	Amount (bn. EUA)	%	Amount (bn. ECU)	%	Amount (bn. ECU)	%
Custom duties	3.4	55.6%	4.7	35 %	7.2	28.8%	9,7	26.7%
Agricultural levies including sugar	0.5	8.6%	2.2	16.4%	2.4	9.6%	3.3	9 %
Contributions to replace VAT	2	34.5%	2.1	15.7%	0.2	0.8%	0.2	0.6%
Carried forward balance	-	-	4.3	32 %	13.7	54.8%	22.8	62.8%
Saldo vorige jaren					1.4	5.6%		
Other receipts	0.07	1 %	0.1	0.7%	0.2	0.8%	0.3	0.8%
Total	6	100%	13.4	100%	25	100%	36.3	100%

Source: H.A.M.C. Notenboom, *Internationale Spectator*, june 1987, p. 325.

In proportion to total revenue, customs duties and agricultural levies have been declining in importance. On the one hand this is due to external factors such as price levels on the world market and the low dollar rate, and on the other hand to the fact that the Community has become self-supporting in a large range of agricultural products, which - due in part to the surplus stocks of agricultural products - again influences prices on the world market. Furthermore, within the framework of the GATT rounds there has been a continual reduction in customs duties and many tariffs have been abolished or else greatly reduced under the system of general preferential tariffs for developing countries. The result has been a structural decline in the importance of these sources of revenue.

The 1970 Decision on Own Resources provided for a rise in VAT revenues to a maximum 1% of the harmonized base. This limit was reached in 1983. In the absence of a decision by the Council to increase revenue there could be no further rise in expenditure, since the Treaty requires that revenue and expenditure remain in balance. In 1984 at Fontainebleau it was decided to raise the maximum VAT rate to 1.4% as from the beginning of 1986, with the option for an increase to 1.6% as from 1 January, 1988. The Commission estimated, however, that the VAT rate needed for proper financing would have to be 1.22% in 1983 and 1.65% in 1987[20].

These developments have changed the nature of the debate on the Community's finances. Where there are adequate resources and a requirement for a balanced budget, the required policy and its financing assume a central role. Where there are inadequate resources and a requirement for a balanced budget, the debate is dominated by the prospects for obtaining additional revenue; examples are the Commission's proposals at the last meeting of the European Council and the draft budget for 1988 (which shows a 5% rise compared to that of 1987). A unanimous decision from the Council to raise the VAT ceiling is needed, but this cannot be expected to materialise if no curb is imposed on spending.

By virtue of the composition of the Community's own resources, with, on the one hand, structurally declining revenue, and, on the other, the ceiling set by the Council on revenues, VAT is worthy of more detailed study as a source of revenue. A frequently used indicator of a country's prosperity is GNP, which consists among other things of investment, savings and government and private consumption[21]. By using the VAT levied on private consumption as the basis for the contribution to the Community, only part of GNP is taxed. This can lead to inequalities, particularly for those countries with a relatively high consumption ratio, which as a result find themselves saddled with a heavy tax burden, and countries with a large informal sector, which contribute far less in relative terms.

A second aspect is the vulnerability of Community VAT contributions to fluctuations in private consumption. The Commission notes that in an expanding economy, consumer spending grows at a slower rate, thereby causing a (relative) decline in VAT revenues[22]. This makes VAT an unsuitable 'buffer' against economic developments and as such provides the Commission with grounds for looking for another source of revenue to function alongside existing sources. Another point is the fact that a source of income that is sensitive to cyclical fluctuations is ill-suited for purposes of long-term planning.

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[20] Commission of the European Communities (see note 7), p. 4.

[21] Under UN practice gross domestic product (GDP) consists of government expenditure, consumption, stock formation and exports minus imports. Gross national product (GNP) is obtained by deducting net factor incomes in relation to other countries from GDP.

[22] Commission of the European Communities (see note 7), p. 3.

A third aspect of the VAT component of own resources is caused by the fact that an increase in the VAT contribution to the Community conflicts directly with the VAT revenues of the Member States themselves, or alternatively means an increased burden for the tax-payers. This will certainly be an issue when the Council is formulating its decision.

1.3.2 *The Fontainebleau mechanism*

The decision of the Council to raise the VAT call-in rate was accompanied by a decision to create an 'improved budgetary balance' between Member States. Since the beginning of the 1970s the problem was that, from an accounting angle, the United Kingdom paid more to the Community than it received in return. In 1976 an abatement mechanism was introduced, but it has never been used because of technical problems. In 1980 measures were agreed consisting partly of direct refunds and partly of special measures favouring the British economy, i.e. measures on the expenditure side of the budget.

At Fontainebleau these measures were replaced by a compensation mechanism on the revenue side of the budget, taking the form of differentiated VAT contribution rates for the United Kingdom and West Germany. The increased charge for the other Member States which resulted from this change is apportioned via their normal VAT share. This means that in fact no single Member State pays the agreed rate and that, bearing in mind that the ceiling fixed by the Council applies to the Member States and not to the Community as a whole, the maximum rate of revenue will never be collected using this method.

The VAT rate proposed for 1987 is 1.24%. The United Kingdom contributes 0.7%, West Germany 1.31% and the other Member States 1.36%, with the exception of Spain and Portugal[23]. The Commission has estimated the cost of the compensation mechanism to be an average of 1,530 million ECU for the period 1983-1985, 2,736 ECU for 1986 and 2,360 million ECU for 1987. This is almost 6.5% of the total revenue in 1987[24].

The compensation system finally brought an end to a protracted conflict but it in turn created a fresh set of problems, namely the perpetuation of the *juste retour* issue, which itself also causes problems. In addition to the drop in Community revenue the Fontainebleau mechanism means that contributions to the Community are seen as a charge on the Member States and not as Community own resources - a charge which, moreover, is offset only against quantifiable benefits, such as cash transfers through the EAGGF. For the advantages of integration for the economy in general and for the Member States' trade balances are difficult to express in figures. This problem of a *juste retour* and its solution create claims on a certain percentage of expenditure. The tendency on the part of individual countries to claim this 'own' portion determines the allocation of revenues and prevents the Community from carrying out its own policies.

The Commission has drawn up proposals to regulate the Community budget in such a way as to take due account of the relative prosperity of the Member States, in accordance with the aims of the Single Act (especially Art. 130A - 130E). To that end a ceiling was proposed based on Community GNP.

The table below shows how this new system will affect the Member States. It is assumed that the transitional measures which at present limit Spain and Portugal's contributions do not apply. The Member States are listed in order of GNP according to their 1985 purchasing power.

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[23] H.A.C.M. Notenboom, op. cit., p. 325.
[24] Commission of the European Communities (see note 7), p. 11.

Table 1.4 Financing of the Community budget, 1987 (in million ECU)

	Present system	New system	Difference
Luxembourg	68	62	-6
Denmark	783	827	44
FR Germany	9,686	9,743	57
France	6,692	6,670	-22
Belgium	1,554	1,600	46
Netherlands	2,209	2,227	18
United Kingdom	6,660	6,354	-306
Italy	4,806	4,993	188
Spain	2,810	2,806	-5
Ireland	366	345	-21
Greece	423	415	-8
Protugal	344	359	15
Total	36,400	36,400	

Source: COM (87) 101 final, p. 30.

1.4 Community expenditure

1.4.1 *The development of expenditure*

When the Community exceeded its revenue ceiling in 1983 it had also exceeded its expenditure ceiling, taking account of the stipulation for annual balance budget as laid down by the Tready. These problems in financing the Community's budget were in particular caused by the continual rise in agricultural expenditure, which simultaneoulsy squeezed the amound of cash available for other policies within the permitted expenditure ceiling. The table below shows how the Community's budget expenditure has developed, per sector. *Table 1.5 Development and composition of Community expenditure*

Table 1.5 Development and composition of Community expenditure

Expenditure category	EUR-9 '75 budget (bn UA)		EUR-9 '79 budget (bn EUA)		EUR-10 '83 budget (bn ECU)		EUR-12 '87 budget (bn ECU)	
	Amount	%	Amount	%	Amount	%	Amount	%
Institutional expenses	0.4	2.5%	0.8	5.9%	1.1	4.4%	1,7	4.7%
Agricultural guarantee spending	4	66.6%	10	74.5%	15.8	63.2%	22.9	63 %
Structural policy (agricultural guidance, social and regional)	0.5	8.3%	1.1	8.2%	3.3	13.2%	6.5	17.9%
Research/technology/industry/energy/environment/transport etc	0.7	11.6%	0.2	1.5%	1.4	5.6%	0.9	2.5%
Development cooperation/food aid	0.3	5 %	0.5	3.6%	0.9	3.6%	1.2	3.3%
Reimbursements to Member States for collection of own resources	0.3	5 %	0.6	4.5%	0.9	3.6%	1.3	3.6%
Restitutions Spain and Portugal + repayment of 1984 advances	-		-		-		1.5	4.1%
Special meaures UK and FRG (1)	-		-		1.5	6 %	-	
Contingency reserve	0		0.5	3.7%	0.5	2 %	0	
Total	6	100%	13.4	100%	25	100%	36.3	100%

Source: H.A.C.M. Notenboom, *Internationale Spectator*, June 1987, p. 327.
1) Since 1986 this adjustment has taken the revenue side.

Apart from the rise in agricultural expenditure, the structural policy has also consumed more cash, although there is no question of the structural policy consuming funds at the same rate. Spending on other policies, such as research and environmental policies, has been lagging behind. In addition it needs to be borne in mind that the budgeted amounts do not as a rule relate to actual expenditure; particularly in the case of the structural funds, large amounts remain unspent on account of a whole range of factors, as discussed in section 1.2.3.2.

1.4.2 *Agricultural policy*

A fundamental principle underlies the Common Agricultural Policy, which is that farmers should earn their income from the sale of their products on the market. This principle has led to the stress being placed on regulating supply and demand so as to ensure that prices reach levels which the Community deems desirable. The instruments adopted for achieving these ends are intervention buying within the Community and the erection of tariff walls to protect Community products from non-EEC products by means of levies and refunds. The Community has drawn up the regulations for the CAP, and the Community is responsible for its financing. Funding is however under heavy pressure since agricultural expenditure has reached such levels as to leave little room in the Community budget for other or new policies. The rise in agricultural expenditure must generally be ascribed to the continuing overproduction of key products, which, given the shrinking world markets, has resulted in enormous surpluses. In addition the fluctuations in the American dollar have resulted in continual readjustments in the export refunds, which have consequently risen in absolute terms.

CAP expenditure is administered by the Agricultural Guidance and Guarantee Fund (EAGGF) which forms part of the Community budget. (The Guarantee Section finances the market and pricing policies, and the Guidance Section finances the structural policy.)

In 1970 expenditure via the Guarantee Fund was 2604 million units of account (UA), of which 1206 million UA were for refunds and 1398 million UA for intervention purposes. In 1985 the Guarantee Fund's total expenditure was 19,744 million ECU (70% of the total Community budget); in recent years interventions have increased in absolute terms, whereas refunds and, since 1986, interventions have declined in percentage terms.

Table 1.6 Guarantee Fund expenditure

	1981	% (1)	1983	%	1985	%	1986 (2)	%
Refunds	5,208.6	46.8	5,559.7	35	6,716.1	34.1	8,470.0	39.1
Interventions	5,932.6	53.2	10,360.0	65	12,490.4	65.9	13,210.8	60.9

Source: *15th EAGGF Financial Report 1985, Guarantee Section,* p. 86.
In million ECU.
(1) In relation to total agricultural spending.
(2) Estimate.

In the case of exports the refunds are designed to cancel out the difference between Community prices and the prices on the world market, which are in general lower. Mainly as a result of the low US dollar, considerable sums of money have had to be paid out in the form of refunds. In 1986 refunds were made notably in the case of dairy products, cereals and beef. The intervention system comprises measures such as price compensation and the withdrawal of products from the market and their storage if so required. The most important instrument is that of 'price support', which applies to approximately 70% of agricultural

products; in 1985 price support amounted to 7,577 million ECU, for 1986, 7,899 million ECU was budgeted, corresponding to 26.4% of total agricultural expenditure. The lion's share went to the dairy sector, followed by oilseeds and the fruit and vegetable sector. In 1985 the withdrawal of products from the market and the implementation of similar measures (e.g. distillation of wine) accounted for 4.2% of agricultural expenditure; for 1986 3.2% was budgeted.

The storage of intervention stocks is, however, an increasingly heavy financial burden for the Community. The system involves both practical costs (i.e. the storage and processing of stocks) and financing costs (interest paid on a fixed basis as compensation to the Member States for capital frozen as a result of the stocks held in intervention storage) and costs paid out as compensation for the losses incurred by the sale of intervention stocks. In 1985 intervention absorbed 4,427.5 million ECU: 22.4% of agricultural expenditure. An ancillary problem is caused by the fact that up until now intervention stocks have been included in the budget at book value; only when there is some room left in the budget at the end of the (financial) year is this used to write off part of the stocks[25]. This means that there can be no real evaluation of the cost of storing surpluses as compared with destroying them or other means of disposal. Furthermore the method of paying interest to Member States is based on the book value, which itself adds to the financial burden the Community has to bear.

Storage costs mainly involve dairy produce (1,972.8 million ECU), beef (1,094.1 million ECU) and cereals (751.8 million ECU).

The unbridled growth of agricultural expenditure was never the intention. Providing subsidies for certain agricultural products was intended to act as a market stabilizer and to raise incomes in the agricultural sector to an acceptable level. That a policy of this type would create surpluses was of course foreseen but the extent to which these stocks have multiplied is almost causing the Community to collapse under the weight of its own 'success'. The intervention measures proved in due course to have become a new sales outlet instead of acting as a buffer to stabilize the market. Guaranteed minimum prices and guaranteed markets led to maximum production, spurred on by technological developments.

The *control mechanism* originally adopted - annual price-fixing talks - has lost its function since non-economic factors have gained the upperhand in the Agricultural Council's political negotiations, in particular the desire to ensure that the farming population has a decent income.

Whenever common agricultural prices are fixed, this is first done in ECU and then converted into national currencies. In this process the so-called 'green currencies' are used. The drop in prices at Community level by 0.3% in ECU (1986-1987) converts to a rise of 2.2% in national currencies[26]. Under these conditions a restrictive pricing policy is difficult to achieve.

Attempts are now being made to tackle the problem of overproduction by introducing a quota system, where the Community will still however be financially responsible for those products whose prices are guaranteed. These are mainly products which were of importance to the Community of the Six: dairy produce, cereals and sugar, for which strict regimes were introduced on the basis of the objectives of the CAP at that time. This meant among other things that products that could not be sold in the market had to be withdrawn against a guaranteed minimum price. This arrangement will therefore not continue unchecked if the quota system is effective.

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[25] Commission of the European Communities, *Fifteenth Financial Report on the European Guidance and Guarantee Fund - 1985 - Guarantee Section and Food Aid Financing*, Brussels, 19 November 1986, COM(86) 631 final, pp. 29-30.

[26] Commission of the European Communities, *The situation of agriculture in the European Communities, 1986 report*, Brussels/Luxembourg, 1987, p. 71.

The Commission has calculated the savings made by the quota system and other restrictive measures[27], namely

1984	1,070 million ECU
1985	2,980 million ECU
1986	4,160 million ECU

In spite of this the Agricultural Guarantee Fund's expenditure rose in the period 1984-1987 by more than 40%, from 18,371 million ECU in 1984 to a budgeted 27,305 million ECU in 1987. If the Commission continues to give in to pressure from the Member States for exceptions, the effectiveness of quota measures must be seriously questioned.

Within the framework of the CAP, the Commission has chosen a policy of maintaining small family concerns, i.e. those farms which are generally speaking structurally weaker. To ensure these concerns receive the guaranteed level of income the stabilization measures are applied individually and income aids are proposed, and have already been allocated here and there. In the WRR's view as expressed in the report 'The Unfinished European Integration', an arrangement will have to be devised under which the Member States are assigned a larger role. But the problem of the marginal regions needs to be studied within a broader context than that of agricultural policy alone. The issue here is the creation of a viable socio-economic structure, which is discussed in section 1.4.4 together with structural policy.

The exceptional provisions are mentioned only to give some indication as to how actively the Community is tying itself up in a web of rules and regulations. Regulations which require still further regulations to rectify unforeseen and unwanted consequences. As a result of the runaway financial policy the level of expenditure, or rather the revenue ceiling, has now become the main objective of the policy deliberations. The existing policy is not being judged on its merits, but is being adjusted and kept going with the result that every attempt that is made to control production and financing amounts to no more than treatment of the symptoms.

1.4.3 *The enlargement of the Community*

Each enlargement of the Community involves a rise in expenditure. A rise in absolute terms that, depending on the structure of the economies in question, can be disproportionate. This was the case with the accession of Ireland and Greece, both of which have a large agricultural sector, as do the newly-admitted Spain and Portugal.

Spain and Portugal's accession to the Community enlarged the Community's agricultural base by three million farms and a production area of 30 million hectares, which is however poorly developed. The farms are small (70% of Spanish farms and 87% of Portuguese farms are less than 5 hectares in size) and the average age of the farmers in generally speaking higher than that of farmers in other Community countries. In 1985 farmers accounted for almost 17% of the labour force in Spain and nearly 24% in Portugal. The Community average was 7.2%. Spanish and Portuguese productivity is far below the Community average: Spain and Portugal's combined cereal producing areas are equal to those of the Ten. But the Ten produced 10% more cereals than they themselves consumed, whereas Spain and Portugal were forced to import extra cereals. To sum up, the Community was expanded by an extensive agricultural area with an inefficient production structure which encompasses more than 65% of the Community's farms, with a low average return in terms of both output and prosperity.

[27] Commission of the European Communities, *A Review of Action Taken to Control the Agricultural Markets and Outlook for the Common Agricultural Policy*, Brussels, 3 August 1987, COM(87) 410 final, p. 6.

In the negotiations for Spain and Portugal's accession to the EC, the agricultural aspect presented the greatest obstacle, but after six years it was decided to subsidize the producers and Community protection was extended to new products. Both countries qualified for the application of EC regulations under the integrated Mediterranean programmes, besides which a specific programme was drawn up for Portugal prior to its accession that would, over a 10 year period, costing 700 million ECU (originating from the EAGGF) for the development of agriculture and the fishing industry.

Subsidies from the Regional Fund also apply to Spain and Portugal now they have joined the EC, which meany the amounts allocated to each country had to be redistributed; in the case of resources that do not increase or only to a very small degree, this therefore means a cut in the allocations for the other Member States.

To support the balance of payments Portugal is receiving loans of up to 1 billion ECU over a period of six years. Prior to their accession Spain and Portugal also qualified for loans from the European Investment Bank for the financing of projects in the field of small and medium-sized businesses. This expenditure does not, however, impinge on the Community budget.

On the revenue side of the Community budget, transitional measures have been laid down. After six years both countries will contribute the full amount of VAT; until then they will be refunded on a sliding-scale basis. Portugal is exempted for a period of five years from having to contribute customs duties and agricultural levies.

In addition to these quantifiable charges for the budget there are of course other expenses for the Community which are not easy to quantify.

The expansion of Community institutions, which include additional MEPs, Commissioners, judges and each Member State's allocated quota of civil servants, has resulted in building alterations and additional expenses for accommodating the new intake, plus a rise in wage and salary costs. Total expenditure for the institutions rose in 1986 by about 17.5% as compared with 1985 expenditure (provisional figures), but this only gives a rough indication of the true costs[28].

The enlargement of the EC involves transitional measures which apply to many different policies and which generally incorporate exceptional provisions referring to measures which are to be taken by Member States within the framework of the completion of the internal market. This could be financially disadvantageous for the Community, but the economies in question benefit, which also helps political relationships, so that in net terms the outcome will be in the Community's favour.

But this does not remove the fact that enlargement does not have a neutral impact on the budget. Under the common structural policy, new selective programmes have been introduced for those areas within the EC most threatened by competition from Spanish and Portuguese agriculture.

1.4.4 *The structural policy*

Even before Spain, Portugal and Greece joined the Community an increasing disparity could be seen within the Community in terms of economic growth and prosperity, one of the factors being the increased concentration of industrial and service-industry activities in the Community's heartlands. Another contributory factor has been the effect of the CAP, under which the richer northern and central agricultural areas receive more than their fair share of funding.

[28] Commission of the European Communities, *Twentieth General Report on the Activities of the European Communities 1986*, Brussels/Luxembourg, 1987, pp. 62-63.

This gap has grown even wider since the admission of Spain and Portugal and will widen even further with the completion of the internal market due to the fact that the economically strong areas will benefit most from the liberalization of the commercial market.

The development and structural adjustment of less favoured regions and the revival of decaying industrial regions are the aim of the Community's structural policy, with the ultimate objective of strengthening economic and social cohesion within the EC.

With the establishment of the EAGGF the Common Agricultural Policy was provided with mutually complementary lines of policies: the market and price policy, and a common structural policy to call a halt to the escalation of the regional disparities arising from the price policy.

A quarter of agricultural expenditure was to go to structural policy. From the outset, however, structural policy has been overshadowed by the market and price policies, not least on account of its meagre financial resources, which allow it little room for manoeuvre. The Guidance Fund budget for 1987 was 4% of the total agricultural budget. The structural funds together were able to spend 6,653.6 million ECU, or 18.4% of the total budget, whereas 63.3% was set aside for the Agricultural Guarantee Fund.

The distribution of resources within the EC in 1984 saw approximately 45% allocated to priority regions, i.e. the Mezzogiorno, Greece, Ireland, Northern Ireland and the French overseas departments, and there are no indications that this figure has risen significantly[29]. It is difficult to imagine that the production structure in these regions can be influenced with these meagre resources, let alone that a common structural policy can be implemented.

As was seen in section 1.2.3.2., the structural funds are - as they are functioning at present - inadequate for the task. The measures that were applied within the framework of the various funds would appear in general to be directed towards the same aims and objectives: regional development (by giving priority to certain areas) and employment. But decisions on the action to be taken have not been coordinated.

This has led to the situation where identical programmes could theoretically be receiving funding from three different sources. Apart from the inadequate nature of the conditions to be fulfilled, this could also be attributed to the lack of proper coordination within the Commission apparatus itself, where every Directorate-General safeguards its own autonomy and different programmes are even implemented alongside one another within the same DG.

Since 1979 attempts have been made to coordinate subsidies for areas in a severe state of economic backwardness or decline. The coordination refers both to financial instruments and to cooperation between various partners (Community, Member States and local and regional authorities). Model projects have been started in Belfast and Naples in order to determine a strategy.

In 1985 a Directive was introduced regarding integrated Mediterranean programmes, which applied to Greece and areas in France and Italy. The integrated Mediterranean programmes have been provided with a regulation that attempts to overcome many of the drawbacks of the structural funds. A flexible decision-making procedure has been created (the Council is not involved and the advice of the committee concerned is not binding), coordination has been decentralised, and provisions have been made for direct contact between the Community and the regional governments. Improved control has been guaranteed by programme contracts between the parties involved and by the mutual and extensive exchange of information. Pilot projects are in preparation in Italy and Greece. These involve long-term programmes in a number of different policy areas such as agriculture, energy, industry and services. Financing

[29] European Parliament, Committee on Budget Control, op. cit., p. 16.

from Community sources consists of contributions from the three structural funds (2.5 million ECU) and an additional share of the budget of 1.6 million ECU. In the course of 1986 the three recipient countries submitted programmes for co-financing. France and Greece each submitted seven programmes, and Italy 17. In 1986 the Commission, working in collaboration with the European Investment Bank (EIB), approved one single project.

Cooperation with the EIB appears to be the first step on the road to the integration of the financial instruments which are under Community control (i.e. subsidies from the structural funds) on the one hand and, on the other, the loans made via the EIB with the same objectives as structural policy.

The increasing divergence in economic development within the Community and its rectification have received renewed attention due to the Single Act. The bias towards the agricultural policy in the budget will have to be counter-balanced by Community structural policy if the requirement for convergence as laid down by the Treaty and the Single Act is to be fulfilled.

1.4.5. *New policy*

With the progress of the Community towards an integrated internal market, compensation must be found at Community level for the diminishing ability to implement effective policies at national level. The Single Act mentions in particular technological and environmental policies, but a communal policy will also have to be implemented in the field of physical infrastructure. These are cost-intensive governmental activities which will exert increasing pressure on the Community budget.

Recent years, however, have seen swinging cuts in these items; in 1987 2.5% of total expenditure was allocated for these policies, where in 1975 11.5% was still allocated. Under the pressure of financing problems, the Council has recently agreed with some reluctance to a five-year research and development project at a cost of approximately 1 billion ECU per year. But without an agreement on budgetary discipline and reduced expenditure, the political will to go much further would not appear present.

ANNEX 1 The budgetary procedure

The current procedures stem from Articles *199-209* of the EEC Treaty and Article 20 of the Solemn Declaration on European Union, supplemented and amended by the Decision on Own Resources of 21 April 1970, the First Treaty Budgetary provisions of 22 April 1970 and the Second Treaty Budgetary provisions of 22 July 1975.

Art. 203 EEG

para 1 - The *financial year* runs from January to December inclusive.

para 2 - Each institution draws up estimates of its expenses by 1 July of the preceding year. The Commission joins these together, if appropriate adding an opinion that may contain divergent estimates, and adds an estimate of revenues.

para 3 - First reading by the Council.
- The draft budget is transmitted to the Council no later than 1 September.
- The Council consults the Commission and, where appropriate, the other institutions concerned, whenever it intends to depart from the preliminary draft. Departures from the draft require a unanimous vote.
- The Council, acting by a qualified majority, draws up the draft budget. (The draft budget does not qualify as a proposal of the Commission under Article 148, so that a majority of at least six members is required.)

para 4 - First reading by the Parliament.
- The Council submits the draft budget to the Parliament no later than 5 October.
- With respect to *compulsory expenditure* the Parliament can only propose amendments to the Council by means of a simple majority of the votes cast.
- With respect to *non-compulsory expenditure* the Parliament can adopt amendments by means of a majority of its component members.

para 9 - Para 9, however, sets a limit: the maximum rate of increase. This is set annually by the Commission on the basis of a number of economic indicators such as inflation, changes in GNP in the Member States and variations in the national budgets.
The Parliament has the right to utilize half the limit laid down, even if the Council is already utilizing more than half. The Council and the Parliament may mutually decide to increase the maximum rate of increase.

para 4 - Parliament has 45 days for the first reading.
The budget is considered finally adopted if within this period the Parliament either states its approval or does nothing (i.e. does not adopt any alterations or proposed amendments). If there are alterations or proposed amendments the draft budget is resubmitted to the Council.

para 5 - Second reading by the Council.
Non-compulsory expenditure - amendments may be altered by the Council, acting by a qualified majority.
- *Compulsory expenditure* - if a proposed amendment leads to an *increase* in the total expenditure of the agency in question, the proposal is rejected unless expressly accepted by the Council;

- if a proposed amendment does *not lead to a rise* in the total expenditure of the agency in question (the effects of the proposed amendment being offset by a cut in spending elsewhere) the proposal shall be accepted unless rejected by the Council acting by a qualified majority.
- The Council has 15 days for the second reading; if it is unable to reach a final decision within that period the draft budget shall be considered as finally adopted, with the exception of the proposed amendments requiring the express acceptance of the Council.

para 6 - Second reading by the Parliament; relates only to *non-compulsory expenditure.*
- If the Council disagrees with the amendments, the Parliament needs a strengthened majority in order to get these amendments into the budget. A strengthened majority means a majority of the members and 3/5 of the votes cast.
- The Parliament has 15 days for the second reading.

para 7 - The President of the Parliament finally adopts the budget.

para 8 - Parliament can reject the draft budget with a strengthened majority and for weighty reasons.

- The two institutions that make up the budgetary authority consult one another under the 'budgetary consultative procedure' (OJ 1971, C124/62). A delegation from the Parliament and the Budget Council meet in July for the first reading by the Council and in November for the second reading by the Council. If necessary a third round of consultations is held prior to the second reading and final adoption by the Parliament.
- In a joint Declaration on 30 July 1982 (OJ 1982, C194/1) a classification into compulsory and non-compulsory expenditure was agreed between the Council, Parliament and Commission.
  Compulsory spending was defined as expenditure which the budgetary authority was obliged to include in the budget in order to enable the Community to discharge its obligations arising under the Treaties or implementing decisions.
  In addition a 'trialogue' was agreed between the presidents of the Council, Parliament and Commission in the event of disputes about the classification of new forms of expenditure or the adjustment of the maximum rate of increase.
  Provisions have also been made to cover the absence of a statutory basis for the administration of budgetary loans for new Community activities.

2. CONDITIONS FOR A BETTER SYSTEM OF FINANCING

A better system of Community financing will need to satisfy a number of conditions, of which some are easy to realize but others of which impose limitations on the range of possible solutions.

Three general kinds of conditions may be distinguished. The first category relates to the nature of budget systems. These conditions apply to national budgets, but also to budgets of pre-federal structures such as the EC, and may be regarded as *technical* requirements. These are discussed in section 2.1. Next there are conditions of a *political or policy* type, which are related to the aims of the Community. Falling under this head are for example the obligations deriving from the Single European Act regarding further integration and convergence. These conditions are discussed in section 2.2.

The third set of conditions derives from the necessity of *controlling* EC expenditure, especially on agriculture. This is gone into more closely in section 2.3.

2.1 Technical budgetary conditions

The requirements with which budgetary systems must comply are known from the theory of public finance. They are connected with the functions performed by a budget, with the decision-making process of 'budgeting' and finally with political choices such as financing according to ability to pay or according to benefit and, on the expenditure side, the desired measure of redistribution. In section 2.1.1 these conditions are outlined for budgets in general. In section 2.1.2 consideration will be given to whether budgets or budgetary processes of pre-federal or federal unions of states set additional requirements.

2.1.1 *Budgets in general*

A budget is a confrontation of resources and payments, of revenue and expenditures. It is a plan directed to the future and provides insight into proposed policies. It may concern a household, a firm, a collective, a unitary state or a federal state. On a national level, being directed to the future means that a budget has a political or *allocative function*. Likewise a budget provides the basis for a retrospective evaluation of policy execution. This is the *monitoring function* of a budget.
The third function is that of *authorization*: a budget approved by the legislative authority provides the executive authority with consent to incur expenditure.

With an eye to these functions the theory of public finance sets the following three requirements[1]:

- transparency, in connection with the authorizing and monitoring function;
- periodicity, again in connection with these two functions;
- flexibility, in connection with the allocative function; there must be room for new policies, so that new items can come into the budget but also so that existing items can be abandoned, reduced or controlled.

[1] R. Boelaert, *Economische aspecten van de overheidsfinanciën* (Economic aspects of public finance), Leiden/Antwerp, Stenfert Kroese, 1978; L. Koopmans, A.H.E.M. Wellink, *Overheidsfinanciën* (Government finance); Leiden/Antwerp, Stenfert Kroese, 1983; Th. A. Stevens, *Openbare financiën en ekonomie* (Public finance and economics); Leiden, Stenfert Kroese, 1975.

Drafting a budget is not only a confrontation of revenue and expenditure, but also a decision-making process by many participants with different interests. In order to guarantee that the functions of the budget are properly fulfilled, the positions of the participants in the budgetary process must be properly defined as regards powers, responsibilities and sanctions. The following may in turn be differentiated:

- *the preparation* of the budget, mostly by the executive authority (in the Netherlands: departmental officials and the Council of Ministers; at EC level: the officials of the Commission and the politically appointed Commissioners);
- *the submission* of the budget to the legislative authority for discussion and adoption (in the Netherlands the Parliament adopts the budget; in the EC there are in practice two legislative authorities, the European Parliament for non-compulsory expenditure and the Council of Ministers for compulsory expenditure);
- *The execution* of the budget by the executive authority. This phase includes implementation but also the administration and monitoring of expenditure (in the Netherlands: the departments, in the EC: the Commission, but also the member states);
- *the auditing* of the execution of the budget by an independent body and by the approval body (in the Netherlands: the Parliament and the General Audit Office, in the EC the European Parliament and the European Court of Auditors);
- *the fixing* of the account and the discharge of the executive authority by the legislative authority. Any sanctions can take place at this moment, for example by the withdrawal of confidence in the executive authority.

It is of particular importance that decisions on expenditure be taken within the framework of revenue. In other words, the decision-making circuit for expenditure must be the same as that for the budget. If the executive authority wants an interim adjustment (of expenditure or revenue), agreement must be sought from the legislative authority.

Besides these requirements which derive from the budget as an instrument and from the budget as a process, there are also specific requirements connected with financing and control.

On the income side: for the financing of the budgeted expenditure a tax system is necessary which must be appropriate and equitable. Appropriate, so that it brings in a sufficient amount and is not too complicated and expensive, and equitable in the sense that the sharing of the tax burden among the taxpayers is broadly in agreement with the prevailing sense of fairness.

A choice will always have to be made between taxation according to ability to pay or according to benefit, or according to both and in what proportion. Where a choice is made in favour of ability to pay, this must be made operational: are income/assets or consumption to be taken as the yardstick? Does the system tax proportionally or progressively? In practice it is usually a question of combinations. Progressive direct taxes on incomes and assets and indirect taxes which are higher on luxury goods and services than on what are deemed necessities fit into a tax system that takes account of ability to pay, measured by means of both income/assets and consumption.

On the expenditure side of the budget it must be decided what expenditure must be made, for whom and where. Both allocative and redistributive considerations have a place in the decision-making process. Thus in an education budget, allocative considerations play a role (the collective financing of educational facilities is similar to investment in human capital with the aim, among other things, of a prosperous future), but so do distributive choices (free education for whom and to what age, what bursary system?). As a general requirement, the allocative and distributive aims should be clear, public and checkable.

On the expenditure side there are further requirements to be formulated for the *control* of expenditure. The latter always has the tendency to grow, but it must not become structurally uncontrollable or the budgetary process will have no point[2]. In order to control expenditure, norms or guidelines are necessary, as are measuring instruments, measuring points, feedback (i.e. self-regulating) mechanisms or adjustment possibilities. In the EC the norm applies that expenditure must not grow faster than revenue.

That the setting of norms does not in itself guarantee control will be clear from the examples given. The revenue side is subject to political and other constraints, but the expenditure side is very difficult to control: once assigned, entitlements become enshrined, many of the regulations are open-ended in nature without maximum limits on the price or volume components and there are always new desiderata calling for expenditure. At Community level this is no different from in national states.

2.1.2 *Additional conditions in federal or prefederal systems*

In so far as a budget is a confrontation of revenues and expenditure, the conditions set as a result apply almost universally - to the budget of a household, firm, country or association of countries like the EC. There are, however, differences between national states and multi-state associations, from which additional requirements derive for the budget.

At national level, decisions about expenditure are embedded in a circuit which runs parallel to the budgetary circuit. Expenditure must fit within the budget. If not, further agreement is required from the authority which has approved the budget, i.e. the budget authority.

In an association of several states there is a considerable chance that the circuit for the decisions about the revenue and expenditure of that association will not coincide with the circuit which decides on its high-cost policy tasks. In these circumstances uncertainty will inevitably arise about the competencies of the respective circuits, since these exist side by side rather than in a subordinate relationship. Furthermore, it is particularly difficult in such a structure to impose sanctions against the transgression of financial margins in the policy sphere. Since the decisions about expenditure taken within the policy framework no longer run parallel with the decisions of the budgetary authority, the budgetary system in a multi-state association tends to become uncontrollable in institutional terms. For the budgetary process in a multi-state system, the supplementary requirement therefore applies that a hierarchical link be applied between the powers and responsibilities of the budgetary authority and those of the spending departments. Such a redefinition of the structure of responsibilities is, however, useful only if it is provided with an adequate legal and political system of sanctions. In terms of practical elaboration, a number of different variants are conceivable, depending among other things on the scale of political and social integration within the polity concerned.

A second difference is that national governments can decide to increase revenue if the budget estimates are exceeded (although agreement must of course be sought from the legislative authority). In multi-state systems there is generally no such scope, since the executive authority's power is delegated. The revenues of the executive authority are therefore mainly fixed or limited under a formula laid down by the participating countries. This lack of a say over the revenue side of the budget (i.e. over own resources) has two consequences:

[2] An analysis of the situation in the EC is provided in Chapter 1, while the Dutch situation is described in NES/HB (internal WRR memorandum of 30 June 1987).

1. Budgeting needs to be particularly precise in order to remain within the agreed revenue ceiling, whereas in fact there is often a tendency to be less strict with regard to expenditure on selected items that exceed the budget as long as the total remains below the ceiling set. This requirement for particularly strict 'monitoring', as compared with a national budget, means that *measuring instruments*, *reporting and warning mechanisms* and *feedback mechanisms* or temporary adjustment and correction mechanisms are especially necessary.
2. However, in order to maintain the necessary flexibility, *reserves* must be established since not all expenditure can be foreseen. A *multi-year framework* in which fluctuations cancel each other out in the budget is also a possibility.

Once the budget ceiling has been reached and more resources are required for implementing tasks (e.g. new functions), this must then become the subject of political debate and the resultant budget deficit may not be used as an independent argument. The considerations on the part of the Member States to agree on an increase in budgetary contributions can then be kept clearly in focus: do the Member States or collaborating parties really want to delegate more tasks to the multi-state structure (and thus attain a closer degree of cooperation)? This raises such questions as the potential economies of scale to be obtained from letting the expenditure take place at a higher level, the degree to which the extra expenditure replaces expenditure at national level and the priority accorded to closer collaboration in the light of non-economic considerations such as security or environmental and social factors.

A third, very important, difference between the budgets of national states and those of multi-state systems is that in the latter case deficits are not generally permitted. This is a logical consequence of the fact that the separate parts or members of the structure have a budgetary responsibility of their own and are not willing to pay for debts incurred (by others). The inadmissibility of deficit financing is connected with the previous point (the lack of own resources or absence of powers to increase such resources) and leads to the same conclusion, i.e. that *even stricter budgetary discipline* is necessary than at national level and that the necessity thus exists of an effective measurement, regulatory or adjustment system, or of reserves and a multi-year horizon.

Concepts such as ability to pay and benefit on the financial side of the budget are often used for natural or legal persons in a unitary state but generally not within collaborative associations of countries or in federal states. In the latter structures the concern is instead with tax distribution mechanisms, budgetary compensation mechanisms and so on[3]. These equalisation mechanisms on the revenue side of (multi-state or multi-member) budgets may be either vertical or horizontal. An example of the former is the central collection of VAT and its subsequent return according to a distribution formula[4]. An example of a horizontal equalisation mechanism is the transfer of own tax resources by the wealthier constituent states or countries to the economically weaker ones.

The concept of fiscal capacity (instead of ability to pay) is often used in equalisation schemes on the revenue side. This capacity is defined as the total of the taxes raised in the constituent state (or country) concerned, plus the possible

[3] Commission of the European Communities, *Report by the Study Group on the Role of Public Finance in European Economic Integration*, Brussels, April 1977. Better known as the MacDougall Report.
At the request of the EC Commission, the MacDougall Committee conducted a survey of the instruments for financial redistribution in six federal systems: West Germany, Australia, Canada, United States, Austria and Switzerland. The report discusses the various kinds of budgetary compensation regulations, tax distribution systems and other general payment systems.

[4] One example of such a system is the Federal Republic of Germany. In the United States there is a general revenue-sharing mechanism, while in Switzerland the federal direct tax is redistributed. See the MacDougall Report, op. cit., part II, Chapter 6.

transfers (from the central authority or from the other constituent states or countries). The 'fiscal capacity' is therefore equal to the 'wealth' of the constituent state or country, measured in terms of the financial resources that can be used for expenditure.

Setting out from the (hypothetical) case of an equal burden of taxation in different constituent states or countries, economically weaker entities bring in less tax because there is less wealth, income or activity than in economically stronger regions. As a result the weaker regions are unable to incur as much public expenditure as the other regions with greater 'ability to pay'. If the tax rates were indeed the same, an equalisation structure would be possible that aimed at enabling the weaker countries to undertake the same relative expenditure as the richer countries. In a system with equal tax rates but lower revenues in the less-favoured regions, a more far-reaching equalisation mechanism could be designed so that the weaker countries receive more for a given period; otherwise the stronger and the weaker regions would never converge. These examples show how simple a concept like ability to pay can appear, but how in practice it can take quite different forms in a multi-state structure (just on the income side). From this the requirement can be derived that it must be quite clear what an equalisation mechanism is designed to achieve.

Redistribution also takes place in national states on the expenditure side of the budget. It is then a question of public expenditure on goods and services on the one hand, and of transfers in the framework of social security arrangements on the other. Such expenditure results in a redistribution that remains partly invisible since it is difficult to measure[5]. In multi-state systems it is not so much a matter of the level of public expenditure but of financial flows between the collaborating elements[6]. As a result the redistribution effect is much more clearly visible. This also leads to additional requirements for the budget.

From the foregoing it becomes clear that the measurement of the initial situation before redistribution is of importance. On the revenue side the fiscal capacity can be used as an indicator for the ability to pay of a constituent or member state. On the expenditure side a measurement must also be made of the level of collective expenditure, social security transfers and indeed also of the available 'wealth' in terms of public goods and services. If we want more or less to equalise the level of expenditure in the various participating entities, the equalisation formula must then take this into account. The financial transfers from the central authority (in the case of vertical redistribution) or between state constituents (in the case of horizontal redistribution) will have to be sufficiently high to achieve (for example) an equalisation about an average level. If convergence is in fact aimed at, the apportionment formula must be directed to that end.

From the analysis of the expenditure side, the requirement (for budgets) can, just as on the income side, therefore be formulated that a *measurement be made of the level of collective expenditure* and that *the distribution formula* be made explicit.

If we consider the income and expenditure sides in conjunction, the requirement may be established that the sum of compensation regulations and mechanisms must be measured. The MacDougall Commission has for example designed a standard scale for measuring the redistributive capacity of interregional (or intra-country) flows of public finances. A redistributive capacity of for example 50% signifies that the existing differences in income per head are reduced by 50% through the equalisation mechanisms.

It may be seen that relatively simple concepts such as ability to pay, benefit and redistribution have taken root at national level and are ap-

[5] In the Netherlands an attempt has been made in, for example, *Profijt van de overheid* (Benefitting from the Government) (1981) and in the *Sociale en Culturele Verkenningen 1988* (Social and Cultural Perspectives 1988).

[6] MacDougall Report, op. cit., Part I, p. 25.

plied with instruments such as progressive taxation and distributive expenditure. At the level of a multi-state association the equivalent concepts are less current and can have a quite different content. The elaboration of these concepts in the form of instruments also provides a multitude of possibilities for achieving redistribution.

The practical elaboration of the (re)distributive function of the budget in a multi-state system or supra-state association requires the existence of consensus with respect to the nature and extent of the desired redistribution. Both on the income and on the expenditure side the necessary mechanisms or instruments will have to be worked out for the realisation of the intended redistribution. Finally benchmarks will have to be developed for the periodical evaluation of the the practical effects of the set of instruments. In formulating the redistributive function of the budget and in its instrumental elaboration, various choices based on political preferences can of course be made. These choices cannot, however, be avoided by the ex ante denial of a redistributive function to the budget of a multi-state system or supra-state association. Such an attitude would be self-defeating for the following two reasons.

In every political structure the redistributive effect of the budget from an inter-regional point of view is a politically sensitive problem and one which is usually presented in terms of equal development potential and national solidarity. It would be inconsistent and lacking in realism to rule out a redistributive function for the budget of a multi-state association where that function occupies such a prominent place at national level. If a minimum of inter-regional parity and solidarity is defended in one's own national sphere, it is difficult to deny similar demands in a multi-state association such as the EC purely on the grounds that one runs the danger of becoming a net contributor. Such an asymmetric attitude entails certain risks, particularly for a relatively light and still not very firmly established structure such as the Community. This applies in particular when states with a large positive balance of visible and less visible benefits from the economic integration process take up such a position.

Secondly it is not possible to evade the demand for a redistributive function on the part of the Community budget, for the budget does in fact have both intended and unintended distributive *effects* that play a large role in political actuality, but one which can seldom be positively evaluated. In order to avoid questions concerning the costs and benefits of the Community policy from leading to justified and unjustified ad hoc debate about distribution policy, a general formulation of the redistributive function of the Community budget is a necessity dictated by political reality.

2.1.3 *Summary*

The budget as an instrument, the budget as a process and, separately, the analysis of revenue and expenditure lead to three clusters of conditions which a budget must satisfy.

In connection with the *technical character* of a budget the following conditions may be formulated:

- the budget must be transparent, in connection with the authorising and controlling role of the budgetary authority;
- the budget must be periodically reviewed; it is a plan for the future and a monitoring instrument for the past;
- the budget must be flexible, in the sense that it must make it possible for tasks to be properly carried out;
- the items in the budget must be sufficiently controllable in the short and medium term to pursue a responsible budgetary policy.

From the *analysis of the budgetary process* the following conditions emerge:

- the competencies of the various parties concerned in the budgetary process must be clearly laid down and regulated;
- sanctions of a political or legal nature must be available if the budget is not respected by the executive authority;
- the budgetary circuit must coincide with the decision-making circuit for expenditure and revenue.

A further *analysis of revenue and expenditure* produces the following requirements:
- for the financing of the proposed collective expenditure there must be a source of revenue, which must be efficient and equitable. The practical elaboration of the concepts of ability to pay and benefit must be explicit and contain political moments of choice;
- on the expenditure side decisions must also be taken about distribution among the potential recipients. Allocation and distribution considerations must be explicit;
- to facilitate control over expenditure there must be mechanisms and norms (or indicators) for 'monitoring' during the budget period.

The following additional conditions apply to the budgets of federal states or multi-state systems:
- the establishment of the powers, responsibilities and sanctions of and for the various institutional parties deserves special attention in view of the fact that a number of parties are participating in the process and some have only delegated powers or responsibilities;
- if the central budgetary authority is not empowered to determine (jointly) the level of revenue and if in addition deficit financing is not permitted, there needs to be a particularly efficient system with measurement and warning or control instruments;
- in order to bring flexibility into the normal annual budgets, there must be sufficient reserves and a multi-year horizon within which offsetting arrangements can be made;
- clarity is required with respect to the extent and nature of possible redistributive mechanisms, both on the revenue side and on the expenditure side;
- redistributive norms and aims must be laid down;
- instruments of redistribution must be inventoried and the choice periodically evaluated.

2.2 Conditions which the Community budget must satisfy, deriving from the Single Act

A solution to the financing problems of the European Community must of necessity address itself to the conditions deriving from cooperation in policy, political and financial terms.

In general it may be laid down that tasks that are adopted jointly must also be financed in common. This is the policy aspect of the financing problem. On the other hand the expenditure for fulfilling the Community's aims and tasks must remain within the limits set by the budget. This is the control aspect.

The first of these aspects is discussed in this section, i.e. the aims and tasks that have been adopted by the EC and the implications these have for the required level of financial resources. The control aspect is examined in section 2.3.

It may be noted that no survey exists of all the aims and tasks adopted by the EC, with an associated estimate of the resources required. As a first precondition it may be laid down that such an estimate should be based on the costs deriving from the cooperative association itself. The discussion about the extent of the resources needed by the EC should be carried out on the basis of aims, tasks and costs. Decisions about (long-term) resources which do not proceed from such an estimate or decisions

on the basis of (short-term) financial problems do not bring a better budgetary system any closer. In the EC context a substantive approach is essential.

A substantive approach is presented below on the basis of an analysis of the supplements to and amendments of the EEC Treaty in the Single Act, recently ratified by the legislative authorities of all the Member States.

The Single Act contains two principal points. Firstly the Member States have laid down in this act that they wish to complete the internal market by the end of 1992. The consequences of this decision for the resources needed and for the budget are discussed in section 2.2.1. Secondly the Act lays down that greater cohesion and convergence will be aimed at within the Community. The conditions deriving from this for the budget are discussed in section 2.2.2.

2.2.1 *Consequences related to the establishment of the internal market in 1992*

The aim of establishing a common market is mentioned in Article 2 of the Treaty of Rome. One element was to be 'the abolition, as between Member States, of the obstacles to the free movement of persons, services and capital' (Article 3-c), but no all-embracing definition was provided of what a 'common market' should be. It was, however, laid down that the common market should be progressively established within twelve years (Article 8.1), an aim that was not achieved. The Single European Act may be regarded as a renewed political expression of intent, in this case seeking to establish the internal market by 31 December 1992 (new Article 8A). In the Single Act the internal market has been defined: 'The internal market shall comprise an area without frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty' (new Article 8A).

As a result of this decision the Commission compiled its White Paper summing up the obstacles that need to be eliminated before 1992. Work is also proceeding on a proposal to expand the economic and monetary cooperation required for the realization of the internal market. In addition efforts are being made to promote liberalization in other areas, for example in the transport sector.

The Commission asked a group of independent experts, led by the Vice President of the Banca d'Italia, Mr. Padoa-Schioppa, to investigate the consequences of this internal-market decision in combination with the recent enlargement of the Community to include Spain and Portugal[7]. The group has not provided a detailed survey of the tasks and costs associated with that decision, but does point to a number of foreseeable consequences, such as the potentially adverse effects of the establishment of the internal market on economically weaker areas. The policy areas that will require further attention if the internal market aim is to be achieved are also specified, such as a strengthening of the European Monetary System (EMS).

Apart from the absence of any survey of the substantive tasks arising from the decision to complete the internal market in 1992, there is also no survey of the *additional* costs that this acceleration in integration will entail. Such extra costs are unavoidable: as integration proceeds, new policy areas and functions will be created at Community level, some of which will replace the erosion of policy capacity at national level[8]. This applies especially to research and technology policy which, at national level, is at present very much centred on the public rather than the pri-

[7] *Efficiency, stability and equity*, A strategy for the Evolution of the Economic System of the European Community, Brussels, April 1987. Better known as the Padoa Schioppa Report.

[8] WRR, *The Unfinished European Integration*, Report to the Government no. 28, The Hague, Staatsuitgeverij, 1986.

vate sector market, e.g. the national telecommunications market. This has the result that resources are often allocated by the Member States within the Community to competing programmes, which in turn leads to the further screening off of national public markets. As the WRR has discussed in its report 'The Unfinished European Integration', the placement of research and technology policy on a - partial - Community basis can lead to improvements in efficiency and be instrumental for the establishment of the internal market in sectors vital for the future of West European industry. As a precondition for and consequence of the realization of the internal market a substantial increase in the level of Community resources for research and technology would therefore appear urgently required.

As long as the cost side of the accelerated process of integration is unknown, it is difficult to say to what level Community resources should be raised. In this respect three conditions may be formulated from the outset.

- Decision-making about any increase in the level of Community own resources should be dependent on a survey of the new tasks and costs of completing the internal market; the order of magnitude needs to be indicated.
- The resources to be allocated on the basis of such an estimate need to be on an adequate scale.
- This presupposes that the Member States which signed the Single European Act are prepared to guarantee the financing of the costs of the decisions (which is not to say that they must give carte blanche).

Nor has any survey been compiled of the benefit accruing from the completion of the internal market in 1992. The economically strong countries, however, expect that they will stand to gain from a larger market for their products. A certain predisposition in favour of the increase in resources sought by the Commission and the Parliament is therefore discernible (except on the part of the United Kingdom), but this would not appear to provide an adequate basis for a major decision of this kind, concerned as it is with the aims, functions and resources of the Community.

Effective decision-making needs of course to be underpinned by quantitative evaluations and calculations. From the literature it is evident that economically stronger regions generally stand to benefit from the further liberalization of trade flows[9]. From this it follows, as a norm or guideline for the economically stronger Member States, that it would be fair for them to transfer some of their growth in national income to regions that gained less or no benefit, or even suffered from, the same process of liberalization. These contributions may be regarded as *compensation* for the losses sustained, where these can be substantiated and quantified. This differs from a *correction mechanism* on the revenue side of the budget, as discussed in section 2.1, and also from *redistribution* as an element in the convergence requirement (discussed in section 2.2.2).

As a precondition for the budget of a community of nations setting out to liberalize trade flows, it may be posited as a general principle that the richer areas (which will probably benefit from the larger market) should be prepared to offer compensation to less prosperous regions adversely affected by the same process of integration. The elaboration of this principle is discussed in Chapter 3.

Although the costs and benefits of integration should not in themsel-

[9] See for example:
- D. Seers, B. Schaffer, M.L. Kiljunen (eds.), *Underdeveloped Europe*, Harvester Press, Sussex, 1979;
- German Development Institute, *European Community and Acceding Countries of Southern Europe*, Berlin, 1979;
- M. Hodges, W. Wallace (eds.), *The economic divergence in the European Community*; Allen & Unwin, London, 1981;
- S. Holland, *Uncommon Market*, Macmillan, London, 1980.

ves form the basis for a decision about increasing EC resources, it would still be desirable for a systematic survey to be conducted into the quantitative consequences of the cooperative arrangements. Now that the EC has become so much more diversified, it is in the interests of effective policy implementation for data to be assembled and analysed so that policies can be consistently evaluated in terms of their effects. In doing so the situation can be prevented whereby Member States with inadequately substantiated financial claims create delays in the decision-making process.

To sum up, the following conditions may be formulated in relation to the aim of completing the internal market:

- a survey needs to be drawn up of the substantive tasks and costs arising from the internal market requirement;
- the resources placed at the Community's disposal by the Member States need to be on a sufficient scale to cover the additional functions and costs;
- if progress towards market integration is at the expense of certain regions, compensation should in principle be possible, payable for example from a convergence fund financed by the Member States. The subject of convergence is discussed next.

2.2.2 *Redistribution of resources as an element of the convergence requirement*

Apart from the completion of the internal market by 1992, the Single European Act formulates a second policy aim: the 'overall harmonious development' of the Community; this must be achieved by 'the strengthening of its economic and social cohesion', while 'in particular the Community shall aim at reducing disparities between the various regions and the backwardness of the least-favoured regions' (new Article 130A).

The conditions flowing from the internal market model were examined in the previous section, including the 'compensation' that may be required for regions that suffer economically. This section examines the consequences for the budget of the intended strengthening of economic and social cohesion. As noted, this is not a matter of compensation for the disadvantages to certain regions of a liberalized market, as discussed in the previous section, but of an *independent policy aim*, namely providing the economically weaker regions with greater opportunity to improve their standard of living.

This desire is not new in the EC. The Regional Fund was established in 1975 in response to the admission of Ireland and under pressure from the United Kingdom, which argued that many British regions suffered from structural problems and hence needed extra help. The Fund was modified in 1985 following the accession of Greece and anticipating the accession of the two Iberian nations. The Fund is designed to help eliminate the major regional disparities in the Community by participating in the development and structural adjustment of backward regions and in industrial adjustment in regions suffering from economic decline.

The required scale of the EC's financial contribution to economically backward areas was, however, never established. Is it the intention to improve the social and economic infrastructure of such areas and, if so, to what level? The improvement in question, the investment required and the consequences for the EC budget as a whole were never publicly discussed. In order to achieve an adequate expansion of EC resources this time round, the cohesion requirement in the Single Act alone will again not be sufficient in itself. This aim needs instead to be underpinned by a further elaboration of the convergence aims in terms of the tasks to be performed and the estimated costs.

As a general condition arising out of the requirement for strengthened cohesion it may be said that *a basis for and specification of the required redistribution of Community resources need to be identified.* This problem can be analysed in three steps:

- what is understood by this requirement, what aims are to be achieved, and when?
- what degree of redistribution is required on behalf of the weaker areas?
- which instruments are the most suitable for this purpose?

As regards the *first* question, the economic data suggest the disparity between the poorest and the wealthiest region in the Community to be in the order of 1:5.5[10]. Indicators of differences in living standards may be arrived at in many different ways, each with their own advantages and disadvantages. On the basis of the figures used by the EC, we obtain the following picture. Corrected for differences in purchasing power, Gross Domestic Product per head of population in the poorest region is only 43% of the EC average, while the GDP/capita ratio for the richest region is 237%. Expressed differently, 21% of the EC population lives in regions with a GDP below 80% of the EC average (roughly the level of income in the poorest region in West Germany), while 16% lives in regions with an income in excess of 120% of the same EC average.

Turning to countries rather than regions, the richest is Luxembourg, with a level of 130% (EC average 100%) and the poorest Portugal, with a level of 47%[11]. If the level of income in the poorest countries were to be increased to 80% of the current EC average, measures would have to be taken in four Member States: Portugal, Greece, Ireland and Spain. These countries account for 12.8% of the EC population. If the southern half of Italy is added, approximately the same number of inhabitants would be the object of selective EC support as in the case of a regional approach.

In terms of the order of magnitude of the required convergence effort (and hence budgetary commitment) it would therefore appear to make little difference whether one uses a convergence yardstick based on regions or on countries. In practice, however, the choice does make a difference: in the first case all the Member States have regions that fall short of the average, but in the second case just five countries are below the average. In order to prevent a confrontation between five countries seeking greater convergence and seven countries concerned that they will have to foot the bill, the following condition may be derived from the convergence debate: *the desired level of redistribution should as far as possible be established with the aid of objective indicators and goals based on a regional breakdown of the EC.* This medium-term objective will indicate the desired increase in living standards in the economically weakest regions. From this a broad estimate can be made of the required scale of investment.

This observation brings us to the *second* element of the problem. In itself it is not difficult to determine the scale of investment required in order to raise the level of income in the weakest regions to 80% of the current EC average over a period of say five years. While it is possible to establish a direct (and empirical) link between investment and economic growth, the effectiveness of investment can change rapidly and depends among other things on the scale and quality of the infrastructure and the general level of education. Certain forms of investment can have a knock-on effect in other areas. The following growth model provides an idea of the level of financial commitment that would be required.

In order to bring a country such as Portugal, with a national income of around 50% of the EC average, up to the 80% mark by 1992, national income would need to grow by 10% per annum (from 50 to 55 to 60.5 to 66.6 to 73.2 to 80.5). The Padoa-Schioppa report calculates that in a country like Portugal, a sum of

[10] See annex 2: List of regions in the EEC. The wealthiest region in the list is Groningen; this is because the entire Dutch earnings from natural gas have been assigned to that province.
[11] See annex 3.

3 billion ECU per year would be required to lift the growth in national income by 1% per year, or 30 billion ECU per year to achieve 10% growth. If the country were to finance half of this amount itself, this would still leave 15 billion ECU to be found elsewhere. The total EC budget in 1987 is equal to 36.2 billion ECU. If one has ambitious convergence goals, therefore, comparatively large sums are at issue. The sums do of course become lower if the aim is to be achieved over a longer period. In the above example, a ten rather than five-year period would reduce the external financing requirement to 7.5 billion ECU per annum. Taking all the least-favoured regions into account, each extra percentage point of growth per year would entail investment of between 55 and 76 billion ECU[12]. If the regions in question were to finance half themselves, the total EC budget would be needed in order to achieve an additional percentage point of growth per year.

Other estimates of the financial efforts needed in order to achieve a given, pre-determined degree of convergence may be derived from systems in other countries that aim at convergence. West Germany, for example, has an equalisation mechanism under which public expenditure in the weakest *Länder* is raised to 95% of the national average. This measure has the effect of reducing the disparity in per capita income between the richest and the poorest *Länder* by 40%[13]. Calculations also exist for other systems, such as those in Canada, Australia, Switzerland and the United States. A less well-known system is that of India, where 22 states are united, with 15 different languages and 800 million instead of 320 million people as in the EC[14]. The Spanish system for the autonomous regions is also of interest[15].

In addition it needs to be borne in mind that the Community budget is still very small in relative terms, amounting to less than 1% of the total Gross National Product of the Member States. The MacDougall Committee previously reached the conclusion that for something genuinely to be done about regional convergence in the EC, the Community budget would need to be in the order of 7.5 - 10% of the combined GNP of the Member States[16]. In the current phase of prefederal integration it might be possible to aim for a budget in the order of 2 to 2.5%, according to MacDougall.

For the present it may be contended that in order to translate the (still to be decided) specific goal for reducing disparities in living standards, the convergence requirements entails setting a structural budget norm.

A *third* aspect of the issue concerns the choice of instruments for strengthening the economic potential of less-favoured regions. At issue here are the absorptive capacity of these regions, their administrative structures, the technical know-how and so on. One question is whether the three structural funds at present administered by the EC are the best instrument for achieving the convergence aims. As noted in Chapter 1, the present structural funds do not provide any guarantee for an effective distribution of the development effort[17]. Similarly the Commission's reform plans, which envisage a shift from projects to programmes and the coordination of the three structural funds, provide insufficient basis for the doubling of these funds being sought between now and 1992[18]

In general it may be said that the less-favoured regions can be helped in many ways and with many different instruments. The World Bank has its criteria and methods, the European Investment Bank has others,

[12] Padoa-Schioppa report, op. cit., pp. E4/E5.

[13] MacDougall Committee, op. cit., part I, p. 29 ff.

[14] The equalisation system used in the Republic of India is discussed in Ruddar Datt and K.P.M. Sundharam, *Indian Economy*, New Delhi, S. Chand & Co., 1977.

[15] See for example Luis Larroque, *Comunidades Autonomas-Qué son, para qué, cuanto cuestan*, Madrid, Edit. Popular, 1984, or: Miquel A. Aparicio, *Introduccion al sistema politico y constitucional Espanol*, Barcelona, Ariel, 1983.

[16] MacDougall Committee, op. cit., vol. I, p. 14.

[17] See also annex 1, Table 2.3.

[18] Commission of the European Communities, *Reforming the Structural Funds*, document COM(87) 376, Brussels, 5 August 1987.

and the individual Member States each have regional policies to promote economic growth and prevent social backwardness in the less-favoured regions. The Community will need to conduct a serious discussion with the less-favoured regions with a view to identifying their needs and, on the basis of existing plans and needs, drawing up multiannual programmes that correspond with the convergence objectives. The order of magnitude of the required financing will depend in part on this survey.

This approach requires a number of things:

- *greater involvement on the part of the least-favoured regions* themselves in the programmes. In doing so use can be made of the existing regional structures. If that is not desired the convergence aim can also be formulated in terms of the Member States, although this would then entail political decision-making problems;
- a *shift in the regulative provisions* from Brussels to the areas in question. The funds have complicated rules that arose in an EC when the administrative traditions were largely homogeneous, although it is evident that Italy, for example, which should receive the most from the funds, has for a variety of reasons received less than either West Germany or France[19]. The Community of Twelve has also become more heterogeneous in an administrative sense, and there is a need for the regulative provisions to be made more 'user-friendly'. Further details are provided in section 3.4.3;
- *greater involvement by the European Investment Bank* in the development process. The specification of social goals and indicators, as done by the World Bank, would be an effective means to this end.

Whatever instruments one uses, the following efficiency requirements will apply, particularly in the light of budgetary problems:

- low overhead costs and simple and flexible decision-making procedures;
- simple allocative rules, both geographical and with respect to the various categories of intervention.

Summing up, the following conditions may be laid down with respect to the convergence requirements arising from the supplemented EEC Treaty:

- a debate should be instituted concerning the degree of convergence to be pursued by means of budgetary redistribution, based on concrete indicators and a framework for the medium term;
- an overall sum should be allocated for this purpose by setting a structural budgetary norm, thus avoiding an annual debate about the size of the redistribution;
- thorough analysis and reform are required of the instruments for promoting development in the backward areas. Deconcentration towards the development regions would appear an essential precondition if the policy is to be directed towards regions instead of Member States.

2.2.3 *The tension between the aims of the Single European Act*

The consequences of the internal market requirement were discussed in section 2.2.1, and those of the cohesion and convergence requirement in section 2.2.2. In this section the two together are examined, and certain conclusions are drawn.

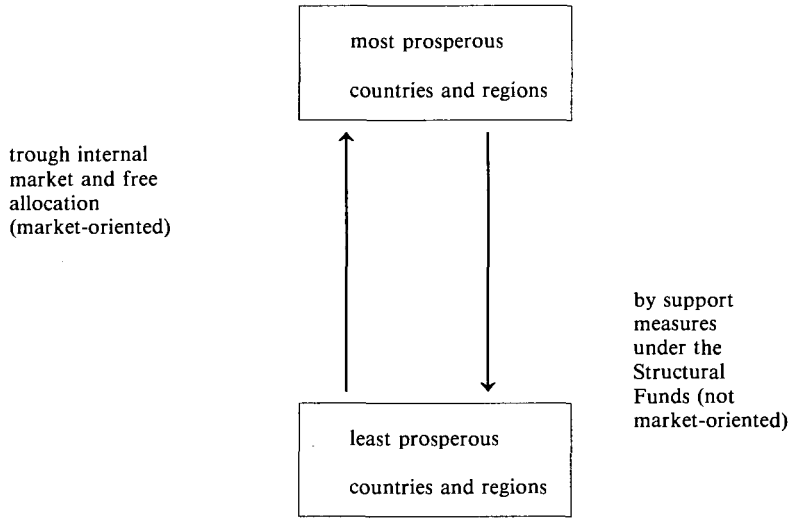
The Single European Act embraces two significant aims: completing the internal market and greater convergence and cohesion. There is, however, a tension between these two goals, in that progress towards the internal market can accentuate regional disparities. If the income in certain regions declines as the result of stiffer competition, this would then constitute a threat to further integration.

[19] See annex 1, Table 2.3.

The European Commission itself says in its proposals: 'The completion of the internal market will inevitably engender new expenditure. If the main objective of a better allocation of factors of production is attained, the result should of course be more vigorous growth and a better employment situation. But another effect could also be a loss or a slackening in cohesion (social and regional aspects of the completion of the internal market), in that an improved allocation of factors generally causes a certain shift towards the more dynamic regions. Some of the additional resources which will be generated by the higher macroeconomic growth rate should therefore be assigned to the Community budget so that it will be possible to attain the objectives of the Single Act as regards cohesion by restoring the balance between the regions in the allocation of the positive effects of growth that should be produced'[20].

In order to prevent the less-favoured regions from lagging behind even further the Commission has proposed a doubling of the financial resources for the structural funds between now and 1992[21]. In diagrammatic form:

Diagram 2.1 Commission's plans in terms of money flows and control form



Although, as noted, there is a tension between the two objectives of the Single Act, they are in essence complementary, as is evident from diagram 2.1. The motives of the signatories relate on the one hand to the expectation of benefitting from further market integration, and on the other - among countries with large less-favoured regions - to the hope of improving their economic circumstances by means of an increased contribution from the structural funds. On the one hand the Member States are feeling the moral pressure of giving practical expression to their previous endorsements in principle, while on the other there are new and fundamental matters related to the growing heterogeneity of the Community and a 'now or never' mentality in relation to the elimination of existing barriers.

As a condition for the budget debate it can therefore be posited that whatever solution is arrived at, it will need to take account of the *different interests*: those of the prosperous countries seeking closer integration, those of the less prosperous nations seeking additional support, and

[20] Commission of the European Communities, *Report by the Commission to the Council and Parliament on the Financing of the Community Budget*, Brussels, 3 March 1987, document COM(87) 101, p. 45.
[21] See note 18.

those of the Commission, European Parliament and other Community institutions. It would therefore appear worthwhile to make a closer study of the specific characteristics of the decision-making structure of the EC and its organs in relation to the implementation of a balanced budgetary policy.

2.3 Requirements flowing from the Common Agricultural Policy

Apart from the implementation of the Single Act, one of the major tasks facing the Community is the reform of the Common Agricultural Policy. The Commission has been trying to reform agricultural policy for many years, but the costs continue to rise, despite public pressure and despite the efforts at government level to reduce these costs, as evident for example from the recent decision of the OECD countries to aim at a gradual reduction in their agricultural subsidies[22].

This report does not set out to provide a survey of all the possible proposals for reform, some of which are very recent, such as those made by the Commission in August 1987 in response to the European Council in Brussels in June 1987[23]. Instead the concern is to arrive at parameters for the EC budget, based on a reform of the Common Agricultural Policy along the lines previously proposed by the WRR in its report 'The Unfinished European Integration' (1986). In broad terms, these proposals amount to the following.

The WRR argues that it is not possible with the aid of just one instrument - the price mechanism - to achieve two different aims, namely market equilibrium and geographical balance (in socio-economic terms). Price manipulations alone cannot bring about both an adequate and regular supply and a reasonable income for farmers throughout the Community. Price policy may be used to achieve stability in the markets, but a more market-oriented price will then be needed. The consequences of this drastic (if gradual) reform for farm incomes and the withdrawal of land from agricultural use would call for compensatory and supporting measures. Five types of measures are specified, including income supplements, buying-out regulations and compensatory payments for natural handicaps. The appropriate mix of instruments would need to be determined from region to region. With respect to financing, account could if necessary be taken of the own contributions on the part of the Member States concerned[24].

2.3.1 *Price guarantee mechanisms versus income supplements*

What would the consequences be for the Community's budgetary problems of a reform in a more market-oriented direction? On the one hand the Community would need to spend less on the price-guarantee mechanism. A fall in guarantee prices would have two effects: a direct effect on the amount that needed to be spent on intervention purchases and export refunds and an indirect effect via lower production on the volume over which guarantee prices have to be paid. The price fall would need to be on a scale to ensure that budgetary charges did in fact fall (unlike the situation up to the present, where small price cuts still lead to higher charges on account of increased production). On the other hand the compensatory and supporting measures would require new resources, partly for the required restructuring of agriculture and partly for the (social) income support needed by certain farmers.

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[22] *National Policy and Agricultural Trade*, 20 July 1987, in response to the OECD ministerial meeting of 12 and 13 May 1987.

[23] Commission of the European Communities, *A Review of Action taken to Control the Agricultural Markets and Outlook for the Common Agricultural Policy*, Brussels, 3 August 1987, document COM(87) 410.

[24] WRR, op. cit., p. 151.

Calculations by the Netherlands Institute of Agricultural Economics commissioned by the WRR, based on a simple model, indicate for example that the complete abolition of price subsidies in the dairy sector would have led to savings of 4.9 billion ECU in 1983, with a fall in dairy prices of 20% (ex-farm) and 17% (ex-factory)[25]. As a result farmers would have suffered a loss of income of 4.7 billion ECU, which could be compensated for by income aids financed out of the contributions no longer required for the price guarantee mechanism. If the 20% price fall were not to be passed on to the consumer in its entirety and an 'excise' were imposed on milk, the positive balance for the EC would of course be still larger. The above figures of roughly 5 billion ECU need to be evaluated in the light of the total Community budget, which amounted to 25 billion ECU in the same year. The reform of the price-guarantee policy in agricultural sectors apart from the dairy industry would therefore have considerable financial potential. If in addition the Member States were to play a larger role in financing national aids (where necessary), the pressure on the budget could be eased still further. Income supplements would probably not be required in the most productive countries, while in the less prosperous Member States it would be possible for the EC to co-finance the aids.

Research into the types of income-guarantee systems that might be applied (financed partly by Member States and partly by the Community) indicates that certain countries already have national income-guarantee systems (e.g. the Special Government Scheme for the Self-Employed in the Netherlands), so that income aids need not necessarily founder on legalistic objections[26]. As it is there are already a number of income transfers from the EC to farmers, such as the buying-out provisions or the permanent compensation for natural handicaps in certain regions. The Commission has itself worked out a number of proposals to facilitate income support[27]. One of the regulations would be charged to the EC budget, while the others would be financed nationally by the Member States.

Whatever the best form of an income guarantee system, the survey carried out on behalf of the WRR by Mortelmans and Feenstra indicates that a system of this kind needs to comply with a number of conditions[28]:

- the support must be provided in accordance with objective criteria;
- the equality principle must apply, i.e. the regulation may not in principle discriminate on the basis of nationality;
- the support should be temporary in nature;
- transitional regulations should apply;
- the system should be transparent;
- the system should be such as to arouse confidence;
- it must afford effective legal protection.

The rules and powers required to maintain agricultural incomes at an acceptable level under a more market-oriented price policy are discussed in greater detail in Chapter 3.

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[25] G. Meester and D. Strijker, *Het Europese landbouwbeleid voorbij de schedislijn van zelfvoorziening* (The Common Agricultural Policy beyond the Dividing Line of Self-Sufficiency), WRR Preliminary Study no. 46, The Hague, Staatsuitgeverij, 1985, p. 81 ff.

[26] K.J.M. Mortelmans and J.J. Feenstra, *Communautair-rechtelijke toelaatbaarheid van nationale inkomenssteun in de landbouw, een eerste verkenning* (Exploratory Survey of the Admissibility under Community Law of National Income Aids to Agriculture), WRR Preliminary Study, 1987.

[27] Commission of the European Communities, *Proposal* for a Council regulation establishing a Community system of aids to agricultural income, *Proposal* for a Council regulation establishing a framework for national aids to agricultural income, *Proposal* for a Council regulation establishing a Community scheme to encourage the cessation of farming; Brussels, 22 April 1987, Document COM (87) 166 final.

[28] See note 26.

In so far as the price-guarantee mechanism is designed to maintain or increase the level of production, there are other, less costly methods. In order to obtain a manageable budget while at the same time maintaining a financial support system linked to production levels or production categories, open-ended, uncontrollable regulations will have to be avoided. A controllable system will need to include feedback mechanisms or stabilizers.

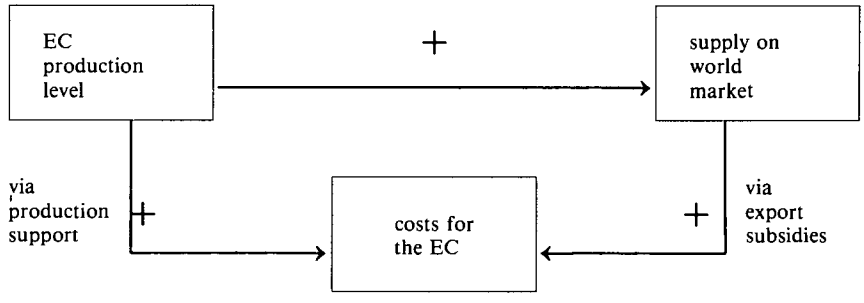
2.3.2 *Feedback mechanisms or stabilizers*

The replacement of the price-guarantee mechanism by a different guarantee system will not automatically bring costs under control. At issue are the conditions that systems must satisfy in order to be regulable[29].

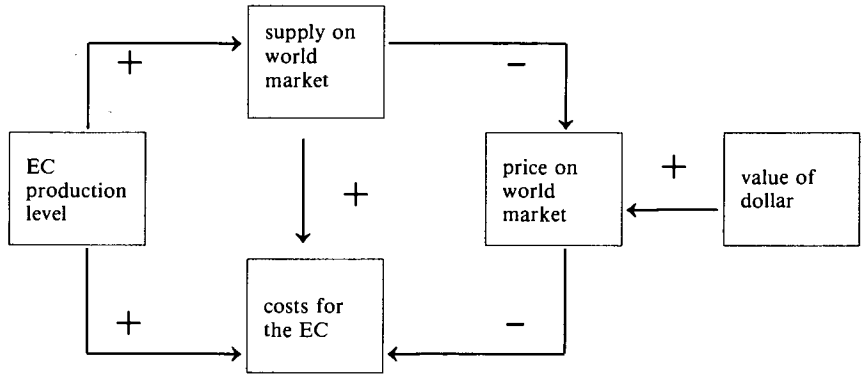
A basic law in any system is the fact that if the *scale* of the generated increase depends on the *quantity* in question, there will be a potential for exponential growth since the quantity is constantly increasing and therefore in principle generating further growth.

Whether or not such growth actually takes place depends on the existence of negative feedback mechanisms that place a brake on growth. As far as the agricultural problem is concerned, an increase in the degree of self-sufficiency and often also in the surpluses has taken place for all products for which there is a price guarantee. The growth is not exponential, but does need to be controlled.

The most important positive feedback mechanism looks as follows:

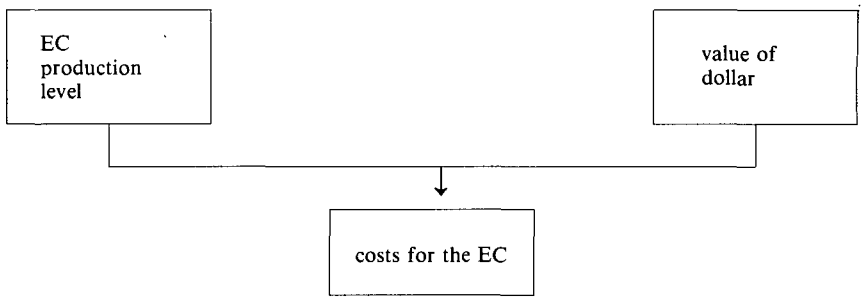


The increase in costs resulting from the increased supply on the world market takes place via the price mechanism: the higher the supply the lower the price and the greater the differential between the EC prices and those on the world market, and hence the higher the export subsidies.

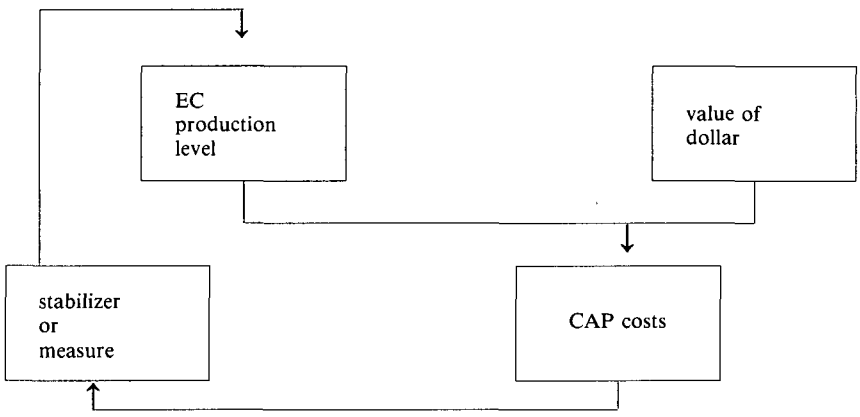


[29] See inter alia D.L. Meadows, W.W. Behrens and D.H. Meadows et al., *Dynamics of growth in a finite world*, Cambridge Mass., Wright-Allen Press, 1974, and P.M.E.M. van der Grinten, J.M.H. Lenoir, *Statistische procesbeheersing* (Statistical Process Control), Utrecht/Antwerp, Het Spectrum, 1973.

The dollar also plays a role; the higher the value of the dollar, the lower the EC export subsidies to compensate for the difference between Community and world market prices. The two most important variables are therefore the level of production and the dollar.



One of these variables is capable of being influenced by EC policies, but the other much less so. Lacking in this open-ended system is a negative feedback mechanism between production and costs and moreover a regulatory mechanism to compensate for the influence of the dollar on the variable to be controlled (i.e. costs). A regulated system would look as follows:



Greater efforts have been made in recent years to incorporate control processes into the Common Agricultural Policy. The dairy quotas are one example; similarly there are proposals to allow the guarantee price for products to decline once surpluses have accumulated to a certain level. These kinds of stabilizers deserve greater attention under the Common Agricultural Policy as long as market forces fail to operate under individual CAP regimes. Bringing CAP spending under control therefore depends on replacing the present open-ended arrangements with greater dynamism and feedback mechanisms. These are examined in Chapter 3.

ANNEX I Selected financial flows between the Netherlands and the EC

Table 2.1 Income transfers between the Netherlands and the EC (billions of guilders)

Year	Payments by NL	Receipts by NL	Net balans
1970	0.11	0.49	+0.38
1975	2.33	1.91	-0.42
1978	3.19	3.7	+0.51
1979	3.79	4.6	+0.81
1980	3.61	4.11	+0.5
1981	3.58	3.23	-0.35
1982	3.89	3.75	-0.14
1983	3.98	4.37	+0.39
1984	4.5	5.15	+0.65
1985	4.96	5.56	+0.6
			2,93

Source: Table 36, *1985 National Accounts*, Central Bureau of Statistics, 1986, The Hague.

Table 2.2 Income transfers between the Netherlands and the EC in 1985 (billions of guilders)

Form the Netherlands to the EC:	
VAT	2.19
Import duties	1.90
Price-increasing levies on foodstuffs	0.6
Other transfers	0.27
	4.96
From the EC to the Netherlands:	
Price-reducing subsidies	5.45
Other transfers	0.11
	5.56

Source: Table 36, *National Accounts*, Central Bureau of Statistics, 1986, The Hague.

Table 2.3 Payments from the Agricultural Guidance Fund to the Member States (up to end of 1985, in thousands of ECU)

	Total	Direct payments	Indirect payments
France	1,303,418	590,029	713,389
FR Germany	1,270,636	655,669	614,967
Italy	1,136,498	797,449	339,049
U.K.	908,725	191,657	717,068
Ireland	493,213	111,200	382,013
Netherlands	300,231	178,590	121,641
Belgium	225,400	155,457	69,943
Denmark	178,401	74,250	104,151
Greece	174,818	18,868	155,950
Luxembourg	26,652	8,729	17,923

Source: WRR, on basis of COM (86) 407 final, European Commission, 1986.

ANNEX 2

List of regions in the Community

Rank	region		GDP/capita current pps 1985 EUR12 = 100	unemp. rate 1986	Population 1985 Total (mill.)	Population 1985 Cumulative % share
1	Thrakis	(GR)	43.2	3.6	0.4	0.1
2	Nison Anatolikou Egeou	(GR)	46.0	6.0	0.3	0.2
3	Extremadura	(ESP)	46.6	28.6	1.1	0.6
4	Ipirou	(GR)	47.1	5.0	0.4	0.7
5	Calabria	(I)	54.4	14.4	2.1	1.4
6	Portugal *)	(POR)	54.6	8.7	9.6	4.3
7	Kritis	(GR)	54.7	4.0	0.5	4.5
8	Thessalias	(GR)	55.4	8.4	0.7	4.7
9	Kent. ke Dit. Makedonias	(GR)	56.3	5.8	1.7	5.2
10	Anatolikis Makedonias	(GR)	57.3	5.6	0.4	5.4
11	Andalucia	(ESP)	58.3	30.2	6.7	7.4
12	Pelop & Dit. Ster. Ell.	(GR)	58.8	5.5	1.3	7.8
13	Anat. Stereas ke Nison	(GR)	61.4	10.2	4.2	9.2
14	Castilla Mancha	(ESP)	62.2	15.7	1.7	9.7
15	Sicilia	(I)	63.0	13.7	5.1	11.2
16	Campania	(I)	63.4	15.4	5.6	13.0
17	Puglia	(I)	64.7	13.3	4.0	14.2
18	Basilicata	(I)	64.7	18.5	0.6	14.4
19	Galicia	(ESP)	65.4	14.0	2.9	15.3
20	Molise	(I)	67.8	7.7	0.3	15.4
21	Sardegna	(I)	68.1	19.3	1.6	15.9
22	Ireland	(IRL)	69.5	18.7	3.6	17.0
23	Castilla Leon	(ESP)	70.7	18.2	2.6	17.8
24	Murcia	(ESP)	70.9	18.4	1.0	18.2
25	Corse	(F)	73.0	12.5	0.2	18.2
26	Canarias	(ESP)	73.5	27.3	1.4	18.7
27	Abruzzi	(I)	74.3	10.5	1.2	19.1
28	Comm. Valenciana	(ESP)	76.3	19.8	3.8	20.2
29	Cantabria	(ESP)	78.2	17.9	0.5	20.4
30	Luxembourg	(B)	78.9	9.8	0.2	20.5
31	Asturias	(ESP)	78.9	18.9	1.1	20.8
32	Lueneburg	(D)	79.3	8.0	1.5	21.3
33	Hainaut	(B)	80.9	14.2	1.3	21.7
34	Namur prov.	(B)	80.9	11.5	0.4	21.8
35	Limousin	(F)	81.4	8.9	0.7	22.0
36	Aragon	(ESP)	81.8	16.7	1.2	22.4
37	Friesland	(NL)	82.4	10.7	0.6	22.6
38	Languedoc-Roussillon	(F)	83.6	13.9	2.0	23.2
39	Poitou-Charentes	(F)	84.8	11.9	1.6	23.7
40	Salop. Staffordshire	(UK)	85.7	11.2	1.4	24.1
41	Umbria	(I)	87.3	11.3	0.8	24.4
42	Auvergne	(F)	88.1	9.6	1.3	24.8
43	Gelderland	(NL)	88.2	10.2	1.9	25.4
44	Bretagne	(F)	88.7	11.0	2.8	26.3
45	Limburg (N)	(NL)	88.9	11.2	1.1	26.6
46	Humberside	(UK)	89.0	14.1	0.8	26.9
47	Heref. & Worc., Warw.sh.	(UK)	89.3	10.2	1.1	27.2
48	Navarra	(ESP)	89.5	17.9	0.5	27.4
49	Northern Ireland	(UK)	89.7	18.7	1.6	27.9
50	Kent	(UK)	89.8	9.6	1.5	28.3
51	Oost-Vlaanderen	(B)	89.8	8.1	1.3	28.7
52	Trier	(D)	90.3	7.5	0.5	28.9
53	Marche	(I)	90.5	6.5	1.4	29.3
54	Overijssel	(NL)	90.8	9.9	1.0	29.7
55	Limburg (B)	(B)	90.9	13.0	0.7	29.9
56	Madrid	(ESP)	91.1	20.5	4.9	31.4
57	Cornwall. Devon	(UK)	91.3	11.8	1.4	31.8
58	Oberpfalz	(D)	91.9	6.9	1.0	32.1
59	Rioja	(ESP)	92.0	16.6	0.3	32.2
60	South Yorkshire	(UK)	92.1	16.5	1.3	32.6
61	Basse-Normandie	(F)	92.1	10.2	1.4	33.1
62	Koblenz	(D)	92.3	6.7	1.4	33.5

Rank	region		GDP/capita current pps 1985 EUR12 = 100	unemp. rate 1986	Population 1985 Total (mill.)	Population 1985 Cumulative % share
63	Cataluna	(ESP)	92.9	21.6	6.0	35.4
64	Nord-Pas-de-Calais	(F)	93.0	12.9	4.0	36.6
65	West Yorkshire	(UK)	93.1	12.3	2.1	37.2
66	Essex	(UK)	93.3	8.7	1.5	37.7
67	Midi-Pyrénées	(F)	93.4	9.0	2.4	38.4
68	Niederbayern	(D)	93.7	5.5	1.0	38.7
69	Lincolnshire	(UK)	94.0	11.5	0.6	38.9
70	Giessen	(D)	94.5	5.5	1.0	39.2
71	Veneto	(I)	94.6	7.1	4.4	40.6
72	Cleveland. Durham	(UK)	94.6	17.6	1.2	40.9
73	Weser-Ems	(D)	95.2	10.1	2.1	41.6
74	Pays Vasco	(ESP)	95.6	24.6	2.2	42.3
75	Pays de la Loire	(F)	95.6	11.1	3.0	43.2
76	Northumber., Tyne & Wear	(UK)	96.3	17.4	1.4	43.6
77	Unterfranken	(D)	96.6	5.0	1.2	44.0
78	Picardie	(F)	96.6	10.4	1.8	44.6
79	Bourgogne	(F)	96.7	10.3	1.6	45.1
80	North Yorkshire	(UK)	96.7	8.6	0.7	45.3
81	Noord-Brabant	(NL)	96.8	9.4	2.1	46.0
82	Hampshire, Isle of Wight	(UK)	97.0	8.3	1.6	46.5
83	Schleswig-Holstein	(D)	97.0	8.4	2.6	47.3
84	Lazio	(I)	97.4	9.9	5.1	48.9
85	Baleares	(ESP)	97.5	13.6	0.7	49.1
86	Dum. & Gal., Strathclyde	(UK)	97.6	16.7	2.5	49.8
87	Dorset. Somerset	(UK)	97.7	8.8	1.1	50.2
88	Franche-Comté	(F)	98.0	9.6	1.1	50.5
89	Liège prov.	(B)	98.8	12.7	1.0	50.8
90	Centre	(F)	98.9	9.4	2.3	51.5
91	Merseyside	(UK)	99.2	19.1	1.5	52.0
92	Lorraine	(F)	99.5	11.1	2.3	52.7
93	West-Vlaanderen	(B)	99.7	7.2	1.1	53.1
94	East Anglia	(UK)	99.7	9.0	2.0	53.7
95	E.Sus., Surrey, W.Sus.	(UK)	100.1	6.2	2.4	54.4
96	Trentino-Alto Adige	(I)	100.3	6.4	0.9	54.7
97	Muenster	(D)	101.4	10.1	2.4	55.4
98	West Midlands County	(UK)	101.5	16.3	2.6	56.3
99	Gwent, M.S.W., Glamorg.	(UK)	101.6	14.7	1.7	56.8
100	Lancashire	(UK)	102.2	12.3	1.4	57.2
101	Aquitaine	(F)	102.3	10.8	2.7	58.1
102	Berk.sh., Buck.sh., Oxf.sh.	(UK)	102.7	6.1	1.9	58.7
103	Clwy, Dyfe, Gwyn, Fowy	(UK)	102.8	14.0	1.1	59.0
104	Friuli-Venezia Giulia	(I)	102.8	8.2	1.2	59.4
105	Utrecht	(NL)	103.0	8.0	0.9	59.7
106	Toscana	(I)	103.1	8.6	3.6	60.8
107	Kassel	(D)	103.1	7.2	1.2	61.2
108	Provence-Alpes-C.d'Azur	(F)	103.4	12.9	4.0	62.4
109	Bor, Cen, Fif, Lot, Tay	(UK)	103.8	13.0	1.8	63.0
110	Zeeland	(NL)	104.2	6.5	0.4	63.1
111	Ost for Storebaelt	(DK)	104.3	7.8	0.6	63.3
112	Leices.sh., Northamp.sh.	(UK)	104.4	9.2	1.4	63.7
113	Derbysh., Nottinghamsh.	(UK)	104.5	11.7	1.9	64.3
114	Champagne-Ardennes	(F)	104.9	12.6	1.4	64.7
115	Oberfranken	(D)	105.2	6.0	1.0	65.1
116	Schwaben	(D)	106.5	4.6	1.5	65.5
117	Avon, Glou.sh., Wiltsh.	(UK)	106.6	8.9	2.0	66.2
118	Detmold	(D)	106.7	8.1	1.8	66.7
119	Saarland	(D)	107.2	10.7	1.0	67.0
120	Arnsberg	(D)	107.4	9.9	3.6	68.2
121	Bedfordsh., Hertfordsh.	(UK)	108.2	6.9	1.5	68.6
122	Braunschweig	(D)	108.4	8.7	1.6	69.1
123	Greater Manchester	(UK)	108.5	14.0	2.6	69.9
124	Freiburg	(D)	109.0	4.5	1.9	70.5
125	Drenthe	(NL)	109.0	9.1	0.4	70.6
126	Tuebingen	(D)	109.1	3.8	1.5	71.1
127	Piemonte	(I)	110.6	8.3	4.4	72.5
128	Cumbria	(UK)	111.4	10.5	0.5	72.6
129	Vest for Storebaelt	(DK)	111.6	6.8	2.8	73.5
130	Highlands, Island	(UK)	112.3	13.8	0.3	73.6

Rank	region		GDP/capita current pps 1985 EUR12 = 100	unemp. rate 1986	Population 1985	
					Total (mill.)	Cumulative % share
131	Hannover	(D)	112.4	8.9	2.0	74.2
132	Emilia-Romagna	(I)	115.7	7.2	4.0	75.5
133	Koeln	(D)	116.6	8.3	3.9	76.7
134	Rhone-Alpes	(F)	116.6	8.2	5.1	78.3
135	Haute-Normandie	(F)	117.0	12.8	1.7	78.8
136	Cheshire	(UK)	117.1	11.8	0.9	79.1
137	Liguria	(I)	117.6	7.9	1.8	79.6
138	Alsace	(F)	118.0	7.1	1.6	80.1
139	Rheinhessen-Pfalz	(D)	118.5	6.4	1.8	80.7
140	Zuid-Holland	(NL)	119.0	8.8	3.2	81.7
141	Lombardia	(I)	119.0	6.7	8.9	84.4
142	Brabant	(B)	121.3	9.2	2.2	85.1
143	Noord-Holland	(NL)	121.4	10.6	2.3	85.9
144	Mittelfranken	(D)	125.4	5.1	1.5	86.3
145	Karlsruhe	(D)	127.9	4.9	2.4	87.1
146	Grampian	(UK)	128.6	8.2	0.5	87.2
147	Dusseldorf	(D)	129.6	9.1	5.1	88.8
148	Antwerpen prov.	(B)	130.8	9.5	1.6	89.3
149	Luxembourg (G.D.)	(L)	131.4	2.5	0.4	89.4
150	Stuttgart	(D)	135.1	3.3	3.4	90.5
151	Valle d'Aosta	(I)	137.0	4.6	0.1	90.5
152	Oberbayern	(D)	142.7	4.6	3.7	91.7
153	Hovedstadsregionen	(DK)	142.9	5.5	1.7	92.2
154	Berlin (West)	(D)	144.4	8.5	1.8	92.8
155	Bremen	(D)	148.7	13.2	0.7	93.0
156	Darmstadt	(D)	150.4	4.7	3.4	94.0
157	Greater London	(UK)	155.1	11.6	6.8	96.1
158	Ile de France	(F)	159.4	8.1	10.2	99.3
159	Hamburg	(D)	195.5	11.4	1.6	99.8
160	Groningen	(NL)	237.4	13.2	0.6	100.0

Source: Commission, Directorate General for Regional Policy.
*) Portugal is included at country level; data refer to continental Portugal.

ANNEX 3 Gross domestic product per head of population (corrected for purchasing power differences)

	1960	1965	1970	1975	1980	1985
L	145.4	135.5	128.8	126.9	124.4	129.3
DK	126.6	129.5	123.5	117.7	115.9	123.9
D	123.4	121.5	118.7	114.5	119.3	121.6
F	104.9	106.9	109.9	114.4	115.6	114.0
B	103.4	104.7	107.1	111.0	112.0	109.8
NL	118.3	114.9	115.6	114.7	110.9	106.1
UK	125.8	116.5	105.9	103.5	98.7	102.0
I	83.5	85.4	92.2	89.3	93.3	91.7
S	59.9	69.8	73.7	81.6	75.2	75.0
IRL	67.3	65.9	66.7	68.5	70.4	70.7
GR	39.1	46.1	52.3	57.7	59.0	57.1
P	32.8	36.5	41.2	43.5	47.3	46.2
EUR 12	100.0	100.0	100.0	100.0	100.0	100.0

Source: Annual Economic Report 1986-87; in *European Economy,* November 1986, no. 30, p. 31

3. POSSIBLE SOLUTIONS

3.1 Characteristics of the present problem

As was seen in the two preceding chapters, the issue of European Community financing may be divided into a number of separate problems. These have in common that they are closely interrelated and structural in nature. The elements of the financing issue may be summarized as follows:

a. A discrepancy exists between the Community's revenue and expenditure. The discrepancy is structural in nature: in amending the Treaty, proper allowance was not made for the expansion in cost-intensive Community functions arising directly or indirectly from the Single European Act. Even if spending on the Common Agricultural Policy did not consume such a disproportionate share of the Community budget as it does at present, the Community would nevertheless face a shortage of resources in the short term on account of the structural decline in revenue from customs duties and agricultural levies.

b. Some two-thirds of Community expenditure - i.e. agricultural spending on the basis of the so-called open-ended regulations - are by nature barely if at all controllable. Although efforts have been made in the recent past to restrict spending on certain products, overall expenditure on the Common Agricultural Policy as currently structured is still particularly sensitive to technological and economic developments over which the Community has little if any control.

c. Under the Single European Act, the Community Treaties currently provide for the Community to promote convergence between the rates of economic growth in the more prosperous and the less well developed parts of the Community. This convergence requirement is an indissoluble element in the Community's present financing difficulties. It plays a role on both the revenue and the expenditure side of the Community budget and, in the absence of fully worked-out Treaty provisions, constitutes a recurrent complication in decision-making on cost-intensive Community activities.

d. The institutional arrangements for drawing up the budget in combination with the horizontal fragmentation of decision-making in the Council render the preparation, determination and implementation of a budgetary policy that satisfies the criteria laid down in Chapter 2 virtually impossible. The importance assigned to national and sectoral interests under the current decision-making arrangements acts as an obstacle to the necessary budget discipline. For the same reason, the budget has proved difficult to manage on the expenditure side. The structural budgetary limits set by the Community's own resources are almost permanently under pressure, while the agreed expenditure limits are subject to pressures that tend to squeeze aside redistributive expenditure within the Community.

e. The Community executive - the Commission - is handicapped in its management of the budget. Budget management satisfying the necessary requirements is impeded by the shortcomings in budgetary policy, the lack of powers of the controlling Community bodies in relation to national executive agencies and, lastly, by the susceptibility to fraud of a number of the Community regulations that govern expenditure.

The history of the Community budget indicates that the Member States tend to tackle the problems associated with the budget in an ad hoc, isolated manner, as moments in the habitual game of give and

take so characteristic of Community decision-making. Experience also shows, however, that problems of this kind are not generally solved by a fragmented, ad hoc approach of this kind. The same problems keep recurring in the same or a comparable guise. Not infrequently, the legacy of an earlier compromise makes them even more difficult to solve than they were originally.

For the financing problem to be tackled adequately, however, it is necessary for the Community bodies concerned and the Member States to get away from daily decision-making as a going concern. As the game becomes harder and harder to play in the absence of all but ineffective rules of the game, decisions taken during the game itself do not have much effect. The Community and Member States are at present required to take some fairly radical decisions on the rules of the game, with a view to providing a consistent and adequate framework for tackling the problems outlined above.

A significant complication in this respect is the special nature of the Community as a public entity with specific features of a partly prefederal and partly intergovernmental nature, which makes it impossible to effect a wholesale transfer of the rules of the game that apply at national level to ensure responsible budgetary policies.

This chapter is arranged as follows:

- section 3.2 deals with the controllability of and convergence in the Community budget, centring on the leading substantive issues that arise in relation to a solution of the financing problems;
- section 3.3 examines the problems of and possible solutions for the revenue side of the Community budget, while section 3.4 deals with the expenditure side;
- section 3.5 analyses the question as to which if any limits should be imposed on intra-Community financial solidarity;
- section 3.6 concentrates on the institutional problems of Community budgetary policy and control.

3.2 Controllability and convergence

3.2.1 *Controllability*

The lack of controllability over spending is one of the two central questions in the Community's financing problems. There are various aspects to the question.

First, the uncontrollable pattern of expenditure undermines the budgetary authority's weighing and authorising functions. It highlights the lack of correspondence between the decisions taken by the budgetary authority and those of the bodies responsible for deciding on cost-intensive Community policies. Seen in this light it is an institutional problem that weakens the powers and responsibilities of the bodies involved in the Community budgetary process.

Secondly, the uncontrollability of Community spending is a substantive problem, in the sense that, within the agreed budgetary limits, each and every instance of overspending necessitates compensation in another sector. The substantive responsibilities of the Community arising under or by virtue of the EEC Treaty are therefore especially susceptible to the lack of budgetary discipline, particularly in the Common Agricultural Policy.

The uncontrollability is, lastly, a political problem, since this issue stands in the way of a proper response to the question of what financial margins the Community needs in a structural sense in order to carry out its responsibilities. For the national governments, it becomes increasingly difficult to accede to requests to transfer resources to the Community as it becomes steadily more evident that the financial margins thus created will almost automatically be used on expenditure that the European Parliament is largely unable to weigh or control.

As such, bringing Community expenditure under control, in terms of both the total level and the composition of spending, forms an essential precondition for a solution to the financing problem. Realizing this objective is, however, exceptionally difficult, since over 60% of Community expenditure is *inherently uncontrollable* due to open-ended regulations. The mere expression of intent to do something about the problem is not sufficient. As discussed in sections 3.4 and 3.5, radical institutional arrangements and safeguards will be required for a solution.

3.2.2 *Convergence*

The concept of 'convergence in prosperity and development potential' within the Community has already been discussed in section 2.2.2. The comparatively imprecise and vague concept of 'convergence' conceals three motives for the assignment of responsibilities and powers to the Community. These motives, discussed below, do not come sufficiently into their own in the often imprecise text of the Treaty and in many political discussions on this subject.

In the first place the convergence requirement entails the necessity to ensure that less prosperous and economically developed regions of the Community are not further handicapped by a geographically uneven distribution of the benefits of the establishment of the internal market and the reform of the Common Agricultural Policy. This *compensation requirement* is designed to prevent the benefits of market integration from accruing one-sidedly to certain Member States (or certain regions) of the Community. Framed more positively, it entails the obligation on the part of the Community to bring about a geographically balanced distribution of the visible and invisible benefits of the integration process.

To avoid possible misunderstanding, it should be noted that the compensation requirement described above cannot be achieved solely by means of financial resources. Among other things it entails the requirement that in establishing the internal market, a certain balance be observed in the necessary liberalizing measures. Radical liberalization of the movement of goods without a parallel liberalization of the movement of services would disproportionately favour Member States with a highly competitive industrial base. Similarly the liberalization of the movement of goods without a simultaneous opening up of public markets would create a structural handicap for private industry in the smaller Member States, where the public markets are too small to permit the development of new technologies. The non-completion of the internal transport market threatens to do serious harm to the Member States on the geographical periphery of the Community.

Secondly the convergence requirement demands the *strengthening of the internal cohesion* of the Community as an economic entity (strengthening cohesion in the real sense). This aspect qualifies the convergence requirement in the sense that the latter must be more than just a redistribution of financial resources which can then be disbursed according to strictly national criteria. By strengthening the economic structure of the weaker Member States, the resources at the Community's disposal for convergence purposes should also be to the benefit of the Community as a whole. Community-financed improvements in the infrastructure of certain Member States should, for example, also entail an improvement in the Community infrastructure. Transferred to national level, the reciprocal nature of convergence has traditionally been an integral element in regional economic policy: the more effective utilization of relatively backward areas contributes towards the national economy as a whole.

This argument comes to the fore particularly vividly in the statutory arrangements in West Germany for the collective improvement of regional economic conditions ('Gemeinschaftsaufgabe Verbesserung der regionalen Wirtschaftsstruktur'). The fact that these motivations formulated at the national, federal level also apply mutatis mutandis in the

Community context is not always evident from the stances adopted by West German ministers.

The third aspect of the convergence requirement consists of the *solidarity* which the constituent parts of a political entity owe one another, irrespective of considerations of economic utility. In the case of multi-tier political structures this - often constitutionally enshrined - solidarity principle performs a significant binding and integrative function. As an expression of a certain collective responsibility it is one of the stabilizers in the complex political play of forces in any multi-tier political structure. A Community which gradually but inevitably affects and helps determine the margins for national socio-economic policies and hence the scope for national economic development necessarily depends on the recognition on the part of all the Member States of the need for intra-Community solidarity. An excessively narrow approach towards the convergence requirement in which short-term national cost-benefit considerations hold sway will have a counter-productive effect because it blocks the necessary progress towards integration and destabilizes the 'acquis communautaire'.

An analysis of the convergence requirement along these lines leads to the conclusion that this requirement needs to be objectified in both quantitative and qualitative terms in the budgetary process. This is by no means straightforward since, as was seen in Chapter 2, there are few if any hard data for quantifying the required compensation. The lack of quantitative reference points also applies to the two other aspects of the convergence principle. In this respect the Treaty (or Community) legislature will need to draw primarily on the practice in stable federal or confederal systems. At the same time, however, the particular structure and specific - limited - tasks of the Community mean that the problem of the vertical and horizontal distribution and equalisation of the burden requires a different solution from that generally found in a federal or confederal state system.

The first major point of difference is the fact that the sharing of costs between a federation or confederation and its constituent parts necessarily presupposes the existence of separate taxation powers. Even if the Community were to obtain its own taxation powers within the foreseeable future, these would be likely to remain so limited as to rule out a vertical equalisation of the burden on any scale.

The second difference is that any horizontal equalisation mechanism between the constituent parts of a federal or confederal structure presupposes an equivalent or highly comparable system of taxation, in the sense that a comparison of and mediation between the 'fiscal capacity' of various constituent or member states must necessarily be conducted on the basis of standard criteria.

The third difference concerns the widely differing views among the Member States concerning the functions that government should perform. By contrast each burden equalisation scheme requires a minimum of consensus about the functions of government.

The fourth difference is closely related to the first three. In principle interstate equalisation within a federal or confederal system extends to all the tasks performed by the constituent polities within their respective fields of competence. In the case of the European Community, by contrast, equalisation would primarily relate to those areas in which the Community exercised powers. In both an absolute and a relative sense, its redistributive capacity will lag far behind that normally found in more fully-developed polities.

The differences summarized above suggest that in deciding the *mechanisms for convergence*, equalisation should be sought not on the income but on the expenditure side, where the link between equalisation and the Community's substantive tasks is most clearly established.

3.3 Revenues

3.3.1 *Starting points for an acceptable own resources system*

As discussed in Chapter 2, the financing of proposed public expenditure at national level must be covered by revenues in the form of taxes and other levies and charges. The collection of revenue must satisfy the principles of efficiency and equity (which may vary according to time or place). The revenues of the Community are subject to comparable if not identical principles as those in the national sphere. In part the differences derive directly from the special nature of the Community as a supra-national public entity with a light institutional structure, whose responsibilities are concentrated in the socio-economic sphere.

More specifically, the efficiency and equity principles apply to Community revenues in the following form.

1. Taxes and levies may be described as efficient Community sources of income if they:
   a. have *positive effects of scale*, i.e. if, given the nature and effect of the tax or levy, they are most effectively applied at Community level and are associated with the lowest costs both internally (for the bureaucracy) and externally (for those paying the taxes and levies).
   b. have *trans-frontier spill-over effects*, i.e. which are levied on activities that also have economic effects outside the Member State in which the levy is actually imposed;
   c. are *transparent and fraud-resistant*, comparatively easy to check in a tiered structure such as the Community and do not give rise at national level to more or less tolerated forms of evasion or avoidance;
   d. produce a *steady and reliable* flow of receipts. Given the fact that the maintenance of macro-economic balance will for the present remain primarily a matter for the Member States and that the Community is bound under the Treaty to observe budgetary balance, it is desirable, for a given package of tasks and expenditure, for the sources of revenue assigned to the Community to produce a highly stable yield, or a predictable one related to gross Community product.

2. The *equity principle*, which takes all sorts of forms at national level, such as ability to pay, the 'least pain' principle and the benefit principle, raises quite different questions at Community level. At national level, the practical application of the equity principle centres mainly on the inter-personal distribution of the burden; in the Community, as in federal or confederal entities, it is primarily a matter of sharing the burden between the constituent polities. As noted in the previous section, there are close links with the convergence principle.

An attempt to solve the problem of distributing the costs of Community policy can best start with the principle often applied at national level of material equality, under which the Member States contribute to the Community's own resources in proportion to their economic capacity, as measured for example by GNP: from a distributive viewpoint Community revenue should be related to the respective levels of national income in the Member States. But however simple and attractive in theory, a proportional system of distribution is not easily instituted in practice.

In the present Community, decision-making is heavily affected by intergovernmental considerations based on national viewpoints. Given this background, it will not be easy to reach a minimum of consensus about the efficiency and equity principles on which the composition of the

Community's sources of revenue and their distribution among the Member States should be based. This means that in so far as a clear consensus currently exists among the Member States concerning certain Community sources of revenue, this should be taken as the starting point for making improvements and additions to the Community's system of own resources.

In assessing the present system the following criteria will therefore need to be taken into account:

- efficiency as a Community source of revenue, of particular importance being continuity in the composition of Community sources of revenue;
- material equality or proportionality with respect to the revenues to be raised by the individual Member States.

3.3.2 *Evaluation of the present system of Community sources of revenue*

At first sight the existing sources of Community revenue satisfy one or more of the criteria outlined above. Customs duties and agricultural levies comply fairly reasonably with the efficiency and equity criteria. Their level and scale are determined by the Community decisions most closely related to Community policy, such as the common commercial policy and the Common Agricultural Policy. The economic effect of these levies, as expressed in the prices of goods within the Community, ultimately departs markedly from the geographical pattern according to which they were levied (the so-called Rotterdam or Antwerp effect). For reasons discussed in more detail below, these levies comply less satisfactorily with the continuity requirement. The same applies, at least to agricultural levies, with respect to the sub-criterion of transparency and fraud-resistance. The shortcomings in this regard will, however, have to be resolved primarily by the Community legislature itself.

The major attractiveness of the now largely harmonized VAT as a source of revenue is its stability in terms of yield and the significant function it performs as an indirect tax that does not lead to any distortions in the inter-state movement of goods and services, provided the VAT rate levied is the same everywhere. As a source of revenue VAT also complies reasonably well with the requirement of transparency but, like any indirect tax, it remains susceptible to evasion.

To this extent there are therefore strong arguments for retaining the Community's present revenue system. This applies all the more now that there is a clear consensus on the subject among most of the Member States.

Nevertheless there are a number of problems, as analysed in Chapter 1, which, however the Community's tasks and expenditure may evolve in the future, will demand decisions on the part of the Treaty legislature. This applies especially to the structural instability of the revenue from agricultural levies and customs duties. As the Community becomes increasingly self-sufficient in an ever-growing number of major agricultural products, the revenue from agricultural levies will continue to decline structurally. With regard to customs duties, the revenue from trade with the rest of the world has lagged behind the growth in the volume of trade on account of the general reduction in tariffs agreed in the GATT. The signs are that this trend - which the Community is capable of influencing only to a very limited and certainly not autonomous degree - will persist. As a result the share of agricultural levies and customs duties in Community revenues has fallen sharply in both an absolute and a relative sense, while that of VAT receipts has risen correspondingly. The conclusion is inescapable that even if VAT were exploited to the fullest permissible extent as a source of revenue and the yield from the two other sources of income continued to decline, the Community budget would find itself permanently stretched to its limits.

The structural instability of the yield from customs duties and agricultural levies - in themselves 'natural' sources of Community revenue - thus create a problem for which other sources of revenue will have to compensate. Quite apart from the uncontrollability of agricultural spending and the extra costs resulting from the Single European Act, the current composition of its sources of revenue create a structural financing problem for the Community for which, one way or another, a solution will have to be found.

When the present Community sources of income are assessed in terms of the material equality principle chosen above as a measure of equity, customs duties and agricultural levies can be left out of consideration on account of the trans-frontier spill-over effects associated with these levies.

In the case of Member States that have recently acceded to the Community, whose import requirements have traditionally been heavily oriented towards non-Community countries, this proposition does not hold in its entirety[1]. Over time, however, a certain redirection of trade flows from other countries to the Community is likely to take place, certainly if the Community price level for the products in question is below that of the world price level as affected by levies and customs duties.

As regards these existing sources of revenue, the redistributive or proportionality aspect therefore centres on VAT. The available data lead to the conclusion that the tax base for VAT - essentially, consumer expenditure - by no means parallels the relative differences in prosperity within the Community. Member States with a comparatively high investment (or savings) ratio, a large surplus on current account and a relatively large informal economy not recorded in the official statistics, contribute less in relative terms than Member States with a relatively high consumption ratio, deficit on current account and a small grey circuit. Where these factors all operate in the same direction, comparatively large differences can arise in the contributions to Community revenues by the populations of the Member States.

There is no reason whatever why these differences should reflect differences in prosperity within the Community, and nor do they do so. The apportionment of the Community's revenues does not therefore comply with the principle of material equality put forward above as a benchmark. Unless further adjustments are made, it may even be assumed that the requirement that contributions to Community revenues be based on national capacity to pay will be satisfied less and less as the VAT share in Community revenues grows.

This constitutes a politically sensitive issue, especially for those Member States making a disproportionately high contribution in terms of their prosperity.

3.3.3 *Solutions in the short term*

The Community's financing problems are acute. They cannot be solved simply by imposing controls on or even freezing agricultural expenditure. The structural decline in receipts from customs duties and agricultural levies, combined with the new tasks arising directly or indirectly from the Single Act, would confront the Community in the very short term with the impossible task of carrying out an even wider range of duties within shrinking financial margins. The issue has become so pressing that a short-term solution has to be found that will afford a breathing-space, at least for the next five years.

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[1] L. Tsoukalis indicates the structural weakness of the acceding countries in *The European Community and its Mediterranean Enlargement*; Allen & Unwin, London, 1981. See also B. Ernste, 'Portugal en Spanje tussen Noord en Zuid - Toetreding tot EG nadelig voor Iberische economieën' (Portugal and Spain between North and South - Accession to EC disadvantageous for Iberian economies), *Internationale Spectator*; April 1983, pp. 235-239.

In such a short space of time the Community and its Member States have few options when it comes to identifying new sources of revenue. There is no compelling reason for radically revising the present structure of revenue sources. All three comply broadly with the requirements for suitability as Community sources of income. The consensus on this subject forms all the more reason for not tampering with the system at present. A general increase in the existing VAT ceiling is, accordingly, the most obvious course of action. The transparency and stability of this source of revenue make it an almost automatic choice.

One drawback is that the yield from this tax reflects the differences in prosperity in the various Member States very poorly. In order to avoid political sensitivities and so as not to increase the redistributive pressures arising from the convergence requirement on the *expenditure side* any more than strictly necessary, it would be advisable to introduce an adjustment on the *income side* to the present VAT ceiling, in the sense that the resources to be transferred by the Member States to the Community under this heading would be limited to a set percentage of national income. This solution would be in accord with the equity principle for sharing the burden of the Community budget as discussed above.

The proposals made by the Commission in its 'triptych' proceed along these lines[2]. There is, however, one important difference: under the Commission's proposals, Community resources would consist of four different categories:

- The yield from 'Community' levies under the Common Agricultural Policy;
- the yield from customs duties;
- the transfer by the Member States of 1% of the harmonized VAT base;
- a complementary transfer, based on the difference between the GNP of each Member State and its harmonized VAT base.

Apart from the fact that the form proposed for it begs certain questions, the last of these categories - that of the complementary, corrective transfer - is subject to the objection in principle that it amounts in practice to a partial reversion to the pre-1970 system of Member State contributions[3]. For these reasons a committee of the Netherlands Socio-Economic Council (SER) recommended in a report on the Community's budgetary policy that the VAT call-in be retained as the financing base[4]. The drawback to the pre-1970 system is that the question of the size of the complementary transfer could complicate the Community budget from year to year by placing it in direct competition with twelve national budgets. The result would be to subject the Community budget to inappropriate trade-offs.

Comparable objections can, admittedly, be levelled against the proposal recommended above, namely a VAT transfer differentiated directly on the basis of the difference between the harmonized VAT base and the level of GNP. These objections are, however, less radical, since the proposed system would not amount to a fundamental break with the present system. A certain degree of competition would continue to exist between the Community budget and national budgets, but it would be less intense since it related to resources that had already been earmarked as potential own resources of the Community. The Community's budgetary procedure could be further eased if the Commission's proposal were

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[2] *Making a Success of the Single Act - A New Frontier for Europe*; document COM(87) 100, Brussels, 23 February 1987. This plan, also known as the 'Delors Plan', is also reproduced in the Bulletin of the European Communities, supplement 1/87.

[3] Decision by the Council of 21 April 1970 about replacing the system of contributions by a system of own resources, EEC Journal, series L, no. 94, 28.4.1980, pp.224-227.

[4] Committee for International Socio-Economic Affairs, *Advies begrotingsbeleid EG* (Report on EC Budgetary Policy), The Hague, Publication no. 11, 1987.

to be adopted for the imposition of an overall ceiling on the required Community resources for a five-year period. If this were to be brought in there would then be no further question of an annually recurrent battle between the Community budgetary authority and national budget legislatures. The advantages of structural multi-year decisions along these lines are returned to in section 3.5.

The strategy being recommended for the short to medium term therefore essentially amounts to the *maintenance of the existing mix of revenue sources* for the Community. The extra financial margin would be sought by increasing the VAT share in Community revenue, subject to the proviso that an *adjustment* would be applied on the basis of the differences in the various Member States between the harmonized VAT rate and GNP. In this way the continuing growth of the Community budget would comply on the revenue side with the requirement deeply rooted in the Western social structure for material equality and equity.

The report by the study group chaired by T. Padoa-Schioppa goes a step further by proposing the introduction on the revenue side of the Community of the ability-to-pay principle[5]. This would amount to a kind of vertical equalisation system on the income side. The report rightly notes that progressivity in Member States' contributions on the revenue side would help alleviate the redistributive function of the Community budget. In the WRR's view, however, greater weight deserves to be given to the objections to vertical or horizontal burden equalisation on the income side. It should also be noted that the introduction of the ability-to-pay principle could further complicate the already difficult process of decision-making with respect to the restructuring of the Community budget while, as noted in the Padoa-Schioppa report itself, the redistributive impact of a progressive system would be comparatively minor.

3.3.4 *Strategies for the longer term*

The Community's revenues and the distribution of the resources raised by the Member States will always touch on sensitivities in the Community decision-making process. The leading point of friction is unquestionably the fact that, as currently structured, Community revenues are drawing - perhaps increasingly so - on an important source of Member State revenue, namely VAT. This causes the national budget legislatures considerable pain, while at the same time this is a levy that is not perceived by the contributor as a Community tax. As the Community's requirement for funds grows with the anticipated expansion in its functions, the competition between the Community budget and national budgets will become more acute. In this way an inappropriate element will be introduced into the Community budget process which could make balanced decision-making very much more difficult and, moreover, impede the Community's ability to carry out its responsibilities properly. In the long term, therefore, the Community will inevitably have to be given its own taxation powers as a supplement to the existing sources of revenue. The latter - especially VAT - could then be 'frozen' at a certain level. The great advantage of this solution is that it would permit the costs and benefits of a further intensification or extension of Community policies to be weighed more accurately. Significant obstacles of a fundamental, political and technical nature will, however, need to be removed first, so that this is a solution feasible only in the medium to long term.

The leading fundamental obstacle is that the assignment to the Community of separate taxation powers would give it a (limited) fiscal sovereignty. As a public entity, the Community would then acquire more of a prefederal stamp. In the light of the constitutional traditions of the Member States, it would be difficult for the exercise of such sovereignty

[5] *Efficiency, Stability and Equity*, Brussels, April 1987.

to take place other than in collaboration with and subject to the control of the European Parliament. The Parliament would, therefore, need to obtain a full-scale right of budget upon the introduction of separate taxation powers. Radical changes would be necessary to the Treaty provisions relating to the institutional position of the European Parliament and its procedures with respect to the budgetary process. The same would clearly apply to the powers of other bodies concerned with the budgetary process.

Certain Member States would be bound to object in principle to the assignment of a limited fiscal sovereignty to the Community: such a qualitative step would not fit into their vision of the process of European integration. But quite apart from that, this step would arouse reservations among those Member States that were prepared in principle to make this move, since the introduction of separate taxation powers, even if only limited, would almost inevitably involve a curtailment of their own taxation powers. The fact that opposition is particularly marked among the national ministers of finance comes as little surprise.

The technical barriers relate primarily to the identification of a tax that lends itself to imposition at Community level in terms of efficiency and equity. If the choice is to be guided by the benefit principle and the principle of 'least pain', the most obvious course would be to spread the burden over industry, benefitting as it does from the process of integration. Of the various possible taxes, corporation tax would therefore appear a logical choice at first sight.

The arguments adduced in favour of this tax in the CEPS study 'The Future of Community Finance' deserve attention[6]. 'The incidence of corporate profits taxation between member states is clearly ambiguous - and on the basis of the 'spill-over' criterion corporate taxes should be levied at Community level. In addition, the existence of different rates of corporate profit tax in the different Member States gives rise to locational distortions, whilst the separate reporting requirements for national corporate profits taxes waste resources and create an impediment to the development of the internal market'.

To this may be added the fact that as progress is made towards completing the internal market, the drawbacks of the side-by-side existence of various national systems of corporation tax will become even more serious, while on the other hand the room for manoeuvre on the part of the national tax legislatures in respect of this tax will narrow.

These considerations lead to the following conclusions:

- the fundamental, political and technical problems of assigning separate taxation powers to the Community are such as to preclude resort to this measure as a solution to the Community's current financing problems;
- in the medium to long term, however, a limited degree of fiscal sovereignty will prove a functional necessity for the Community;
- in order to assist the formulation of ideas on this subject and to identify the possibilities and objections more clearly, further analysis is required of:
  a. the institutional consequences of separate taxation powers for the Community;
  b. the suitability of corporation tax as a basis for separate taxation powers and the steps that would be required to that end (e.g. the amendment of national systems and possible variants in the personal range of a Community tax, etc.).

This aspect will be analysed more closely by the WRR in its final report.

16 *The Future of Community Finance*, Centre for European Policy Studies, Brussels, September 1986.

3.4 Expenditure

3.4.1 *Starting points for an acceptable system*

A number of general conditions which the Community budget needs to fulfil on the expenditure side, and where there are currently shortcomings, were formulated in Chapter 2.

The *first* general condition derives directly from the EC Treaty. The rule that the budget shall be in balance entails the more specific requirement that expenditure should be controllable in the short term.

The *second* condition is related to the fact that the Community is bound on the expenditure side to the structural ceiling set by the available own resources. This condition has significant policy implications for cost-intensive Community tasks and for the discipline required in this respect. It assumes a strict link between the decisions taken by the Community in respect of the budget and those relating to substantive policies.

The *third* condition is that the separate expenditure categories should reflect the cost-intensive tasks which the Community is required to undertake under the Treaty, subject to the special emphases arising from Community policy. This condition is of fundamental importance for the instrumental policy function of the budget. The requirement of material concordance between expenditure and tasks implies that there must be a lack of uncontrolled shifts or displacement phenomena between the various categories of expenditure.

The *fourth* condition entails that the geographical allocation of actual Community expenditure should be consistent with the requirements flowing from the convergence principle. It is, in fact, a refinement of the third condition. However, given the political weight attached in Community decision-making to the convergence principle, it deserves to be a reference point in its own right.

The *fifth* and final condition is that Community expenditure should comply with the functional requirements of allocative and distributive efficiency. Even at national level, this condition is not easily complied with, since decision-making on the budget is heavily influenced by specific interest-groups with direct access to the government agencies concerned with the budget. In the institutionally much more fragmented Community decision-making procedures, it becomes even more difficult for Community expenditure to comply with the requirements of functional efficiency.

These five conditions reflect the two main issues of relevance for solving the Community's financing problems:

- the issue of controllability, as expressed particularly in the first three conditions;
- the issue of the convergence or distributive/redistributive function of the Community budget, which finds expression especially in the latter two conditions.

Put somewhat baldly, the solution of these two issues presupposes that the Community budget process will be governed by much tighter discipline and coordination than that customary at national level - whereas in fact the opposite obtains. Even if adopted, recommendations in relation to Community expenditure policy will, in consequence, all too easily remain without effect unless the budgetary authority is bound by procedural and substantive guidelines.

3.4.2 *Towards a controllable budget*

The Community budget faces three separate problems of control on the expenditure side:

- it continually tends to overshoot the structural ceiling set by Community revenues;

- the balance between revenue and expenditure has to be maintained annually by means of accounting manipulations and comparable emergency remedies;
- within the budget, compulsory agricultural guarantee spending displaces non-compulsory spending on the structural funds.

The central problem in this respect consists of spending under the Common Agricultural Policy, in that the market-price guarantees and export subsidies are by nature open-ended.

In its report 'The Unfinished European Integration', the WRR examined the causes of the structural and cyclical uncontrollability of agricultural expenditure in more detail[7]. Here it must suffice to note that this uncontrollability is structurally caused by the rise in agricultural productivity, not just in Western Europe but also elsewhere. This has the result that market equilibrium is disturbed at a given minimum price level and that growing surpluses have to be sold at subsidized prices on a world market where the price level is also structurally under pressure. The cyclical uncontrollability stems from seasonal fluctuations and short-term exchange rate variations, especially of the dollar against the 'green' ECU.

Since the causes of the uncontrollability of agricultural guarantee expenditure are susceptible only (if at all) in very small measure to government policies, an effort needs to be made to control the overall volume and composition of spending by reforming the Common Agricultural Policy itself. A number of these changes, in the form of policy feedback mechanisms, are discussed in Chapter 2. The choice of feedback mechanism is determined by the particular features of the product market in question, the relevant CAP regime and by political preferences. In Chapter 5 of 'The Unfinished European Integration' the WRR discussed how these feedback mechanisms in the Common Agricultural Policy could be reduced to two main types, namely restoration of market equilibrium by the adjustment of the (guarantee) price levels or by a reduction in the quantities that can be marketed at guaranteed prices (quotas). In its report, the WRR expressed its preference for the application of feedback mechanisms of the first type since these have unmistakable advantages from the viewpoint of the allocation of the factors of production and administrative costs. A central consideration in the WRR's report is the two-fold observation that whatever feedback mechanism one selects to control agricultural expenditure,

a. the fall in the number of people employed in agriculture will continue at an accelerated pace with a reduction in the area under cultivation;
b. this phenomenon will take place highly unevenly throughout the Community and will have particularly serious consequences in marginal areas.

Put in rather more stark terms, bringing Community agricultural spending under control will in all probability increase the need for redistributive convergence expenditure.

Space does not permit a detailed account and evaluation of the numerous proposals put forward by the Commission for bringing expenditure on the various agricultural products under more effective control[8]. These proposals still have to pass through a lengthy decision-making procedure, in which they could be substantially modified. This report concentrates primarily on the yardsticks in terms of which the Commission's proposals should be assessed:

1. In the first place it should be noted that the introduction of feedback mechanisms in the various CAP regimes will not in itself suffice to

[7] WRR, *The Unfinished European Integration*, Report to the Government No. 28, The Hague, Staatsuitgeverij, 1986.

[8] Among others *A Review of Action Taken to Control the Agricultural Markets and Outlook for the Common Agricultural Policy*; document COM(87) 410, 3 August 1987.

bring agricultural expenditure under permanent control. Given the horizontal fragmentation of decision-making in the Council in its various sectoral formations, the existence of feedback mechanisms will by no means guarantee that they would if necessary be used by the Council of Agriculture Ministers. The experience until the recent past with 'binding' or 'solemn' decisions by the European Council to which little if any follow-up has been given in the specialized Councils does not provide grounds for optimism. In brief, a solution will need to be found in a combination of feedback mechanisms in the CAP regimes and an obligation enshrined in the Treaty to apply those mechanisms when there is a danger that a previously agreed multi-year ceiling will be exceeded.

2. The second element of the combination of feedback mechanisms and the objectified requirement for those mechanisms to be applied can be elaborated in various ways. A possible variant would be as follows: at the Commission's proposal, in consultation with the European Parliament, the European Council would set a binding ceiling for agricultural *market* expenditure once every five years, expressed as a percentage of the budget (or in the form of a nominal, possibly indexed, amount). This ceiling would form the structural financial framework within which the Council of Agricultural Ministers would be permitted to operate. An arrangement of this kind would require an amendment to the EEC Treaty.

   To be effective the first element of the combination would require greater delegation of the management of the agricultural market to the Commission, accompanied by a more limited degree of procedural buffering. The EEC Treaty would not need to be amended.

   An arrangement such as that proposed above leads to a logical decision-making sequence in the Community. The structural financial framework is determined by the European Council. The setting of policy priorities within that framework would be a matter for the relevant specialized Councils, while the Commission (plus the European Parliament) would have prime responsibility for policy preparation and implementation.

3. A separate point of concern is the cyclical control of agricultural expenditure. Exchange rate variations, seasonal fluctuations and decisions by agricultural producers can lead to variations in spending under the various regimes that are very difficult to predict and which could not be fully offset even given the prompt application of the feedback mechanisms. One-off annual budget overshoots in the field of agriculture could not, therefore, always be averted under this system. In order to cushion these movements, various buffering arrangements are conceivable which, applied separately or in combination, could help prevent the structural framework for the agricultural market from being overshot.

   The most obvious course of action would be the formation of a reserve to offset erratic movements in the short term. A second possibility would be to average out spending on a particular agricultural product over more than one financial year. An overshoot in one year would then be compensated for in subsequent years. A third solution could lie in an adjustment in the budget for the various CAP regimes.

   Under these arrangements, the structural framework for agricultural expenditure would require highly watchful market policies and alert market management on the part of the relevant Community institutions, since the financial consequences of failure to do so would have to be absorbed within that framework.

4. Each and every conceivable remedy to restore market equilibrium in the agricultural sector and to control expenditure under the Common

Agricultural Policy has in common that the income of agricultural producers will be adversely affected. The social consequences of a policy switch along these lines will be the most serious where a high proportion of the population is engaged in agriculture, where productivity is low and where the regional economy and social infrastructure depend heavily on agriculture. This brings us to the issue of income support in agriculture and its financing. The numerous questions that arise in this respect can only be mentioned in passing, and not properly answered, in this interim report:

- Should Member States be permitted to pay national income supplements to agricultural producers whose earnings are inadequate? If the emphasis is placed on the *social character* of such support, there would seem to be a sound case. If on the other hand the potential economic consequences of social income support are taken into account, namely that these supplements can act as disguised producer subsidies and hence help keep unprofitable enterprises in business at the expense of profitable, unsubsidized enterprises, the answer is less self-evident. At any event, any form of national income support in agriculture will need to comply with strict Community criteria.
- What motives other than purely social ones can provide a basis for income and production support for agricultural enterprises that are no longer viable under the revised Community agricultural regulations? The relevant Community regulations, including the so-called hill-farmers regulation, take into account objectives not of a strictly agricultural nature, such as landscape preservation and nature conservation, the maintenance of the social infrastructure and the prevention of rural depopulation. Here again, however, the problem arises that the protection on other than strictly economic grounds of agricultural enterprises that are no longer viable under the current market conditions can severely curtail the scope for otherwise viable agricultural activities. The Community will at any event need to lay down stringent qualitative and quantitative criteria for the appraisal of national income or producer support to farmers on other than strictly economic grounds. Certainly if a comparatively prosperous Member State such as West Germany were to designate the bulk of its rural countryside as a kind of agricultural reserve and to continue with farming in these areas on that account alone, serious disruption to selected agricultural commodity markets within the Community could be envisaged.
- The third question focusses on the uneven geographical distribution of the socio-economic consequences of restrictive agricultural policies aimed at controlling expenditure. In the report 'The Unfinished
  European Integration' it was noted that the most prosperous agricultural regions were by and large located in or in close proximity to the most prosperous regions (and Member States) of the Community. In those areas where the impact of a Common Agricultural Policy brought under control was least serious in a socio-economic sense, the consequences could most easily be absorbed and countered.
  The reorientation of the Common Agricultural Policy therefore creates a distribution problem for the Community, in the sense that the economically weaker regions (and Member States) will be unable to bear the social and economic consequences of a financially controlled agricultural policy by themselves. The Community will therefore need to bear a substantial proportion of the social and economic adjustment costs in these regions. Since this spending will, as noted in the WRR's earlier report, need to cover more than the field of agriculture alone, it would be advisable to separate these funds from the agricultural budget as such and to transfer them to the structural and convergence funds, which are discussed in the next section.

5. The CEPS study 'The Future of Community Finance' puts forward the notion that spending under the Common Agricultural Policy might be removed from the Community budget and transferred to a separate fund, which could be furnished with a set proportion of Community revenues and the yield from specific agricultural levies[9]. The attractiveness of a detached and essentially self-financing agricultural fund is that Community budgetary policy would be substantially simplified as a result. The objections against such an arrangement, however, are more serious.

   Given the interests of the contributors and consumers, it is unacceptable to leave decision-making about the costs and benefits of the Common Agricultural Policy to a closed agricultural circuit in which producers' interests are firmly entrenched. This is an important objection in principle to the proposed Community levy on oils and fats, which could form a step along the road towards the budgetary autonomization of the Common Agricultural Policy. To this may be added the fact that as a result of economic, technological and organizational developments in agriculture, the more advanced and productive element of this sector has come increasingly to resemble economic activity in other sectors. Precisely on account of these developments, the economic arguments for placing agriculture in a privileged position have therefore steadily lost force. The fact that insufficient account has been taken of these factors in the Common Agricultural Policy in the past essentially forms a reason for reforming the policy rather than consolidating it by means of isolation in a separate fund.

   As noted above, the evolution of the Common Agricultural Policy has had particularly penetrating external effects extending far beyond the field of agriculture as such. This forms all the more reason for periodically reviewing the budgetary margins for the Common Agricultural Policy within the framework of multi-year Community budgetary planning. In the light of the new priorities associated with the convergence requirement and the Community technology and industry policies required within the completed internal market, a gradual reduction in the share of this expenditure category in the Community budget should certainly not be ruled out in advance. In all probability the influence of the Community budgetary authority on the substance of agricultural policy will therefore grow, both in determining the structural framework and in setting the annual budget.

The objection could be levelled against linking agricultural spending to a structural ceiling that the Community would thereby gratuitously weaken its stance in the GATT negociations on the regulation of world trade in agricultural commodities. The objection is not, however, particularly convincing. The reform of the Common Agricultural Policy is necessitated primarily by structural economic and technical innovations within the agricultural sector itself. There is no sense in persisting with an inefficient policy that is rendering itself unfinanceable simply with a view to maintaining a negotiating position vis-à-vis countries with a comparably inefficient policy. The objection also fails to hold water because the Community would have sufficient room for manoeuvre within a structural financial framework to place its opposite numbers under pressure by selecting the appropriate mix of control instruments. Finally the Community would always have available the ultimate remedy of reacting to outside pressure by adjusting its structural financial framework. The application of such an 'escape valve' - the very existence of which could lead to a lack of discipline in agricultural policy - would, however, need to be subject to strict substantive and procedural conditions.

These considerations lead to the following conclusions:

[9] Centre for European Policy Studies, *The Future of Community Finance*, Brussels, September 1986.

a. in order to control Community spending the Common Agricultural Policy must be subjected to discipline;
b. such discipline must involve the introduction of financial feedback mechanisms in all CAP regimes under which financial claims can be made on the Community, *combined* with an obligation under the Treaty to apply these mechanisms when there is a risk that the structural financial framework for agricultural spending will be exceeded;
c. the structural financial framework would be laid down by the European Council, and would be binding on the Community budgetary authority;
d. the administrative arrangements for the Common Agricultural Policy should include one or more buffers for evening out the short-term fluctuations in agricultural spending. Such buffering arrangements should take place *within* the structural financial framework for agricultural policy;
e. within limits determined by the Community, provision can be made for the Member States to compensate for the social, agricultural, ecological and infrastructural consequences of a slimmed-down Common Agricultural Policy aimed at the restoration of market equilibrium;
f. in order to compensate for these consequences in the economically weaker parts of the Community, Community financial support will be required under the convergence requirement; the logical course would be to detach such spending from the agriculture chapter and to house it under the funds earmarked for convergence;
g. the nature of the structural developments in agriculture are making it increasingly difficult economically to defend a specific sectoral market policy, especially for the more advanced agricultural enterprises; in view of the other newly emerging policy requirements (arising among other things under a completed internal market), a trend-based reduction in the relative share of agricultural spending in the Community budget is desirable.

3.4.3 *Administrative arrangements for convergence in Community expenditure*

The experience of the past decade has taught that an ad hoc and incidentally worked out convergence requirement has delaying and other negative effects on the weak and easily over-burdened Community decision-making structure in each field of administrative responsibility involving high spending. The need to pose and answer the distributive question in relation to each Community task and decision means that the end results fail to comply with the minimum requirements of allocative efficiency and that their aggregated distributive effects derive more from accident than from fundamental decisions about distributive policy.

In short, the allocative and distributive distortions inherent to some extent in a budgetary democracy are much more pronounced in the institutional context of Community decision-making about the budget and policy than they are in the national context. For this reason particular attention will need to be paid to the substantive and procedural elaboration of the convergence principle in the Community budget. A number of variants are conceivable, each of which would take a different quantitative form. They would, however, have in common that they each took the form of objectified rules of the game that acted as guidelines in the preparation and implementation of budgetary policy. One possible and attractive strategy would be as follows:

- Under the Treaty the European Council, at the proposal of the Commission and in consultation with the European Parliament, would be required once every five years to set aside a fixed percentage of the Community budget for Community interventions designed solely or specially to benefit regions in which per capita income is less than a

set percentage of the Community average. This structural limit would be binding on the Community legislature and the budgetary authorities during the period to which it applied.

As noted in Chapter 2, no unambiguous quantitative data are available on the basis of which these two percentages could be automatically set. It is even highly questionable whether such data are even procurable. The setting of these percentages will therefore partly depend on normative expectations concerning the degree of solidarity to be achieved, actual economic developments (are living standards within the Community converging or diverging?), the priority attached to other policy objectives and the level of available budgetary resources.

In the light of these preconditions, it would appear reasonable to set aside 40% of the budget for areas in which per capita income is less than 80% of the Community average.
Compared with the inter-state financial solidarity in West Germany, the first of these percentages may appear on the high side. In an absolute sense, however, as a proportion of Community GNP, the amount in question would be modest, assuming the Community budget to run at around 1.25% of Community GNP. Given the content of Community tasks and competences and the economic heterogeneity of the Community, a comparatively large Community contribution would be desirable, but the still limited absolute size of the contribution would keep it acceptable to the more prosperous Member States.

The second percentage has been selected primarily on grounds of efficiency. For the redistributive impact to be sufficiently large in political terms, it would be desirable for the percentage to fall well short of the Community average. The results of national regional economic policies indicate the necessity of concentrating on problem areas with endogenous potential.

- For the purpose of disbursing the funds, the reorganization and merger of the existing structural funds (Social Fund, Regional Fund, Agricultural Guidance Fund) into a single structural fund recommends itself since the aims and practical range of these funds overlap or are not far apart. Article 130D of the recently amended EEC Treaty would appear to provide room for a merger along these lines[10].

  In doing so lessons will need to be drawn from the existing structural funds. As discussed in Chapter 1, the interventions under these funds are split up over numerous support regulations, some of which overlap and some of which are mutually at variance. In terms of the geographical distribution of funds, eligibility criteria and definition of objectives, these regulations have - often for misinterpreted reasons of distributive equity - become so detailed as to be unmanageable. The decision-making procedures are overly complex and the financial administration of the regulations, like the check on their application, leaves a lot to be desired. In their anxiety to keep a watch on one another, the Member States have imposed a set of support regulations

[10] 'Once the Single European Act enters into force the Commission shall submit a comprehensive proposal to the Council, the purpose of which will be to make such amendments to the structure and operational rules of the existing structural Funds (European Agricultural Guidance and Guarantee Fund, Guidance Section, European Social Fund, European Regional Development Fund) as are necessary to clarify and rationalize their tasks in order to contribute to the achievement of the objectives set out in Article 130 A and Article 130 C, to increase their efficiency and to coordinate their activities between themselves and with the operations of the existing financial instruments. The Council shall act unanimously on this proposal within a period of one year, after consulting the European Parliament and the Economic and Social Committee'.

on the Community which, in terms of political and administrative efficiency (or inefficiency), is on a par with the worst in the Member States. Most of the present shortcomings could be eliminated by merging the present schemes and rationalizing the objectives and resources. The rules governing the actual administration of the schemes, and the conditions to be satisfied, should be pared down to the essentials, since the major administrative, economic and social variations within their area of application do not make it feasible to go into specifics.

In addition it is important to draw a clear distinction between policy for and the management of the structural funds. Policy should be confined to drawing up the basic rules for the management of the funds and to indicating the basic priority areas in terms of objectives, allocation and the scale of the annually available resources. Management relates to tapping the structural fund for individual projects or programmes in the regions in question. In addition, as evident also from the experience at national level, there are strong arguments for subsidy schemes to be administered on an autonomous basis. Projected programmes and projects should be evaluated primarily in terms of the economic prospects; the allocation of funds purely on redistributive grounds is inefficient and will in the long term arouse serious resistance.

It is a pity that the Treaty legislators failed to recognize the shortcomings of the present funds and the effects these have had in practice. If the new Article 130E of the EEC Treaty were to be applied to the letter, and the Council were to take every implementing decision relating to the European Regional Development Fund itself, this would lay the basis for a continuation of the existing ineffective practice[11]. By encumbering the Council with implementing allocative decisions, the Treaty legislators have threatened to add further to its burdens and seriously to interfere with the (from a Community viewpoint) responsible implementation of the convergence principle. The Council will need to recognize the limitations of its functioning as an institute in this respect by assigning the Commission the necessary administrative powers in the regulations that govern the future functioning of the structural funds.

- National experience with centrally-determined support measures or subsidy arrangements for decentralized tiers of government and for enterprises indicates how difficult it is for the specific problems of the intended beneficiaries to be identified at central level. The result is either that these regulations are inadequately exploited as user-unfriendly, or that implementing procedures are developed that depart from the original intentions. It is, however, no accident that the governments in the various Member States are currently trying to improve the efficiency of their economic support schemes by increasingly passing on their implementation to the market in the form of functional and/or territorial decentralization or deconcentration.
  Within the Community the communication between the central legislature and the administrative or private implementors of the support schemes is considerably more difficult again. Even more important than the factor of distance are the marked administrative and social differences within the Community. The closer the administrative culture and language of a Member State or region to those of the Community administration, the easier the contacts and the more readily use is made of Community facilities. These factors result in unin-

[11] 'After adoption of the decision referred to in Article 130 D, implementing decisions relating to the European Regional Development Fund shall be taken by the Council, acting by a qualified majority on a proposal from the Commission and in cooperation with the European Parliament.

tended and unnecessary imbalances in the use made of resources earmarked for convergence. This state of affairs may not be attributed solely to the lack of absorption capacity of certain Member States and regions. In some instances genuine needs for which funds are available cannot be met because differences in administrative culture or inadequate bureaucratic competence prevent the establishment of the necessary contacts. In order to overcome these and comparable frictions and stumbling blocks in the administration of the structural funds, consideration should be given among the relevant Commission agencies to the scope for forms of administrative deconcentration. This could help ensure that the allocation of resources was more in line with policy intentions, with more effective control over the correctness of the expenditure.

- As noted earlier, the Community budget is just one of the available instruments for solving the convergence problem. One of the principal tasks of the European Investment Bank is the financing of public and private projects in poorer areas of the Community. The allocation of the EIB's funds has concentrated increasingly on these regions. The EIB has a large measure of autonomy, which it guards jealously. One of the questions that will need in due course to be explored in the WRR's final report is if and how the EIB's policies can be geared to the priority areas identified by the Community budgetary authority for the promotion of convergence. With respect to the decisions they will be taking in Council, the Member States need to realize at this stage that the form and elaboration of the powers for administering the structural funds will have an important bearing on the part the EIB will be able to play in helping implement the convergence principle.

These observations on the practical form of the convergence principle lead to the following conclusions:

a. desirably there would be a requirement under the Treaty for the European Council every five years to lay down a binding percentage of the Community funds that were to be used solely or specially for regions where per capita income was below a fixed percentage of the Community average;
b. in order to disburse these funds the formation of a single structural fund is needed, while at the same time simplifying and reducing the numerous specific financing regulations in the Community. The Council will have to confine itself to drawing up the statutes and the overall policy lines of the fund, while the Commission should have broadly defined administrative powers;
c. with a view to a more balanced and efficient allocation of the resources, the preparation of and decision-making about the allocation of funds should be conducted on a highly decentralized basis (since the pronounced administrative and social differences within the Community are not compatible with tightly centralized preparation and implementation);
d. the potential role of the EIB, and its possible coordination with Community budgetary policy in the implementation of the convergence principle, deserve further study.

3.5 The margins for intra-Community financial solidarity

3.5.1 *Are institutional margins needed?*

Efforts to quantify the direct and indirect costs and benefits of the European process of economic integration and their distribution among the various Member States have to date remained confined to rough estimates. These are too imprecise and unreliable to act as a

basis for firm policy-oriented pronouncements. It does, however, seem clear that the economic advantages of the integration process, particularly for economies with a considerable degree of specialization, such as West Germany in the industrial sector and the Netherlands in the agricultural sector, are of a totally different order of magnitude from the pattern of financial transfers to and from the Community, which are capable of fairly precise quantification.

The debate about transfers to and from the Community and about the net balance per Member State is in fact as old as the Community itself. It has manifested itself with respect to the aggregated balances, but also in relation to the financial flows per sector of Community policy and even per topic. In those instances where the positive or negative spillovers of the economic integration process could not be incontestably quantified, the political tug of war between the Member States about the advantages and disadvantages of Community policy was almost bound to concentrate on cost-intensive forms of Community policy and on the Member States' contributions and the directly quantifiable returns.

However controversial the wish recurrently expressed by the United Kingdom since 1973 for a 'fairer' system for calculating the British contribution to the Community may have been, it has to be admitted in retrospect that the British case elevated the debate about the apportionment of costs and benefits on to a higher plane than that of a 'juste retour' in its various guises. In essence it was a matter of British resistance to the initial contribution, and, in the case of the compensation mechanism designed to cope with this point under the Fontainebleau agreement, of the margins of financial solidarity between the Member States involved in a process of partial integration[12]. As noted above, that solidarity is essential for the stability of the Community; but the benefits, as well as the costs, must be distributed in a structurally acceptable manner. The need to identify and institutionally formulate these margins cannot be avoided by declaring a financially-based evaluation of the direct advantages and disadvantages to be out of order on the grounds of the indirect and diffuse nature of the benefits of the integration process. In the final analysis such an attitude - which, in the Netherlands and also elsewhere, has long been regarded as essentially 'Community-minded' (and beneficial) - is too one-sided, lacking in realism and not very effective. It negates the political relevance of visible financial flows to and from the Community and fails to acknowledge that while the distribution of tangible advantages and disadvantages may be distorted, the distribution of indirect, less tangible advantages and disadvantages may be even more skewed. And if Member States that clearly derive both tangible and less tangible benefits from the process of integration appeal to the intrinsic lack of justification for a simple financial allocation of costs and benefits, this will fail to carry conviction.

Any persuasiveness such an appeal might carry would be completely lost if it were made solely in a debate about the net contributions of the respective Member States and not as part of the debate about the distribution of public resources *between* the Community and the Member States. In the latter debate, the indirect benefits of the process of economic integration also deserve to play a prominent part in arriving at a judgement.

As noted, the refusal to enter into a discussion about the desirability of institutionalized margins for intra-Community financial solidarity is politically ineffective and can have undesired results. Failure to think through the basic premises can mean that the political interplay of forces results in ad hoc solutions that can ultimately seriously interfere with

[12] The correction mechanism on the revenue side of the EC budget is laid down in the Council Decision of 7 May 1985, EEC Journal, series L, no. 128, 14.5.1985, pp. 15–17.

the ability to reach a lasting and acceptable solution to the financing problem. As argued persuasively in the Padoa-Schioppa report referred to earlier, the lack of a durable arrangement laying down the margins of intra-Community financial solidarity can result in a state of affairs where the Member States - out of anxiety that they might ultimately be paying too much or getting too little in return - continually keep a watch over their visible costs and benefits in individual policy sectors or in relation to specialist topics[13]. Inevitably, this spills over into Community decision-making and policy. Clearly a Community that seeks the capacity in the future to implement a technology policy and an environmental policy, that confronts the necessity of a radical reform of its agricultural policy and which needs to have a generous margin for manoeuvre in its external policy, cannot allow the content of all its specialist decisions to be dependent on the geographical distribution in each case of the costs and benefits. Even if it aims at an *overall* distribution acceptable in terms of the equity and convergence principles, the concrete distribution of the visible and invisible benefits of its actual policies can sometimes differ radically since the Community has only limited control over the factors that ultimately determine the distribution.

And finally, does it provide evidence of sufficient insight into the possibilities of the still vulnerable integration process to deny that process an institutionalized compensation mechanism, when an arrangement of this kind is regarded as indispensible in much more deeply-rooted governmental systems with a far longer history?

It would, in brief, not be appropriate to dismiss the vicissitudes of the British contribution as an example of insular stubbornness. The question of appropriate margins for intra-Community financial solidarity may well arise in the near future in relation to (for example) a negative Portuguese or Spanish balance. In these circumstances it will not be easy for the pressures that then arise for 'fair' compensation to be rejected out of hand as non-Community-minded and at variance with the principles of economic integration.

3.5.2. *An institutional correction mechanism in broad outline*

An institutionalized correction to the visible resource flows from the Member States to the Community and the other way round can be worked out and given quantitative expression in a number of ways. Space does not permit the various possible variants and their potential financial consequences for the Community and the individual Member States to be elaborated in this interim report. A number of conditions can, however, be summed up with which a safeguard mechanism would need to comply. These conditions are:

a. Is the mechanism sufficiently objectified, is it of general application and is it applicable to a conceivably large variety of cases? Ad hoc solutions to the temporary problems of selected Member States will fail to achieve the desired result. The problems tend to become entrenched and render the Community budgetary process unnecessarily complicated. They also incite other Member States to insist on specific arrangements. A mechanism that serves generally to limit and objectify claims to an adjustment can therefore have a disciplinary effect.
b. Is the mechanism sufficiently transparent? Does it spell out sufficiently clearly the situations in which the correction mechanism could be resorted to, and are its quantitative consequences for both the Member States making use of the mechanism and the remaining Member States sufficiently precise? Does it, in short, provide sufficient legal certainty in political decision-making on the Community budget and Community policy? Only if the participants in the Community policy-

[13] *Efficiency, Stability and Equity*, op. cit.

making process have the certainty that they will be compensated for whatever they clearly fail to receive in the process will they be prepared to negotiate flexibly in assessing the costs and benefits in individual policy areas or in relation to specific topics.

c. Is the mechanism sufficiently robust? A compensation or correction mechanism that is activated by small or no more than short-lived transgressions of the limits imposed under the system would rapidly become unmanageable, if only for the decision-making and verification problems to which it would give rise. The mechanism should only come into effect if the margins have been significantly exceeded for at least three financial years. In essence it would be a mechanism for *structural* overshoots or undershoots, which in turn have structural origins.

d. The mechanism will need to be consistent with the proportionality and convergence principle. This means that the quantitative financial parameters for triggering the mechanism would need to be a good deal more stringent for the richer than for the poorer Member States. These parameters would be set in such a way that the richer Member States would have to demonstrate the existence of an excessively high negative balance, while in the case of the poorer Member States it would be sufficient to establish an excessively low positive balance.

e. Decision-making about the application of the mechanism will need to be tied, in the sense that an overshoot of the margins laid down under the system would create clear entitlements and obligations for the Member States concerned. This would need to be taken into account in deciding on the form of the trigger mechanism.

3.6 The institutional context

3.6.1 *Linkage between the substantive and the institutional problems of Community financing*

As we have seen, the substantive requirements which the Community budget has to satisfy are in many respects more exacting than the requirements which the national budgets must meet. This applies in particular to the requirements of controllability in the short and medium term, of a balanced geographical distribution of revenues and expenditure and of correspondence between the Community's responsibilities arising, directly or indirectly, under the Treaty and the composition of expenditure. The national budget legislature has considerably more room for manoeuvre in these three respects than does the Community budgetary authority. In this light one would expect the institutional framework for the Community budget to be at least as substantial as that for a national budget. The opposite is, however, the case. The institutional framework for the Community budget exhibits a number of serious built-in shortcomings. The most important of these are:

a. The Community budgetary procedure is not a genuine process of weighing priorities and posteriorities since the bulk of the expenditure consists of obligatory spending that cannot be weighed against other forms of expenditure. This division means that the European Parliament has only a partial right to approve the budget, in that it is confined to non-obligatory expenditure. In practice, however, even this partial right is undermined because the uncontrollable 'obligatory' expenditure under the CAP continually threatens to drive out non-compulsory expenditure, and the Parliament has no say over the substance of the statutory arrangements on which these financial obligations are based.
This means that in terms of evaluation and policy determination, the Community budgetary procedure lacks the significance it has at national level, while its partial democratic backing - at national level, the

traditional right of Parliament to authorize the budget - remains highly vulnerable.

b. The decisions taken by the budgetary authority are not binding on decision-making in the Council. In those instances where Councils are able to overshoot the financial ceilings laid down by the budgetary authority without fear of political or legal sanction, those ceilings lose their disciplinary effect on decision-making. At national level, the decisions taken by the budgetary authority (government and parliament) vertically coordinate the policy decisions taken by the individual ministries, but in the Community there is no such institutional mechanism. Instead, decision-making by the budgetary authority and that by the specialists Councils are horizontally fragmented.

c. In an institutional environment that is sectorally fragmented along policy lines, organized interest groups can operate particularly effectively. There are at least three points within the Community institutional environment which they can lobby: the specialized Council and Commissioner in question; the relevant departmental ministers; and the relevant committee of the European Parliament. In this context, sectoral and national sectional interests tend to reinforce one another. The national budgetary process, in which the articulated wishes are evaluated in the specialist circuits against the available financial margins, forms a particularly effective institutional counterweight to the demands of specific interest groups. The Community budgetary process, by contrast, is unable to fulfil a contra-balancing function along these lines. Indeed, the specialist Councils - which are little enough inclined as it is to exercise strict budgetary discipline - are encouraged by the environment in which they operate to be financially undisciplined, while the Commission and Parliament, whose position in the budgetary process is in any case weak, are unable to act as an effective counterweight.

d. As was seen in the preceding chapters, the functions and responsibilities of the Community have undergone an evolution determined in part by the recent amendments to the EEC Treaty but in part also by the inherent dynamic of the process of economic integration. The determination of the permissible scale of the Community budget and of the resources required to that end needs, therefore, to be *periodical* in nature. It is important to recognize that each and every statement about the permitted size of the Community budget can apply for a limited period only. The Community and the Member States will need to review the overall financial framework for the Community at set intervals, basing the review on the development in the scale and direction of the Community's tasks and not on the growth of expenditure itself. In the absence of a definite institutional framework for decision-making on the Community's structural budgetary policy, the Community will consistently run into financial crises that seriously impede the process of integration.

Given the fragile, fragmented decision-making structure of the present Community with its marked vulnerability to outside lobbying, statements and decisions about bringing expenditure under control, about the margins that need to be taken into account in the geographical allocation of costs and benefits and about the total scale of the EC budget will lack binding force in the policy arena. Indeed, the lack of political or legal enforceability of such statements means that they can continually obstruct and hamper the necessary substantive policy formation and render the relevant decision-making chaotic. As such the conclusion is inescapable that the Community budgetary process requires an institutional foundation providing reasonable assurances that the Community budget will be able to satisfy the conditions set out in Chapter 2 from the viewpoint of control, convergence and policy concordance. The Community budgetary authority is even less able than the national budgetary

authority to do without a consistent and binding institutional framework for the budgetary process. The institutional framework for the Community budget will only be able to fulfil the exacting substantive demands made of it if it is radically reviewed and supplemented. The strategy outlined below for dealing with the institutional problem is consistent with the substantive recommendations made in the preceding sections. Other variants, which are not discussed, would certainly be possible but, like the variant outlined below, these would need to fulfil the fundamental requirement that the budgetary procedure should enable the budgetary authority to discharge its responsibilities in the specific Community context. This is certainly not the case at present.

3.6.2 *The institutional framework for budgetary policy*

In its report 'The Unfinished European Integration', the WRR discussed the fact that the strategic political decisions that determine the progress and shape of the integration process are taken by the Member State governments and that the decision-making, even though frequently instigated by Community institutions, often bears a clear intergovernmental imprint[14]. These decisions concern the amendment and supplementation of the Community treaties, the accession of new Member States, arrangements to strengthen European economic and monetary cooperation and new Community functions. Within the margins laid down by these strategic decisions, the Community conducts its policies in accordance with the decision-making procedures provided for in the Treaties. The WRR - and not just it alone - has pointed out that the 'ordinary' Community decision-making dominated by the Council is not particularly efficient and readily becomes over-burdened. The present decision-making structure does not really lend itself to more managerial-style policies, which require recurrent 'directive' decisions. For preference it should instead be used to make the most important policy choices within the policy framework jointly designated by the Member States and the Community. If it is not to get bogged down, the Council will have to delegate its involvement with policy as a 'going concern' to the Commission, which will have to be given increasing policy powers. In devising the appropriate institutional structure for the budget process, it is important to distinguish these three levels discernible in the substantive decision-making processes of the Community.

a. The *strategic decisions* relate to the structural financial framework for the Community (i.e. the overall expenditure ceiling and the corresponding level of own resources), the proportion of the budget to be allocated to cohesion spending and the permitted ceiling for agricultural spending.
   At issue here is the *global* yet at the same time internally *binding* planning of Community budgetary policy in the medium term (five years), which also helps establish the guidelines for the evolution of the Community's substantive tasks and responsibilities and the policies it is required to implement. This structural financial planning would introduce into the Community's decision-making structure the minimum of vertical coordination needed for a balanced and responsible development of the Community budget.

   The decisions taken about the structural financial framework itself would be largely an intergovernmental matter, since consensus would be required on the part of the Member States with respect to the way in which the integration process should evolve. During the initiating and preparative stages, by contrast, the accent will need to switch more to the Community:

- taking account of the development of the Community's tasks in the

[14] WRR, op. cit.

medium term, the Commission draws up a draft financial framework in which proposals are made concerning the overall financial ceiling, the share of convergence expenditure and the share of agricultural spending. These proposals should be substantively based on indications of the Community policies to be implemented during the planning period;

- the draft financial framework is submitted to the European Parliament, after which it is adopted in line with the Parliamentary reaction;
- *on the basis of the proposals*, the European Council determines the permitted increase in the expenditure ceiling, together with the shares of agricultural and convergence expenditure. In deciding on the detailed nature of the decision-making procedure in the Council, account will need to be taken of the strategic and in many respects fundamental character of the decisions to be taken. Consideration of these questions in the Finance Council and the most important specialized Councils by way of preparation for the final decision may well be useful. Institutionalized, periodic statements about the strategic development of the integration process imposes considerable demands on the governments of the Member States. It would, however, have the major advantage that the potential exchange of views and interests would be concentrated into a single decision-making moment and confined to essential questions.

b. The Community's *budgetary policy* will need to take place within the confines of the structural financial framework. The decision-making on the budget can have a more pronounced Community flavour than that on the structural framework. In drawing up the budget, the Community budgetary authority weighs the Community's cost-intensive tasks and responsibilities and the allocation of the *available* resources to those tasks and responsibilities *within* the margins of the binding framework. The results of the decision-making, in the form of the annually determined budget, should in turn be binding on the decisions taken in the specialist Councils. The introduction of a more or less compulsory legal link between budget and policy, as provided for under national government accounts legislation, would remedy two fundamental shortcomings in Council decision-making. The horizontal coordination within the sectoral formations of the Council would be strengthened, while utterances by the budgetary authority and the content of substantive policy would be brought more closely into line with one another. The fragmentation currently so characteristic of Community decision-making would be overcome, and supra-sectoral interests would receive greater emphasis. The decision-making procedure of the budgetary authority would be drawn more closely into line with that of the national budget legislature responsible for weighing alternatives and authorizing expenditure, except that it would be subject to the structural financial framework.

- The European Commission draws up the annual draft budget.
- In consultation with the Commission, the Budget Council finalizes the draft budget and submits it to the European Parliament.
- The Parliament debates the draft budget and, after consultation with the Council, adopts it as budget.
  The qualified exercise of budgetary powers as proposed above would mean that the weighing and authorizing functions of those powers would find much clearer expression than they do now. The fact that the Parliament would share substantive powers with the Council for the *entire* budget would mean an increase in its influence over the substantive policies of the Community, since the latter would be bound by the budget. By this means the democratic 'cover' for Community policy would be appreciably strengthened.
- With respect to consultation between the Council and the European

Parliament prior to the actual determination of the budget, detailed rules of decision could be laid down, derived from national budgetary procedures.

- A system along these lines would necessarily involve abolishing the distinction between obligatory and non-obligatory expenditure. By linking material policies to the budget it would enforce expenditure control, both in its totality and per budgetary chapter.
- Unforeseen circumstances could compel an interim reallocation of resources or an increase in the expenditure total. In these circumstances authority will need to be obtained in the form of a supplementary budget that goes through the same procedure as the 'ordinary' budget. Needless to say the budgetary authority would still remain bound by the current structural financial framework. This would constrain the budgetary authority in its budgetary policy to provide for a certain reserve within the set limits.

c. The Community accent will become more pronounced in the *execution* of the annual budget. Under the definition of its functions in the Treaties, the European Commission is called upon to monitor the link between policies with expenditure implications and the pronouncements of the budgetary authority. Its role in the preparation and implementation of these policies will be able to grow correspondingly. A requirement under the Treaty for the Community institutions to observe budgetary discipline in implementing policies will necessarily render decision-making more mobile. A more far-reaching delegation of policy-implementation powers to the Commission would therefore appear unavoidable. This certainly applies to the management of the feedback mechanisms in the various CAP regimes, because the Council is not institutionally equipped to handle the decision-making burden that the financially responsible application of those mechanisms would entail. The same applies to the management of the structural funds.

Apart from the administrative and legal monitoring by the Commission of the links between policy and the budget, Parliament can, as one arm of the budgetary authority, strengthen its political control over the adherence of Community policies to budgetary constraints. Such monitoring is required if the authorizing function of the Parliament's budgetary powers are to find practical expression.

3.6.3 *The institutional framework for budget management*

A number of shortcomings in the management of the Community budget were summed up in Chapter 1. Compared with the central issues in Community financing, such as the permitted budgetary ceiling and the volume of own resources, these shortcomings attract little political interest. In terms of the legitimacy of the Community and the activities of its institutions, however, the evident lacks in Community budget management form a serious drawback and will need to be addressed by the Community in its efforts to resolve the financing problems. Space does not permit a detailed analysis in this interim report of all the evident shortcomings; instead a number of general recommendations must suffice.

The current management problems may be traced to three main causes:

- In the first place the lack of discipline is a source of disorderly conduct in the institutionally far from satisfactorily worked out budgetary policies and, worse, in budget management. The improper accounting practices for valuing the agricultural surpluses in intervention storage, as noted in Chapter 1, the transfers within the budget from one financial year to the next and the carryover of financial obligations from one year to the next stem directly from shortcomings in budgetary po-

licy. The disciplining of that policy in the sense discussed above could therefore mean that, as a positive side-effect, significant elements of budget management were subjected to discipline too.

- Secondly all sorts of disciplinary shortcomings arise from the nature and content of the substantive regulations under which specific payments are made. Particular difficulties arise in relation to the decentralized management of the CAP regimes and the management of the structural funds, governed as these are by numerous detailed regulations. More responsible Community budget management would necessarily entail the review of the substantive regulations governing expenditure. One problem in this respect is the comparative indifference on the part of the Community legislature - like, for that matter, the national legislature - to the managerial implications of its legislative and administrative provisions. However, given the fact that a review of the rules and regulations governing the Common Agricultural Policy and structural policy will be unavoidable in the interests of responsible budgetary *policy*, the opportunity also arises of making those regulations more appropriate from a viewpoint of budget *management*. The Commission and European Parliament, in particular, will need to concern themselves more actively with this aspect, since the members of the Council can be expected to display little interest in the managerial aspects of the Community budget.
- A third cause of managerial shortcomings is the inadequate control over the execution of the budget. There are three aspects to this problem. In the first place it is a problem of competency, in the sense that the controlling powers of the Commission, European Court of Auditors and the European Parliament are not geared to the nature and scale of the supervisory tasks. Secondly it is a problem of resources, in that the machinery of the Commission and European Court of Audit is not equipped to deal with the scale of the control function. Finally, it is a problem of method: should control be confined to an examination of legality, or should it extend to the efficiency of expenditure?

The competency aspect centres on the politically sensitive issue in the Community as to whether, and to what extent, the Community should have independent powers to investigate the way in which national administrations apply cost-intensive Community regulations. The administrative capacity aspect is not just quantitative but also qualitative, in the sense that effective Community control demands familiarity with national administrative practices, which may not always be present on sufficient scale in the relevant Community institutions. While there is an almost natural preference within the legalistic Community administrative culture for a limited right to assess legitimacy, there are strong arguments for more far-reaching powers in this respect, in that most forms of Community expenditure have instrumental policy implications. Checks on the efficiency of expenditure would serve to strengthen insight into the instrumental value of the various categories of expenditure and hence contribute towards a more appropriate allocation of resources in policy terms.

Numerous technically adequate solutions are conceivable for overcoming the various obstacles towards more effective control over Community expenditure. A number of these have been floated by the Commission. Generally, however, these proposals entail a diminution in the administrative autonomy of the Member States. As such they are not warmly received in the Council. It is possible that the growing interest in the administrative aspects of the budget at national level can persuade the Member States to address themselves to the implications for their own bureaucratic machineries of a responsible management of the Community budget. The Dutch representatives on the Council could draw more attention to this problem, which is gaining in significance with the growth of the Community budget.

3.6.4 *Coercive Treaty-based rules of decision*

Given the present state of European economic integration, the Community budget process cannot be wholly modelled on national budget procedures. If the Community budget is to satisfy four fundamental requirements, namely:

- a development of the budget reflecting the tasks and responsibilities of the Community;
- maintenance of budgetary equilibrium and control over expenditure;
- geographical distribution of income and expenditure in accordance with the convergence principle;
- a binding link between the budget and substantive Community policies,

the budgetary process will then have to be conditioned by operationally and institutionally coercive rules of decision.

These rules of decision to which all actors in the budget process would be bound have been discussed in various places above. They constitute the necessary rules of the game for a proper solution to the financial crises with which the Community is continually faced. In the absence of coercive rules of decision of this kind, each and every political or administrative pronouncement about resolving the Community's financial problems, irrespective of the level at which or person by whom it is made, will remain without effect simply because the present institutional decision-making structure of the Community is unable to carry it through. Put somewhat baldly, the present structure gives the Member States licence to act in a schizophrenic manner by on the one hand demanding that Community spending be brought under control while on the other persisting with policies that render that expenditure uncontrollable. Coercive rules of decision would also prevent the solution to budgetary problems from being made dependent on - and not infrequently ruled out by - concessions not in fact related to the issue in question.

The coercive rules of decision proposed in this report do not of course provide the sole possible solution to the financing issue. A number of other variants are possible, each of which would in themselves be consistent and effective. It would, for example, be possible to work out a more Community-oriented or prefederal variant, or an intergovernmental variant. The WRR considers, however, that the system of substantive and institutional checks and balances for the Community budgetary authority that it has worked out is the most closely in tune with the present stage of the integration process. Future developments could of course necessitate adjustments in one direction or another.

A summary of the proposed coercive rules of decision is provided below by way of conclusion to this interim report.

1. In order to ensure that the development of Community tasks and the Community budget move in parallel, the European Council would draw up a structural financial framework once every five years, which would be binding on the budgetary authority.
2. In order to keep the budget in balance and to control expenditure, the annual growth of the budget would be tied to the financial framework and substantive policies to the budget. In the case of agricultural expenditure there would be a double linkage: in the first place spending would be limited to a ceiling laid down as part of the financial framework, and secondly it would be limited to the annual budget within that ceiling.
3. The geographical allocation of Community income and expenditure would be based on the convergence principle. If the governments of the Member States, in their capacity as Treaty legislature, lack the vision to subject the Community budgetary process to rules of this kind, it must be feared that they will cripple the development of the

Community with a permanent financing problem. On the revenue side, the proportionality principle in terms of national ability to pay would apply; on the expenditure side a percentage of Community expenditure, to be determined once every five years, would be assigned to the less prosperous regions.

In the case of serious structural imbalances between Member State contributions and what they receive from the Community, a general objectified compensation would take place retrospectively.

4. The cohesion between the budget and substantive policy would be achieved by an explicit administrative and legal limit on cost-intensive Community policies. This would be done by binding expenditure in general terms to the financial framework and more specifically to the content of the budget.

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The Council commissioned a number of experts to carry out preliminary studies for the report 'A Coherent Media Policy'. The following studies were published in a separate series entitled 'Media Policy Background and Preliminary Studies' (in Dutch):

M 1 J.M. de Meij: Overheid en uitingsvrijheid *(The Government and Freedom of Speech)* (1982)

M 2 E.H. Hollander: Kleinschalige massacommunicatie; locale omroepvormen in West-Europa *(Small-scale Mass Communications: Local Broadcasting Forms in Western Europe)* (1982)

M 3 L.J. Heinsman/Nederlandse Omroep Stichting: De kulturele betekenis van de instroom van buitenlandse televisieprogramma's in Nederland – Een literatuurstudie *(The Cultural Significance of the Inflow of Foreign Television Programmes in the Netherlands – A Survey of the Literature)* (1982)

M 4 L.P.H. Schoonderwoerd, W.P. Knulst/Sociaal en Cultureel Planbureau: Mediagebruik bij verruiming van het aanbod *(Media Use and a Wider Media Range)* (1982)

M 5 N. Boerma, J.J. van Cuilenburg, E. Diemer, J.J. Oostenbrink, J. van Putten: De omroep: wet en beleid; een juridisch-politicologische evaluatie van de Omroepwet *(Broadcasting – Legislation and Government Policy: A Legal and Political Evaluation of the Broadcasting Act)* (1982)

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1. *Europese Unie* (European Union), 1974.
2. *Structuur van de Nederlandse economie* (Structure of the Netherlands Economy), 1974.
3. *Energiebeleid op langere termijn* (Long-term Energy Policy,) 1974. Reports 1 to 3 are published in one volume.
4. *Milieubeleid* (Environment Policy), 1974.
5. *Bevolkingsprognoses* (Population Forecasis), 1974.
6. *De organisatie van het openbaar bestuur* (The Organization of Publis Administration), 1975.
7. *Buitenlandse invloeden op Nederland: Internationale migratie* (Foreign Influence on the Netherlands: International Migration), 1976.
8. *Buitenlandse invloeden op Nederland: Beschikbaarheid van wetenschappelijke en technische kennis* (Foreign Influcence on the Netherlands: Availability of Scientific and Technical Knowledge), 1976.
9. *Commentaar op de Discussienota Secorraden Wetenschapsbeleid* (Comments on the Discussion Paper on Sectoral Council of Science Policy), 1976.
10. *Commentaat op de nota Contouren van een toekomstig onderwijsbestel* (Comments on the White Paper on the Contours of the Future Education System), 1976.
11. *Overzicht externe adviesorganen vna de centrale overheid* (Survey of External Advisory Bodies of the Central Government), 1976.
12. *Externe adviesorganen van de centrale overheid, beschrijving, ontwikkelingen, aanbevelingen* (External Advisory Bodies of the Central Government: Description, Developments, Recommendations), 1977.
13. *'Maken wij er werk van?' Verkenningen omtrent de verhouding tussen actieven en niet-actieven* ('Do we make Work our Business?' An Exploratory Study of the Relations between Economically Active and Inactive Persons), 1977.
14. *Overzicht interne adviesorganen van de centrale overheid* (Survey of Internal Advisory Bodies of the Central Government), 1977.
15. *De Komende vijfentwintig jaar, een toekomstverkenning voor Nederland* (The Next Twenty-Five Years: a Survey of Future Developments in the Netherlands), 1977.
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Second term of office

17. *Etnische minderheden – A. Rapport aan de Regering; B. Naar een algemeen etnisch minderhedenbeleid?* (Ethnic minorities – A. Report to the Government; B. Towards on Overall Ethnic Minorities Policy?), 1979.
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Reports nos. 13, 15, 17, 18, 28 and 31 have been translated into English; English summaries are available of Reports nos. 16, 18, 19, 20, 25, 26, 27 and 29; Report no 23 has been translated into German.