PO/CH/GH/0165
PART. A

PO CH/GH/0165
PART. A

CONFIDENTIAL

European Economic Community
Budget Corrective

1981

DD's 25yo NAJ/3 24/4/97

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

23.1.81

195/3/2 2

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Couzens o/r
Mr Jordan-Moss
Mr Byatt
Mr Middleton
Mr Ashford
Mr Michell
Mr Thomson
IG2CS

OD(E)(79)19. THE EEC BUDGET : 'CORRECTIVE' OR 'OVERRIDING' MECHANISMS

In introducing the paper you could make the following points:

a. Your main aim at this stage is to provide background for Ministers fighting our corner on the inequitable UK contribution.

b. You are sorry the material is bulky. It has been prepared with interdepartmental agreement at the official level. Your officials have tried to pare it down and avoid overlap. The paper on the existing Financial Mechanism remains detailed and long. But this was deliberate. The Europeans will attach importance to the Financial Mechanism, the outcome of the 1974/75 negotiation. It may be on the Financial Mechanism that we have to do a clever demolition and rebuilding job. It may also be on the Financial Mechanism that the others (? the French) will try to pull the wool over our eyes - to offer a few changes and to try to present them as enough. We are not going to fall for anything like that. But big changes in the Financial Mechanism are not to be ruled out as a possible couse, particularly as, presentational this might be the least awkward course for the others to accept.

c. There is a gulf between all this preparatory job on over-rides, and its further refinement, let alone its use in

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negotiation. There is a chicken and egg problem. We don't know just where to stake out positions until we have rather more idea how the others are reacting. In spite of the results of the Prime Minister's talks with Chancellor Schmidt and President Giscard the UK has not yet had its main point acknowledged by the Community. And even when they have acknowledged it, solutions will not be easy to find. Getting money out of the others will be like drawing teeth.

d. You could reiterate the conclusions in the paper. We stick for the present with the line that the Commission should put forward solutions. But we begin to make it clear in bilateral talks that we are unmoved by ideas that the UK problem can be met by bigger receipts, and we expect a correcting mechanism to be necessary. We should be ready to do further work on correcting mechanism in the light of Strasbourg.

2. On the substance of the papers:

a. Annex A. "How did it happen." The simple answer is the inequity of the CAP - its huge proportionate share of expenditure, ~~its~~ bloated absolute size because of surpluses, and the small CAP expenditure in the UK. It is quite interesting that the ratio of UK expenditure to receipts is actually not as bad as had been earlier envisaged.

b. Annex B. Receipts. The point here is that action on expenditure is no salvation. The particular presentation of this simple point choosen for the paper was to show how extreme and unrealistic the assumptions have to be to get receipts for the UK to provide anything like a better balance with contributions. The note also makes the point that greater receipts - even if there were no public expenditure arguments against swollen spending - would be a gradual and indeed unreliable and inefficient way of getting more money, net, into UK hands.

c. Annex C. The existing Financial Mechanism. This identifies, in paragraph 4, three relatively Easy (though still difficult) changes; and five more profound ones. The three would not do enough to remedy the UK's situation adequately.

d. Annex D. Overrides. The main possibilities are:

- 'Quantum' changes in the Financial Mechanism
- Arbitrary lump sum payments to bring receipts up to an agreed figure
- Arbitrary lump sum payment to bring the net contribution down to an agreed level.

How to finance these lump sum payments to the UK is a separate issue. Denmark, Belgium and the Netherlands would feel the pinch if payment was provided by net recipients with above average GDP per head. Germany and France would be worst affected by a decision to provide refunds through the Budget. If they were provided through the Budget, there would be the further question whether the UK should contribute to its own refunds.

Annex D is nothing like so comprehensive as Annex C, on the Financial Mechanism. The Treasury has in fact a great number of variant calculations. But they are not worth displaying. Any given result can be derived from the 'arbitrary' lump sum approaches; if the will is there the answer can be provided. The Financial Mechanism works in a different fashion, by a series of tests. But we can judge well enough which changes would be likely to produce a big enough result.

3. The following points may be useful in the discussion.

4. First, Italy. If, (as I fear they might) FCO Ministers suggest that we ought to get together with the Italians to work out corrective mechanisms I hope you will denounce the idea. Italy has been a splendid ally in getting the whole exercise to the present point.

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We do not want to abandon Italy unless we have to. But Italian ideas of solutions lie in the direction of extra receipts, and of concessions, like compensation for tariff concessions on Mediterranean agricultural products, which do not suit the UK at all. Italy may be able to be bought off by offers in areas which would be troublesome for the UK. We need to be absolutely sure what correcting mechanisms would suit the UK before we dream of getting enmashed with Italy on details. We do not know yet that it would not suit us best for the UK to have a correcting mechanism and for Italy to be helped in other ways. We might be dangerously trapped if we had to take account of their ideas of correcting mechanisms. The very furthest we ought to go at the moment is to tell Italy that we ourselves are looking at corrective mechanisms.

5. We have to ensure that any mechanism that we go along with would be robust. We do not want to be responsible for another failure like the present Financial Mechanism.

6. The Government has not yet precisely defined the ultimate aim in terms of money. It is best not to expose our hand yet. We need to know more about the attitude of the other countries in order to assess the chances of getting the maximum (which I imagine we define as a nil net contribution) or something less. Annex D hints, in paragraph 16, that there could be a respectable argument for not holding out for the absolute maximum. Whatever they think of our attitude to the inequities of the present budgetary result of Community policies, the UK's generally sensible approach to budgetary matters is, we believe, valued in the Community. The partner countries would not want us to loss all interest in policies, efficiency, costs, and so on, as we theoretically might if our net contribution was always going to be wiped out. P Three other points. Whatever mechanism we favour:

- it could be presented as 'interim' - until Community policies themselves result in a sensible outcome.
- It might also be part of a wider 'arrangement'. This talk of packages or bargains is to be avoided. But there

could be gestures which the UK could make, which would come in some sense into the reckoning.

- It might be phased in over two or three years.

MHM

MRS M HEDLEY-MILLER
14 June 1979

1G(2)CS pc

CABINET. 33/36

cc: Chief Secretary
Financial Secretary
Minister of State (L)
Minister of State (C)
Mr Cardona
Sir D Wass
Sir K Couzens
Mr Jordan-Moss
Mrs Hedley-Miller o/r
Mr Shore
Mr Thomson
Mr Coombes
Mr Spreckley - FCO
Mr Walsh - Cabinet Office
Mr Fitchew - UKREP
IG2CS

CHANCELLOR OF THE EXCHEQUER

CABINET, 13 SEPTEMBER
REPORT ON EEC BUDGET COUNCIL

You may wish to make a brief statement to Cabinet on this Council;
... I attach a draft.

G R ASHFORD
IG2 Division
12 September 1979

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EEC BUDGET COUNCIL

The Financial Secretary to the Treasury attended the meeting of the Budget Council on 11 September.

The Council had a discussion with a delegation from the European Parliament led by Mdm. Veil who emphasised the Parliament's determination to use budgetary powers given to it under the Treaty to the full with the new authority accorded to it by direct elections. Several members of the delegation criticised the preponderance of agriculture in the Budget and the decisions of the Agricultural Council on the price-fixing.

Following agreement in Preliminary Council discussion, the Irish Presidency drew the Parliament's attention to the latter's action in paying from their own provisional appropriations 1 MEUA to the United Nations High Commission for Refugees to assist the rescue of the boat people. This was not in accordance with established budgetary practice (Ministers had in their own discussion agreed that it set a dangerous precedent). Mdm. Veil considered that the Council should not question its action.

The Financial Secretary emphasised his need to consider detailed provisions in the Preliminary Draft Budget for 1980 in the context of the cumulative budgetary effect of Community policies which produced a totally inequitable distribution of the net financing costs. He referred to the forthcoming meeting of the Finance Council on 17 September to consider the Commission's reference paper and stressed that the UK's net contribution to the Community Budget was not a problem which the Community could ignore.

The Financial Secretary said that it now appeared that the UK was unlikely to qualify for a repayment under the Financial Mechanism, out of the 1980 Budget, in respect of 1979 budget contributions; this underlined the fact that the Mechanism was not a satisfactory instrument. He proposed, and it was agreed, that the substantive provision in the 1980 Budget be deleted.

In discussion on the many individual Budget items the only major dispute was on the provision for the Regional Development Fund. The Commission had proposed 1200 MEUA. The Italians, Irish and ourselves supported this in the Council, while the French, Germans, Belgians and Danes took a very restrictive position on 650 MEUA. After long discussion the French and Germans, who throughout the Budget Council had worked together, were persuaded to move up to 850 MEUA; with the Financial Secretary's support a qualified majority was then obtained for this figure. The Italians remained rigid to the end on 1200 MEUA and were outvoted. The figure of 850 MEUA is likely to be increased by the European Parliament in the next stage of the 1980 Budget process, and will be further discussed at the Second Budget Council in November.

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TREASURY
- 4 DEC 1979
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Chancellor 21
Our paper to the EEC Commission: to you for information.

GYPHER

LVO 61/29

FDW G 048/29

PP BELGRADE

GR 150

CONFIDENTIAL
FM F C O 281925Z SEP 79
TO PRIORITY UKREP BRUSSELS
TELEGRAM NUMBER 956 OF 28 SEPTEMBER 1979.
AND TO BELGRADE.

COMMUNITY BUDGET : UK PAPER FOR COMMISSION

MIFT CONTAINS TEXT OF A UK PAPER, BASED ON CHANCELLOR OF THE EXCHEQUER'S INTERVENTION AT THE FINANCE COUNCIL ON 17 SEPTEMBER, SETTING OUT NATURE OF THE UK'S PROBLEM AND POSSIBLE SOLUTIONS. WOULD UKREP PLEASE PASS COPY, AT APPROPRIATE LEVEL, TO COMMISSION IN RESPONSE TO THEIR REQUEST FOR A STATEMENT OF MEMBER STATES' VIEWS. IN DOING SO, THEY SHOULD EXPRESS OUR READINESS TO SUPPLEMENT THE PAPER ORALLY WITH WHATEVER FURTHER INFORMATION THE COMMISSION MAY REQUIRE AND INDICATE THAT WE SHALL HAVE FURTHER IDEAS TO COMMUNICATE TO THE COMMISSION IN THE NEXT STAGE OF THE EXERCISE. WE ASSUME THAT THE COMMISSION WILL CIRCULATE THE PAPER TO OTHER MEMBER STATES.

2. WOULD BELGRADE PLEASE PASS COPY FOR INFORMATION TO CHANCELLOR OF THE EXCHEQUER.

CARRINGTON

GYPHER

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TREASURY
25 OCT 1979

fc Correction Mechanism

CONFIDENTIAL
FM F C O 281925Z SEP 79
TO PRIORITY UKREP BRUSSELS
TELEGRAM NUMBER 956 OF 28 SEPTEMBER 1979.
AND TO BELGRADE.

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CARRINGTON

FILES

EID (I)
FRD
WED
MR BUTLER
MR FRETWELL
MR FERGUSSON

COPIES TO:

MR N JORDAN-MOSS, TREASURY
MR C. BAKER, TREASURY
MR H WALSH, CABINET OFFICE

CONFIDENTIAL

TREASURY
- 4 DEC 1979
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LVO 63/29

FDW G Ø82/29

CYPHER

PP BELGRADE
GRS 9ØØ

CONFIDENTIAL
FM F C O 28192ØZ SEPTEMBER 79
TO PRIORITY UKREP BRUSSELS
TELNO 957 OF 28 SEPTEMBER
AND TO PRIORITY BELGRADE.

MIPT - COMMUNITY BUDGET: UK PAPER FOR COMMISSION

1. THE FOLLOWING IS TEXT OF UK PAPER:

1. THE UK'S BUDGETARY PROBLEM IS SIMPLE AND READILY VISIBLE. THE COMMISSION'S REFERENCE PAPER HAS SHOWN CLEARLY ITS SIZE AND SERIOUSNESS. BY 198Ø THE UK WILL BE ONE OF ONLY 2 SIGNIFICANT NET CONTRIBUTORS TO THE BUDGET. ON ANY ATTRIBUTION OF MCAS OUR PAYMENT WILL BE OVER 15ØØ MEUA, (£1ØØØ MILLION) - OVER 4Ø PER CENT LARGER THAN GERMANY'S AND REPRESENTING 55-6Ø PER CENT OF TOTAL NET TRANSFERS THROUGH THE BUDGET IN THAT YEAR, ALTHOUGH THE UK RANKS 7TH IN THE COMMUNITY IN GNP PER HEAD.

2. OUR NET CONTRIBUTION HAS GROWN FAST - FROM ONLY £167 MILLION IN 1976 AND IS LIKELY TO GROW EQUALLY FAST AFTER 198Ø UNLESS A SOLUTION IS FOUND.

3. THE REFERENCE PAPER HAS ALSO SHOWN CLEARLY THE 2 CAUSES OF THE PROBLEM, - BOTH OUR EXCESSIVE CONTRIBUTIONS TO FINANCING THE BUDGET AND OUR LOW LEVEL OF RECEIPTS FROM IT. NEXT YEAR WHEN OUR SHARE OF GNP WILL BE 16 PER CENT, WE WILL FINANCE OVER 2Ø PER CENT OF THAT BUDGET, BUT GET BACK ONLY 1Ø PER CENT OR LESS. THIS IS A MANIFEST INEQUITY WHICH THE COMMUNITY MUST FIND A WAY OF REMOVING. IT IS BAD FOR THE COMMUNITY IF A COUNTRY WITH BELOW AVERAGE WEALTH IS A MAIN SOURCE OF ITS FINANCE, AND IS NOT TOLERABLE FOR ANY BRITISH GOVERNMENT.

4. IT IS ACCEPTED THAT BUDGETARY TRANSFERS ARE NOT THE ONLY ELEMENT IN COMMUNITY MEMBERSHIP. BUDGETARY FIGURES MAY ALSO BE MISLEADING, AS REGARDS THEIR TRUE ECNOMIC INCIDENCE, FOR OTHER MEMBER STATES SUCH AS BELGIUM AND LUXEMBOURG, BUT THE REFERENCE PAPER SHOWS THAT FOR THE UK THEY ARE A REASONABLY ACCURATE REPRESENTATION OF THE FACTS NON-BUDGETARY EFFECTS MAKE THE POSITITION WORSE, AS THE UK INCURS SUBSTANTIAL RESOURCE COSTS AS A RESULT OF THE CAP. NOR DOES THE QUOTE ROTTERDAM EFFECT UNQUOTE ALTER THE POSITION OF THE UK.

5. AS REGARDS SOLUTIONS, GIVEN OUR PER CAPITA GNP THE UK SHOULD AT WORST BE IN BROAD BALANCE ON CONTRIBUTIONS AND RECEIPTS TO THE COMMUNITY. THE SOLUTION MUST:-
(A) ACT EFFECTIVELY ON THE NET CONTRIBUTION, COMPENSATING FOR THE LOW LEVEL OF RECEIPTS - OVER HALP THE PROBLEM - AS WELL AS THE EXCESSIVE GROSS CONTRIBUTION:
(B) BE PUT INTO OPERATION IMMEDIATELY:
(C) LAST AS LONG AS THE PROBLEM, AND NO LONGER.

6. THE UK RULES OUT NO APPROACH AT THIS STAGE, BUT THERE ARE A NUMBER OF FALSE TRAILS. WE SEE NO SCOPE FOR AN ADEQUATE SOLUTION THROUGH:-

) REFORM OF THE COMMON AGRICULTURAL POLICY. HOWEVER DESIRABLE AND NECESSARY IT MAY BE TO CURB CAP EXPENDITURE, AS THE COMMISSION RECOGNISES, THIS WILL NOT ACT QUICKLY ENOUGH OR BE SUFFICIENTLY LARGE SCALE, OR BE SUFFICIENTLY RELATED TO THE BUDGETARY PROBLEM.

(B) INCREASED RECEIPTS FROM REGIONAL AND SOCIAL FUNDS. SOME EXPANSION MAY NO DOUBT BE JUSTIFIED. BUT THEY COULD NOT CONCEIVABLY REMOVE UK'S IMBALANCE ON A SUFFICIENT SCALE. NOR WOULD IT BE RIGHT OR PRACTICABLE TO SOLVE OUR PROBLEM THROUGH UNNECESSARY EXPANSION OF THE COMMUNITY BUDGET OR THROUGH ARTIFICIAL DISTORTIONS OF EXISTING COMMUNITY POLICIES:

(C) LOANS. AS THE COMMISSION HAS RIGHTLY POINTED OUT, THESE DO NOT CONSTITUTE A TRANSFER OF RESOURCES, THOUGH THEY HAVE AN IMPORTANT ROLE TO PLAY IN THE DEVELOPMENT OF COMMUNITY POLICIES. THEY BEAR INTEREST AND THEY HAVE TO BE REPAID, AND THE UK HAS NO PROBLEMS IN RAISING LOANS FROM OTHER SOURCES.

7. IT IS EQUALLY INSUFFICIENT FOR THE UK TO WAIT UNTIL THE DEVELOPMENT OF OUR TRADE PATTERNS AND THE DEVELOPMENT OF COMMUNITY POLICIES SOLVES OUR PROBLEM WITH THE PASSAGE OF TIME. OUR TRADE HAS UNDERGONE THE BIGGEST REORIENTATION TOWARDS THE COMMUNITY OF ANY MEMBER STATE SINCE 1972, TO THE CONSIDERABLE BENEFIT OF OUR PARTNERS. THIS REORIENTATION WILL NO DOUBT CONTINUE, BUT EVEN AT THE PRESENT RATE OF PROGRESS THIS CANNOT HELP WITH OUR IMMEDIATE PROBLEM OVER THE BUDGET.

8. THE REMIT FROM THE STRASBOURG EUROPEAN COUNCIL INVITED COUNTRIES TO MAKE CLEAR THEIR VIEWS ON A SOLUTION IN CONCRETE TERMS. IN OUR VIEW SOME FORM OF CORRECTIVE MECHANISM IS INDISPENSABLE. BUT IT MUST CORRECT THE NET POSITION - COUNTER-ACTING OUR LOW RECEIPTS AS WELL AS OUR EXCESSIVE GROSS CONTRIB-UTION.

9. ONE POSSIBILITY WHICH WE THINK THE COMMISSION SHOULD EXAMINE IS A MECHANISM WHICH ADDRESSES ITSELF DIRECTLY TO THE NET CONTRIB-UTION POSITION, AND TAKES ACCOUNT OF GNP PER HEAD AS DOES THE PRESENT FINANCIAL MECHANISM.

10. ANOTHER POSSIBILITY IS THAT THE COMMISSION MIGHT START FROM THE EXISTING FINANCIAL MECHANISM. THEY WOULD FIRST HAVE TO REMOVE ALL THE MULTIPLE RESTRICTIONS, WHICH AS THEY HAVE SHOWN, IN THE REFERENCE PAPER, LIMIT OR EXCLUDE THE UK FROM BENEFIT AT PRESENT. THE RESTRICTIONS WHICH WOULD HAVE TO BE REMOVED INCLUDE THE BALANCE OF PAYMENTS CONDITION, THE TRANCHES SYSTEM AND THE OVERALL 3 PER CENT LIMIT.

11. REMOVAL OF THESE RESTRICTIONS ALONE, HOWEVER, WILL BE NOTHING LIKE SUFFICIENT. SO LONG AS THE FINANCIAL MECHANISM IS RESTRICTED TO DEALING WITH THE GROSS CONTRIBUTION, IT CANNOT MEET THE LARGER PART OF OUR PROBLEM. A FURTHER CHANGE WOULD HAVE TO BE MADE TO AMEND IT TO COMPENSATE FOR AN INADEQUATE LEVEL OF RECEIPTS.

12. WE DO NOT SUGGEST THAT THESE EXHAUST THE POSSIBILITIES. THERE MAY BE OTHERS, AND OTHER COMBINATIONS.

CARRINGTON

CYPHER

NNNN

CONFIDENTIAL

36/13

CHANCELLOR OF THE EXCHEQUER

cc Sir Douglas Wass (or)
Sir K Couzens (or)
Mrs Hedley-Miller (or)
Mr Middleton
Mr Ashford
Mr Michell
Mr Baker
Mr Thomson

COMMUNITY BUDGET

Your two reservations on the note by officials for OD on Monday encountered opposition from the FCO. On the first point, the FCO felt that the additional safeguard in the form proposed in your telegram would require too great an expenditure of negotiating capital for too remote a contingency. On the second point, they considered that it would be premature to raise a contentious problem of financing before we had secured the principle of a correcting mechanism.

2. I refused to accept these arguments (though I will be dealing with them in briefing for you for OD). This meant that in your absence it would not be possible to resolve these points before the OD discussion on Monday; but I had to accept that it would be desirable to put what we could to the Commission before their own meeting on "solutions" this weekend, provided that your two reservations were fully safeguarded.

3. The Prime Minister's authority was therefore sought to instruct Sir D Maitland to speak informally and on a personal basis to our contacts in the Commission on the basis of the conclusions to the official paper, with two provisos:

(a) that it should be made clear that, in addition to the "double criterion", Ministers were still considering whether, and if so in what form, there should be a further provision for limiting the UK's net contribution even if the UK ceased to have a below average GNP; and

(b) that the method of abating our payments should not be mentioned at this stage.

I attach a copy of the Cabinet Office submission to No 10.

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CONFIDENTIAL

4. Meanwhile, I arranged for your telegram to be copied to Sir D Maitland, in Brussels, so that he is fully aware of what you have in mind.

5. The Prime Minister approved the Cabinet Office submission and Sir D Maitland was instructed accordingly.

NJM

N. Jordan-Moss
3 October 1979

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CONFIDENTIAL

DRAFT MINUTE FROM SIR JOHN HUNT TO MR ALEXANDER

Community Budget

1. A note by officials OD(79)25 which deals with possible mechanisms to achieve our Budget objective is due to be discussed in OD on 8 October when the Chancellor is back from Belgrade. We have learnt however that, at their informal meeting this coming weekend, the Commission will be having a first discussion of our (and the Italian) problem and that the Secretary General of the Commission has asked his officials for preliminary advice on possible solutions. We have good contacts among these officials and it seems important that we should not lose this opportunity to give them some steer.

2. The Chancellor of the Exchequer has reservations about two points in the paper. He believes we should have a permanent provision for limiting the UK's net contribution even if the UK's GNP rose above the Community average whereas the paper suggests that it might be sufficient to cover this (unlikely) event by a temporary phasing arrangement (paragraph 6). Secondly, he would like to see a quicker acting method of abating our payments than those suggested in paragraph 19. In the Chancellor's absence it will not be possible to resolve these points before the OD discussion next Monday. However, the second point is not one which we need to discuss with the Commission at this stage. As to the first, the Chancellor's position should be protected by making clear that Ministers are still considering whether and, if so, what form there should be a further provision for limiting the UK's net contribution even if the UK ceased to have a below average GNP.

CONFIDENTIAL

3. I should be grateful to know whether subject to these points the Prime Minister agrees that Sir D Maitland should be authorised to speak informally and on a personal basis to our contacts in the Commission on the basis of paragraphs 22 and 23 of OD(79)25. This at least should avoid the Commission's discussions getting off on the wrong foot. The Prime Minister will be able to consider on Monday what we should say formally to the Commission about the solutions they are due to propose. I hope that, if at all possible, you will be able to consult her overnight: we only received the Chancellor's reactions earlier today.

195/52/02 16/12/05 31 17

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

cc Sir Douglas Wass (or)
Sir K Couzens (or)
Mrs Hedley-Miller (or)
Mr Middleton
Mr Ashford
Mr Michell
Mr Baker
Mr Thomson

TREASURY
- 4 DEC 1979
1&2 CS

COMMUNITY BUDGET

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CONFIDENTIAL

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NJ-M

N. Jordan-Moss
3 October 1979

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CONFIDENTIAL

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TREASURY
- 4 DEC 1979
1&2 CS

CONFIDENTIAL

16(2)(Spa

OD 32

1. MR JORDAN-MOSS I agree 5/10
2. CHANCELLOR OF THE EXCHEQUER

copies attached for:

Sir Kenneth Couzens
Sir Douglas Wass
Minister of State (C)
Minister of State (L)
Financial Secretary
Chief Secretary

cc: Mrs Hedley-Miller (or)
Mr Ashford
Mr Michell
Mr Thomson
Mr Shore
Mrs Lomax
Mr Meyrick

how [illegible] DO

OD(79)25: UK COMMUNITY BUDGET CONTRIBUTION -
CORRECTIVE MECHANISMS

This paper will be discussed at OD on 8 October. The Chancellor has already received a synopsis of the paper, sent to him in Belgrade in FCO Telno. 114. He made certain comments on the synopsis in Belgrade Telno. 172. Copies of both telegrams are attached. As the Chancellor will have seen from your note to him of 3 October, his position has been protected, pending the OD discussion, in the confidential briefing that will be given to Commission officials prior to this weekend's informal meeting of the Commissioners to discuss corrective mechanisms.

Yr. own notes from Belgrade are also below.

Robustness of the mechanism to
the UKs GNP per head

2. We have been thinking about the Chancellor's two reservations. There are a number of possible ways of getting round the problem posed by the risk that we might at some point exceed the Community average GNP per head. The formula suggested by these in paragraph 3 of Telno. 172 would be highly effective as long as France was a net contributor. If she became a net beneficiary (which she has been at various stages in the past) a formula along these lines would only constrain our net contribution to the level of Germany's. That would be an improvement on our forecast position in 1980, but would not

necessarily provide much relief in future years. An alternative possibility is to ~~establish criteria~~ for the operation of a corrective mechanism which will clearly benefit the UK and no other Member State regardless of our level of GDP per capita. Two examples are:-

(a) receipts per capita below $^2/_3$ of the Community average;

(b) a net contribution greater than 30% of gross contribution.

These could be put forward as qualifying criteria, and not as mechanisms, but in practice there is likely to be a link between the two. Thus if we accepted a criterian which said that the mechanism would apply to a Member State whose receipts per capita were less than $^2/_3$ of the Community average, other Member States are likely to argue that the mechanism itself should do no more than make receipts up to $^2/_3$ of the Community average. This would refund to us only 618 meua on an "importer pays" basis for mca's and 899 meua on "exporter pays" basis. Similarly, a mechanism which limited our net contribution to 30% of our gross contribution would yield 618 meua on an importer pays basis, and 880 meua on an exporter pays basis. This would fall far short of the objective of broad balance..

3. One possibility would be to combine such criteria with the double criteria of below average GNP per head and being a net contributor described in the paper. We would qualify on an either/or basis, but we might well have to accept a lower refund on the lines detailed in the preceeding paragraph once we were beyond 100% of the Community average GNP per capita. There would be negotiating difficulties, too, in the sense that criteria of this type would be further away from the sort of criteria in the existing financial mechanism and we would lose the tactical advantage described in the paper of appearing to build a new mechanism on the Financial Mechanism. There would also be a negotiating disadvantage in that an either/or criterion would in principle open the way to significant refunds for us

even if we were to become the wealthiest Member State. This would be extremely difficult to negotiate with our partners.

4. As the paper point out, every additional feature that we want in a corrective mechanism will have its negotiating price and this might mean that at some point there would be a trade-off between securing our position against a variety of eventualities, and the actual amount that Member States were prepared to concede to us. In this context, the Chancellor may find it useful to have some calculations about the likelihood of our reaching 100% of the Community average GNP per head. Broadly, this could happen if relative growth rates in the Community changed, and we start to grow more quickly than our partners, or if there is a sustained appreciation of sterling.

5. Between 1967 and 77, the average growth rate in the EEC was 3.6%, and in the UK 2%. Enlargement will tend to raise the average growth rate in the Community, as the applicant states are still relatively underdeveloped and growing quickly, so that an extremely pessimistic assumption for the Community average growth rate over the next 10 years would be 2%. In order to reach the Community average in GNP per head, the UK would have to grow 2.1% faster than the average Community growth rate, and sustain this for 10 years. We should therefore need to sustain an average growth rate for that period of 4.1%. The only years in which we have exceeded such a growth rate in the past are 1963 and 1967.

6. An alternative scenario is that the Community average growth rate drops, perhaps because of energy shortages which would affect the UK relatively less. If there was zero growth in the Community over 10 years, the UK would have to grow at an average of 2.1% for 10 years to catch up with the average GNP per capita. ~~The forecast in the NIF for growth over the~~ The immediate prospects for growth are very poor.

~~period 1979 to 81 is 0.5%~~. 2.1% would in fact represent a very significant rate of growth, indeed in circumstances where our major export markets in Europe were not growing at all.

7. The third possibility is that there might be a further sustained appreciation of the exchange rate. From the current rate, it would require a real appreciation of 13% to bring us to the average of GNP per capita in a Community of 12. At the moment, the rate for sterling against the ECU is 1 ECU = £0.65. A 13% appreciation would bring us to 1 ECU = £0.57. At the height of the appreciation of sterling during the summer, our rate against the ECU was £0.599.

8. My conclusion is that the more imminent threat is posed by the possibility of exchange rate appreciation, but that even this is fairly remote.

Rapid Financing

9. It is technically possible within the own resources system (which we have said we do not wish to modify as such) to secure a refund to the UK more quickly than the most favourable basis referred to in the paper - quarterly in arrears on the lines of the Article 131 refunds. The best, however, would still be refunds in arrears, but on a monthly basis. Assuming that our eligibility under the various criteria for the mechanism was not in question, the Commission could be empowered to make an adjustment to our contribution in a given month on the basis of our net position in the previous month. A more rapid refund than this would run into the practical objection that an adjustment to the UKs net position necessarily requires an adjustment to the net positions of all other Member States, and it seems reasonable to allow a few weeks for the Commission to make the necessary calculations. There is also a likely theological objection that more rapid refunds would look like withholding own resources at source. Monthly in arrears would be in line with the precedent established under the transitional arrangements for Greek contributions to the Community Budget, where the Community will refund to Greece "during the month

25

following its availability to the Commission" a proportion of the VAT payments that Greece will make. This could be a useful precedent for us, although it would be difficult to persuade the Community to extend the principle to payments of own resources other than VAT.

10. There are essentially two problems about a delay in refunds to the UK of our net contribution. These are a public expenditure problem, and the problem of a straightforward cost to the UK derived from making an interest free loan to the Community. Provided we can obtain prompt payment, it is possible that even a payment one year in arrears (ie payment in early 1981 in respect of 1980) could be scored within the public expenditure totals for 1980/81. Payments quarterly in arrears would certainly allow the 1980/81 figures to be credited with at least $^3/_4$ of our likely refund in respect of 1980. In any case, this is an initial problem only: money would be coming in in each of the years after 1980, even though it might be in respect of an earlier year.

11. The interest loss represents an unambiguous cost to the UK, and one which we should try to avoid if at all possible. At the end of the day, however, a judgement will need to be made on whether it is worth pursuing this point at the expense, for example, of a larger absolute mechanism.

Detailed points on the paper

12. The units in table 1 should be meua. There appears to be an incorrect figure in table 7. Row (a) column (b)(Net) has a figure of 784. This should read 984.

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of the 1% VAT ceiling. In fact, our latest estimates suggest that there may be as much as 2,000 meua left within the 1% ceiling in 1980. This will depend in part on the outcome of the second Budget Council. The point argued in the paragraph remains valid, however, in that a refund to the UK, financed through the Budget, will bring us so close to the ceiling - even if it does not take us over it - to introduce the risk of the two issues becoming confused.

14. Paragraph 21 states that Ministers need to consider whether contributing to our own refund would be compatible with the objective of broad balance. This formulation skates over an important point, which is that if we secured a refund with a gross yield equivalent to our net contribution in 1980, we would still be making a net contribution to the Community Budget of some 17% of that amount, since 17% is estimated to be ~~a~~ our marginal rate of contribution to the Budget. Public Expenditure Programme 2.7, therefore, would show a minus, and not zero. It follows that if we are to contribute to our own refund our objective needs to be a total refund about 20% greater than the net transfer figures given in table 1. Of course, conceding a contribution to our own refund, so as to leave us with a small net contribution, might be a concession we can make during the discussions, but that is a tactical consideration which is not the purpose of this paper to cover.

Conclusion and Recommendation

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27

16. On balance, it is our view that at present the price for securing a nil risk to UK benefits under the mechanism should we pass the Community average GNP per capita looks like being rather high. But there are political factors here which the Chancellor will no doubt wish to weigh in deciding whether we should press for this provision now, or leave it to a later stage in the discussions.

17. Finally, the Chancellor is recommended to urge the Committee not to become too heavily committed to particular financing arrangements. There is an extent to which financing is an issue which the other Member States will have to decide among themselves, although as the note points out there are potential risks for the UK in some of the possibilities. Essentially, we see financing questions as ones to be decided at a much later stage in the negotiations. The more immediate objective is to make sure that a mechanism or combination of mechanisms is proposed which meets the UKs requirement of broad balance.

CJBaker

C J BAKER
5 October 1979

28

GR 430
CONFIDENTIAL
FM BELGRADE 020530Z OCT 79
TO IMMEDIATE FCO
TELEGRAM NUMBER 172 OF 2 OCTOBER

YOUR TELNOS 113 AND 114:
UK CONTRIBUTION TO THE COMMUNITY BUDGET.

1. THE CHANCELLOR HAS TWO RESERVATIONS ABOUT THE NOTE: FIRST, HE IS EXERCISED ABOUT WHETHER WE SHOULD RELY WHOLLY ON THE TEST OF BELOW AVERAGE GNP PER HEAD (OR ANY OTHER SINGLE TEST) TO PROTECT US IN THE FORESEEABLE FUTURE FROM ANY SUBSTANTIAL NET CONTRIBUTION THAT IS WHOLLY OUT OF LINE WITH OUR ECONOMIC STRENGTH. HE REALISES THAT, AS THE PAPER SAYS, THE RISK OF OUR FAILING TO QUALIFY UNDER THE GNP TEST IS SMALL IN THE NEAR FUTURE, EVEN ALLOWING FOR ACCESSIONS AND A HIGHER EXCHANGE RATE. BUT HE THINKS IT SHOULD BE NIL, AND THAT THE UK SHOULD NOT BE A VERY LARGE NET CONTRIBUTOR EVEN IF WE GO ABOVE AVERAGE GNP PER HEAD.

2. THE TAPERING OFF SUGGESTED IN PARAGRAPH 3 OF TELEGRAM 114 DOES NOT MEET THIS POINT. IN DISCUSSION WITH THE COMMISSION THEREFORE THE DOUBLE CRITERION NEEDS TO BE PROTECTED AND UNDERWRITTEN BY A FURTHER PROVISION LIMITING THE UK'S NET CONTRIBUTION EVEN WHEN THE UK GNP HAS REACHED OR EXCEEDED THE AVERAGE.

3. THE PROPOSITION COULD, FOR EXAMPLE, BE THAT NO COUNTRY SHOULD MAKE A CONTRIBUTION LARGER THAN THAT OF THE COUNTRY, ITSELF A NET CONTRIBUTOR, HAVING THE NEXT HIGHEST GNP. HE EMPHASISES THAT THIS IS NO MORE THAN AN EXAMPLE. IT IS THE PRINCIPLE OF A DURABLE AND EFFECTIVE LIMIT TO THE SIZE OF THE UK'S NET CONTRIBUTION THAT IS IMPORTANT.

4. SECOND, ON FINANCING, THE CHANCELLOR THINKS WE MUST HAVE SOMETHING WHICH ACTS AS QUICKLY AS POSSIBLE, NOT JUST IN TERMS OF OPERATIVE DATE BUT IN TERMS OF CASH FLOW. WE WANT TO AVOID A SYSTEM IN WHICH OUR ABATEMENT IS REFUNDED IN ARREARS: OTHERWISE WE SHOULD BE MAKING A PERMANENT LOAN TO THE

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COMMUNITY -- AND CONCEIVABLY A LOAN OF AN INCREASING SUM. THIS SITUATION COULD BE AVOIDED, OR AT ANY RATE MITIGATED, IF OUR NET CONTRIBUTION WERE ABATED AT THE TIME OF PAYMENT-- THE ABATEMENT BEING A ROUGH APPROXIMATION OF WHAT WOULD BE DUE WITH THE FINAL ADJUSTMENTS BEING MADE WHEN ALL THE RELEVANT FIGURES WERE AVAILABLE.

5. THESE POINTS SHOULD BE REFLECTED IN THE PAPER. THE PRECISE FORMULATIONS WILL NEED MORE DETAILED WORK IN LONDON.

6. FCO PLEASE PASS AT ONCE TO BUTLER AND FRETWELL, JORDAN-MOSS AND HARL CHANCELLORS OFFICE TREASURY AND FRANKLIN (CABINET OFFICE).

FARQUHARSON

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MR J THOMSON } TSY.

Mr C. Roker
Treasury

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GRS 830

CONFIDENTIAL
FM F.C.O. 231805Z SEP 79
TO IMMEDIATE BELGRADE
TELEGRAM NUMBER 114 OF 23 SEPTEMBER
INFO UKREP BRUSSELS.

MIPT: UK CONTRIBUTION TO THE COMMUNITY BUDGET.
FOLLOWING SUMMARISES NOTE BY OFFICIALS.

1. THE NOTE CONSISTS OF:-
- I. AN INTRODUCTION:
- II. A SECTION ON QUALIFYING CONDITIONS (THE QUOTE TRIGGER UNQUOTE):
- III. A SECTION DESCRIBING POSSIBLE MECHANISMS:
- IV. CONCLUSIONS.

2. THE INTRODUCTORY SECTION BEGINS WITH THE COMMISSION'S ESTIMATES OF THE PATTERN OF NET CONTRIBUTIONS IN 1980. IT THEN GOES ON TO MENTION:
- I. THE UK'S REQUIREMENTS FOR A SOLUTION, AS SPELT OUT BY THE CHANCELLOR AT LAST WEEK'S FINANCE COUNCIL:
- II. TWO CONDITIONS ON WHICH OTHER MEMBER STATES ARE LIKELY TO INSIST, I.E. THAT THE UK MUST REMAIN A MARGINAL NET CONTRIBUTOR AND THEREFORE RETAIN AN INTEREST IN THE DEVELOPMENT OF THE BUDGET, AND THAT THE UK REFUND MUST NOT EXCEED ITS VAT CONTRIBUTION (1400-1500 MEUA IN 1980): AND,
- III. VARIOUS REQUIREMENTS ON WHICH INDIVIDUAL MEMBER STATES MAY TRY TO INSIST, TWO OF WHICH ARE CONTRADICTORY I.E. BREACHING OR ENFORCEMENT OF THE 1 PERCENT VAT CEILING.

3. THE SECTION ON QUALIFYING CONDITIONS PROPOSES A DOUBLE CRITERION: BELOW-AVERAGE GNP PER HEAD AND A NET CONTRIBUTION TO THE BUDGET, WITH THE FORMER ASSESSED OVER THE PRECEDING THREE-YEAR PERIOD. THESE CONDITIONS SHOULD RESTRICT ANY REFUNDS TO THE UK. THE PAPER EXAMINES THE RISK THAT THE UK ITSELF MIGHT FAIL TO QUALIFY AND CONCLUDES THAT IT IS SMALL. IT SUGGESTS, HOWEVER, THAT SOME PROTECTION AGAINST A SUDDEN LOSS OF RELIEF SHOULD BE SOUGHT, POSSIBLY PHASING-OUT THE REFUND OVER A THREE-YEAR PERIOD. COUPLED WITH THE AVERAGING PROVISION, THIS WOULD

ENSURE THAT WE WOULD BE PROTECTED FROM MAKING A FULL NET CONTRIBUTION FOR 4-5 YEARS AFTER WE HAD CEASED TO BE BELOW AV IN GDP PER HEAD.

4. THE ANALYSIS OF POSSIBLE MECHANISMS FORMS THE CORE OF THE PAPER AND INCLUDES CALCULATIONS SHOWING HOW MUCH RELIEF CAN BE OBTAINED FROM DIFFERENT VARIANTS OF EACH MAIN TYPE DESCRIBED. THE FOUR TYPES CONSIDERED ARE THOSE LISTED BY THE CHANCELLOR IN OD(E)24:

I. A RADICALLY IMPROVED FINANCIAL MECHANISM;
II. A CASH PAYMENT TO BOOST UK RECEIPTS;
III. A HYBRID COMBINING (I) AND (II); AND
IV. A STRAIGHTFORWARD RULE, LIMITING THE UK'S NET CONTRIBUTION.

5. THE PAPER SHOWS THAT REVISIONS TO THE FINANCIAL MECHANISM ALONE CANNOT YIELD A LARGE ENOUGH REFUND UNLESS THEY INCLUDE THE INTRODUCTION OF QUOTE PROGRESSIVITY UNQUOTE HITHERTO ANATHEMA IN THE COMMUNITY. IT LISTS THE CHANGES TO THE MECHANISM THAT WOULD BE NEEDED IF IT WERE TO PROVIDE A SATISFACTORY CORRECTIVE EVEN ON THE CONTRIBUTIONS SIDE (GROSS REFUND 676 MEUA) FINALLY IT MENTIONS THE TACTICAL ATTRACTIONS OF TAKING THE EXISTING FINANCIAL MECHANISM AS A STARTING POINT FOR ANY SOLUTION.

6. THE SECTION ON AN QUOTE ENHANCED RECEIPTS UNQUOTE MECHANISM SHOWS THAT THE UK WOULD BE A NET RECIPIENT FROM THE BUDGET IF ITS RECEIPTS PER HEAD WERE RAISED TO THE COMMUNITY AVERAGE. THUS EVEN A REFUND WHICH MADE UP LESS THAN THE FULL RECEIPTS SHORTFALL COULD SOLVE THE UK PROBLEM. THE PAPER NOTES THAT THIS APPROACH HAS THE ADVANTAGE OF FOCUSSING ATTENTION ON THAT PART OF THE UK'S NET CONTRIBUTION THAT ARISES ON THE RECEIPTS SIDE, AND THE DISADVANTAGE THAT IT INVOLVES A CONCEPT ENTIRELY NEW TO THE COMMUNITY. A FURTHER ATTRACTION IS ITS ROBUSTNESS: WHATEVER HAPPENED TO COMMUNITY EXPENDITURE, THE UK WOULD BE PROTECTED.

7. THE DISCUSSION OF A HYBRID MECHANISM SEES ITS ADVANTAGES AS PRIMARILY THOSE OF NEGOTIABILITY: IT DOES NOT INVOLVE QUOTE PROGRESSIVITY UNQUOTE FOR AN AUTOMATIC REFUND OF OUR TOTAL RECEIPTS DEFICIENCY. THIS ENSURES THAT THE UK RETAINS AN INTEREST IN COMMUNITY POLICY (THOUGH BY THE SAME TOKEN IT DOES NOT GUARANTEE A [illegible] NET CONTRIBUTION IN ALL FUTURE YEARS).

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8 VARIOUS RULES LIMITING THE UK'S NET CONTRIBUTION ARE ILLUSTRATED. THEIR MAIN ADVANTAGE IS SIMPLICITY, THE PRINCIPAL DRAWBACK IS THAT A RULE LIMITING OUR NET CONTRIBUTION TO ZERO IS TOO CLOSELY AKIN TO THE QUOTE JUSTE RETOUR UNQUOTE, AND MAY BE DIFFICULT TO NEGOTIATE. RULES LIMITING OUR NET CONTRIBUTION TO A FIGURE GREATER THAN ZERO ARE SEEN AS POSSIBLE FALLBACKS.

9. THE FINANCING SECTION IS LARGELY TECHNICAL. THE CHOICE IS BETWEEN FINANCING INSIDE THE BUDGET OR OUTSIDE IT. THE FURTHER THE ARRANGEMENTS ARE REMOVED FROM THE NARROW BUDGETARY ONES, THE GREATER THE LIKELIHOOD OF DOMESTIC PARLIAMENTARY PROCESS BEING NECESSARY IN OTHER MEMBER STATES. THIS WOULD CAUSE DELAY. UNLESS SPECIAL ACCOUNTING ARRANGEMENTS COULD BE DEVISED (A POINT TO BE EXPLORED WITH THE COMMISSION) THE 1 PERCENT LIMIT IS LIKELY TO BE BREACHED IF THE REFUND IS FINANCED WITHIN THE BUDGET. IT WILL BE A MATTER FOR DECISION WHETHER WE SHOULD CONCEDE CONTRIBUTING TO OUR OWN REFUND (AS IN THE EXISTING FINANCIAL MECHANISM), IF ITALY AND IRELAND ARGUED THAT THEY SHOULD NOT CONTRIBUTE WE SHOULD ARGUE THAT WE SHOULD NOT.

10. THE CONCLUSIONS TO THE PAPER ARE IN MIFT.

CARRINGTON

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MR FRETWELL

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MR C BAKER
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TREASURY

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TREASURY
- 5 OCT 1979
IG2 C8

1. MR JORDAN-MOSS
2. CHANCELLOR OF THE EXCHEQUER

copies attached for:

Sir Kenneth Couzens
Sir Douglas Wass
Minister of State (C)
Minister of State (L)
Financial Secretary
Chief Secretary

cc: Mrs Hedley-Miller (or)
Mr Ashford
Mr Michell
Mr Thomson
Mr Shore
Mrs Lomax
Mr Meyrick

fc Corrective Mechanisms

OD(79)25: UK COMMUNITY BUDGET CONTRIBUTION - CORRECTIVE MECHANISMS

This paper will be discussed at OD on 8 October. The Chancellor has already received a synopsis of the paper, sent to him in Belgrade in FCO Telno. 114. He made certain comments on the synopsis in Belgrade Telno. 172. Copies of both telegrams are attached. As the Chancellor will have seen from your note to him of 3 October, his position has been protected, pending the OD discussion, in the confidential briefing that will be given to Commission officials prior to this weekend's informal meeting of the Commissioners to discuss corrective mechanisms.

Robustness of the mechanism to the UKs GNP per head

2. We have been thinking about the Chancellor's two reservations. There are a number of possible ways of getting round the problem posed by the risk that we might at some point exceed the Community average GNP per head. The formula suggested by these in paragraph 3 of Telno. 172 would be highly effective as long as France was a net contributor. If she became a net beneficiary (which she has been at various stages in the past) a formula along these lines would only constrain our net contribution to the level of Germany's. That would be an improvement on our forecast position in 1980, but would not

necessarily provide much relief in future years. An alternative possibility is to establish criteria for the operation of a corrective mechanism which will clearly benefit the UK and no other Member State regardless of our level of GDP per capita. Two examples are:-

(a) receipts per capita below $^2/3$ of the Community average;
(b) a net contribution greater than 30% of gross contribution.

These could be put forward as qualifying criteria, and not as mechanisms, but in practice there is likely to be a link between the two. Thus if we accepted a criteria which said that the mechanism would apply to a Member State whose receipts per capita were less than $^2/3$ of the Community average, other Member States are likely to argue that the mechanism itself should do no more than make receipts up to $^2/3$ of the Community average. This would refund to us only 618 meua on an "importer pays" basis for mca's and 899 meua on "exporter pays" basis. Similarly, a <u>mechanism</u> which limited our net contribution to 30% of our gross contribution would yield 618 meua on an importer pays basis, and 880 meua on an exporter pays basis. This would fall far short of the objective of broad balance.

3. One possibility would be to combine such criteria with the double criteria of below average GNP per head and being a net contributor described in the paper. We would qualify on an either/or basis, but we might well have to accept a lower refund on the lines detailed in the preceeding paragraph once we were beyond 100% of the Community average GNP per capita. There would be negotiating difficulties, too, in the sense that criteria of this type would be further away from the sort of criteria in the existing financial mechanism and we would lose the tactical advantage described in the paper of appearing to build a new mechanism on the Financial Mechanism. There would also be a negotiating disadvantage in that an either/or criterion would in principle open the way to significant refunds for us

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even if we were to become the wealthiest Member State. This would be extremely difficult to negotiate with our partners.

4. As the paper point out, every additional feature that we want in a corrective mechanism will have its negotiating price and this might mean that at some point there would be a trade-off between securing our position against a variety of eventualities, and the actual amount that Member States were prepared to concede to us. In this context, the Chancellor may find it useful to have some calculations about the likelihood of our reaching 100% of the Community average GNP per head. Broadly, this could happen if relative growth rates in the Community changed, and we start to grow more quickly than our partners, or if there is a sustained appreciation of sterling.

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period 1979 to 81 is -0.5%. 2.1% would in fact represent a very significant rate of growth, indeed in circumstances where our major export markets in Europe were not growing at all.

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37

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C J BAKER
5 October 1979

Mr Baker

40

GR 400
CONFIDENTIAL
FM BELGRADE 020530Z OCT 79
TO IMMEDIATE FCO
TELEGRAM NUMBER 172 OF 2 OCTOBER

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FRD.
MR BUTLER.
MR FRETWELL

COPIES TO.
MR FRANKLIN CABINET OFFICE
MR N. JORDAN-MOSS TSY.
MR C BAKER
MR J THOMSON } TSY.

FINANCIAL SECRETARY TO THE TREASURY

CHANCELLOR OF THE EXCHEQUER

Chief Secretary
Minister of State C
Minister of State L
Sir D Wass
Sir K Couzens
Mr Jordan-Moss
Mrs Hedley-Miller
Mr Ashford
Mr Michell
Mr Thomson
Mr Baker
Mr Shore
Mrs Lomax
Mr Meyrick

UK COMMUNITY BUDGET CONTRIBUTION CORRECTIVE MECHANISMS: OD(79)25

I am sure we should not waste time worrying about the possibility of the UK's GNP per head exceeding the average for the EEC, and we should certainly not risk alienating other member states by trying to construct a mechanism which would ensure us a refund even if it doe

Raising the UK's GNP per head above the EEC average it not only (regrettably) a most unlikely event; but if it were to occur it would be such a major economic success that we could take in our stride a setback on the corrective mechanism front: not only that, our economic resurgence would give us a political clout in the EEC context which would transform the whole problem in a much wider and more fundamental sense.

Finally, while it is true that to some extent the exchange rate is the joker in the pack, we can always manipulate the exchange rate (in a downward direction) should it really pay us to do so.

NIGEL LAWSON
8 October 1979

174/1c

SS

CONFIDENTIAL

✓ Mr. Baker

cc: Financial Secretary
Sir Kenneth Couzens
Mr Jordan-Moss
Mrs Hedley-Miller
Mr Michell
Mr Shore
Mr Fitchew - UKREP
IG2CS

CHANCELLOR OF THE EXCHEQUER

MECHANICS OF EEC BUDGET CONTRIBUTIONS BY OTHER MEMBER STATES

I understand from Sir Kenneth Couzens that you have expressed interest in the mechanics of EEC Budget contributions by ourselves and by other Member States, including in the extent to which any of them may, deliberately or through mal-administration, pay less to the Commission than they should. With this in mind we asked Mr B Halliwell, Deputy Accountant General, Customs & Excise, to prepare a note on a personal basis and Sir Kenneth Couzens has now asked me to let you have a copy of this for your information; I am also sending a copy at his request to the Financial Secretary.

2. In fact within the last few days the Prime Minister has asked, through the Cabinet Office, for information in the same area and we have therefore suggested that the Cabinet Office should forward a copy of the same document to her.

G R ASHFORD
IG2 Division
12 October 1979

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CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

TREASURY 17 OCT 1979

MR ASHFORD

Mr. Baker. →

Principal Private Secretary
Sir K Couzens
Mrs Hedley-Miller
Mr Michell
Mr Shore

MECHANICS OF THE EEC BUDGET CONTRIBUTIONS BY OTHER MEMBER STATES

The Financial Secretary was interested in your minute of 12 October on this subject, and has asked (given the level of VAT evasion recorded in paragraph 6 of the note attached to your minute) whether there is any possibility that the above average VAT contribution we pay in relation to our GDP is a product of below average VAT evasion in this country. If there is any evidence pointing in this direction the Financial Secretary feels that this argument too should be presented as a grievence in the budgetary context.

pp P C DIGGLE
16 October 1979

1605-20

195/52/02

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

cc Sir K Couzens
Mr Byatt
Mrs Hedley-Miller
Mr Middleton
Mr Ashford (or)
Mr Michell
Mr Meyrick
Mr Thomson
Miss Spottiswoode

Mr H. Walsh,
Cabinet Office

EEC: UK BUDGET CONTRIBUTION

You will recall that the OD Committee on 8 October asked you to supply the Committee with further information on the developments in exchange rates and relative growth rates that would be needed for the United Kingdom to reach the Community average GDP per head in an enlarged Community: this was to help to form a judgment on how robust a GDP per head criterion was likely to be in any corrective mechanism.

2. I attach a draft memorandum which you might care to send to the Prime Minister and members of OD on this point, covering a note by officials (which has been agreed between the Departments chiefly concerned). These papers, if approved by you, could be circulated by the weekend in time for the next OD meeting on Wednesday, October 24.

N. Jordan-Moss
18 October 1979

PP COPENHAGEN

195/53/02

TREASURY
19 OCT 1979
IG2 CS

PS/Lord President, CSD.

Mr Alexander, No 10 Down St.

RC

HD EID(1)

PS

PS/LPS

Mr Butler

PP THE HAGUE

PP ROME

PP LUXEMBOURG

Mr Mitchell

To see

Officer

PP DUBLIN

[Files]

PP PARIS

PP BONN

GRS 950

IMMEDIATE

Mr Franklin
Mr Elliott
Mr Walsh
} Cabinet Office

PS/Chancellor
Mr Couzens
Mr Jordan-Moss
Mrs Hedley-Miller
Mr Ashford
Mr Thomson
Mr Baker
} Treasury

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DUBLIN PARIS BONN

UK BUDGET CONTRIBUTIONS : COMMISSION DISCUSSION OF 17 OCTOBER

for Corrective Mechanism

(FOR HEADS OF MISSION ONLY)

WE HAVE BEEN GIVEN IN CONFIDENCE (PLEASE PROTECT) AN ACCOUNT OF YESTERDAY'S FIRST DISCUSSION IN THE COMMISSION OF POSSIBLE SOLUTIONS TO THE UK BUDGETARY PROBLEM.

2. THE COMMISSION HAD BEFORE IT A PAPER DRAFTED BY THE SECRETARY-GENERAL'S WORKING GROUP. THIS CONTAINED FOUR MAIN OPTIONS:
(A) AMENDING THE FINANCIAL MECHANISM BY REMOVAL OF THE EXISTING CONSTRAINTS TO PRODUCE A PAYMENT OF 630 MEUA GROSS IN 1980. IN ADDITION, THE POSSIBLE INTRODUCTION OF QUOTE GEARING UNQUOTE (IE PROGRESSIVITY, THOUGH IT IS NOT SO DESCRIBED) INTO THE MECHANISM. THIS IS ESTIMATED TO QUOTE ALMOST DOUBLE UNQUOTE THE MAXIMUM REFUND:

(B) QUOTE PROLONGING ARTICLE 131 UNQUOTE. THIS IS BRIEFLY DISCUSSED, UNDER THE TITLE QUOTE A NEW MECHANISM UNQUOTE. NO FIGURE IS GIVEN , THOUGH WE KNOW AN ESTIMATE OF 310

[illegible] ... [illegible].
NO FIGURE IS GIVEN, THOUGH WE KNOW AN ESTIMATE OF 310 MEUA NET HAS BEEN MADE. THE COMPLICATION OF INTER-ACTION WITH THE FINANCIAL MECHANISM IS MENTIONED.

(C) RADICAL SOLUTIONS. THIS PART OF THE PAPER EXPLORES (WITHOUT ANY FIGURES) A NUMBER OF TYPES OF NET LIMIT ON THE UK CONTRIBUTION OR ENHANCED RECEIPTS MECHANISM ALONG THE LINES OF THOSE PUT TO UK MINISTERS. IT IS SUGGESTED THAT AN ENHANCED RECEIPTS MECHANISM COULD IN SOME WAY BE LINKED DIRECTLY TO QUOTE CERTAIN COMMUNITY OBJECTIVES UNQUOTE AND SO TO THE QUOTE OVERALL AIM OF CONVERGENCE UNQUOTE.

(D) EXPANSION OF COMMUNITY EXPENDITURE POLICIES. ILLUSTRATIVE FIGURES ARE GIVEN TO SHOW THAT EXPANSION OF EXISTING STRUCTURAL FUNDS IS NOT A PRACTICAL OR EFFECTIVE SOLUTION, BUT REFERENCE IS ALSO MADE TO POSSIBLE NEW COMMUNITY POLICIES, EG TO RAISE THE UK'S LEVEL OF INVESTMENT.

IN CONNECTION WITH SOLUTIONS (A) - (C) REFERENCE IS MADE TO THE POSSIBILITY OF FINANCING OUTSIDE THE BUDGET.

3. THERE WAS NO DISCUSSION OF THE SUBSTANCE OF THE PAPER AT YESTERDAY'S MEETING. ORTOLI GAVE AN ACCOUNT OF THE 15 OCTOBER FINANCE COUNCIL, INCLUDING A VERY FAIR STATEMENT OF THE UK POINT OF VIEW. FOLLOWING A SUMMARY BY NOEL OF THE PAPER DESCRIBED ABOVE, ROY JENKINS SAID IT WAS CLEAR THAT THE COMMISSION SHOULD NOT LIMIT ITSELF TO THOSE OPTIONS WITH QUOTE A SHARP FINANCIAL CEILING UNQUOTE (THIS IS UNDERSTOOD TO MEAN THE FINANCIAL MECHANISM AND ARTICLE 131). HE SUGGESTED THAT MORE WORK WAS NEEDED ON THE LEGAL IMPLICATIONS OF THE DIFFERENT SOLUTIONS OUTLINED IN THE PAPER AND THAT THERE SHOULD ALSO BE AN ADDITIONAL SECTION DEALING WITH THE ITALIAN PROBLEM. THE COMMISSION SHOULD HAVE A FURTHER DISCUSSION ON 24 OCTOBER AT STRASBOURG.

4. DAVIGNON AND GUNDELACH SHOWED SOME UNEASE AT THE POSTPONEMENT OF A SUBSTANTIVE DISCUSSION. DAVIGNON SAID THAT THERE WAS AT LEAST ONE SOLUTION (UNSPECIFIED BUT POSSIBLY THE GEARED FINANCIAL MECHANISM) WHICH HE COULD NOT ACCEPT. HE WAS INVITED TO PUT IN A PAPER. GUNDELACH WAS INVITEDTO NOMINATE A MEMBER OF HIS STAFF (CABINET OR DG VI) TO JOIN THE NOEL WORKING GROUP AND TO HAVE A MAJOR HAND IN DRAFTING THE ITALIAN SECTION, BECAUSE OF ITS AGRI-CULTURAL IMPLICATIONS.

MAJOR HAND IN DRAFTING THE ITALIAN SECTION, BECAUSE OF ITS AGRI-CULTURAL IMPLICATIONS.

5. NOEL'S WORKING GROUP WILL NOW REDRAFT THE PAPER WITH THESE ADDITIONS AND TURN IT INTO A DRAFT COMMUNICATION FROM THE COMMISSION TO THE COUNCIL. THE REVISE WILL BE PUT TO THE COMMISSION ON 24 OCTOBER, WHEN THE PRESIDENT COMMITTED HIMSELF TO HAVING A MAJOR SUBSTANTIVE DISCUSSION. (THE MEETING WILL BE A SHORT ONE BECAUSE IT WILL BE IN STRASBOURG IN THE MARGINS OF THE PARLIAMENTARY SESSION.) THE FURTHER DISCUSSION SCHEDULED FOR 29 OCTOBER HAS NOW SLIPPED TO 31 OCTOBER. THE PAPER IS NOW EXPECTED TO BE CIRCULATED TO MEMBER STATES BY THE FOLLOWING WEEKEND (IE 3 NOVEMBER).

6. A COPY OF THE PAPER DISCUSSED BY THE COMMISSION YESTERDAY FOLLOWS BY BAG. THE ECONOMIST CORRESPONDENT HERE HAS TOLD US THAT HE HAS A COPY: IT IS LIKELY TO BE EXTENSIVELY QUOTED IN TOMORROW'S EDITION.

FCO ADVANCE :
FCO - PS/SOS. PS/LPS. BUTLER FRETWELL SPRECKLEY
CAB - FRANKLIN ELLIOTT WALSH
TSY - PS/CHANCELLOR COUZENS JORDAN-MOSS MRS HEDLEY-MILLER
ASHFORD THOMSON BAKER
NO 10- ALEXANDER
CSD - PS/LORD PRESIDENT

MAITLAND

NNNN

~~Draft~~ /M

195/S2/02
6L COPY
7. 49

DRAFT MEMORANDUM BY THE CHANCELLOR OF THE EXCHEQUER

QUALIFYING CONDITIONS FOR A CORRECTIVE MECHANISM : THE ROBUSTNESS OF A GDP PER HEAD CRITERION

At the ~~last~~ meeting of OD Committee on 8 October I expressed reservations about the two-part qualifying criterion proposed in OD(79)25, on the grounds that the GDP per head condition was insufficiently robust. The Committee ~~then~~ asked me to supply it with further information on the developments in exchange rates and relative growth rates that would be needed for the United Kingdom to reach the Community average GDP per head in an enlarged Community.

2. The attached note by my officials goes into this question in some depth. Its conclusions are on the whole reassuring. The improvement in the United Kingdom's real growth rate that would be required to bring us to the Community average GDP per head before the end of the century without a sustained rise in the real exchange rate is almost inconceivable, however successful our economic policies may prove. A steep rise in the real exchange rate, sufficient to carry us over the same threshold, appears a slightly greater risk. But for such an exchange rate appreciation to disqualify us under the averaging arrangements proposed in OD(79)25, it would either have to be sustained and accompanied by a significant improvement in our growth performance, or to continue at a rate sufficient to offset the growth rate differential against us. It seems unlikely that we could achieve the historically high rates of growth that would be needed in either case at a time when real exchange rate rises were eroding significantly the competitiveness of UK industry.

3. If GDP per head were measured at purchasing power parities the UK would now be very close to the Community average in a Community of 12. But unless our relative growth rate improves markedly we shall already be 11% below the average by 1983, the earliest feasible date for full enlargement. And because calculations on this basis are insulated from the vagaries of market exchange rates

UK GDP per head could only rise above the average by this route if ther were a real improvement in our relative economic performance.

4. I conclude that the possibility of changes of the required size and duration occuring over the next five years is small, too small to justify our expending a significant amount of negotiating capital in safeguarding ourselves against the risk entailed. I suggest therefore that for the present we should confine our efforts to securing one vital objective in this area - the raising of the GDP per head threshold from the figure of 85% of the Community average embodied in the Financial Mechanism to 100% - and to a second, highly desirable one - the retention of a three year averaging provision. We should also resist any suggestion that GDP per head should for the purposes of a mechanism be calculated using purchasing power parities.

5. Any mechanism that is established will no doubt include a clause providing for a review after a specified period. I suggest that we should insist that a review should also take place if at any point a country that has previously qualified for relief ceases to do so. A provision on these lines, which could hardly be triggered before 1985, would give the United Kingdom an opportunity to fight its case for continued relief on its merits in the circumstances then prevailing. We should also insist on the automatic three-year phasing-out arrangement proposed in OD(79)25. Taken together these two provisions should, I believe, provide us with as much protection against loss of relief as we can hope to negotiate.

6. I invite my colleagues to endorse the conclusions set out in paragraphs 4 and 5 above.

TREASURY
24 OCT 1979
HG2 CS

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1. SIR KENNETH COUZENS
2. CHANCELLOR OF THE EXCHEQUER

cc Mr Jordan-Moss
Mr Byatt
Mr Middleton
Mrs Hedley-Miller
Mr Michell
Mr Baker
Mr Thomson
Miss Spottiswoode

QUALIFYING CONDITIONS FOR A CORRECTIVE MECHANISM : THE ROBUSTNESS OF A GDP PER HEAD CRITERION (OD(79)36)

Briefing for OD

I attach briefing for tomorrow's OD meeting. It includes some material on the Dutch experience (sparked off by your recent minute to me), which is not the OD paper. The Chancellor may find it useful to rebut suggestions that the risks of a large rise in the real exchange rate are so negligible that they can be completely discounted. We understand that the Foreign Secretary is being briefed to take this line. The Dutch experience shows that large trend rises in the real exchange rate do occur. This example is particularly suggestive because the real rise in the Dutch exchange rate seems to be associated with Dutch gas. But it is no more than illustrative. It does not affect the central judgment of the paper, that such a move for the UK is improbable, though not totally to be dismissed. The underlying trends are much worse in the case of the UK than of the Netherlands. It would take an even sharper rise in the real exchange rate trend than the Dutch seem to have had, plus an improvement in our relative growth rate to bring us up to the EEC average by the end of the 1980s. Three-year averaging coupled with three-year phasing out should provide adequate - albeit important - safeguards.

RL.

RACHEL LOMAX
23 October 1979

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QUALIFYING CONDITIONS FOR A CORRECTIVE MECHANISM : THE ROBUSTNESS OF A GDP PER HEAD CRITERION (OD(79)36)

Memorandum by the Chancellor of the Exchequer, covering a paper by officials

This paper fulfils the remit given to you at the 8 October meeting of OD, to examine the robustness of a simple below-average GDP per head criterion, as proposed in OD(79)25. On the basis of the detailed paper by officials, your covering memorandum endorses the conclusions of the earlier paper, that three-year averaging, buttressed by automatic three-year phasing out arrangements, should provide as much protection to a below-average GDP per head criterion as we can hope to negotiate.

2. The bulk of the paper by officials discusses the chances of the UK reaching EEC average income per head as defined by GDP per head at market prices. This could come about by an improvement in the UK's real growth rate, an appreciation in the real exchange rate or some combination of the two. While the risk of the UK reaching the Community average in the foreseeable future looks remote, unpredictable, and possibly large, movements in the real exchange rate are always a danger. The three-year averaging provision could therefore be an important safeguard.

3. The Foreign Secretary is being briefed by his officials to argue that the risk of the real exchange rate rising by the necessary amount is so remote that it can safely be ignored. The supporting argument is that, once oil production has peaked in the mid-1980s, and possibly sooner, the main pressures on the real exchange rate are likely to be downward. This possibility

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is in fact mentioned in paragraph 9 of our paper. You can agree that this is possible, but that the real point is the uncertainty surrounding exchange rate projections for an economy newly rich in oil, which is compounded by the uncertainty surrounding the future course of oil prices. Few if any economists predicted the large appreciation in the real exchange rate that has taken place since 1976.

4. You may want to cite the Dutch experience. Between 1970 and 1978, the Dutch real exchange rate appreciated by an average 6½ per cent a year. Coupled with a real growth rate little better than the EEC average, this has taken Dutch income per head, at market exchange rates, from 99 per cent of the Community average in 1970 to 123 per cent in 1978. The upward trend in the Dutch real exchange rate represented a marked acceleration compared with the 1960s, when the real exchange rate rose less than 2 per cent a year on average. It is tempting to attribute the change in large part to Dutch gas, which is now broadly comparable with North Sea oil (relative to the size of the respective economies).

5. The Dutch experience only illustrates what can happen. The chances of the UK repeating this performance still seem remote, however, for reasons rehearsed in the paper. Unlike the Netherlands, past trends in the UK's real exchange rate have been down not up, at least until 1976, and our real growth rate has been well below the EEC average, rather than slightly above it. Nevertheless, North Sea oil is likely to push up the UK real exchange rate, as Dutch gas has pushed up the guilder, and it is almost impossible to say with confidence for how long and how far the movement will go. The risk posed by the exchange rate, while relatively remote, is worth insuring against, to the extent of seeking a three-year averaging provision.

6. As the paper points out, the use of purchasing power parities would avoid the risk that we might be carried above the EEC average by a sharp rise in the real exchange rate. We could only

rise above the Community average, on this basis, if there were a real improvement in our relative economic performance. This is again illustrated by the Dutch experience: at purchasing power parities, Dutch income per head has changed very little relative to the Community average, in contrast to the sharp rise when GDP per head is measured at market exchange rates. Against this undoubted advantage in the use of purchasing power parities, there is the difficulty that the UK is very much closer to the EEC average, on this basis, and would have been scarcely below the average in a Community of 12 last year.

7. It still seems improbable that we would rise above the EEC average, even at purchasing power parities. But our case would be weakened by the use of this measure, to the extent that it depends on our being "less prosperous". Use of purchasing power parities in this context would set a precedent, which could be unwelcome to us in other contexts. And we would be very vulnerable to moves to keep the GDP threshold at 85 per cent of the EEC average. Your memorandum therefore recommends that we continue to resist any suggestion that GDP per head should be calculated at purchasing power parities for the purposes of a mechanism.

33/137

CONFIDENTIAL

Mr Thomson.
Sir Kenneth Couzens was grateful for your draft, which has now gone forward in a slightly amended form.

GS 29/

cc: Mr Jordan-Moss
Mr Middleton
Mr Ashford
Mr Michell
Mrs Lomax
Mr Baker
Mr King
Mr Shore
IG2CS

SIR KENNETH COUZENS

REFUNDS UNDER THE EXISTING FINANCIAL MECHANISM FOR 1980

At your meeting yesterday you suggested that the PPS might write to No.10 explaining that we now thought it likely that the UK would qualify for a refund of around £210 million in respect of the 1980 Budget under the provisions of the existing Financial Mechanism. You thought that the letter should also comment on the implications that this might have for our general negotiating stance on the Budget issue.

... 2. I attach a draft.

J. A. Thomson.

J A THOMSON
IG2 Division
25 October 1979

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DRAFT LETTER TO: C A Whitmore Esq
10 Downing Street
London SW1

UK CONTRIBUTION TO THE EEC BUDGET : REFUND UNDER THE EXISTING FINANCIAL MECHANISM FOR 1980

You will recall that there is already provision for some modest easement of the UK's contribution to the Community Budget in the 1975 Financial Mechanism, the detailed workings of which were described in the Note by Officials which formed Annex C to OD(79)19 - "The EEC Budget : Corrective or overriding mechanisms".

2. As that note made clear, the existing Financial Mechanism is quite incapable of meeting the UK's requirements for a solution to its budgetary problem. Its main drawback is that the relief it provides relates only to a Member State's excessive gross contribution, whereas the bulk of the UK's net contribution stems from the low level of its receipts. But it also contains a series of qualifying conditions and restrictions which make the size, and indeed the existence, of a refund a matter of great uncertainty. This applies even to the UK, which the Mechanism was designed to help and whose contribution is manifestly disproportionate to its ability to pay.

3. For this reason, it has hitherto been very difficult to foresee what, if any, refund the UK would receive in respect of the 1980 Budget. The critical factor in determining this is its cumulative balance of payments

performance over the three years 1977 to 1979. If the current account is in cumulative deficit the UK will qualify for a refund related to the full excess of its contribution over its share in Community GNP. If it is in cumulative surplus, the refund will be based only on the margin by which its share of VAT contributions exceeds its GNP share. The difference is very substantial. In the first case the gross refund would be around £210 million (£175 million net), in the second a derisory £8 million (£7 million net).

4. The margins of error in balance of payments forecasting are considerable and up till now we have not been able to assess with any confidence the likelihood of the UK running in 1979 a balance of payments deficit large enough to outweigh the cumulative surplus of around £1.3 million built up in 1979 and 1980. However, now that we have trade statistics covering the first nine months of this year we are in a better position to judge. So far this year the current account has been in deficit to a total of £2.6 million. Even allowing for the expected improvement in the last quarter and for some upward revision of the invisibles figures, such as has generally occured in the past, it now seems likely that the eventual outturn for 1977 to 1979 will be a deficit.

5. As I have explained, this should result in a refund to the UK (without modifying the Financial Mechanism) of about £210 million gross. This would be payable in 1981, $\frac{3}{4}$ of it in the first quarter and therefore within the 1980-81 fiscal year.

6. The prospect of a refund on this scale under existing provisions must have some bearing on the tone of voice that we adopt when pressing our case for further relief. It proves, as our partners will no doubt be quick to point out, that the present arrangements are not entirely useless. But at the same time it demonstrates just as strikingly their inability to produce relief on the scale needed to meet the Government's objective of a "broad balance". And of course, a £210 million refund reduces pro tanto the extra money that our partners would have to find if they agreed to a solution which satisfied our requirements.

7. In our view, these considerations more or less balance out. We conclude therefore that the prospect of a significar refund under the Financial Mechanism need not greatly influence our negotiating line. Although we can no longer damn the existing Mechanism quite as roundly as before, we must continue to insist that it requires far-reaching revision before it can play any part in a satisfactory solution. This means in particular raising the GDP per head qualifying threshold from 85% of the Community average to 100%, abolishing the tranche system and the 3% ceiling on refunds and removing the balance of payments condition.

8. The case for this last reform is well-illustrated by the uncertainty that has arisen over the 1980 refund. It is plainly ridiculous that a mechanism designed to reduce the burden of excessive payments on a country ill-equipped to bear it shou be sensitive to marginal changes in its balance of payments performance in a preceding period. There can be no justificat

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ion for such a provision in any solution designed to bring about greater equity in the Community's finances.

9. I am copying this letter to George Walden.

A M W BATTISHILL

60

cc: Sir Kenneth Couzens
Mr Jordan-Moss o/r
Mr Michell
Mrs Lomax
Mr Baker
IG2CS

1. MR ASHFORD
2. PRINCIPAL PRIVATE SECRETARY

UK CONTRIBUTION TO THE COMMUNITY BUDGET : PQ FROM MR WILLIE HAMILTON

Mr Hamilton has tabled the following question for oral answer on 8 November:

> "To ask the Chancellor what steps he is intending to take immediately to reduce the United Kingdom's contribution to the European Economic Community Budget."

It is likely to be reached.

... 2. I attach a suggested draft reply, together with a large number of supplementaries, which are based on material already supplied to No.10.

J A THOMSON
IG2 Division
1 November 1979

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ORAL

Thursday 8 November

No.4C

Lab. Central Fife
MR W W HAMILTON : To ask Mr Chancellor of the Exchequer, what steps he is intending to take immediately to reduce the United Kingdom contribution to the European Economic Community Budget.

DRAFT REPLY

We are negotiating with our partners and have impressed on them the need for agreement at the November European Council on measures that will bring about a rapid and very substantial reduction in the United Kingdom's net contribution.

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MR W W HA.

BACKGROUND

This is one of many questions on this theme which will no doubt be tabled over the next month.

The attached notes for supplementaries cover a wide range of possible follow-up questions.

NOTES FOR SUPPLEMENTARIES

BUDGET CONTRIBUTION

Q1 What is the extent of the UK's budget problem?

A The Commission's latest estimates show that, unless something is done, the UK's net contribution in 1980 will be well over £1,000 million. Our own calculations show that if present trends were allowed to continue, it would rise still further in succeeding years.

Q2 Why has the problem arisen?

A Partly because our share of gross contributions under the Own Resources system is somewhat larger than our share in Community GNP, but to a greater extent because our share of receipts is very low. This results from the predominance of agricultural spending in the Budget. The bulk of this expenditure goes to finance the storage and disposal of surpluses which arise elsewhere in the Community.

Q3 What are we doing about it?

A I have made it absolutely clear to our Community partners that the present situation is manifestly inequitable and politically indefensible. The European Council in June requested the Commission to produce a paper setting out the effects of the Budget on Member States. This appeared last month. It demonstrated the injustice of the UK's net contribution. The Commission are now preparing a further paper on possible solutions to the problem, which they intend to circulate in early November. The European Council has declared its intention to take appropriate decisions when it next meets on 29 and 30 November.

Q4 What exactly do you want?

A We are looking for a solution which will produce a broad balance between our contributions and receipts. It must apply to the 1980 Budget and last as long as the problem, but no longer. We believe that in the short-term these conditions can only be satisfied by some form of corrective mechanism, dealing with the whole of the UK's budgetary problem.

Q5 Why won't the existing Financial Mechanism do?

A As the Commission itself has shown, the previous Government accepted conditions which prevent us from ever getting much out of it. In any case it is concerned only with our excessive gross contribution to the Community Budget. The larger part of our problem arises from the low level of Community expenditure in the UK.

Q6 What are the longer-term modifications to Community policies that will eventually remove the need for a corrective mechanism?

A One cannot at this stage foresee precisely what form they will take. The vital thing will be to achieve a better balance of expenditure between the Community's various policies. This means in particular reducing the 70% share now absorbed by the CAP, most of which goes to finance wasteful agricultural surpluses.

Q7 Aren't you really asking for Community handouts to solve problems of the UK's own creation?

A Not at all. We are not seeking subsidies from the Community, merely that the UK should not be its main financier.

Q8 Aren't you in danger of undermining the Community altogether by pursuing UK interests in this way?

A No. This Government is strongly committed to the European Community. There is nothing uncommunautaire in what we are asking. We believe that the Community cannot thrive if it bases its future financing on this unacceptable and deteriorating foundation. It is in the Community's interest, as well as the UK's, that this problem should be speedily solved, and solved for good.

Q9 Aren't you narrow-mindedly ignoring the wider benefits of Community Membership?

A Absolutely not. That is precisely why this Government is determined to participate fully in developing the Community further. But most of these wider benefits are shared equally by all Member States; there is no reason why the UK alone should have to pay a budgetary price for them.

Q10 Isn't it true that the UK incurs further non-budgetary costs as a result of Community membership?

A The non-budgetary costs and benefits of membership are very hard to quantify exactly. Many of the benefits of such an association are quite incalculable. But they are the benefits that accrue to all Member States. The only area where any well-based estimates are possible is the CAP. And in this area the UK, as a net importer of the products covered by the price support provisions of the CAP, is bound to lose out. But the loss is small compared with that arising from our net budgetary contribution.

Q11 Why was nothing done earlier?

A A potential UK budget problem was identified during our accession negotiations, but the Community argued that it would not occur because of the expected shift of spending away from agriculture and a consequent rise in UK receipts. The matter came up again during the 1974 renegotiation, but our partners were not convinced of the seriousness of the problem. Only after the appearance of the Commission's latest estimates of 1980 net contributions has it been widely acknowledged that there is an imbalance on the scale which we had originally anticipated.

Q12 Do your Community colleagues really accept that something must be done?

A We have made some progress. We are under no illusions about the difficulties ahead. If we pay less, they will pay more. But I believe that justice will prevail.

Q13 Will the Chancellor comment on the status of the "non-paper" containing UK proposals for a solution, that has recently been discussed in the press?

A Under the terms of its remit from the June European Council, it is for the Commission to bring forward proposals for a solution. If, in the process of formulating their proposals, they seek the views of individual Member States, that is perfectly proper and only to be expected. I do not think there is anything to be gained by speculating further on the ideas that individual Member States may have; we must wait and see what the Commission come up with.

Q14 Is there any truth in press reports that we shall withdraw/withhold our contribution if we do not achieve a satisfactory solution in Dublin?

A This question does not arise. We are in negotiation with our partners and I am sure that they will recognise the justice of our case.

206/80

F/EEC gen.

Mr Fryer

NOTE OF A MEETING AT NO.11 DOWNING STREET ON MONDAY, 3RD MARCH AT 6.00 P.M.

Present:

Chancellor of the Exchequer
Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Hancock
Mrs. Hedley-Miller
Mr. Unwin
Mrs. Lomax
Mr. Michell
Mr. Ridley

UK CONTRIBUTION TO THE EUROPEAN COMMUNITY BUDGET

The discussion was held to consider possible further steps on the UK Community Budget contribution issue, in the light of Sir Kenneth Couzens' minute to the Chancellor of 29th February.

2. Sir Kenneth Couzens said that there was as yet little prospect of our securing a settlement which would in effect restrict our net contribution to one third of our gross contribution and it seemed likely that we would be asked to pay a high price in terms of CAP prices, sheepmeat, etc. for any relief we received on the Budget contribution issue. There was no escape from the Prime Minister continuing to negotiate hard at unpleasant meetings; although the European Commission were working out a mechanism whereby money could be channelled to the UK, no figures would be mentioned before the European Council.

3. Sir Kenneth Couzens thought the UK might be offered up to 900 million units of account at the March European Council; but if we were to achieve our objective, we needed something

more like 1300 million units of account. The Financial Secretary said that we had in effect been offered 520 MUA at Dublin through the removal of the limitations in the existing financial mechanism; if we could now secure a similar amount of additional expenditure, we should be approaching the sort of minimum settlement which it might be politically possible to sell, provided that the additional receipts from Community expenditure were indexed.

4. In further discussion it was suggested that we could accept a settlement which went only, say, halfway to meeting our requirements in 1980, provided we received full satisfaction in 1981 and subsequent years. Indexation of the receipts was essential, and if this could not be secured, then fixing the Community expenditure as a proportion of volume programmes, although this had other disadvantages, could help to protect the UK position. If all else failed, there might be a case for accepting that the amounts to be paid to the UK should be reviewed each year; this would at least ensure that the problem was continuously in the foreground, and the other Members might in due course conclude that it was worth accepting our preferred solution of a receipts mechanism in order to get the problem off the table.

5. It seemed likely that the best we could hope for at the March European Council would be the emergence of the outlines of an eventual settlement, whose details would be filled in in time for the June Council. The main problem remained the French, and they were only likely to make the necessary concession if pressed by Schmidt. Despite what Schmidt had said about EMS, the judgement was that concessions on sheepmeat would buy much more in the way of movement towards an acceptable solution of UK Budget contribution problem. It was helpful that the Commission were now thinking in terms of much bigger amounts for the UK than ever before, and that there would be a mechanism through which they could be paid. However, we could not be certain that the atmosphere in June would be better than in March.

6. It was noted that Padoa-Schioppa had suggested that, if immediate progress on the Budget contribution issue were blocked, we might as an alternative try to get the Community to agree to a series of general propositions which in effect accepted the UK case. Possible examples were that expenditure of agriculture should not exceed a certain proportion of the Community Budget, and that no Member State should pay an utterly disproportionate net contribution. The fact that the Community had explicitly accepted propositions of this kind would give the UK a stronger base on which to build future demands.

7. There was general agreement that at some point withholding of some part of the UK contribution would have to be contemplated, despite the FCO objection that it could not be relied on to achieve our objective (in the short run other Members' response would probably be to withdraw all concessions hitherto offered), and that it could be argued to amount to "constructive withdrawal". Obstruction of Community business would not be an effective sanction, and would in practice be of no use beyond July; but withholding should actually strengthen the UK negotiating position, which was based on the fact that we were paying over the money. There was a dilemma about the timing of legislation to support withholding; if we made an overt move, it would make it more difficult for us to argue that we were in no sense putting our membership in question (although we would strongly argue that we were not doing this), but if we made no move, and "Euro-fanatics" started proceedings against the Government about withholding, the Government would inevitably lose the litigation. The <u>Chancellor</u> was inclined to favour legislation as soon as we embarked on withholding, but wanted to reflect further on the problem.

8. It was generally agreed that the Attorney General's advice against trying to start proceedings against the Community under Article 175 of the Treaty would have to be accepted. It would be impossible to show that the Community had failed in its duty towards the UK. However, if the UK were taken to the

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CHANCELLOR OF THE EXCHEQUER

European Court over withholding, then the arguments about unfair treatment would constitute a useful defence. The Germans were already very worried that the UK might follow the French example (i.e. over sheepmeat). On the other hand the fact that the French had made links between the UK Budget contribution issue and other topics (sheepmeat, fish, agricultural prices, oil) suggested paradoxically that they were looking for a settlement which would avoid such litigation. Given the present circumstances, linkages were inevitable, and although we should not explicitly accept them, we could in practice go along with them if the eventual settlement on the Budget contribution issue were right.

9. The Financial Secretary's desire to avoid a Parliamentary Debate before the European Council was generally shared. However it would be necessary for a Debate to be held shortly afterwards, at which the weight of opinion could make itself felt. If the March European Council made absolutely no progress, we might at that point issue a White Paper setting out the case we had contemplated trying to make under Article 175, and indicating that withholding could prove inevitable if a settlement was still not reached in June.

EMS

10. It was noted that the Bank of England now seemed to be taking a more favourable view of EMS, apparently on essentially political grounds. The balance of economic argument remained against UK membership in present circumstances, but it was generally accepted that if, in the light of recent German remarks, it proved that joining the EMS was the key to a settlement of the Budget contribution issue, then we should be willing to do this.

Draft Article on Common Oil Policy

11. The Financial Secretary had prepared a draft Article making clear the absurdity of the CAP by analogy with a common oil policy constructed on the same lines, which he had suggested might be published in the Financial Times. However, the

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Chancellor thought it would be better for UK Ministers not to take the initiative in publishing this kind of material for the time being, although we should be ready to draw on the arguments in response to further repetitions of the French suggestions that North Sea oil had solved all our economic problems. We should also bear in mind the advantage the French had received from the increase in the value of their gold reserves as an effective immediate riposte to claims that the UK benefitted greatly from each increase in the price of oil.

Procedure

12. It was suggested that the Chancellor might send a minute to the Prime Minister in advance of the meeting of OD fixed for 11th March about the next steps in relation to the Community Budget issue. Such a minute might cover a separate note on EMS, for which the Prime Minister had already asked. (It was subsequently agreed that the minute should be converted into a paper for the Chancellor to send to OD, with the EMS note being treated separately. The objective would be to complete the EMS note by 7th March, following interdepartmental discussion.)

Postscript

13. The Chancellor reported a further talk with the Prime Minister on 4th March. She had indicated her continuing dislike of linkages and of Community money being tied to particular UK projects. She wanted so far as possible to focus on the UK net contribution, and to secure the sort of primacy for this issue in Community discussions that the French had so often secured for matters of concern to them. She doubted whether much real progress would be made in March, but accepted that she would have to go on arguing. She was ready to contemplate the possibility of deploying the threat of withholding as the UK's main sanction thereafter. She remained doubtful about

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joining EMS, but would be inclined to accept this if it were the price of a reasonable settlement on the Budget contribution issue.

JW

(A.J. WIGGINS)
6th March, 1980

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F(EEC B't) 73

CHANCELLOR OF THE EXCHEQUER

copies with enclosure

Chief Secretary
Financial Secretary
Sir D Wass
Sir K Couzens
Sir A Rawlinson
Mr Ryrie

copies without enclosure

Mr F E R Butler
Mrs Hedley-Miller
Mr Lovell
Mr Unwin
Mr Ashford
Mrs Lomax
Mr Michell
Mr Thomson

EEC BUDGET NEGOTIATIONS

The Commission have produced a new document on "Convergence and Budgetary Questions" and this will be the basis for the discussion of our contribution issue at the Summit. A copy of the new document is attached. It is shorter than the earlier one - fourteen paragraphs. It covers the revised figures for the net contributions of member states for 1979 and 1980. The 1980 figures are new.

2. I make some initial comments below and take the opportunity to report on a meeting I held this morning with representatives of the Commission about the expenditure programmes to which they would contribute under the proposed new Article 235 regulation.

<u>The New Document</u>

3. The main features of the new document are as follows:-

i) in paragraph 6 it defends the Commission's view that the present Commission proposals are appropriate at this stage and that it would be premature to make more formal proposals until the amount and scope of the solution to the problem are agreed. This is a clear repudiation of the French suggestion (which we now believe may have been misinterpreted) that the Council could not discuss the issue because the Commission had made no formal proposals.

ii) In paragraph 8 the document repeats the proposal to remove the main constraints from the existing Financial Mechanism and says that on its new figures this will be worth 495 MEUA to the UK in 1980.

iii) Paragraphs 9 to 13 repeat the proposal for an Article 235 regulation to develop "supplementary Community measures" in the United Kingdom. It defines the approach as that of "a special, temporary and ad hoc action in the shape of a number of expenditure programmes within regions of the United Kingdom which would be part financed by the Community". It goes on to say that, from the work which the Commission has undertaken on possible programmes, it is already evident that the method will be sufficient to give effect to any solution agreed by the European Council. This is a very helpful statement and marks a distinct step forward to our goal.

iv) Although the document specifically refers to regions it also says that there could be special cases where financial participation by the Community would also be possible in certain programmes outside the regions. This is a useful element of flexibility in case we have difficulty in getting enough approved regional programmes.

v) In paragraph 13 it says that a consultative procedure would be developed under which the Council of Ministers would be formally associated with the examination of each programme. This sounds rather threatening but

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our talks with the Commission reported below indicate that they will co-operate with us in ensuring that this form of consultation is as little onerous as possible.

vi) It says nothing about additionality which is a relief. However the discussions reported below show that this is still a delicate point with the Commission.

vii) On duration it says that the new regulation should last for perhaps three or four years which is helpful in that it is not a firm figure. The last sentences of paragraph 14 are very helpful in that they make it clear that the aim of any review should be to examine the effectiveness of the actions taken. "It can be to the advantage of no one to see an early recurrence of present difficulties".

4. The document contains nothing on dynamism and nothing on the amount. These/problems will have to be solved by negotiation at the Council. But in other respects it is, on balance, very helpful indeed.

The New Figures

5. The new figures for 1980 are on the third and fourth pages after the document. The third page shows calculations on an importer benefit principle; the fourth page on an exporter benefit principle. The UK net contribution on an importer benefit principle is 1683 MEUA compared with 1552 before. On the other basis the new figure is almost unchanged at 1813 compared with 1814 before.

6. The calculations are of course based on the Commission's proposals for a reduced budget in 1980. The actual outcome will depend on the changes made to the Budget, the price settlement and the developments in markets during the course of the year.

The Commission have also assumed, for reasons which are not quite clear today, that the UK will continue to receive MCA's during the course of 1980 which reduces our net contribution on an importer benefit principle by 130 MEUA. Despite all these uncertainties, the figure of 1683 is now almost certain to be the basis for the negotiations at the Council. But the Prime Minister will be able to say legitimately that, although she is willing to discuss on the basis of 1683, reality is likely to make the outcome higher.

7. We are preparing an analysis of the new figures which will be available for the Prime Minister's briefing meeting arranged for next Wednesday morning. The new figures confirm that all the other member states except Germany are expected to be net beneficiaries in 1980 and that the German contribution is much smaller than ours. If we secured a re-distribution so that our net contribution was reduced to 300 MEUA (a figure which the Prime Minister mentioned to Herr Schmidt) then the French would become a net contributor to the tune of something close to 300 MEUA as well.

Discussions with the Commission

8. Three Commission officials visited the Treasury this morning to discuss the preparation of indicative programmes that could be the object of Community finance under the new regulation. They brought with them a document which, on first inspection, we found rather disturbing in that it seemed to require us to produce a mass of information. But the discussion was more encouraging. What the Commission are trying to do is to dress up our applications to be as persuasive to the other member states as possible. We think it probable that we will be able to meet their requirements to their satisfaction. The next step will be for the Department of Industry to produce a model programme relating to one of the English regions for discussion with the Commission. When the format has been agreed, we will get other Departments to produce comparable applications relating to Northern Ireland, Scotland, Wales and the other English regions.

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9. The most sensitive matter raised at this morning's meeting concerns additionality. The Commission need to protect themselves against the charge that the Community is simply financing programmes which the United Kingdom would have undertaken anyway. For that reason it is extremely important that the Budget Speech should contain a passage on the lines of the present paragraph D15 which implies that, unless we achieve a reduction in our net contribution, there will be further cuts in public expenditure programmes. The figures that we will put to the Commission will be figures consistent with the new Public Expenditure White Paper for the programmes in question. But our story to the Commission will have to be that the figures are of what it would make sense to spend on the projects in question. But their inclusion in our public expenditure plans is based on the assumption that there will be a major contribution from the Community. We shall have to imply that, if there is no satisfactory solution to the Budget problem, the public expenditure figures will have to be revised.

10. This is a little awkward; but we have the Commission's assurance that, so long as we play along with them, they will not create difficulties for us.

D. H.

D J S HANCOCK
21 March 1980

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F(EC)

Mr ~~Fraser~~

SECRET

10 DOWNING STREET

From the Principal Private Secretary

28 March 1980

Dear George,

I attach the record of the Prime Minister's tête-à-tête meeting with Chancellor Schmidt held earlier today at Chequers.

I am sending copies of this letter and of the record to John Wiggins (HM Treasury), Garth Waters (Ministry of Agriculture, Fisheries and Food) and David Wright (Cabinet Office).

Yours ever,

Clive Whitmore.

G.G.H. Walden, Esq.,
Foreign and Commonwealth Office.

SECRET

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RECORD OF A MEETING BETWEEN THE PRIME MINISTER AND CHANCELLOR SCHMIDT HELD AT CHEQUERS AT 0945 ON FRIDAY 28 MARCH 1980

Present: Prime Minister	Chancellor Helmut Schmidt
Mr. C.A. Whitmore	Herr Otto von der Gablentz

* * * * * * * * *

Reform of the CAP

The Prime Minister said that the problem of the UK's net contribution to the Community budget had grown worse since Dublin. The more the total of Community expenditure rose, the greater was the disproportionate increase in the British net contribution. For this reason the UK would stand absolutely firmly on the 1% VAT ceiling. It was in our own national self-interest that we should do so, but it was also in the interest of the Community as a whole that we should take this line, since some elements of the CAP were absurd. There was no hope that the Community would develop the will to reform the CAP until it was brought up against the necessity for change; and that would happen when the 1% VAT ceiling was reached. Chancellor Schmidt said that he agreed completely.

The Prime Minister continued that she knew that Chancellor Schmidt would like the UK to take the lead on CAP reform. But she was very concerned that if we were to do so, the UK would be accused of being non-communautaire and other members of the Community might attempt to use such action on our part against us. She was therefore reluctant to see the UK take the lead on this. Rather, she hoped that it would be possible for all members of the Community to agree upon the need to change a policy which was so outdated and out-of-tune with reality.

Chancellor Schmidt said that he hesitated to agree with what the Prime Minister had just said. Much would depend on the way in which the reform of the CAP was brought up in the Community. He had had it in mind for years that reform would be brought about only on the initiative of the UK. He took this view because the British agricultural system was such that the UK was better placed than any other member of the Community to give a lead. Most continental

/ members

members have much stronger vested interests which were opposed to the reform of the CAP. Nonetheless, he did not believe that those countries would criticise the UK for raising the issue of reform. He had mentioned this when talking to President Giscard two days previously. He had put it to the President that the question of medium-term reform of the CAP would need to be included in any package designed to solve the problem of the UK's net budgetary contribution. President Giscard had said that he thought that procedural reform of the CAP would have to be included in any package, though he had gone on to point out that it would not be possible to say very much about the substance of reform in a deal that had to be struck this Spring. He had said that to give the issue of reform concrete substance would take much more time. President Giscard had suggested that it might be possible to ask Agriculture Ministers or the Commission to come forward with firm proposals on how to proceed, perhaps in time for the meeting of the European Council in Venice.

Chancellor Schmidt continued that he had mentioned his conversation with President Giscard to show the Prime Minister that there was not a general reluctance within the Community to consider reform of the CAP. He was sure that, as well as Germany and the UK, France, Denmark, Holland and perhaps Italy would all agree at the level of Heads of Government that reform was necessary, in particular in order to be able to reduce expenditure on the CAP. He believed that President Giscard would stick to the 1% VAT ceiling and the Presiden had implied to him that he accepted the need to limit agricultural expenditure.

The Prime Minister said that she was encouraged to hear what Chancellor Schmidt had said. She had been concerned by some French statements which suggested a rather different attitude. Nonetheless, she remained concerned that if the UK took the lead on CAP reform we should be charged with being non-communautaire and we would then have to retreat very quickly. She would prefer to see the UK, France and Germany taking the initiative together.

/ Community Budget

Community Budget

The Prime Minister said that reform of the CAP was for the longer term, but the UK's budget problem was immediate and urgent. The increase in our forecast net contribution which had taken place since Dublin showed the speed with which the problem was running away from us.

Chancellor Schmidt said that he agreed that the matter was urgent. But it was important to look at it not only from the British point of view, but also from the standpoint of each of the other eight members of the Community. When he had seen the Prime Minister of Denmark recently, he had told him that he thought that the Community was in a very serious situation over the UK's budget problem. He had asked him to consider what it would mean for Denmark if the UK withheld its contribution to the budget or even left the Community altogether. If either of those things happened, the Commission would immediately stop all financial outlays. The Eight would then have to fill the gap or would have to accept an absolute cut in Community expenditure. He had told Mr. Jorgensen that the effect might well be more than the Danish economy could bear. The same was probably true of Italy and Holland. He recognised that the UK could not make this kind of point to its partners since it would imply a threat to leave the Community, but he was ready to draw the attention of his partners to these worst case possibilities. He had done so recently with President Giscard. The President's reply had been that he did not think that the UK would interrupt its payments to the Community because he believed what the Prime Minister had said about the UK's commitment to Europe. He had, however, told President Giscard that he was less confident in the light of British public opinion at present.

The Prime Minister said that Chancellor Schmidt was right to be concerned about British public opinion. The feeling that the UK was not getting a equitable deal was growing stronger and stronger. One hundred and twenty backbench Members of her own Party had signed a motion calling for the withholding of Britain's VAT contribution if a reasonable settlement of the bugetary problem was

/not

not reached. Moreover, Mr. Callaghan had recently challenged her twice in the House of Commons to say that she would be ready to withhold VAT. In reply to him she had had to agree that in the last resort we would indeed have to consider withholding our VAT contribution. If she had not said this, the implication would have been that she was not fighting hard enough for the UK. She accepted, however, that it would be clearly illegal for the UK to withhold its levies.

Chancellor Schmidt said that to withhold levies would indeed be flagrant breach of Community law, but he accepted that VAT was different and that the UK might be able to claim that it was unable to transfer its contribution.

The Prime Minister said that now that the meeting of the European Council had been postponed, it was even more important to be in a position to reach an accord by the end of April than it had been by the end of March. We had only three or four weeks in hand and we must make the very best use of this time. She recognised that President Giscard wanted other outstanding problems settled. She believed that these issues and the problem of the budget had to be settled on their respective merits, though she accepted that, with the probable exception of fish on which matters were going ahead rather more slowly though still steadily, they might all be solved within the same time scale.

The Prime Minister continued that any settlement of the budget problem had to be one that would endure. She did not want to have to come back to her partners again in 2 or 3 years time and ask for yet another settlement. They would accuse the British of coming back a third time and would understandably find it that much more difficult to be sympathetic on the issue. We needed a solution that would endure as long as the problem of our contribution itself lasted.

/Chancellor Schmidt

Chancellor Schmidt said that it was quite clear that all the Community's major outstanding problems would have to be solved at the same time. If they were not, he saw no hope of resolving the budget issue. He accepted that the UK case was just and sound, but the plain political fact was that when it was resolved, the other Eight partners would have to be able to take something home to their own Parliaments and public and show that they too had obtained something. It would be impossible for any of the other Heads of Government, especially himself and President Giscard, to return home empty-handed, saying that they had agreed to pay more to the Community budget in order to help Britain. There had to be a semblance of a quid pro quo. In saying this, he asked the Prime Minister to bear in mind that if the Eight were each to find its contribution to the solution of the UK problem, they would all have to make substantial sacrifices and reduce important programmes. None of them had made provision for such changes, and the political difficulties they would cause were plain. There therefore had to be a package deal which would be such that all nine governments left the battle scene with an equal feeling of dissatisfaction. If that did not happen and one country was able to emerge claiming a victory, the compromise that had been achieved would not be workable.

As regards duration, he did not believe that it would be possible to bring about a solution to the UK's budgetary problem that would stick for a number of years. In the short term it would be possible only to find a compromise made up of gimmicks, gadgets and tricks to improve Britain's receipts, but such an arrangement would not be in true accord with the Community's basic regional, social and agricultural policies as they existed today. The kind of compromise he foresaw might last 2 or 3 years but no longer. If a solution was to stick the basic policies would have to be revised. He agreed with the Prime Minister's views that some of these policies were absurd, but we had to reckon with the inescapable fact that they had been developed by first the Six and then the Nine over 20 years.

/In particular

In particular, there were some very powerful agricultural lobbies on the continent which were politically much more important than the British farming lobby. Nonetheless, as he had already made clear, he was convinced that the CAP had to be reformed. He thought that an essential element in the package deal he was envisaging would be a declaration that agricultural policies had to be changed so that expenditure in this area ceased to grow disproportionately in relation to the total budget but might, for example, be limited as a proportion of the growth of GNP of the Nine members. He knew that all the Agriculture Ministers of the Nine would oppose some part of the set of principles for reforming agricultural policies which the package deal would have to contain, and for this reason the declaration he had in mind could come only from the Heads of Government. It might similarly be necessary to lay down in the package a set of principles for settling the problem of fish.

The Prime Minister said that although Chancellor Schmidt understood the political pressure which she was under to reach an equitable settlement of the budget problem, she was not so certain that the other members of the Community really grasped her difficulty. She saw the difficulties facing the other members of the Community and she hoped that they equally would put themselves in her shoes. She agreed that there would be no lasting solution to the budget problem unless the underlying policies were changed. For example, every time the Commission proposed changes in the cost of the CAP, the burden fell unduly heavily on British farmers because they were large and efficient, whereas the smaller and less efficient farms of the Eight escaped. At the same time, because of the structural surpluses, our farmers were denied export opportunities despite their greater efficiency.

Chancellor Schmidt said that he agreed that the best possible use needed to be made of the time between now and the postponed meeting of the European Council. He did not propose, however, to offer himself as a mediator. He could not carry his own party if he volunteered himself to settle a problem whose solution was bound to lead to Germany paying more. Moreover, he had been

/criticised

criticised by the French and Dutch after Dublin for putting forward precise figures too soon. But someone had to come forward with figures because otherwise there would be no solutions. There were three possible sources. The first was the Commission. The Treaty of Rome required the Commission to make proposals in this kind of situation, and he had tried to convince Mr. Jenkins that it was his duty to take the initiative. But he had not done so, perhaps because he was inhibited because he was British. Second, one might normally expect the Presidency to put forward solutions. But the fact was that Signor Cossiga was in a weak position to do so because of his domestic problems: nobody could dance at two wedding parties simultaneously. Third, the country seeking a solution, in this case the UK, could offer a solution. Of these three possibilities, he believed that the Commission should be pressed to propose solutions to the present critical situation.

The Prime Minister said that she believed that Mr. Jenkins would like to solve the problem, but because he was British, he was reluctant to make the attempt. She did not want to put forward figures herself. She had already moved away from asking for broad balance and her position now was that she was ready to be a modest net contributor, even though in terms of average GNP per head there was a perfectly good case for asking that the UK should be a net beneficiary. If the UK now came forward with figures, these would be negotiated down, just as in any industrial pay dispute.

Chancellor Schmidt said that however figures were eventually put forward, the amount that the Community settled upon would be much lower than the UK had been seeking in Dublin. Broad balance was impossible. If that was the principle of the eventual settlement all nine countries would want it: it would, for example, give Germany an enormous sum of money.

/Sheepmeat

Sheepmeat

In response to a question by Chancellor Schmidt, the Prime Minister said that the issue of sheepmeat was of considerable domestic importance in the UK. Just as it would be unconstitutional to interfere with the transfer of levies to the Community, so the interruption of the free movement of goods within the Community - which was what the action being taken by the French on sheepmeat amounted to - was also illegal. In the UK's view the French were in clear breach of the Treaty. Britain was the biggest producer of mutton in the Community, and if there were to be any benefits available, we should receive them. We did not want an intervention regime for sheepmeat. We could not see why the French could not provide financial assistance nationally for their sheep farmers.

Chancellor Schmidt said that he did not pretend to understand the details of the sheepmeat problem. He agreed with what the Prime Minister had said about the unconstitutional nature of the action taken by the French, though he understood President Giscard to claim that there was a provision in the Treaty which allowed a country to apply to the European Court twice on any particular issue and that the Court's first ruling was therefore not yet final. But he agreed that it was dangerous if any country defied a ruling of the Court, even though the problem of sheepmeat was in itself a small one. He did not believe that the rest of the Community understood what the argument about sheepmeat was all about and he thought that if the UK and France could reach an agreement between them, the other members would accept it (though he added that he did not wish this to be quoted in Community circles). It would be psychologically very good for the Community if France and the UK could pull an agreement out of their pockets and say the problem of sheepmeat was solved.

Chancellor Schmidt continued that one way of dealing with the disposal of the present surpluses might be to make food from them available to Third World countries and to use the Community's Development Aid Budget to meet the cost. This might sound absurd but it made political sense and he thought the possibility should be explored. The Prime Minister agreed.

SECRET

/Fish

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Fish

Chancellor Schmidt reverted to his suggestion that any package deal should include a series of principles for solving the fisheries problem. He doubted whether it would be possible to put together a package, if there was no mention in it of fish. Fish was becoming an urgent political problem not only in the UK but also in Germany, Denmark and France.

The Prime Minister said that discussions on fish, particularly with the French, were going ahead satisfactorily, though slowly. We had not, however, yet reached the point of talking about figures, and this would be when the difficulties really started. She doubted whether we were in a position to include fish in any package of the kind the Chancellor had in mind. Fish was the only resource which was designated under the Treaty as a common resource, and the UK contributed 60 per cent of the Community's waters and 72 per cent of its fish. The UK was therefore contributing massively to the Community's resources. Fish was a highly political issue in the UK, and we had to have an acceptable settlement. When she had talked about solving problems on their merits she had meant that she could not enter a bad permanent agreement on fish in order to get a temporary agreement on the budget.

EMS

Chancellor Schmidt repeated that the UK could not declare that it had certain vital national interests and simply ignore the fact that her eight partners also equally had such interests. Whether the Community would be able to solve the problem of the budget and the other outstanding issues was a question of political will and whether that will would develop would be strongly affected by the UK's readiness to solve the other issues such as fish and energy. He accepted that we were not going to join the EMS at the present moment, but it was a pity that we had missed the chance to demonstrate, by joining the EMS, our will to settle other issues.

/The Prime Minister

The Prime Minister said that the UK would like to join the EMS when we had established clearly that we had the money supply under control.

The International Context

Chancellor Schmidt reiterated that France and Germany did not want the UK to make all the sacrifices while everybody else benefited. President Giscard was as aware as he was that in the present world situation we could not allow the Community to break up because of the problems now facing it. He knew that the UK had to do something about its budget problem: he understood the pressures on the Prime Minister. But he did not want the UK to do something which would prevent the Community, and in particular France, Germany and the UK, holding together.

The Prime Minister said that she agreed. It was the political significance of the Community which was our main reason for joining it.

The meeting ended at 1145 hours.

MAS.

CONFIDENTIAL F(EC). 89

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir A Rawlinson
Mr Burns
Mr Ryrie
Sir K Couzens
Mr Littler
Mr Middleton
Mr Battishill
Mr Bridgeman
Mr Britton
Mr F E R Butler
Mr Cassell
Mrs Hedley-Miller
Mr Unwin
Mr Ashford
Mr P G Davies
Mrs Lomax
Mr Michell
Miss Peirson
Mr Folger
Mr Thomson
Mr Ridley

EC BUDGET SETTLEMENT

You asked for briefing to be prepared on the answer that the Government should give to the question of what it proposed to do with the money if there were a settlement to the Budget issue. (Mr Tolkien's minute of 23 April refers.)

2. I attach a brief prepared after discussion with the Central Unit, GE, HF, FP and Sir K Couzens. It deals not only with your point, but also with one or two other obvious Treasury questions. I have sent copies to the Cabinet Office and FCO as a contribution to the briefing for the Prime Minister's Press Conference after the Summit and for questions after her statement to the House of Commons on Tuesday. The text of all the answers will, of course, have to be checked against the actual Summit decisions.

3. You may be asked similar questions at the Select Committee on Monday afternoon. This briefing could therefore be of use on that occasion also provided that we know for sure by then what has been decided in Luxembourg.

4. The first brief on what to do with the money reflects our advice that it would not be wise to drop any hints that the money might be used to increase public expenditure or cut taxes. To say anything like that would be to give a hostage to fortune.

It would also make our line on additionality very much more difficult to sustain. If the Government were merely to hint that the money was available for use for some purpose other than to reduce the PSBR or provide a margin of safety, then those in the regions will be able to say that the Government has no reason for preventing the Community's expenditure under the new regulation being additional to what the Government provided for in the Public Expenditure White Paper.

5. The argument about providing a margin of safety reflected in the brief is not merely presentational. It is indeed possible that the aggregate public expenditure figures in the White Paper will be threatened by new developments - e.g. an overspend by the nationalised industries; but there is no need to say so since our line is that any such overspends should be absorbed by offsetting savings or use of the contingency reserve.

D.H.

D J S HANCOCK
25 April 1980

CONFIDENTIAL

DRAFT ANSWERS FOR THE PRIME MINISTER'S POST-COUNCIL PRESS CONFERENCE

Draft answers are provided below to the following likely questions on Treasury subjects:-

1. What are we going to do with the money?
2. Additionality.
3. The refund due to the UK under the existing Financial Mechanism.
4. Community influence over UK spending decisions under an Article 235 Regulation.
5. The effect of exchange rate movements on the value of the settlement expressed in sterling.
6. Are we going to join the EMS?

EC BUDGET SETTLEMENT

Treasury contribution to Q and A Brief

What will the Government do with the money?

We made it clear that we were determined to cut public expenditure. We did so and published the results in the White Paper /Cmnd 7841/. But, as the Chancellor explained in his Budget Speech, the cuts published in that White Paper were incomplete because no settlement had been achieved on the Community Budget issue. It has now been achieved and the resulting savings mean that the Public Expenditure Review can now be considered to be complete.

Will the PSBR now be lower than £8.5 billion in 1980-81?

Not necessarily; but we now have an increased margin of safety that will make a valuable contribution to confidence. As a result, interest rates should be lower than they otherwise would have been.

The Government's medium-term strategy is based on the public expenditure figures in the White Paper which did not include the cut in our contribution. Surely the cuts are not needed to implement the strategy and can therefore be used to finance increased public expenditure or extra cuts in taxation?

We made it clear that the figures in the medium-term strategy published in the Financial Statement and Budget Report for the PSBR in years after 1980-81 were not to be interpreted as a target path. /FSBR, page 18, para. 12, first sentence./ There will be many influences on the PSBR apart from the cut in our contribution to the Community Budget. We have now got an extra margin of safety and this should enable us to achieve our monetary targets with lower interest rates to the benefit of investment and growth.

The medium-term strategy was based on cautious assumptions. Surely it would be over-cautious to treat the cut in the contribution to the Community Budget simply as a margin of safety?

It is far better to be cautious than to lose credibility by over-ambition. So many things can go wrong. We will not make the mistake so often made in the past of counting our chickens before they are hatched.

ADDITIONALITY

As the Commission have said (in paragraph 19 of their paper COM(80)50), "this additional /Community/ contribution should help the UK in the efforts it is already making in some of these fields".

/Defensive - if pressed/ The Government has carried out a major review of public expenditure, the results of which are crucial to our medium term fiscal and monetary strategy and to the success of our attack on inflation. In one important respect this review was incomplete: it left open the question of how much the UK would be paying over net to the Community Budget.

The Community help that we have now secured greatly reduces the risk that we will have to look again at our domestic public expenditure programmes to ensure that we meet our monetary targets. If we had to do so, of course, none of these programmes, including those which will qualify for Community aid under the new scheme agreed in Luxembourg, could be regarded as sacrosanct. So the Community money which we are to receive will help to ensure that these programmes can be maintained and that the regions do not suffer.

In any case, I find the whole dispute over additionality very contrived. The question of how much domestic public spending the Government would have been able to afford in the absence of the measures adopted at the European Council is entirely hypothetical. No-one can be sure what decisions the Government might otherwise have had to take, particularly in future years. What one can say with confidence is that the total resources available to the UK will be greater than they would have been if we had still been paying over £1 billion or more a year to the rest of the Community. That will benefit all of us.

REFUND DUE UNDER THE EXISTING FINANCIAL MECHANISM?

[Defensive] It is true that we would have got some [£170 million] of this money under the existing Financial Mechanism in respect of the 1980 Community Budget. But we have now ensured that the UK is likely to benefit year by year, not just for 1980; and to do so on a very substantial scale. The scale of relief is greatly improved and the requirement that we should be in current account deficit over a period to get anything significant has been removed.

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UNDUE COMMUNITY/COMMISSION INFLUENCE OVER UK EXPENDITURE PRIORITIES AND DECISIONS?

What we have agreed is that the Community should help to finance our own national expenditure programmes. We are not establishing a new Community policy, comparable with the CAP.

The Council will of course have to approve the broad qualifying criteria which will be embodied in the Regulation. But it will be for the UK to decide which programmes to put forward for assistance within that framework. /The task of any consultative body will be confined to ensuring that the programmes submitted satisfy the qualifying criteria laid down in the Regulation/ I see no reason to suppose that the Community will refuse to assist programmes which satisfy the agreed criteria.

EFFECT OF EXCHANGE RATE MOVEMENTS ON THE SETTLEMENT

The value of our settlement, expressed in European Units of Account, will not be greatly affected by any movement in the £/EUA exchange rate. The value in sterling terms will of course reflect any changes in this exchange rate.

At today's exchange rate of [ ] EUA to the £, the expected sterling value of the measures agreed for 1980 is £ [ ] million. If the £ falls against the EUA this sterling value will increase - by around £6 million for every 1% rise in the sterling rate. If the £ rises, the sterling value will fall by a similar amount.

<u>EMS</u>

Q Are we going to join?

A The UK fully supports closer monetary co-operation in the Community and intends to join the EMS when conditions permit, although we cannot tell at present when that will be.

Q What are the important conditions?

A Our priority is gaining control of monetary conditions, and bringing our rate of inflation nearer to the Community average. When we have succeeded in doing this we should find it easier to reconcile an exchange rate objective with our monetary objectives, although we should also continue to have regard to sterling's status as a petrocurrency.

Q Has our hesitancy on the EMS affected the budget discussions?

A Our partners fully recognise the technical complexity of the problems EMS membership poses for us. [We have said that we are willing to discuss them further with our partners if they so wish.]

cc Sir Douglas Wass
Sir Anthony Rawlinson
Sir Kenneth Couzens
Mr Burns
Mr Ryrie
Mr Middleton
Mr Battishill
Mr Britton
Mr F E R Butler
Mrs Hedley-Miller
Mrs Lomax
Mr Michell

MR HANCOCK

EC BUDGET

The Chancellor has noted that should the outcome of the forthcoming meeting of the European Council be a reduction in the UK's net contribution of £X00 million this fiscal year it is more than likely that the Government would be pressed on the question of what it proposed to do with the money. Would it mean less taxation, or more public expenditure at home or, perhaps, a reduction in the NIS etc.

2. I understand from Mr Halligan that some work has already been done on this. I should be grateful if you would ensure that it is updated and developed as seems appropriate. You may need to consult FP and GEP about the terms of answers to questions about tax and expenditure. This material will need to be ready in good time for the Prime Minister's post-summit press conference.

R.I.T.

R I TOLKIEN
23 April 1980

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PC Folder

✓ – PC folder

M J Folger 27.5.80

CH/EXCHEQUER
REC. 22 MAY 1980
ACTION Mr Ashford
COPIES TO CST
FST
Sir D Wass
Sir K Couzens
Mr Hancock
Mr Hedley-Miller
Mr Michell
Mr ~~Unwin~~ (a.l.)

pm

3/vi

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

22 May 1980

Visit of the Irish Prime Minister:
21 May 1980

I enclose a record of the discussion in plenary session yesterday between the Prime Minister and the Irish Prime Minister, Mr. Charles Haughey.

I am sending a copy of the entire record to David Wright (Cabinet Office) and of the second part of the record to John Wiggins (HM Treasury) and Garth Waters (MAFF).

M. O'D. B. ALEXANDER

Paul Lever, Esq.,
Foreign and Commonwealth Office.

CONFIDENTIAL

The Community Budget

Mr. Haughey said that his Government had a substantial vested interest in ensuring that the Community worked. The agricultural prices settlement was vital to them. He hoped the Prime Minister would let him know, therefore, if there was anything that he could do to help resolve the British budgetary problem. The Prime Minister said that she intended to battle on until a satisfactory solution was agreed. She wanted the problem resolved before Venice. Mr. Lenihan described the Ministerial meetings in prospect. Mr. Haughey asked if there was anything that the Irish Government should be canvassing on the British Government's behalf. The Prime Minister said that it was essential that there should be an agreement covering three years. She recognised that it would not be easy to achieve this. The position of the Germans was particularly difficult since they, together with the U.K., had to finance the whole Community budget. Referring to the sheepmeat regime, the Prime

/ Minister

Minister said that French, Irish and New Zealand farmers, like those of the U.K., were entitled to a decent standard of living. However, intervention was absurd. It was in no-one's interest to create a lamb and mutton mountain. It would make far more sense to have a system based on deficiency payments. The Foreign and Commonwealth Secretary said that the present Commission proposals would guarantee that all Irish and UK lamb would go into intervention in France. Mr. Haughey said that he had an important sheep farming constituency in Ireland. He thought it should be possible to avoid the creation of a new mountain and intended to press for a support system of some kind. The Foreign and Commonwealth Secretary said that the UK would be asking for a system based on variable premia. This would mean that if the French were to insist on intervention in France, we would be able to prevent our own product going into intervention there.

Presidency of the Commission

Mr. Haughey said that the Irish Government felt they had a claim to the succession to Mr. Jenkins. They had it in mind, if sufficient support seemed likely to be forthcoming, to put forward a major political personage as their candidate. If he were to be appointed, it would be of advantage to both the Irish Republic and the UK. The Prime Minister said that the only candidates of which she was aware at present were Mr. Gundelach and M. Thorn. Mr. Haughey said that Mr. Gundelach would be quite unacceptable to the Irish Government. If he were to maintain his candidacy, the Irish would certainly put forward a candidate against him.

The plenary session broke up into working parties to discuss the communique at 1615. The session re-assembled, briefly, at 1645 when Mr. Haughey said how much he had enjoyed his talks with the Prime Minister and extended a warm invitation to the Prime Minister to visit Dublin.

22 May 1980

CONFIDENTIAL

Mr Unwin o.r. EC folder

BRITISH EMBASSY
BONN

23 May 1980

CH/EXCHEQUER
REC. 28 MAY 1980
ACTION CST
COPIES TO FST, Sir D. Wass, Sir K. Couzens, Mr Hancock, Mr Mitchell, Mr Unwin, Mr P. Davies

A J Wiggins Esq
HM Treasury
Parliament Street
London SW1

Dear John,

VISIT TO BONN OF THE CHANCELLOR OF THE EXCHEQUER

1. I wrote to you on 16 May about the Chancellor's speech. We also had a word about the programme when I called at the Treasury on 19 May.

2. You thought that given the absence of Schmidt and Matthofer from Bonn on 10 June (SPD Party Congress in Essen) and consequent difficulty in putting forward items of serious interest for that morning the Chancellor might prefer to spend the night of 9 June in Luxembourg and drive up in the course of the morning of the 10th. On this basis, and drawing together the elements in the outline programme in my letter of 22 April we should welcome your view on the following for 10 June:

11.30	-	Arrive in Bonn
12.00	-	Press Conference
13.15	-	Luncheon with the Ambassador, including a strictly limited number of senior German editors if this is agreeable to the Chancellor (see below)
16.00	-	Lecture at DIHT: Speech lasting, the DIHT suggest, an absolute maximum of 45 minutes followed by questions/discussion. The DIHT already have the agreed title.
18.00	-	Call on Lambsdorff at Ministry of the Economy.
20.00	-	Ambassador's Dinner

3. An additional word about the editors might be in order. We have brought small groups of senior editors to London in the past for intensive briefing at high level. We did this last just before the Dublin Summit and got excellent exposure here in the serious press for the UK point of view, at a time when decisions were being formed in Bonn. We had considered sending a similar group to London later in the Spring and I understand

/from

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from the correspondence that had we done so the Chancellor would have been prepared to brief them. As you know we want to take advantage of Sir G Howe's visit to Bonn to achieve maximum exposure for British views on economic questions and would see that the Ambassador's luncheon as an excellent opportunity to influence editorial thinking among the heavies - we had in mind Die Welt, Handelsblatt, Zeit as examples - if you do not feel that this is overloading the programme. I should be grateful for your reaction to this.

Yours sincerely,

John

J D I Boyd

cc: Miss E Morhange
HM Treasury

M Mercer Esq
HM Treasury

J S Laing Esq
WED/FCO

21110

FST
SIR D. WASS
SIR K. COUZENS
MR HANCOCK
MRS HEDLEY-MILLER
MR MICHELL
MR D.F. ROBERTS
MR UNWIN

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

4th June 1980

R. Prescott Esq.
Private Secretary to the
Paymaster General
Cabinet Office
70 Whitehall
LONDON
SW1

F(EEC)

Dear Richard,

5/vi

EUROPEAN COMMUNITY BUDGET SETTLEMENT

In accordance with the conclusions of the Cabinet on 2 June (CC(80)21st meeting), I attach an explanatory note on the budgetary settlement.

Copies of this letter and enclosure go to No.10, to the Private Secretaries to all members of the Cabinet, the Minister of Transport and the Chief Whip, and to Sir Robert Armstrong.

Yours ever,

MH

M.A. HALL
Private Secretary

COMMUNITY BUDGET SETTLEMENT

A. Value of the Settlement

The settlement will yield a total rebate to the UK of at least £1,570 million over the two year period 1980-81. On Commission estimates this will reduce the UK's net contributions in those two years to £370 million and £440 million respectively. Any increase over those levels resulting from higher-than-expected Community spending will be much abated by a risk-sharing formula, under which the UK will bear only a fraction of the cost of any excess.

2. The settlement also provides for a radical review of the Community's budgetary arrangements and of the pattern of Community spending. If this review has not of itself solved the UK's budget problem by 1982, the Community is committed to extending the arrangements negotiated for 1980 and 1981. So the total value of the settlement over all three years is unlikely to be less than £2.5 billion.

(For a more detailed account of the settlement, see Annex A.)

B. Effect on public expenditure

3. As the latest Public Expenditure White Paper makes clear, the reduction in our Budget contribution will increase the savings in public spending which the Government has already achieved. The amount set aside for contributions to the Community Budget in Programme 2.7 of the White Paper will be reduced.

4. The settlement should not be seen as opening the way to increased expenditure on domestic programmes, although it reduces somewhat the risk that further reductions in these programmes will be needed in order to keep public expenditure and borrowing within acceptable limits.

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C. Effect on the PSBR

5. The reduction in public spending that will follow from the settlement will certainly assist our efforts to contain the PSBR. The effect on the PSBR may be a little less than the overall change in our net contribution. This is because the associated agricultural price settlement, which will also produce a reduction in our net contribution in 1980-81, will involve a matching increase in doemstic public spending.

D. Effect on the balance of payments

6. The effect on the settlement will be to improve the current balance by slightly more than the value of the refund. This is because the extra sheepmeat and whisky receipts will probably exceed slightly the extra cost of our food imports from the Community.

E. Effect on the domestic money supply, and on the Government's need to sell gilts

7. A cut in our EC contribution which is used to reduce the PSBR will help to ease the pressure on the monetary target. With the exchange rate determined by market forces, the Government's need for sterling finance will be reduced. Its need to sell gilts to stay within the monetary target will be less. It should therefore be possible to meet the target with lower domestic interest rates than would otherwise have been necessary. It is not possible to say precisely what the size of this effect will be though it is likely to be small. But since we are not expecting the major part of the refund until the end of the year, it is not realistic to look for an immediate effect on domestic monetary conditions.

F. Effect on the exchange rate

8. The effect on the exchange rate is likely to be small. There are two influences which work in opposite directions:-

(a) the cut in the contribution will tend to push sterling up, because it will be improving the current account;

(b) lower interest rates (see E) will restrain the rise.

G. Method of payment

9. The money will be provided by improvements in the operation of the 1975 Financial Mechanism, and through supplementary Community spending in the UK, under a new Article 235 Regulation.

(For details of the existing Financial Mechanism and the proposed amendments to it, see Annex B.)

H. Operation of Article 235 arrangements

10. The new Article 235 regulation will enable the Community to participate in the financing of programmes designed to help with the problems of the disadvantaged regions of the UK and possibly of certain expenditures outside those regions. It has yet to be decided exactly which programmes will benefit from Community assistance.

11. The next step will be for the Commission to propose a draft regulation to the Council and to the European Parliament. This will lay down the broad criteria under which the programmes will attract Community assistance.

I. Undue Community influence over UK expenditure priorities and decisions?

12. The Commission are proposing that the Community should help to finance the UK's own national expenditure programmes, not that it should establish a new Community policy, comparable with the CAP.

13. The Council will approve the broad qualifying criteria which will be embodied in the Regulation. But it will be for the UK to decide which programmes to put forward for assistance within that framework. There is no reason to suppose that the Community will refuse to assist programmes which satisfy the agreed criteria.

J. Timing of payments

14. The main receipts will accrue to the UK in the first quarter of next year. We expect the bulk of what is due for 1980 to be paid before the end of the 1980-81 financial year.

(For details of payment arrangements see Annex C)

K. The review

15. In the long-term the commitment to review the development of Community policies and the operation of the Budget is perhaps the most important part of the package. Together with the constraints imposed by the 1% ceiling, it will enable the UK to press for the lasting reform needed to prevent any recurrence of the British budgetary problem.

16. The review therefore offers an opportunity which has never been available before, since we joined the Community, to work with our partners for financial arrangements, and Community policies, which are to the advantage of all Member States, as befits a Community of equals.

L. What happens if 1% ceiling is reached before 1982?

17. That would be a Community problem to which a Community solution would have to be found. The Council will need to take action to cut the increase in the expenditures which are causing the problem.

M. Would our refund be cut back?

18. Our refund is a prior commitment. But if the expenditures are contained, the cost of the refund will be contained too.

N. Effect of exchange rate movements on the settlement

19. The value of our settlement, expressed in European Units of Account, will not be greatly affected by any movement in the £/EUA exchange rate. The value in sterling terms will of course reflect any changes in this exchange rate.

20. The figures the Government has quoted are based on an £/EUA rate of 1:1.65.* If the £ falls against the EUA this sterling value will increase - by around £6 million for every 1 per cent rise in the sterling rate. If the £ rises, the sterling value will fall by a similar amount.

O. Comparison of figures with those published in the Public Expenditure White Paper

21. The figures quoted are the outcome of negotiations about transfers between the Member States. The figures in /Table 2.2.1 of/ the Public Expenditure White Paper include, in addition, our contribution to certain transfers to countries outside the Community which are financed through the Community Budget. These are perhaps best regarded as part of our aid programme rather than as part of our contribution to the Community.

22. There are other differences - for example, the latest figures are more up-to-date than those incorporated in PEWP, which was publish in March, and the price bases of the estimates are different.

23. The exchange rates used are also different. The figures now quoted used 1.65EUA = £1 which is roughly the current market rate. The Public Expenditure White Paper used 1.55EUA = £1 because sterling was less strong when the Public Expenditure survey was carried out.

* roughly where it stands at present.

ANNEX A

SIZE OF REFUND : DETAILED FORMULA
(as announced by Lord Privy Seal on 2 June)

The first element in the solution is the following formula:

- for 1980, provided that our net contribution, before the formula is applied, does not exceed £1,080 million, there will be a ceiling on our net contribution, after adjustment, of £370 million.

- for 1981, provided that our net contribution, before the formula is applied, does not exceed £1,300 million, the ceiling will be £440 million. (All these sterling figures are converted at a rate of 1.65 European Units of Account to the £.)

2. This will result in a total rebate to Britain over the two year period of £1,570 million, implying a UK payment $\frac{1}{3}$ of what had been expected.

3. A further element of the solution is a risk-sharing formula. Should the amounts of the United Kingdom's uncorrected net contribution in 1980 and 1981, as estimated by the European Commission, in fact be exceeded, the arrangement is that in 1980 we will bear only one quarter of the cost of this excess.

4. For 1981 a more complex formula exists under which we would meet the first £12 million of any excess, the next £60 million would be shared between us and our partners equally, and thereafter we would meet only a quarter of the excess cost, as in 1980.

5. For 1982, it was envisaged that by this time the Council would have completed a radical review of the pattern of Community expenditure and the operation of the Budget.

6. However, if that had not by 1982 produced arrangements resolving the United Kingdom's budget problem, the Commission would put forward proposals along the lines of the 1980 and 1981 solutions and the Council would act accordingly.

7. We can therefore be sure that for 1982 as well there will be similar restrictions on the level of the United Kingdom's net contribution.

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FINANCIAL MECHANISM : PROPOSED AMENDMENTS

The 1975 Financial Mechnism provides for payments to a Member State which is "forced to bear a disproportionate burden in the financing of the Community Budget" whilst its economy is "in a special situation". It provides that a Member State with:

i) a GNP per capita less than 85% of the Community average; and,

ii) a growth rate of real per capita GNP less than 120% of the Community average,

should, subject to certain further conditions, be entitled to a partial refund of any excess of its share in gross contributions over its share in Community GNP.

2. These further conditions have meant that so far the UK has received no benefit from this Mechanism although it has satisfied the main economic criteria for relief mentioned above. The improvements now proposed are designed to ensure that, provided the UK continues to satisfy the qualifying criteria, the Community will refund in full the excess of its share in gross contributions over its GNP share.

3. This entails a number of amendments to the existing Mechanism:

i) the removal of the balance of payments condition, under which the size of a Member State's refund depends critically on its aggregate balance of payment position over the preceding three years, with the refund being very much larger if this shows a deficit (however marginal) rather than a surplus;

ii) the abolition of the so-called "tranche system" under which any excess contribution less than 30% above a Member State's GNP share is refunded only in part; and,

iii) the removal of the provision limiting any refunds under the Mechanism to 3% of total Budget expenditure.

ANNEX C

TIMING OF PAYMENTS : DETAILED ARRANGEMENTS

The procedure for payment of Financial Mechanism refunds is already well-established. It involves payment of $\frac{3}{4}$ of the estimated entitlement in the first quarter of the calendar year following that to which the refund relates. Because of the difference in financial years, this is the final quarter of the UK's financial year. The balance of the refund is paid when the final entitlement can be calculated. This occurs when the Commission draws up its accounts in the middle of the year.

2. Following the precedent of the Financial Mechanism, the credits under the new Article 235 regulation will appear in the Community Budget for the following year, but with the possibility of advance payments in the current year. Precise details of the arrangements have yet to be settled.

CONFIDENTIAL

Mr Folger F (ECC (gen))

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1. MR HANCOCK

2. FINANCIAL SECRETARY

23/vi

cc: attached for:
Principal Private Secretary
Sir K Couzens

cc: Mrs Hedley-Miller
Mr F E R Butler
Mr Kitcatt
Mr Unwin
Miss Peirson
Mr Patterson
Mr Edwards
Mr Davies IDT
Mr Ridley
Mr Ashford o/r
Mr Folger
Mr Donovan
Mr Shore o/r

ADDITIONALITY AND EC SUPPLEMENTARY MEASURES

The European Parliament will be debating the Budget settlement on 26-27 June. There is evidence that some European Democrat MEPs are unsound on the question of "additionality" and might support resolutions demanding that the Community assistance under the proposed Article 235 regulation should go to finance spending additional to that provided for in the last Public Expenditure White Paper.

2. This attitude is to be strongly discouraged. But the topic is not one where formal briefing would be appropriate.

3. The opportunities for informal, "political" briefing before the debate are limited, as the MEPs are in Luxembourg/Strasbourg all this week. But you are expecting a 'phone call from Mr Taylor tomorrow, and have agreed to mention the matter to him.

4. I attach a speaking note which, if you agree, could form the basis not only for conversation with Mr Taylor (for which it is rather too full) but also for briefing of MEPs by other Ministers as and when the opportunity arises (I understand that the Prime Minister and the Lord Privy Seal expect to see a delegation of European Democrats on 2 July). It is based on advice from GE and the Central Unit as well as CF, and stresses the wider political dimensions of the issue as well as the financial realities. This

emphasis should prove effective with the European Democrat audience for which it is intended.

J A Thomson

J A THOMSON
23 June 1980

SPEAKING NOTE

The Government believes that its present economic strategy is the only one capable of reversing the UK's secular economic decline. At the heart of this strategy is a policy of controlling and reducing inflation through a progressive containment of monetary growth.

This was the programme which the Government was elected to carry out and which it elaborated in the Medium Term Financial Strategy announced in March. It never offered an easy ride. The going has become tougher still of late, particularly after OPEC's recent decisions on oil prices.

The Government is nonetheless determined to stick to its present policies. The high interest rates now prevailing in the UK are a necessary consequence of applying those policies in present conditions. But they are no less unwelcome for that, both economically and politically.

If the Government is to achieve a reduction in interest rates while still adhering firmly to its monetary strategy it will need to maintain and even intensify its present squeeze on public spending. There is no other way of reconciling the two objectives.

In these circumstances there can be no question of increasing planned expenditure on regional programmes beyond the levels provided for in the last Public Expenditure White Paper. But the Community assistance now available will afford the Government greater room for manoeuvre in pursuing its medium term objectives without the need for further major cuts in public spending. It will therefore protect the programmes agreed with the Commission for such cuts.

It is in this context that the question of "additionality" should be seen. It is not simply a matter of comparing the expenditure which is undertaken with that planned in the last White Paper: such a comparison would be static and unrealistic. The real question is: what difference will the Community money make to the amount of public expenditure - on these and other programmes - which in present circumstances the country can afford consistently with the broader objectives mentioned earlier? The answer is obvious: it will make a very substantial difference. That is the only really meaningful way of looking at things, and in that sense there can be no doubt that the Community-financed expenditure will be "additional".

5|/

CH/EXCHEQUER	
REC.	11 JUL 1980
ACTION	Mr Edwards
COPIES TO	CST
	FST
	Sir D Wass
	Sir K Couzens

F(EC) Mr Folger
Mr Hancock GEN
Mr Hedley Miller
Mr Roberts
Mr Ridley
Mr Ashford
Mr Unwin

14/
cc Mr Ryr
Mr Lovell

Ref: A02600

PRIME MINISTER

Future Community Strategy

1. I held a meeting of Permanent Secretaries on 24 June to consider the implications of the budget settlement for our future Community strategy. This minute sets out our conclusions, describes the work we have put in hand for the coming months, and seeks your agreement to the procedure proposed for bringing this work to Ministers and establishing bilateral contact with the French and Germans.

2. We agreed that the first requirement was to get the settlement implemented. This involves getting the Regulations for the amended Financial Mechanism and the Article 235 measures brought forward, cleared with the European Parliament, and adopted as soon as possible. Then we face the task of getting agreement to the infrastructure programmes that will benefit from Community finance under the Article 235 Regulation without increasing our previous public expenditure plans. Ministers will be considering this shortly. Because the European Parliament will not give its opinion on the Regulations before the Summer Recess, they are unlikely to be adopted by the Council before October. Despite German budgetary difficulties on which the Chancellor reported to Cabinet, we are taking steps to get during this year advance payments of part of the money due to us in respect of 1980.

3. The next requirement is to use the respite given us by the budget deal to exploit to the full the Community's commitment to structural changes aimed at preventing the recurrence of unacceptable situations for any member state. My meeting agreed that we now have a better opportunity than ever before to work for reforms designed to give the United Kingdom a firmly and equitably based economic stake in the Community. The problem, and the responsibility for solving it, is now explicitly acknowledged to rest with the Community as a whole and not with the United Kingdom alone. This time we have the 1 per cent VAT ceiling to help ensure that the whole Community gets to grips with the problem. And, as Chancellor Schmidt's recent utterances have indicated, the fact that the budget settlement will shift the major part of any future increase in agricultural expenditure on to the Germans has given them an added

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incentive to tackle the cost of CAP surpluses, although we have still to discuss with them the best way of doing so, and we may not always see eye to eye with the Germans - or with the French - on that.

4. Our main objective in the restructuring negotiations must be to consolidate the gains made in the budget settlement, so that our net contribution can never again rise to unacceptable levels. We should exclude no possibility at this stage, but examine the potential for change in the three main areas: the own resources system itself, reforming and reducing the cost of the CAP, and developing the Community's non-agricultural expenditure policies in such a way as to give us a built-in net gain. Besides cutting the budgetary cost of the CAP, we also need to tackle its resource costs, whilst taking account of the effect on our own farmers.

increase % VAT is [illegible] available!

5. Although, as you noted in Cabinet on 19 June, the negotiations may not get very far before the German and French elections, we need without delay to translate these broad objectives into a detailed negotiating strategy in the context of the own resources ceiling, to identify the mechanisms which offer the best means of achieving them, and to consider the tactical problems and opportunities which we are likely to encounter on the way.

6. The negotiations on the restructuring pledge will in principle fall into two main phases. The first phase will probably last until the new Commission produce their proposals around May or June 1981. We shall want to use this period to probe the thinking of other member states in bilateral contacts and to influence both the preparatory work the present Commission intend to do and the thinking of the new Commissioners when they are appointed. We should be ready to do some kite-flying in the autumn of this year. The second phase will begin next summer, when the Commission's proposals are tabled and the draft 1982 Budget comes forward, although the final crunch is unlikely to come until later. Chancellor Schmidt has said that he does not expect agreement to be reached until well into 1982; but a great deal of the work will probably fall during the United Kingdom Presidency in the second half of 1981.

7. This timetable could be influenced by other factors. The accession negotiations with Spain and Portugal will present difficulties, especially on agriculture, and the prospect of further enlargement will be relevant to the restructuring exercise. The 1981 CAP price fixing discussions may be at their height just before the French Presidential elections in May of that year, in which event the French will be under even greater pressure to satisfy their farmers than this year. This, and the need to face up to the 1 per cent ceiling, could precipitate a financial crisis before the restructuring exercise has got very far. We need to be ready to turn this situation to our account as well, bearing in mind both the political and financial implications for us of how President Giscard fares in the elections.

8. Against this background we have commissioned a range of papers from Departments designed to produce answers to the two main questions that events are likely to pose in the period ahead -

i. What means are open to the Community to postpone the exhaustion of own resources under the 1 per cent VAT ceiling, and which among them would best suit British interests?

ii. How can we best exploit the longer term restructuring review, in terms of possible budget corrective mechanisms, changes in the operation of the CAP and increased Community expenditure in the United Kingdom which takes into account our special needs such as industrial restructuring?

(Franklin group)

These papers will be brought together by a group under Cabinet Office chairmanship, and I will consider the results with Permanent Secretaries immediately after the summer break. We will bring the results of this work forward to Ministers shortly thereafter. This programme will enable Ministers to reach preliminary decisions in time for us to influence the thinking of our partners and the Commission as the first exploratory phase of the restructuring negotiations is beginning in the autumn.

9. My meeting also considered the proposal put to you by Chancellor Schmidt in Venice on 12 June that we, the French and the Germans should set up small bilateral task forces to work out ideas on restructuring. It seemed to us

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that it would be to our advantage to agree to such bilateral meetings, which could at worst be used to establish where our interests coincided or differed and to draw out more clearly our partners' objectives. We therefore concluded that we should respond promptly and positively to Chancellor Schmidt's suggestion. If you agree, I accordingly suggest that the Foreign and Commonwealth Office should arrange for Sir Oliver Wright to inform Chancellor Schmidt's office that, having considered this idea further as you promised, you now wish to pursue it. Sir Oliver might suggest an early meeting between officials, who on our side would be drawn from the Cabinet Office, the Foreign and Commonwealth Office, the Treasury and, as appropriate, the Ministry of Agriculture. We should also tell President Giscard's office that we should like to have bilateral talks with the French Government on a similar basis. We shall need also to talk at official level to other member states, who will be greatly affected by any radical re-casting of the present budget system; and of course to the Commission. We might begin with the Germans; discuss with them how best to get things started with the French; and be ready to have bilateral talks with our other partners and the Commission as well.

10. I am sending copies of this minute to the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and the Minister of Agriculture, Fisheries and Food.

RTA

ROBERT ARMSTRONG

11 July 1980

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FUTURE COMMUNITY STRATEGY: PROPOSED PROGRAMME OF WORK

1. The series of papers in Section A below will be prepared by 11 July for consideration in EQR in mid-July. The second series of papers in Section B below should be ready by end-August, for discussion in EQS in early September. In the light of these discussions a paper or papers will be prepared for a further meeting of Permanent Secretaries.

A. SHORT TERM ECONOMIES AND OTHER DEVICES FOR REMAINING WITHIN THE 1 PER CENT VAT CEILING

Paper A i. The Economic and Financial Background (Treasury)

Coverage of Paper

a. 1981 Community Budget figures and prospects for 1982; headroom under the ceiling.

b. Prospective rates of growth of Community expenditure without policy changes compared with the prospective rates of growth of public expenditure in the UK and other member states.

c. Buoyancy of Own Resources in the short/medium term.

Paper A ii. Short-term Savings in the CAP (MAFF) (in consultation with IA1 Division, Treasury)

a. Genuine economies in operating CAP market support operations (including handling of 1981 price-fixing).

b. National financing of CAP expenditure.

c. Scope for reducing export subsidies.

d. Scope for postponing CAP expenditure until the next financial year.

e. Making the producer pay (co-responsibility levies etc).

f. Making the consumer pay (tax on vegetable oils etc).

Paper A iii. Short-term Savings in Non-CAP Expenditure (Treasury) (in consultation with FCO Legal Advisers, Departments of Trade and Industry and Customs and Excise).

Coverage of Paper

a. Scope for cutting non-CAP expenditure - pro rata or selective.

b. Revenue raising (non-agricultural taxes etc).

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B. LONGER TERM RESTRUCTURING OF THE COMMUNITY BUDGET

Paper B i. Correcting the System of Contributions to and Receipts from the Community Budget (Treasury)
(in consultation with the Departments of Energy and Industry)

Coverage of Paper

a. The Giscard/Schmidt proposals for limits placed on net benefits from the Community Budget and contributions to Own Resources, according to some criterion such as GDP per head.

b. Other reforms of the Own Resources system, including taxes raised from the Energy Sector.

Paper B ii. Reform of the CAP (MAFF)
(in consultation with IA1 Division, Treasury)

Coverage of Paper

a. Statement and assessment of objectives: financial effects, resource costs, surpluses, effects on consumers.

b. The implications for agricultural policy of confining the rate of growth of CAP expenditure to the rate of growth of Own Resources as at present defined.

c. Price restraint.

d. Selective income support for farmers (including United Kingdom farmers).

e. National financing of proportion of CAP expenditure according to a key, eg according to where the surplus is produced, GDP per head, total agricultural production, number of producers. Consequences for funding IBAP.

f. National aids.

g. Ways of preventing expenditure on Mediterranean agriculture from increasing.

h. Standard quantities/quotas.

i. More private storage and less intervention storage.

j. Making the producer and/or consumer pay.

k. Others.

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Paper B iii. Increased Community Expenditure in the United Kingdom/ Increased Stake in Community Policies (FCO) (consulting as necessary)

a. Energy sector expenditure (eg coal and energy research).

b. Transport infrastructure.

c. Expanded Regional Fund/Social Funds (restricted to less prosperous countries?) Criteria favourable to the United Kingdom (eg peripherality).

d. Others.

Paper B iv. The Negotiating Scenario: Political and Tactical Implications (FCO)

2. All papers will examine the objectives and proposals of our partners as well as our own. A separate paper on the issues arising from the accession of Spain and Portugal will be coming forward after the holidays, but nonetheless papers under heading B above will take account of the implications of enlargement to a Community of 12 in their respective fields.

ROBERT ARMSTRONG

Cabinet Office

11 July 1980

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CONFIDENTIAL

CH/EXCHEQUER

REC.	23 JAN 1981
ACTION	Mr Edwards
COPIES TO	CST
	FST
	Sir D. Wass
	Sir K. Couzens
	Mr Mayne

Mr Hancock
Mr Middleton
Miss Hedley-Miller
Mr Lovell
Mr Unwin
Mr Ridley

Mr Fitzgerald

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23/1

PM/81/2

PRIME MINISTER

Restructuring the Community Budget

1. When we discussed this in OD last October, we agreed that officials should have exploratory discussions with other Member States and with the Commission. I attach a progress report which has been prepared by the Cabinet Office in consultation with officials from the Foreign and Commonwealth Office, the Treasury and the Ministry of Agriculture.

2. I suspect that we have done as much homework on this as anyone and we need to be careful not to rush things in what will undoubtedly be a protracted negotiation. We shall not achieve our objective in getting the problem looked at as one for the Community as a whole if we are seen to be trying to make too much of the running. The French are in any case going to play the whole exercise down before the Presidential elections. But there are things which we can do behind the scenes and your forthcoming meeting with van Agt will be an opportunity to ensure that the Dutch Presidency keep up the pressure. The report by officials also suggests that we should now begin to develop the argument that the Community budget should have a redistributive function; and try out some ideas on the Germans and the Commission services. This will need to be handled carefully but I agree that we should try to push things forward in this way.

3. If you agree, I suggest that the report should be circulated to our colleagues in OD, but I would not myself

/have

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have thought that further collection discussion at this stage was necessary. In the meantime, I am sending copies of this minute with copies of the paper to the Chancellor of the Exchequer, the Minister of Agriculture and Sir R Armstrong.

C

(CARRINGTON)

Foreign and Commonwealth Office

23 January 1981

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RESTRUCTURING THE COMMUNITY BUDGET: PROGRESS REPORT

1. When OD considered the Note by the Secretary of the Cabinet (OD(80) 57) at their meeting on 13 October (OD(80) 20th Meeting) they agreed that exploratory bilateral contacts on budget restructuring should proceed. This note reports on the outcome of those contacts and on other relevant developments since October.

2. A list of the meetings during which there has been discussion of budget restructuring and/or reform of the Common Agricultural Policy (CAP) is at Annex 1.

3. The outgoing Commission put in hand certain basic studies but recognised that the formulation of proposals would have to be taken up by the new Commission. Mr Thorn and his colleagues can be in no doubt that the restructuring mandate represents one of their most important and immediate tasks. The Dutch, who are in the Presidency for the first half of 1981, are urging the Commission to present their proposals under the 30 May mandate in time for discussion at the European Council at the end of June.

4. The general presentation we have given of our approach to budget restructuring, in accordance with the line agreed by OD, has been listened to with interest and with some support. We have been careful to avoid giving the impression that we already have cut and dried solutions of our own. Nevertheless, there have been some encouraging developments -

a. The firm support of both Germany and France - reiterated by President Giscard at the last European Council meeting - for the maintenance of the present limit of one per cent on VAT contributions. While other countries are not willing to endorse the one per cent ceiling as an aim in itself, there is a realistic understanding that the Community will have to learn to live with existing own resources at least for the time being. This was also recognised by Mr Roy Jenkins but it remains to be seen whether the new Commission will be content to put forward proposals which are compatible with the ceiling or whether they will wish to indicate the conditions under which, in their view, an increase in the ceiling would be justified;

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b. the announcement of the new German Coalition Government that, after 1981, the rise in expenditure on the Common Agricultural Policy (CAP) should be markedly less than the rise in own resources. In the immediate future, we are hoping to secure German support for laying down an effective financial ceiling within which the 1981 decision on agricultural prices and related measures will be taken. In bilateral discussions we shall indicate our broad support for the German ideas for imposing a financial limit on the growth in the CAP in the longer term. We have to keep in mind however that the Germans would accept in order to reduce the budgetary cost of the CAP, co-responsibility levies and economies of types which would not be in the United Kingdom's interests.

c. The approach of the 1 per cent ceiling and the prospects of enlargement are forcing all member states to face up to restructuring seriously.

5. Less satisfactory have been French attempts to block other Community decisions, especially external trade, in advance of the restructuring exercise. They have argued that until the Community has completed its discussions especially on the CAP it is not possible to enter into long-term commitments eg on New Zealand butter or agricultural imports from Cyprus. It remains to be seen whether their primary motive is to avoid difficult decisions before the French Presidential elections or whether the linkage with budget restructuring will prove a continuing obstacle. Conversely, the French are anxious for a satisfactory settlement of 1981 CAP prices before their elections whereas our aim must be a settlement which, having regard to the interests of our own industry, is consistent with our longer-term objectives for restructuring and CAP reform. The Commission agreed in December a paper setting out ideas for CAP reform. Some of these are unhelpful to the United Kingdom and we have commented on them as well as on the price level to be proposed for 1981.

6. While everyone is a long way from admitting it in public, our exploratory bilateral talks have shown a growing realisation that reform of the CAP and the development of alternative Community policies will not, by themselves, be sufficient to prevent the recurrence of an "unacceptable budgetary situation" for the United Kingdom, and certainly not by 1982. We have been careful not to stress this conclusion ourselves but to allow it to emerge from a realistic assessment of what can be done within the 1 per cent ceiling. The reluctance of others to admit it stems from -

i. strong dislike among the smaller member states of the Schmidt/Giscard idea for limits on net contributions and benefits; and

ii. the realisation that, to do so, would mean admitting that Community policies were not capable of producing an acceptable budgetary situation for all member states.

7. As regards i. the German Chancellor made it clear to the Prime Minister that he is still greatly interested in the idea of limiting net benefits as well as net contributions although his officials have so far refused to discuss it. Predictably, large net beneficiary countries have made it clear that they see little justification for such limitations. The objection at ii. is clearly one which we are going to have to overcome sooner or later. The Community cannot totally ignore the budgetary consequences of its policies which at present have a random and often perverse effect. Having got the Community at long last to recognise that there is such a thing as an "unacceptable budgetary situation" we now need to take the Community's thinking on to a further stage of consciously deciding what the redistributive effect of the budget should be.

8. Officials have therefore considered ways in which the budgetary position of member states could be adjusted on logical principles and not simply by way of arbitrary corrections of the kind discussed in the report by officials attached to OD(80) 57 (paragraphs 57-63). Two approaches are envisaged both of which start from the premise that the pattern of distribution between member states emerging from the present budget arrangements needs to be changed; both are also compatible with the maintenance of the 1 per cent VAT ceiling.

9. The first - which we call the <u>objective budget approach</u> - involves comparing the actual distribution of contributions and benefits with an "objective" distribution which would reflect relative prosperity. The latter would represent a long-term target for the Community to aim at. In the meantime while the necessary changes in policies were taking place, a partial adjustment would be made to bring net contributions and benefits closer to the "objective". The extent to which the actual distribution would be adjusted towards the long-term objective could be decided, say, for a period of three years at a time (although the amount of adjustment necessary would have to be worked out annually). A problem with this approach is the substantial scale of transfers which could be required after enlargement to the poorer countries, particularly Spain.

10. Another approach - which we call the two budget approach - would involve splitting the budget in two: a "central budget" financing CAP guarantee expenditure, industry, energy, research and administration. This would be made distributionally neutral between member states ie each would get out as much as it contributed; and a "structural budget" for expenditure intended to promote economic convergence like the Regional and Social Funds, FEOGA guidance expenditure and the EMS interest rate subsidies. The distribution of expenditure under the structural budget would be consciously decided at the outset, fixing the net amount by which member states with below average GDP would benefit, thus enabling the cost of enlargement to be contained. There would be a transitional period moving from the post-30 May situation, to a pre-determined level of net contributions and benefits under the two-budget approach.

11. Tables illustrating these two approaches are at Annex 2. The figures are not definitive but both approaches are of course capable of achieving the objectives which Ministers have laid down. Anticipating future negotiations, they assume that the United Kingdom might actually end up as a net beneficiary.

12. Both approaches could serve to direct discussion on to the proposition that the redistributive effects of the Community budget as a whole should be willed as a matter of policy rather than resulting from the chance outcome of the cumulative effect of individual policies. Our purpose in exposing these ideas is a tactical one, to start a train of thought in the minds of others which would be helpful to us when the substantive negotiations begin. At this stage we would not wish to go too far in exposing these ideas and run the risk of arousing adverse reactions. Moreover there are in any case problems such as the scale of budgetary transfers required and the risks of trade diversion by member states trying to offset the loss of their present budgetary benefits. But we consider it would be worth exploring our ideas with the staff of the Commission, who have already expressed some interest in our ideas on budget adjustment mechanisms, and with the Germans as a means of encouraging them to develop their own thinking on the subject. Only in the light of their reactions would it be sensible to consider carrying the discussion forward with other member states. In the meantime however we should certainly try to persuade other member states of the view that the overall distributive effects of the budget must be a matter of conscious Community policy.

Cabinet Office
January 1981

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ANNEX 1

BILATERAL CONTACTS ON BUDGET RESTRUCTURING

Date	Country	Department	Level
16 Oct	Germany	MAFF	Official
27 Oct	President elect Thorn	PM/Foreign Secretary	-
30 Oct	Netherlands	MAFF	Ministerial
31 Oct	Germany	FCO/Cabinet Office	Official
6 Nov	France	FCO/Cabinet Office	Official
16/17 Nov	Germany	Prime Minister	-
18/19 Nov	Greece	FCO/Cabinet Office	Official
19 Nov	Ireland	MAFF	Official
23/24 Nov	Italy	Prime Minister	-
24 Nov	Commission	FCO	Official
26 Nov	Belgium	FCO	Official
2 Dec	Greece	MAFF	Ministerial
4 Dec	Denmark	MAFF	Official
5 Dec	Netherlands	FCO	Ministerial
11 Dec	Italy	FCO/Cabinet Office	Official
17 Dec	Denmark	FCO	Ministerial
17 Dec	Netherlands	FCO	Official
19 Dec	France	FCO	Ministerial

TABLE 1: OBJECTIVE DISTRIBUTION OF NET BUDGETARY CONTRIBUTION (-) AND RECEIPTS (+) (See paragraph 11)

MEUA

	Unadjusted net contribution to allocated expenditure	Position after 30 May agreement	Possible intermediate stage (25% of Col 1 + 75% of Col 5)	Objective distribution: for Community of 10	for Community of 12
	(1)	(2)	(3)	(4)	(5)
Germany	-1350	-1900	-1050	- 815	- 965
France	NIL	- 400	- 400	- 395	- 535
Netherlands	+ 550	+ 450	+ 45	- 85	- 125
Belgium	+ 600	+ 500	+ 70	- 70	- 105
Denmark	+ 550	+ 500	+ 80	- 60	- 75
Luxembourg	+ 300	+ 300	+ 70	- 5	- 10
Italy	+ 850	+ 650	+ 665	+ 770	+ 605
UK	-2150	- 750	- 355	+ 400	+ 245
Ireland	+ 650	+ 650	+ 195	+ 60	+ 45
Greece	NIL	NIL	+ 125	+ 200	+ 165
Spain	na	na	+ 395	na	+ 525
Portugal	na	na	+ 170	na	+ 230

Notes: Column 1: From Commission estimates for 1981

Columns 4 and 5: Distribution obtained from formula: Net position = Budget x Population share x (1 - GDP per head as percentage of Community average) ÷ 2

TABLE 2 : DUAL BUDGET APPROACH : ILLUSTRATIVE EFFECT OF CENTRAL ANI STRUCTURAL BUDGETS COMBINED*

NET CONTRIBUTIONS (-) AND RECEIPTS (+) OVER TRANSITIONAL PERIOD

MEUA

	1981	1982	1983	1984	1985	1986
Germany	-1900	-1650	-1400	-1335	-1145	-955
France	- 400	- 420	- 445	- 575	- 635	-695
Netherlands	+ 450	+ 340	+ 230	+ 90	- 35	-155
Belgium	+ 500	+ 380	+ 265	+ 125	-	-125
Denmark	+ 500	+ 390	+ 280	+ 160	+ 50	- 65
Luxembourg	+ 300	+ 240	+ 180	+ 115	+ 55	- 5
Italy	+ 650	+ 680	+ 710	+ 740	+ 770	+800
UK	- 750	- 540	- 330	- 120	+ 90	+300
Ireland	+ 650	+ 550	+ 450	+ 350	+ 250	+150
Greece	nil	+ 30	+ 60	+ 90	+ 120	+150
Spain	na	na	na	+180	+ 240	+300
Portugal	na	na	na	+ 180	+ 240	+300

*excluding aid

/ This postulated final composition of the structural budget is assumed to be a political decision, but taking account of member states' relative prosperity and population size, and their non-budgetary resource transfers. Alternativel the global sum of net benefits could be decided at the outset, but with the precise distribution allocated according to a formula.

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