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Financing of the EU budget

The own resources system

SUMMARY *The system of "own resources" ensures the financing of the EU's policies. Total revenues amounted to €130 billion in 2011. Successive reforms have determined its current configuration, which relies on three key streams of revenue: traditional own resources (mainly customs duties); a resource based on value added tax (VAT); and a resource related to gross national income (GNI).*

At present, the system provides sufficient resources to cover planned expenditure, but is often criticised for its complexity and opacity. Modification of the own resources system requires unanimity in the Council and ratification by each Member State (MS). For the Own Resources Decision, the European Parliament (EP) is only consulted.

The EP considers that the system has several shortcomings. For example, it says that the current arrangements do not follow the provisions of the Treaties since most EU revenue depends on resources that are perceived as national contributions, which MS wish to see minimised. Therefore, the EP has pushed for reforms.

In 2011, the European Commission put forward proposals with a view to reshaping the system and improving its functioning. The European Council has now reached a series of conclusions on these proposals as part of the complex negotiations on the 2014-2020 Multiannual Financial Framework (MFF).

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In this briefing:

Context

The EU's annual budget is worth around 1% of its Member States' gross national income (GNI), or 2% of total public spending in the EU. It ignites heated debates on both its nature and objectives. And the revenue side of the budget is equally controversial. Different options for financing EU policies reflect different visions of the EU, ranging from an inter-governmental to a more integrated approach.

Contributions from national budgets usually finance international organisations, such as the United Nations, in which citizens are only indirectly represented through their government.

In the EU, citizens are represented both directly in the EP and indirectly by their government in the Council. In many respects, the EU institutional structure is unique, being neither inter-governmental organisation nor federal State.

This originality also marks the financing of the EU budget. With a view to ensuring the financial autonomy of the Union, [Article 311 TFEU] establishes that *own resources* finance its budget. The Council decides the rules governing the own resources system through a special legislative procedure, which requires unanimity and ratification by all MS, while the EP is only consulted.

Author: Alessandro D'Alfonso
Contact: alessandro.dalfonso@ep.europa.eu

In the absence of a definition of own resources, academia has long debated their nature. Over time, their *automaticity* has been recognised as one of their main characteristics. This means that, once the system has been ratified, own resources are automatically due to the EU without the need for a further decision at MS level. By ruling unlawful delays in making available own resources by MS, the [Court of Justice of the EU] has confirmed this crucial aspect.

The need for unanimity explains the difficult evolution the own resources system has experienced. That has not prevented agreements from being reached, with six Decisions adopted since 1970. But many analysts deem it to have resulted in an opaque system. Modifications have often added new layers of complexity onto the existing mechanism rather than streamlining it.

Historical overview

1952-1969: initial phase

In 1952, the Treaty of Paris provided the European Coal and Steel Community (ECSC) with full financial autonomy. Its High Authority was able to impose levies on the production of coal and steel. In addition, it could contract loans.

On the contrary, the 1957 Treaty of Rome established that transfers from national budgets would initially finance the European Economic Community (EEC). But its Article 201 foresaw that these could be replaced at a later stage by "own resources", including revenue from the Common Customs Tariff that was to be created. The debate on setting up the own resources system was among the causes that triggered the famous ["empty chair crisis"].

1970-1987: creation of own resources

The first Own Resources Decision of April 1970 is a milestone in the history of European integration, providing the EEC with financial autonomy. It included three main sources of revenue: 1) agricultural levies; 2) customs duties; and 3) a resource calculated on a harmonised VAT base. The first two, also known as *traditional own resources* (**TOR**), were closely related to EEC policies. The third was conceived as a balancing resource to meet the *principle of equilibrium*, enshrined in the Treaty. This means that the EU budget cannot run a deficit and revenue must always equal expenditure.

In 1976, TOR financed around 65% of the budget, but it soon became apparent that they would be inadequate to cover the budget of the Community. On the one hand, their total amount was on a decreasing trend, due to the progressive reduction of tariffs in the framework of GATT negotiations, coupled with increasing European self-sufficiency in agricultural production. On the other hand, expenditure was rising further to a combination of factors (creation of new common policies; strengthening of existing ones; inability to restrain agricultural expenditure; and the accession of three new MS in the 1980s, all of them net beneficiaries).

The *VAT resource* became operational only in 1979 due to delays in the harmonisation of the VAT base. National contributions played the balancing role until that date. However, being capped and relatively stagnating, the *VAT resource* was not able to solve the growing financing tensions.

Budgetary imbalances and UK rebate

Another source of conflicts was the question of budgetary imbalances, especially after the UK joined the Community in 1973. The UK had a small agricultural sector and was quite open to trade with non-EEC countries. Given the structure of EEC expenditure and revenue at the time, this resulted in significant negative balances for a country with per capita income lower than the EEC average. In 1984, MS reached an agreement at the *Fontainebleau* European Council. While indicating that "*expenditure policy is ultimately the essential means of resolving the question of budgetary imbalances*", they established a principle, according to which the contribution of a country should be considered in relation to its relative prosperity. Temporary solutions to reduce the UK's negative net balance were replaced by a correction mechanism, known as the *UK rebate*. First included in the Own Resources Decision of 1985, the *UK rebate* has become de facto permanent, since unanimity is required to change it. The concepts of net contributors and net beneficiaries appeared in this context and have inflamed the budgetary debate since.

1988-1999: Delors reforms

Two packages of measures, Delors I and Delors II, introduced reforms with a significant impact on the EU budget. They included: the creation of multiannual financial frameworks (MFF) for budgetary planning and discipline; containment of agriculture expenditure; strengthening of cohesion policies and, notably from 1992, of internal policies related to the single market.

For revenue, the aim was to overcome the budgetary problems experienced in previous years by ensuring appropriate funding for a Community that had been entrusted with a growing number of tasks. To this end, the own resources system underwent a series of changes:

- The *global own resources ceiling* was introduced. This concept expressed the maximum amount of resources available as a percentage of the Community's gross national product (GNP). It was 1.15% in 1988 and 1.27% in 1999.
- A *fourth resource* - based initially on GNP and subsequently on GNI - was created to play the budget balancing role. Each MS transfers a percentage of its GNP/GNI - considered as an indicator of prosperity - to the EU.
- The *VAT resource* was modified, with attempts to neutralise its perceived regressive aspects that some consider impose a higher burden on less wealthy MS.
- TOR were rationalised.

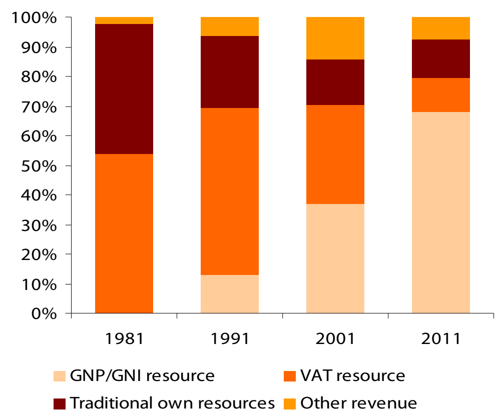
The revised system was able to ensure sufficient resources to finance the planned expenditure.

Since 2000: ad hoc changes

The *own resources ceiling* has been kept stable since the year 2000. In view of EU enlargement, the European Commission explored possible ways of making the system more transparent. These included: creating new own resources and replacing the *UK rebate* with a general correction mechanism applicable to all EU countries.

MS could only agree upon relatively minor modifications. They further reduced the importance of the *VAT resource* in favour of the *GNI resource*, which many observers consider more a national contribution than a real "own resource". A series of specific temporary correction mechanisms were set up for Austria, Germany, Sweden and the Netherlands. Despite being a strong advocate of enlargement, the UK would have contributed little to its costs due to the *rebate*. To tackle this issue, adjustments to the *UK rebate* were phased in. As a result of all these ad hoc measures, the own resources system has become more and more complex.

Figure 1 - Structure of EU own resources



Data source: European Commission.

The current system

Council Decision (EC, EURATOM) 2007/436 is the legal basis currently in force. The *own resources ceiling*, which is now calculated on

GNI, remains virtually unchanged at 1.23%. Total revenue was €130 billion in 2011.

The financing of the EU budget comes from the three categories of own resources:

- *Traditional own resources,* mainly customs duties, represented 13% of total revenue in 2011. MS retain 25% of the amounts established as collection costs.
- *VAT resource* accounted for 11% of total revenue in 2011. Based on a very complex statistical calculation, its link to the VAT collected in MS is very weak.
- *GNI resource,* the "budget balancing element", represented around 70% of total revenue (2011).

Other revenue, which is not classified as own resources, includes taxes on EU staff salaries, contributions from non-EU countries to certain programmes, and fines on companies for breaching competition law.

The *UK rebate* means that its contribution is lowered by a reimbursement. Based on a complex statistical calculation, it changes every year. It was worth €3.6 billion in 2011, reducing the UK contribution by around 24% to €11.3 billion. Austria, Germany, Sweden and the Netherlands benefit from a reduction in their contributions to the financing of the *UK rebate*. The same four countries also enjoy temporary correction mechanisms until 2013. Their estimated effect on the draft budget for 2012 ranged from €95 million for Austria to €1.6 billion for Germany.

How the system is performing

The Commission and Parliament, as well as academic researchers, have identified several criteria against which the financing system and its components can be assessed. These include economic, political and administrative factors such as revenue sufficiency, simplicity, fairness between MS and EU financial autonomy. A good system would aim to strike the right balance among the various goals of all these factors; however they may conflict with each other.

On the positive side, the current system has provided sufficient and stable resources, thus overcoming the financing problems the EU experienced in the 1980s. In general, it is considered to have achieved this result effectively; according to a qualitative analysis by the Commission, the operating costs of the system are likely to be marginal. In addition, actual payments remain below the *own resources ceiling*. The unused margin under the 1.23% threshold has served as a guarantee for the European Financial Stabilisation Mechanism (EFSM), the rescue mechanism that the EU created in 2010 to tackle the debt crises.

On the negative side, the Commission's EU Budget Review of 2010 notes a series of shortcomings identified by stakeholders. In their view, the financing system is complex and opaque. It lacks fairness, mainly due to correction mechanisms. In addition, it relies too much on resources which have little relationship to EU policies and, despite their *automaticity*, are often considered as national contributions, which MS aim to minimise.

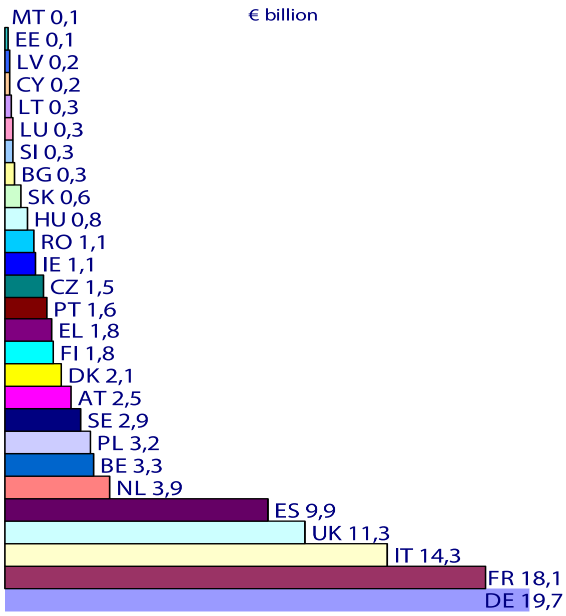
The thorny debate on balances

Over time, the debate on the EU budget has focused more and more on budgetary balances. These measure the difference between contributions to and receipts from the EU budget for each MS.

Apparently simple, the concept is highly controversial. Any estimates of MS' budgetary balances are necessarily based on assumptions, including on the items to be considered in calculating revenues and payments. According to the Commission, "*combining only the two or three most important assumptions [...] produces no fewer than 30 to 40 perfectly defensible definitions of budgetary balances*", each of them giving different results and sometimes significantly so for smaller MS. In many cases, it is difficult to identify the final beneficiary of funds with much precision. For example, Structural Funds are attributed to a MS, but contracts implementing related projects may be awarded to companies from other MS. Both students' MS of origin and the countries hosting these same students under Erasmus can reasonably be expected to benefit from the same funds.

In addition, according to some analyses, the concept is weak from an economic standpoint. As purely an accounting exercise, it results in a "zero-sum game" in which one participant's gains are balanced by another participant's losses. This cannot reflect positive spill-over effects of EU policies. On the contrary, they say, European integration would be better seen as a "positive-sum game" from which all participants benefit thanks to achievements such as the internal market. While the Commission publishes operating budgetary balances, it emphasises the fact that this is an accounting allocation which does not provide an exhaustive picture.

Figure 2 - National contributions by MS in 2011 (VAT and GNI resources, after corrections)



Data source: European Commission.

The excessive focus on budgetary balances is often considered to be one cause of several shortcomings in the current system. It results in decisions that favour instruments with geographically pre-allocated funds rather than those with the highest EU added value. In addition, ad hoc correction mechanisms make the system less equitable and have distortive effects.

Parliament's role

As regards EU expenditure, the EP is now co-legislator on an equal footing with the Council (annual budget) or has to give its consent (MFF). This is not the case for EU revenue. The Council establishes the *own resources system* by unanimity after consulting the EP. Some analyses argue that this asymmetry sharpens the differences in the perspectives of the two institutions. One limited change introduced by the Lisbon Treaty is that the implementing measures for the system now need the EP's consent.

A 2007 resolution reflects the negative opinion the EP has of the current system. Its structure is considered complex and opaque for EU citizens. In addition, the system has departed from the provisions of the Treaty which aimed to ensure the EU's financial autonomy, because it mainly depends on resources from national budgets. The text called for a reform that should first improve the system of national contributions and subsequently explore new resources, but without increasing overall public expenditure or the tax burden for citizens.

In the framework of the negotiations on the 2011 budget, the EP pushed for a reform proposal to be tabled and discussed. A further resolution called for an in-depth reform.

Commission's reform proposal

In 2011, the Commission put forward proposals for a Council Decision and four related Regulations with a view to improving the functioning of the system. The key suggested changes are threefold:

- MS' contributions would be simplified by abolishing the *current VAT resource* on 31 December 2013. The Commission deems this resource to create a significant administrative burden without producing real added value.

- A *financial transaction tax (FTT) resource* and a *new VAT resource* would be introduced (respectively in 2014 and by 2018). They would be better related to EU policies and objectives. The resulting revenue would reduce the amounts of national contributions correspondingly.
- As of 2014, a new system of temporary corrections would replace all the current mechanisms, for which the underlying conditions have changed significantly since their creation. It would consist of lump sums in favour of Germany, the Netherlands, Sweden and the UK. Furthermore, the "retention rate" for collection costs on TOR – which can be regarded as a hidden correction – would be lowered from 25% to 10%.

These changes would result in a different mix of resources in 2020. TOR and the two new own resources would respectively account for 20% and 40% of total revenue. The *GNI resource*, which would keep its budget-balancing role, would be reduced to 40%. This is expected to decrease the focus on budgetary balances.

However, the Commission's estimates need to be revised, since no agreement could be reached on the introduction of an FTT at EU level. 11 MS wish to move ahead with an FTT through enhanced cooperation. The press reports that they have conflicting opinions on using part of it as an EU own resource.

State of play in the debate

In 2012, the Court of Auditors analysed the Commission's proposals. In its opinion, the elimination of the *current VAT resource* would address a weakness of the system. The *new VAT resource* is considered complex, but less so than the current one. The Court notes that, being based on a volatile economic activity, the revenue raised by an *FTT resource* would be by nature unpredictable. In addition, it deems lump sum corrections to be simpler than the current mechanisms, but still not transparent. Finally, the amount of TOR in 2020 could be overestimated. The link between the retention rate on TOR and the real collection cost is considered unclear.

The EP is examining the proposals and has supported the *new VAT resource*, calling on the Commission to investigate how to further reform it. In its agreement on the MFF 2014-2020, the European Council has reached the following conclusions: collection costs on TOR should be lowered to 20%; a *new VAT resource* should be further worked on and could replace the existing one; MS cooperating on an FTT should examine if this could become an own resource; the *UK rebate* should be kept; corrections should be granted to Denmark, Germany, the Netherlands and Sweden until 2020 (and to Austria until 2016).

On 23 October 2012, the EP asked for the Commission to put forward proposals for new own resources should the new system not result in a significant decrease of the *GNI resource*. In a joint statement following the conclusions of the European Council, the leaders of Parliament's four largest political groups warned that the current deal on the MFF may not receive the necessary majority.

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Author: Alessandro D'Alfonso
Contact: alessandro.dalfonso@ep.europa.eu