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EC

## Distributional Effects of the EC Budget

by Angela Nottelmann, Hamburg\*

**The continuing dispute concerning the distribution of EC budgetary contributions among the member states, felt to be unjust particularly by Britain, has been marring the Community's public image for some time now. How is this distribution effected and what possibilities are there for readjustment?**

Spectacular clashes over budgetary issues have been part and parcel of everyday affairs in the EC for over two years now. Particular attention is focused on the state of the EC fiscal transfers, with Britain leading the attack in denouncing existing disproportions. The measures agreed upon during the past have generally failed to solve the problem, their main mistake being that they viewed the problem as a temporary one. In reality, however, some characteristic shortcomings inherent in the budgetary system have led to unsatisfactory financial repercussions.

The contributory payments of the member states are regulated according to the so-called Community's "Own Resources" system<sup>1</sup>. The EC has exclusive sovereign powers over the revenue resulting from customs duties and agricultural levies ensuing from trade with third countries. In addition, it is entitled to a part of national VAT revenues, which must not exceed 1 % of a common basis of assessment. The VAT serves to make up for that part of annual financial requirements not covered by the remaining revenue. The foreign trade and VAT revenue components are at the moment of roughly the same size<sup>2</sup>.

Whereas the percentage figure of payable VAT is the same for all member states, the payments thus being closely linked to the individual countries' actual economic strength, the national differences in economic structure and political and economic ties with third countries have resulted in disproportions in terms of customs revenues foregone by the various EC countries. Those members with substantial imports from third countries bear the brunt of revenue payment to the EC budget. Factors of trade policy and agricultural policy determine to a great extent the taxation of the member states, lead to imponderabilities and in fact prevent the countries from being burdened according to their ability to pay. A correcting mechanism based on the criterion of fair taxation does not exist with regard to Community revenue.

The allocation of Community spending reflects the differing degrees of integration in the various economic sectors. The Common Agricultural Policy (CAP) is the only policy which has as yet seen practical application, on a large scale, of the principle of financial solidarity. The remainder of the common sectoral policies envisaged in the EEC-Treaty have not been developed beyond their initial stages. Consequently, about two thirds of total budget resources are channelled into agriculture so that the share of any one member state in the EC transfer payments closely corresponds to its retransfer share of the guarantee section of the European Agricultural Guarantee and Guidance Fund (EAGGF) (cf. Table 1). The latter, for its part, depends on the widely varying size and structure of agricultural production in the individual member states.

The often criticised "over-emphasis on agricultural policy" in the budget is not the result of the undoubtedly existing inefficiencies within the CAP, but of the stagnation of European integration. (Calculations relating to models which are supposed to be more efficient in preventing surplus production suggest that in the medium term the budgetary expenditure on the European agricultural sector cannot be substantially reduced.) If other Community policies had been developed as far as the agricultural policy, the resulting distributional effects of the budget would probably have appeared fairer.

Since the financial requirements and economic strength of individual countries have not been decisive for the direction of fiscal transfer via the EC budget, unplanned distributional effects have occurred. After being pressured by some of the member states, the EC Commission, with many reservations, has tried to quantify these effects of the budgetary system. This was

<sup>1</sup> Cf. the Council Decision of 21 April 1970 on the Replacement of Financial Contributions from Member States by the Community's "Own Resources", in: Official Journal of the EC, Series L 94 of 28 April 1970.

<sup>2</sup> Cf. General Budget Plan for the European Communities for the Financial Year 1982, in: Official Journal of the EC, Series L 31 of 8 February 1982.

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done by calculating the countries' so-called net positions, i.e. the balance of the payments made to the EC and the payments received as a result of Community policies.

Calculations for 1980 and 1981 – up to now the only years in which the financial contributions of the three acceding countries of the first enlargement phase, Britain, Ireland and Denmark, were not limited by transitional stipulations – have revealed that the only countries to record a surplus of in-payments over retransfers are the Federal Republic of Germany and Britain. Among the net recipients are Denmark, the Netherlands and France, which register a similarly high per capita GDP to Germany, and a much higher one than Britain (cf. Table 2)<sup>3</sup>.

The budgetary resources are thus being redistributed in favour of some of the most prosperous states and at the expense of one of the less prosperous ones. As far as Germany is concerned, the problem is not so much the fact of being a net contributor. Its primary concern is its position compared with the high net recipient positions registered by countries which are similarly prosperous. The transfers in their favour have led to net payments *the extent of which* cannot be justified.

Despite the apparent weaknesses in the EC's financing system, Britain's repeated demand for a substantial relief of its financial burden – a demand

which has increasingly been voiced by Germany, too, with regard to its own contribution – was not immediately viewed as justified. The reason is to be seen in the diverging assessments by the EC-countries and the EC-organs of the legitimacy and meaningfulness of the net position with regard to the question of financial equity:

□ Legal doubts are levelled against the calculations, since they imply that the contributions to the EC budget amount to a financial quantity to which, basically, the member states are entitled. The latter's acceptance of the EC's own resources system in 1970, however, was at the same time a relinquishment of any national entitlement to these resources.

□ Neither can the EC budgetary receipts and expenditures be assigned completely to the individual member countries, nor can they be assigned in such a way as to reflect the actual economic effects of the EC budget on these countries. The net position is defined with reference to budgetary accounting rather than to the economic effects of receipts and expenditures<sup>4</sup>.

□ Finally, the net position has in the public discussion frequently been used as a yardstick for the benefit of Community membership to any one particular country. Not only does such an approach ignore the effects of EC membership in the field of trade, effects which are important though difficult to quantify, but also the activities of the European Investment Bank, the European Development Fund and the lending and

<sup>3</sup> Belgium and Luxembourg reveal high positive net transfers, which cannot, however, be compared with those of other countries, since a large part of the EC administrative expenditure is included in the calculation. How far these can be classified as payments received is a subject of controversy.

<sup>4</sup> A more detailed analysis can be found in Angela Nottelmann: *Der Haushalt der EG – Probleme und Reformvorstellungen* (The Budget of the European Community – Problems and Possible Reforms), Hamburg 1982, part I.

**Table 1**  
**Basic Data and Financing Key, 1980 and 1981**  
(in %)

Countries <sup>b</sup>	1980				1981 <sup>p</sup>			
	GDP share	Financing share	Retransfer share <sup>a</sup>	Retransfer share from EAGGF, Guarantee <sup>a</sup>	GDP share	Financing share	Retransfer share <sup>a</sup>	Retransfer share from EAGGF, Guarantee <sup>a</sup>
Belgium	4.2	6.2	7.9	5.1	3.9	5.7	7.9	4.8
Denmark	2.4	2.3	4.5	5.4	2.3	2.1	3.8	4.8
France	23.4	19.4	22.2	25.1	23.6	20.4	23.9	28.0
Fed. Rep. of Germany	29.5	29.9	19.5	21.7	27.9	28.4	17.4	19.8
Ireland	0.6	0.9	5.2	5.0	0.7	0.9	4.6	4.0
Italy	14.1	12.3	17.4	16.2	14.3	13.1	17.9	17.5
Luxembourg	0.2	0.1	1.7	0.1	0.1	0.1	1.9	0.1
Netherlands	5.7	8.2	11.2	13.6	5.3	7.3	8.5	10.5
United Kingdom	18.5	20.7	10.3	7.8	20.3	20.5	11.8	9.5

<sup>p</sup> = Preliminary.

<sup>a</sup> = Own calculations according to Commission data of November 1981.

<sup>b</sup> = Due to the transitional regulations, Greece was not included in the calculation.

Sources: Commission of the European Communities: Annual Economic Review 1981-1982, Brussels 1981; European Parliament: General Budget Plan for the European Communities for the Financial Year 1982, in: Official Journal of the EC, Series L 31, 8 February 1981.

**Table 2**  
**National Fiscal Transfers and per capita GDP**  
 (in ECU)

Countries	1980			1981 <sup>p</sup>		
	Per capita GDP <sup>a</sup>	Net position in ECU million <sup>b</sup>	Net per capita transfer	Per capita GDP <sup>a</sup>	Net position in ECU million <sup>b</sup>	Net per capita transfer
Belgium	8,469	236	24	8,637	317	32
Denmark	9,329	326	64	10,055	281	55
France	8,739	422	8	9,619	536	10
Fed. Rep. of Germany	9,622	-1,531	-25	9,932	-1,770	-29
Ireland	3,646	650	190	4,188	588	169
Italy	4,971	739	13	5,506	775	14
Luxembourg	8,493	206	564	8,767	270	740
Netherlands	8,092	459	32	8,288	215	15
United Kingdom	6,620	-1,507	-27	7,975	-1,376	-25

<sup>p</sup> = Preliminary.

<sup>a</sup> = At current prices and exchange rates.

<sup>b</sup> = According to EC Commission data of April 1982.

Sources: Commission of the European Communities: Annual Economic Review 1981-1982, Brussels 1981, Statistical Appendix; own calculations.

borrowing activities of the Community, which are not contained in the budget. The EC's political dimension, too, is ignored completely.

The net position cannot therefore assume the function of an overall indicator of the costs and benefits of Community membership. Regardless of these reservations and weaknesses, however, the extreme positions shown in the respective statistics (cf. Table 2) indicate the need for a certain degree of readjustment in the EC's budgetary system. The finer details of the EC's fiscal transfers cannot be measured by the net position. However, for lack of more generally accepted and suitable assessment criteria, the net position is the only indicator in which the effects of a wide range of Community policies are expressed in a quantitative form.

The volume of the EC budget in 1982 will probably amount to ECU 22 billion (about DM 54 billion)<sup>5</sup>. In a

<sup>5</sup> Cf. West German Federal Ministry of Finance: Der Haushalt der Europäischen Gemeinschaften 1982 (The Budget of the European Communities 1982), in: BMF Dokumentation, 1982, No. 1, February 8, 1982.

<sup>6</sup> Regulation (EEC) No. 1172/76 by the Council of 17 May 1976 on the Creation of a Financial Mechanism.

<sup>7</sup> Cf. *ibid.*

<sup>8</sup> Cf. Commission of the European Communities: Report on the Application of the Financial Mechanism, COM (81) 704 fin., Brussels, November 13, 1979.

<sup>9</sup> Cf. Geoffrey Denton: How to Prevent the EC Budget Reinforcing Divergence: A British View, in: Michael Hodges, William Wallace (ed.): Economic Divergence in the European Community, London 1981, p. 95.

situation characterised by considerable strains on national budgets, this is a magnitude in view of which the direction and the amount of fiscal transfers can no longer be regarded as unimportant. In addition, this estimated sum would almost reach the 1 % ceiling of own VAT resources, at present the upper limit. The prevailing distribution of budgetary burdens is given by those countries who feel they are discriminated against as the reason for their negative attitude to further increases in the Community's budget resources. For several years now certain countries have been blocking the development of new policies or the continuation of existing ones, not least for fear of additional financial burdens. If a financial crisis is to be avoided and progress made in integration via the stimulation of common policies, those politically responsible in the EC must bring about agreement on a "systematic" fiscal equalisation, with a corresponding set of policy tools.

Up to now, attempts at adjusting the national contributions have focused on Britain's situation, and, as shown by the latest controversy, have not come up to expectations. The oldest and at the same time most promising measure was the introduction of the so-called financial mechanism in January 1976. This mechanism, which was formulated in a general way, yet tailored to Britain's specific situation, envisages, within a trial period of seven years, repayment of contributions to member countries which find themselves in a special economic situation and whose economy has borne an unreasonable burden in financing the Community budget<sup>6</sup>. Such a special situation or unreasonable burden is established by referring to a number of different indicators, most of which are related to the national product<sup>7</sup>. The conditions for repayment, however, are formulated in such a restrictive way that the financial mechanism, even after being eased in 1980, is never likely to be applied during its entire period of validity<sup>8</sup>. In addition, the allocations to a member country were restricted to a maximum of 3 % of total expenditure in any one financial year, thus limiting the redistributive effects of the financial mechanism. No reasonable justification for this limitation can be found<sup>9</sup>.

The principles underlying the financial mechanism, however, could well point the way towards a solution of the problem of fair distribution of financial burdens: considering the continuing disproportions in the budgetary system, the existence of an automatic kind of corrective mechanism must be regarded as advantageous; the permanent negotiations, in which a solution to the contribution problem is linked to ever new conditions which have little to do with the problem in hand, would then become superfluous. Most useful

would be to link the corrective adjustment to indicators which take both the relative prosperity of the member countries and the transfers via the budget into account.

Such a mechanism, however, can only serve to correct the *effects* of Community policies *ex post*. The structure of the revenue and expenditure sides of the budget is not affected, and thus the *cause* of the imbalances is not eliminated. The EC Commission expressed the fear that the setting-up of this kind of mechanism to limit contributions would have negative effects on the process of integration in the long run: a country whose net contributions are severely limited would thus have the possibility of avoiding the financial implications of policies which it had helped bring about or adopting an indifferent attitude towards the development of new Community policies<sup>10</sup>.

Indeed, there can be no doubt that a long-term solution of budgetary problems must be reached primarily by changing the structure of expenditure. However, considering the imminent depletion of the Community's own resources and the still low level of integration, such an approach would not appear to be viable in the medium term. The policies of the Community should not be changed just in order to achieve better fiscal equalisation, if no other reasons support such changes and programmes for new

Community policies are not yet far-advanced<sup>11</sup>. In the present situation, therefore, the fact that Community policies are not affected by the financial mechanism should rather be seen as a positive factor.

Since the hopes of reducing conflict potential in the question of budgetary burdens by creating the financial mechanism were not realised, the British government pushed through additional measures in May 1980. A request made to the EC Commission forms the essential feature of the resolutions passed by the Council of Ministers. The Commission was asked to develop a concept for a solution to the problem of fair contributions, taking the situation and interests of all member states into account, so that in future no new unacceptable situation would occur for any one member country<sup>12</sup>.

Since the Commission was given until summer 1981 to work out such a concept, an ad hoc measure in Britain's favour was agreed upon for the financial years 1980 and 1981. Based on the Commission's estimates of the national fiscal transfer balances, Britain was assured a refund of ECU 1,175 million for 1980, its net contribution then being ECU 609 million. In 1981 Britain was to receive a refund amounting to ECU 2,140 million, being left with a net contribution of ECU 730 million. Should the British net position be greater than the respective estimated levels, further graduated forms of relief would be considered.

In reality, however, a quite different situation occurred, one for which no provision had been made in the resolution of May 30: Britain's net contributions to

**Table 3**  
**Estimated and Actual Net Positions of EC Member States<sup>a</sup>, 1980 and 1981**  
(in ECU million)

Countries	1980			1981		
	Estimate of May 30, 1980	Net positions before relief for UK <sup>b</sup>	after relief for UK <sup>c</sup>	Estimate of May 30, 1980	Net positions before relief for UK <sup>b</sup>	after relief for UK <sup>c</sup>
Belgium	484	236	188 to 174	600	317	544 to 513(BLEU) <sup>d</sup>
Denmark	422	326	303 to 296	560	281	262 to 240
France	15	422	163 to 82	20	536	344 to 119
Fed. Rep. of Germany	-1,192	-1,531	-1,877 to -1,982	-1,330	-1,770	-2,006 to -2,285
Ireland	535	650	642 to 640	670	588	582 to 575
Italy	808	739	590 to 544	830	775	661 to 525
Luxembourg	287	206	204 to 202	320	270	Cf. BLEU
Netherlands	425	459	396 to 373	560	215	173 to 122
United Kingdom	-1,784	-1,507	-609 to -332	-2,140	-1,376	-730 to +34

<sup>a</sup> Excluding Greece.

<sup>b</sup> According to EC Commission data of April 1982.

<sup>c</sup> The margins result from the various possibilities of interpreting the "May 30" resolution by the EC member states.

<sup>d</sup> BLEU: Belgium-Luxembourg Economic Union.

Sources: West German Federal Ministry of Finance; BMF Finanznachrichten No. 26, June 11, 1980; own calculations.

the Community budget were much lower than the Commission had estimated, particularly in 1981 (cf. Table 3). The reason for the miscalculation was an unexpectedly low increase in agricultural expenditure – only 3 % instead of the expected 12 %. This was due, on the one hand, to the high world market prices for agricultural products induced by the development of the dollar, and on the other, to the combined effect of the devaluation of the lira, the revaluation of the £-sterling, and the drop in monetary compensatory amounts before October 1981. It is still not clear whether Britain has to pay net contributions of ECU 609 million and ECU 730 million respectively, as originally provided for in the resolution of May 30, or whether irrespective of its actual net position it should receive refunds of ECU 1,175 million and ECU 2,140 million – and thus move, for 1981, into the position of net recipient (ECU 34 million).

The low level of net contributions in 1980 and 1981 compared to the initial estimates cannot be seen as a trend which might make new regulations superfluous. They were the result of considerable fluctuations in exchange rates, which cannot be traced back to any long-term change in important economic data. Moreover, the fact remains that without an equalisation payment Britain would be the only net contributor, apart from Germany, its net payments being almost as high as Germany's.

The report presented by the Commission in the summer of 1981, as mandated in the resolution of May 30, 1980<sup>13</sup>, plans the setting-up, for a limited period of time, of a special kind of financial mechanism, which is specifically designed for the British situation. As opposed to the existing general financial mechanism, the criterion for possible refunds is not the contributory position with regard to the general budget, but the recipient position in the Agricultural Guarantee Fund. The Commission proposes to establish the extent of the imbalance to be rectified by comparing the United Kingdom's share in the Community's gross national product with the United Kingdom's share of the EAGGF (Guarantee) intervention sums within the overall expenditure of this section of the Fund<sup>14</sup>. The implementation and financing modalities are not described in concrete terms.

One positive aspect of this concept is the fact that once again an automatic kind of corrective mechanism was suggested. Another is the attempt to move away from the controversial indicator, net position, and to apply the lever directly to one of the basic causes of the imbalances in the distribution of resources, namely the agricultural sector. However, on the whole the suggestion remains unsatisfactory:

□ The most important point to be criticised is the limitation of the problem to the British situation. The unbalanced distribution of financial burdens in the budget is already now no longer a purely British problem. The British example only goes to illustrate the situation most clearly. A mechanism which only applies to Britain would not last long during the second phase of enlargement of the Community.

□ The fact that the size of the (gross) contributions made by the member countries to the EC budget is no longer taken into account when deciding on refunds, is a further weakness. This means that one of the decisive reasons for the unequal financial burden of individual countries is left unconsidered.

□ Finally, the share of any one particular country in the Community's gross national product, calculated at current prices and exchange rates, serves as the only indicator for the relative prosperity of that country. The drastic appreciation of the £-sterling against the ECU, which was in no way a sign of an improved economic situation in Britain, underlines that the indicator, gross national product, which is dependent on exchange rates, is inadequate as a criterion of a country's ability to pay.

The proposals put forward by the Commission were obviously not likely to bring about general agreement and are no longer the subject of negotiations. More recently the discussion has focused on the so-called Thorn-Tindemans proposal<sup>15</sup>. It contains a five-year relief regulation in Britain's favour. For the years 1982 to 1984, a pre-determined fixed sum (the same sum each year) is to be refunded. The amount is to be determined by means of a comparison between Britain's GDP share and Britain's retransfer share. A correcting possibility is planned if actual development deviates more than 10 % from the estimates. In such a case re-negotiations are to be carried out.

A further adjustment is to be carried out if the British share of the Community's VAT revenues exceeds the share of the Community's gross national product. For 1985 and 1986, the level of the refunds is to be determined by a unanimous decision of the Council of Ministers.

The only argument which can be put forward in favour of this proposal is its practicability. Otherwise, it represents a serious step backwards in comparison with

<sup>13</sup> Cf. Commission Report on the Mandate of May 30, 1980, in: Bulletin of the European Communities, Vol. 14 (1981), Supplement No. 1.

<sup>14</sup> Ibid.

<sup>15</sup> Cf. This plan is so complicated that it just might work, in: The Economist, March 27, 1982, p. 55 f.

the other attempts made at solving this problem. Not only does the proposal ignore the fact that the problem of distributing the financial burdens of the EC-budget is not a specifically British one, but it does not seem to recognise that, given the present budget structure, a long-term solution is needed. Instead of an agreement which, basically, only covers three years, a mechanism should have been created which applied to all member countries, and which could register the need for corrections and make adjustments automatically where necessary.

Furthermore, apparently no lessons have been learnt from the miscalculations of the net transfers for the financial years 1980 and 1981: yet again a fixed refund is to be laid down *ex ante*. The future development of the Community's revenue and expenditure is known to be characterised by considerable uncertainties<sup>16</sup>. Bearing

<sup>16</sup> Cf. on this point, Angela Nottelmann, *op. cit.*, part II.

this in mind, it seems inexplicable that fixed equalisation sums should be opted for, and not some form of percentage figure.

One cannot avoid the impression that the fiscal equalisation planned is to be determined merely by the other member states' willingness to pay and not by reference to relevant economic criteria.

If this proposal, or a similar one, is accepted – the one-year regulation for 1982, agreed on May 25, has merely postponed further negotiations until the end of the year – it could mean the end of hopes kindled by the mandate of May 30, 1980, which tried to develop a systematic fiscal equalisation solution. This would mean that short-term crisis-management thinking of the member states had yet again won the upper hand over attempts at finding medium- and long-term solutions to the problems of the Community. The problems cannot be eliminated, however, simply by stringing together a set of temporary solutions.

## FOREIGN TRADE

# Toward Better Japan-Europe Economic Relations

by Hiroya Ichikawa, Tokyo\*

**Present economic relations between Japan and Europe are marred by misunderstanding and ignorance of one another's positions, Mr. Ichikawa stresses here. Neither side has anything to gain from the continuance of this situation: a new phase – one of understanding and cooperation – must be begun.**

The Japanese of the nineteenth century saw Europe as the epitome of progress. Europe was the symbol of political freedom, new technology and new ways of thinking. Japan and the rest of the world were stagnant and weak. Today, the situation appears to be totally reversed, at least to Japanese eyes. Many in Japan foresee that during the coming decade Western European economic growth rates will probably be lower than Japan's. They do not find it surprising to hear that Western Europe will also probably continue to have higher unemployment and inflation than Japan. The volume of international trade is not expected to show any dramatic increase in the near future, and the newly industrialising countries (NICs) are becoming a threat to the advanced countries. Many who foresee increasing

rivalry among the industrialised nations for markets, resources and investments point out that it will take time for Western Europe to modernize its industries and adapt to the new age. If inflation and unemployment are expected to continue to be especially severe in Europe, and greatly intensified competition among the industrial nations is to be inevitable, with two of the main competitors being Europe and Japan, one might reasonably ask if it isn't time for both Japan and Europe to redefine their relationship by stepping back and taking a long, cool look at the illusions that their peoples hold about each other.

Underlying the history of Japan-EC trade relations in the postwar years has been the conflict between Western Europe's discriminatory response to Japanese exports to Europe and Japanese insistence on Most Favoured Nation (MFN) treatment. As trade

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