PO-CH/NL/0363 PART C

Part. C.

CONFIDENTIAL

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21/10/87.
Begins: ~~1/12/87~~.
Ends: ~~18/7/89~~. 30/11/87

~~COMMERCIAL-IN-CONFIDENCE~~

PO -CH /NL/0363

PART C

Chancellor's (Lawson) Papers;

FUTURE FINANCING OF THE EUROPEAN COMMUNITY

DD's: 25 Years

29/11/95.

PO -CH /NL/0363
PART C

CONFIDENTIAL

PMK 21 OCT 1987 -25

FROM: M PARKINSON
DATE: 21 October 1987

Agreed with me.
AJCE 21 x

1. MR EDWARDS
2. CHANCELLOR

cc Paymaster General
Chief Secretary
FST
EST
Sir P Middleton
Sir G Littler (o/r)
Mr Mercer
Mr Mortimer
Mr Donnelly
Mr Tyrie

Ch/ Content to write as proposed? (One or two minor drafting suggestions). JF 2

OK w suggs.

FURTHER ENLARGEMENT OF THE EC

1. Sir Geoffrey Howe wrote to the Chancellor on 6 October enclosing a paper setting out an analysis of the UK cost/benefit of possible further EC enlargement. He invited confirmation of the FCO's approach. This submission recommends agreement to the main conclusions. A draft reply is attached.

The FCO Paper

2. The context of the FCO paper is that possible further enlargement of the EC is again an issue, even if not a very live one. The Turkish application is being processed by the Commission. Morocco has formally registered its interest; Malta and Norway are showing interest; and Cyprus could follow suit. There are also distant prospects for Switzerland, Austria and Sweden.

3. The Foreign Secretary recommends that the UK's general line should be sceptical. The Moroccan, Maltese and Cypriot cases are regarded as academic. He concludes that a Norwegian application would be in our interests, but that Turkey's would not. But to avoid an outright rebuff which might damage the Alliance, the EC-Turkey Association should be developed further.

Discussion

4. For the most part, the FCO paper is acceptable; indeed their opposition to Turkish entry is welcome. Turkish entry would be costly. The FCO estimate that if Turkey had been a member in 1986 the net transfer to Southern States would have increased from $5 billion to $7.5 billion and this probably is an underestimate in view of the likely pressures for compensatory Southern structural programmes. Furthermore Turkey has a much higher population than Greece or Portugal, a much lower GDP per capita and is a net agricultural exporter. The only contrary consideration is that the effects are potentially so large that accession of Turkey would perhaps force the Community to realise that its whole financial system would have to be reformed to achieve a better balance of net contributions and receipts along Hague Speech lines.

5. The suggestion to strengthen the EC-Turkey Association of Agreement is reasonable provided the focus is on political consultation, as the paper says. In financial terms, Turkey has already received Community aid via the EIB since 1963, although the fourth, and largest protocol at 600 mecu is being blocked by Greece.

6. The case of Norway is very different, and it is likely that entry would be in the UK's interest. However this would need to be reassessed more fully nearer the time of any reapplication. The case is not completely clear-cut. The Norwegian economy faces difficult structural problems in the wake of its oil dependence and currently pursues a high level of agricultural support.

7. In the long term perspective of the FCO paper, the case for Austria, which the FCO do not describe may need considering further, perhaps involving a position similar to Ireland of economic integration but political neutrality. Sweden and Switzerland might eventually follow. There could be a good economic case, though political and unwieldyness considerations would also need to be carefully weighed.

8. The comparative position is illustrated by the following OECD statistics.

	Population (m)	GDP per head ($)	Employment in agriculture (%)
Turkey	49.9	1057	57
Norway	4.1	13960	7
Austria	7.6	8743	9
Sweden	8.4	12006	5
Switzerland	6.5	14195	7

Recommendation

9. I recommend that you support the Foreign Secretary's approach. A draft reply is attached.

Mark Parkinson

M PARKINSON

Re type final

CONFIDENTIAL

Chancellor

Draft reply from ~~Paymaster General~~ to Foreign Secretary

Further enlargement of the Community

Thank you for

[~~The Chancellor has asked me to reply to~~] your minute [and paper] of 6 October. and the enclosed paper

2. I very much agree with the general approach in your paper. A case by case analysis of UK interests is appropriate. While the EC needs to assimilate the recent accession of Spain and Portugal, further enlargement may be worth encouraging in cases which would benefit the UK.

3. In this context, I agree that it is likely that our economic interest lies in Norway entering in the 1990's, although its structural problems and high level of agricultural support would need to be taken into account in a fuller assessment of UK interests nearer the time of any possible reapplication. Furthermore if Norway was likely to be a substantial net contributor to the EC budget, it is not clear that the Norwegians themselves would perceive entry on those terms as being unequivocally in their own interests.

4. There may be a case as well for considering the other Northern States mentioned in your paper. Austria might sometime wish to enter, on a basis of political neutrality but economic integration into the Community. This would

help to counter the increased influence of the Southern states. If Austria came, Sweden and Switzerland might eventually follow.

5. More immediately I would strongly support your conclusion that Turkey's membership ~~is likely to~~ would be counter to the UK's interests. It would, as you say, be costly in budgetary terms and potentially detrimental to the internal market. ~~The only contrary consideration is that the effects are potentially so large that the Community might perhaps be forced to conclude at last that its whole financial system would have to be reformed along the lines of your 1981 Hague Speech so as to bring an equitable distribution of net contributions and receipts.~~

6. On tactics, I agree that we should not raise false Turkish hopes; any conciliatory response needs to be handled carefully so as not to give such an impression. The EC/Turkey Association Agreement provides, as you say, an appropriate framework for developing a closer relationship, particularly closer political consultation, while avoiding new financial commitments.

7. Some key statistics for the countries mentioned above are in the accompanying table:

	Population (m)	**GDP per head ($)**	**Employment in agriculture (%)**
Turkey	49.9	1057	57
Norway	4.1	13960	7
Austria	7.6	8743	9
Sweden	8.4	12006	5
Switzerland	6.5	14195	7

limit of a

8. I agree that Morocco, Malta and Cyprus are not even credible candidates. ~~and~~ we must avoid any commitment to ~~long term~~ their eventual membership ~~in the long term~~.

9. I am sending copies of this minute to OD(E) colleagues, to the Defence Secretary, and to Sir Robert Armstrong.

N.L.

CONFIDENTIAL

Thanks. I reckon X is the best course. As for 4, surely [illegible] [illegible] [illegible] to the [illegible]. N.

From : D L C Peretz
Date : 26 October 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler o/r
Mr Cassell
Mr A J C Edwards
Mr H P Evans
Mrs Lomax
Mr Scholar
Mr C W Kelly
Ms Goodman
Mr Cropper

PS/IR
Mr Houghton - IR

Ch
I don't much like draft letter, & suspect best thing is not to write
AA

EC CAPITAL MARKET LIBERALISATION

M. Delors has sent you a draft version of the Commission paper that will be on the agenda for the next ECOFIN meeting, together with one or more draft directives. He has also sent a copy to the Foreign Secretary. His letter says he is only attaching the opening paragraphs, but in fact he seems to have sent the entire paper.

2. The paper (in substance the same draft) will be on the agenda for the Monetary Committee meeting this Friday. But the draft directive(s) will not - because, absurdly, the Commission insist on unveiling the directive to Ministers first. This procedure is extremely irritating, and can only slow progress down.

3. Delors says he is sending you the paper "as agreed". My impression (confirmed by UKREP and Geoffrey Fitchew) is that he is particularly anxious for you to see Section VI - which argues that liberalisation will make sterling's participation in the ERM more pressing.

4. It is not too late to influence the drafting of the paper, and you will want to decide whether or not to respond on this point. My own view is that the section is an unnecessary irritant - which would be much better greatly toned down. The

arguments on the whole do not even have the merit of logic; and a more relevant point - that removal of exchange controls in the EC will remove one of the arguments sometimes advanced against sterling's membership - is not mentioned at all.

5. As to the rest, the paper is just about as bad as we might have expected. For example, it proposes that the 1972 Directive (of which we are now probably technically in breach, with the repeal of the Exchange Control Act) should not only be retained, but strengthened. The majority of the Monetary Committee earlier in the year concluded that this directive had no value at all, and recommended that it be repealed; and Delors seemed to accept this at the Nyborg ECOFIN. This majority included the Germans who, in the 1970s, were the main country interested in imposing inflow controls to prevent monetary expansion.

6. Another difficult section is the final one, on tax problems and capital market liberalisation. Happily it does not say that corporation tax harmonisation is a precondition for capital market liberalisation. But it seems to get quite close to saying that liberalisation should not proceed until action is taken either to impose harmonised withholding taxes on bank and bond interest, or to oblige cross-border disclosure by banks to tax authorities. (Again this is not what Delors said at Nyborg). Geoffrey Fitchew's reading of this (please protect), however, is that Delors and Lord Cockfield recognise that it is not a runner - since it would simply drive funds to offshore centres - and that they will gracefully withdraw this idea in due course.

7. Hopefully the version of the paper that goes to ECOFIN will be revised in the light of the Monetary Committee discussion on Friday. I guess at that meeting some of the sillier Commission ideas will get fairly firmly sat upon. It is, however, irritating that the draft directive itself will not be able to benefit from the same process. I know that Sir G Littler as Chairman of the Monetary Committee is minded to suggest that all members brief their Ministers to decline to discuss the details of the draft directive in any real substance at ECOFIN until they have had a report on it from the Monetary Committee.

Action

8. The only immediate question is whether there are any points you want to make at this stage to Delors. On most aspects I would suggest holding fire until we know better what the line-up is (the Commission may well turn out to be in a minority of one on some issues). But if you agree with the comment above on the section about sterling's membership of the ERM, it might be worth passing that to Delors, in the hope of influencing the final version of the paper. The letter of 16 October from Mr Westcott in UKREP says that the Commission meet again to discuss the proposal on 28 October, so we should aim to get any message to Delors before then.

9. I attach a draft letter that you could send, if you were minded to write. It would probably be better though, given the nature of the message, to arrange for it to be passed orally to Delors' Cabinet, via UKREP. That, I understand, is what Delors' Cabinet are expecting. A third possibility is simply to leave it to Sir G Littler and me to make the points at the Monetary Committee on Friday

X

Y

10. How best to play this depends a bit on what if anything, you "agreed" with Delors at Nyborg. I have in any case agreed with the Foreign Office that if anyone is to respond to Delors it should be you, not the Foreign Secretary.

D L C PERETZ

cc Mr Loehnis - Bank of England
Mr S Wall - FCO

DRAFT LETTER

From : Chancellor

To : M. Delors

CREATION OF A EUROPEAN FINANCIAL AREA

Thank you for your letter of 13 October and for showing me the draft Commission paper.

2. I look forward to discussing this at the November ECOFIN. By then I understand we will have the benefit of comments on the paper from the Monetary Committee. At Nyborg you said you would also be tabling for the November ECOFIN one or more draft directives. Again, I am sure we will want to have a detailed commentary from the Monetary Committee before we can take the discussion in ECOFIN very far forward.

3. At this stage I should like to make just one comment of substance on the paper. The section on the relationship with sterling's participation in the ERM struck me as not very well thought out, and generally rather unhelpful in tone. For example, the link between capital flows and exchange rate movements could be the reverse of what is argued : in some circumstances exchange rate movements will tend to choke off undesired private capital flows.

4. I believe there is a link between the removal of exchange controls and sterling's participation in the ERM, but of a different kind. It is sometimes argued that the continued existence of various forms of exchange control between countries that participate in the ERM suggests that if sterling were to join the UK would need to reintroduce exchange controls. If we can make real progress on dismantling the remaining exchange controls in Europe, that argument against sterling's participation will fall away. This seems to me a rather more important point than those listed in the present draft; and this point apart it would, I suggest, be better to shorten and tone down this section of the paper.

CREATION OF A EUROPEAN FINANCIAL AREA: CAPITAL LIBERALISATION

UK Objectives

The discussion is expected to be largely procedural. Your objectives are to limit substantive discussion at this stage and to ensure that the work is carried forward under the German Presidency with the advice of the Monetary Committee - chaired by the UK. It may not be possible entirely to avoid discussion of the issues, particularly on tax on which separate brief is attached. In any discussion there are a number of markers you may wish to put down on the key points.

Points to Make

(i) Agree with Commission that rapid progress on this needed. But need advice of Monetary Committee. Suggest that it be remitted to Monetary Committee and at the same time that Coreper set up a Council Working Party to be ready to start work as soon as comments from the Monetary Committee are available [likely to be in January, when ECOFIN itself does not usually meet].

(ii) Agree with Commission that harmonising supervisory structures, changes in tax, and membership of ERM "must not be regarded as pre-conditions" for capital liberalisation [Page 2 of Commission paper].

(iii) [If points of substance are raised]. Should await comments of Monetary Committee and Central Bank Governors on details. But:

X - disappointed with proposal to retain and extend 1972 directive. Thought it had been agreed at Nyborg that this directive was obsolete and should be abrogated.

Y - doubtful about need for additional safeguard clause.

- will want to examine proposals to merge medium term credit facilities, and conditions for access, very carefully.

Surely Y amounts [illegible] for X

Background

The Commission are presenting to ECOFIN a paper on the creation of a European financial area, two draft Directives (one covering the liberalisation of capital movements and the second amending the 1972 Directive), and a draft regulation (on medium term credit facilities). The paper largely follows the version discussed by officials in the Monetary Committee on 30 October and by Governors in Basle last week.

The paper outlines the basis of the proposals, and looks at the "complementary questions" of:

(a) harmonising supervisory structures to facilitate freedom of financial services while ensuring adequate protection;

(b) the problems of fiscal evasion and fiscal differences leading to distortions in capital markets; and

(c) any linkage between financial integration and participation of all EC currencies in the ERM.

Fortunately, the Commission paper states, clearly, that solutions to these issues are not pre-conditions for capital liberalisation (though Delors has said that he, personally, does see sterling's membership of the ERM as a pre-condition).

The proposals are:-

(a) a Directive for the full liberalisation of capital movements;

(b) amendments to the 1972 Directive which allows restrictions to be imposed for monetary policy reasons, to include also a statement of intent that flows should be liberalised vis-a-vis third countries, as well as within the Community;

(c) changes to the Community instruments for medium term balance of payments assistance.

Draft Directives and Regulations

On the new Directive the Commission sensibly argue that liberalisation cannot be phased according to the nature of capital movements; should be completed in one step; and that dual exchange markets (as run by Belgians) should not be maintained. The current drafts do not make it clear to what extent it is intended that liberalisation should cover indirect obstacles (for example, capital market queuing arrangements).

The Commission propose an additional safeguard clause allowing temporary derogation from the capital liberalisation obligation to deal with financial disturbance for monetary and exchange rate policy reasons. Member states could either impose controls before or after consultation and these measures could apply for six months. Up to now opposition to this has come from the UK, German, Danes, Dutch, Belgians and Luxembourg; and support from the Italians, French and Greeks.

Transitional arrangements are proposed for Spain, Portugal, Greece and Ireland. These will allow additional periods for the implementation of both existing and new community liberalisation obligations. It is unrealistic to think that we can proceed without some such arrangements.

The Commission are now proposing to amend instead of abolish the 1972 Directive. They are proposing to include a declaration of intent that liberalisation should also be vis a vis third countries - the so called "erga omnes" principle. They are also proposing to extend the range of instruments covered. And it is proposed that the Commission should be able to recommend activation of the provisions. Since we are already technically in breach of the 1972 Directive, its retention could mean that the UK would have to take domestic legislation to meet the requirements. This is all disappointing since (according to the offical report to the Monetary Committee) it was agreed at Nyborg that the 1972 Directive is "obsolete and should be abrogated". This is still the UK and German view: though others - including the French, Dutch and Danes - appear to be wavering. There seems no reason why the "erga omnes" principle should not be included in the new directive, instead.

The Commission propose combining the two existing medium term finance mechanisms (community loan mechanism for balance of payments assistance and medium term financial assistance). Loans will be made subject to a Council decision taken by a qualified majority for a country implementing a programme of capital market liberalisation. The loans would be primarily financed by Community borrowing, but in some circumstances by credits from member states. The Commission are also proposing an increase in the mechanism from the present ECU 8 billion to ECU 13 billion and that any higher assistance would be financed by member states (which for the UK would score as public expenditure). There are no provisions to trigger early repayment if economic conditions improve. There are obviously several points we will need to watch very closely. Nor is it clear that this proposal is necessarily linked with progress on capital market liberalisation.

Nor is there anything relevant [illegible] in it

Complementary Questions

(a) Prudential Supervision

The Commission are seeking rapid progress on the adoption of harmonised prudential and supervisory rules for the protection of savers and depositors, but rightly acknowledge this should not be regarded as a precondition of capital liberalisation. The overriding objective should be of all countries to get the right balance between regulation, market freedom and supervision in an EC context at the speed which is necessary to keep up with market developments. The Commission argue that differences in supervision could create competition which could in turn distort the movement of capital and or reduce investor protection. There is no evidence that this is happening.

We would [illegible]

(b) Taxation

See attached note.

(c) ERM

The Commission argue that capital liberalisation makes the question of sterling's participation in the ERM more urgent. As far as the UK is concerned they believe it would add credibility to our use of the exchange rate as a monetary indicator, reduce problems the Irish have because of the large potential capital flows between the two countries and facilitate the creation of an integrated capital market.

There seems little to be said for any of these arguments. As far as the Irish are concerned capital flows between the two countries would arguably rise rather than fall if sterling was a member of ERM. Non-membership of the ERM has not been a barrier to our having liberalised capital markets far earlier than the other EMS members; and we have been able to cooperate with others on our economic and monetary policy without formally belonging to the ERM. The more convincing argument works the other way round. Abolition of exchange controls in European would remove the concern sometimes expressed in the UK that were we to join we would have to reintroduce exchange controls.

TAXATION QUESTIONS

The Commission paper addresses four tax issues: harmonisation of company taxation; tax evasion; discriminatory provisions in national tax schemes that provide incentives for private individuals to invest in national securities and restrictions on investments by pension funds in Member States.

Harmonisation of Company Taxation

The Commission argue that a genuine internal market will not be attained if the tax conditions influencing company investment and production decisions differ. They argue that tax distortions can be removed by a closer approximation of company taxation in Member States. The Commission are to issue a White Paper on this topic before the end of the year. They will take as their starting point the draft Directive for the harmonisation of company tax systems put forward in August 1975

COMMENT

Much depends on the detailed proposals on the Commission's White Paper which is promised before the end of the year. Glad that Commission recognise that any scheme of harmonisation of company taxation must involve lower tax rates than the 45-55 per cent bracket proposed in 1975. But must record now that UK would have no sympathy with any proposals which obliged it substantially to alter its present system of company taxation. This is particularly true of proposals which would narrow the tax base or increase tax rates. The reform of the UK system of company taxation in 1984 has been widely recognised as the first major example of a low rate/wide base approach to taxation which is now being widely emulated elsewhere, notably in the USA.

Tax evasion

The Commission recognise that their proposals on liberalisation of capital markets carry serious risks of tax evasion for some Member States. When investors are allowed to have investment income paid into bank account held outside their country of residence, it may not be declared in the country of residence, and so lead to substantial tax evasion. Their paper makes a number of proposals to counter this. One possibility is for dividends and interest to have harmonised deduction of tax at source, along the lines of composite rate tax. Another, which would also be applied to bonds, would be to impose an obligation on the banks to disclose information to the tax authorities. Agreement with third countries on withholding tax and stronger exchange of information procedures are also options. The Commission's paper now recognises the danger that effective measures to combat tax evasion limited to EC states risk encouraging capital movements to third countries.

COMMENT

Glad that Commission paper now recognises that tax evasion already exists in parallel with exchange controls; and that where such controls have been removed, as in the UK, substantial additional tax evasion has not been found to be a problem. Also glad that paper acknowledges that effective measures against evasion limited to EC countries will tend to drive capital to third countries where such measures do not exist. In these circumstances, a broad measure of international agreement providing for greater co-operation between national tax authorities is the most promising approach.

3321/035/AC

Discrimination provisions

The Commission criticise provisions in national tax systems that provide an incentive to private individuals to invest in national securities as distortionary. They propose discussion aimed at gradually removing tis distortion. Member States could either discontinue the tax concession or extend it to securities in other Member States.

COMMENT

[This looks like a straight allusion to Loi Monory and PEPs.] Willing to discuss the Commission's proposal, but note that it involves a number of issues, both of policy and practicality, for all Member States. These would need to be fully considered.

Restrictions on investments by pension funds in Member States

WHICH?

The Commission point up the fact that some Member States do not allow pension funds established there to invest freely abroad. They propose to discuss the gradual removal of such restrictions.

COMMENT

The UK welcomes the Commission's approach.

If France opens up 'Loi Monory' we will agree to 'Europeps'

SEC (87) 1667

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

(Creation of an European Financial Area)

Creation of a European Financial Area

Introduction

In April 1983, the Commission sent the Council a Communication on Financial Integration[1]. This gave new impetus to Community discussions and was followed in May 1986 by a programme for the liberalistion of capital movements[2], which is a vital element in the cration of an integrated financial area. The first stage of that programme was put into effect by the Council in November 1986 when it adopted a Directive which entered into force on 1 March 1987 extending the list of liberalised transactions.

Several Member States have taken measures which go beyond their Community obligations; and the relaxation of exchange controls in France and Italy has made it possible to terminate the protective clauses under Article 108 of the Treaty from which they previously benefited.

The programme adopted in May 1986 stipulates that the Commission will study with the Monetary Committee and the Committee of Central Bank Governors the implications of financial integration for monetary cooperation and on the liberalisation of financial services. It also stated that proposals for a Directive establishing the full liberalisation of capital movements will be submitted to the Council in 1987.

A link was established between the strengthening of the EMS and the liberalisation of capital movements during the discussions which followed the realignment of January 1987. At their informal meeting in Knokke in April 1987, the Ministers of Finance agreed that the measures under examination for strengthening the EMS should be adopted in September and that the Commission would present as soon as possible afterwards its proposals on the liberalisation of capital movements.

The informal meeting of Ministers in Nyborg in September approved a package on the strenghtening of the EMS and welcomed the Commission's intention to send its proposals for the implementation of the final stage of the liberalisation of capital movements to the Council meeting of November.

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[1] COM(83)207 final

[2] COM(86)292 final

The first part of this document outlines the main options on which those proposals are based.

The second part considers the following three complementary questions, which have been posed during the Commission's considerations on the implications of the full liberalisation of capital movements and in the notes sent by the President of the Commission to the President of the Council for the informal meetings of the Finance Ministers.

- How should the programme to liberalise capital movements fit in with the programme to harmonise national supervisory structures, whose purpose is to facilitate the full freedom of financial services while ensuring the protection of savings and the conditions for fair competition between financial intermediaries?

- With no restrictions, capital movements will be determined to a greater extent by fiscal considerations. What measures may be necessary to ensure that there is no misallocation of capital; and to combat a possible increase in fiscal evasion?

- Maintaining stable exchange rates is necessary both for achieving and preserving the large internal market. What relationship is there between financial integration and participation in the exchange rate mechanism of the EMS?

The Commission's view is that solutions to these questions must not be regarded as pre-conditions for the programme of liberalisation of capital movements. An integrated financial market will not be achieved by simultaneously implementing all the necessary measures. On the contrary it will be achieved by creating a dynamic movement towards integration and accepting some disequilibrium within an overall programme which is both coherent and binding. The liberalisation of capital movements will itself provide the momentum for this process.

I. Legislative Proposals for the Final State of the Liberalisation of Capital Movements

The Commission's proposals are based on three texts:-

- A proposal for a Directive for the full liberalisation of capital movements

- A proposal for the amendment of the 1972 Directive on regulating international capital flows

- A proposal for a Regulation amending and combining the existing two Community instruments which are available to provide medium-term balance of payments assistance.

1. The Directive to Implement the Full Liberalisation of Capital Movements

The purpose of this Directive, which will be based on Article 69 of the Treaty is to extend liberalisation to all capital movements. This extention will cover mainly the following operations:-

- investments in short-term securities;
- current and deposit account operations;
- financial loans and credits;

As the Directive will also stipulate that transfers made for the purposes of capital movements must be effected on the same exchange rate conditions as those for current payments, a dual exchange market could not be maintained or introduced except under a safeguard clause, provided for in the Treaty or in this Directive.

Belgium

The obligation to liberalise will be worded in a general way. This will remove any ambiguities over its scope, which may remain even after the decisions of the Court of Justice on this subject. The obligation must be interpreted to imply:-

- not only the elimination of restrictions on capital transfers but also on the underlying transactions;
- the possibility for a resident in one Member State to have access to the financial system of another Member State and all the financial products that are available there; this resident therefore puts himself in the regulatory framework of the market in which he deals;
- the elimination in domestic rules of discriminatory measures, for example fiscal discrimination, and restrictions imposed on certain types of investor, in so far as they are not strictly necessary for prudential reasons.

The new Directive will contain a safeguard clause which would permit the re-introduction of controls, on short-term capital movements if they were seriously endangering a Member State's monetary or exchange rate policy.

Exercise of the safeguard clause would be subject to Community procedures. Either the Commission, after consulting the Monetary Committee and the Committee of Central Bank Governors, would authorise the implementation of protective measures; or in an emergency the Member State would do so itself, in which case it would inform the Commission and the Member States. The Commission may then decide whether the measures taken should be amended or suspended. In all cases the measures would be limited in time to a maximum of six months and could only affect transactions newly liberalised by the Directive.

?

A safeguard clause in the Directive itself is necessary, despite the fact that the Treaty provides safeguard clauses through Articles 73, 108 and 109, for the following reasons:

- Articles 108 and 109 require that the Member State has balance of payments difficulties, but there can be disruptive short-term capital movements without a balance of payments crisis. Article 73 refers to "disturbances in the functioning of capital market". There are risks in encouraging a wide interpretation of this to cover monetary and exchange rate difficulties connected with short-term transactions.

what risks?

- As the measures would affect short-term and monetary transaction, the Committee of Central Bank Governors should be consulted; but the safeguard clauses of the Treaty do not provide for this.

- It is desirable to have a short fixed time limit.

Four Member States - Spain, Portugal, Greece and Ireland - are not in a position to proceed to the final stage of the liberalisation of capital movements at the same pace for a variety of reasons such as : precarious balance of payments positions, high external indebtedness, less developed domestic financial systems, etc.

The new Directive will provide for a longer time-table over which these countries would remove controls on the transactions covered. This would not affect the special provisions which already apply in these countries on other transactions covered by previous legislation.

For Spain and Ireland it is proposed that the transitional period would terminate at the end of 1990; and for Portugal and Greece at the end of 1992.

2. <u>Amendment of the 1972 Directive on regulating international capital flows</u>

The purpose of amending this Directive is the following:-

- To include a declaration of intent that the degree of liberalisation of capital movements to and from third countries should be equivalent to those within the Community. This solution is preferable to the introduction into Community law of an obligation to liberalise "erga omnes". Although this would probably be done in practice, such a legal commitment, which would be more difficult to reverse than to make, could compromise the Community as a whole or individual Member States in negotiations with third countries.

why not put this in new directive?

?

- To give operational content to the notion that there should be a Community dimension, which is contained in the preamble to the existing text but not in the Articles. The proposal is that Member States would keep the Commission informed of measures taken vis-à-vis third countries, and that the Commission, after consulting with the Monetary Committee would be able to make recommendations to the Member States.

and thus?

- To extend the range of instruments covered by the Directive, to make them the same as the instruments which would be necessary for the implementation of the safeguard clause in the new Directive implementing Article 67 of the Treaty.

It is desirable to include these aims in an amended version of the 1972 Directive rather than in the new Directive because they have to be based on different Articles of the Treaty. why?

3. Mechanisms providing medium-term balance of payments assistance

The purpose of the proposal, which takes the form of a Regulation based on Articles 108 and 235, is to:

- establish a single instrument to provide medium-term financial support (MTFS) by combining the existing Community loan and medium-term financial assistance mechanisms;

- make the Community loan the primary instrument for medium-term assistance;

- extend the conditions under which medium-term assistance can be granted to cover needs associated with the liberalisation of capital movements as well as general balance of payments difficulties.

It is desireble to fuse the two instruments for the following reasons:

- it will unify the conditions under which they can be granted, while preserving their different financing methods;

- it reflects the current reality that the MTFA is not used; ✓

The granting of the loan, or the opening of a credit line, would be made by a Council decision taken by a qualified majority on a proposal from the Commission after the Monetary Comittee had been consulted. The decision would cover : the amount of the loan, its length, procedures (e.g. single or phased payment) and the economic policy conditions to be attached. The nature of the conditionality would depend on whether the loan was activated for purely balance of payments reasons or whether it was granted to assist the process of liberalisation of capital movements.

The broadening of the mechanisms' scope and the order of precedence introduced between the two financing methods will mean that the upper limit on the outstanding amount of financing in the form of market borrowing should have to be raised to /ECU X 000 million/, instead of the present ECU 8 000 million). ?

II. Complementary Questions

1. The Protection of savers and depositors: the Harmonisation of Supervisory and Prudential Rules

The liberalisation of capital movements, combined with the full liberalisation of financial services, will not only allow capital to move freely throughout the Community, but will also make it possible for banks, the many different categories of savings institutions and other financial intermediaries to offer and advertise their services to savers and depositors throughout the Community either through establishments in the Member States or across frontiers without establishments.

It is important that this liberalisation should take place in a framework which ensures: a satisfactory level of protection for savers and depositors; high standards of disclosure and information for investors and shareholders; equal conditions of competition in financial markets; and the solvency and stability of banks and other financial institutions.

The Commission's approach to the question of investor and depositor protection distinguishes between two different situations. The first case is where a resident in one Member State addresses himself on his own initiative to a supplier of financial services in another Member State. The second case is where a supplier from one Member State wishes to market his services and solicit business from the residents of another Member State, either from an establishment in that other Member State or across frontiers under the freedom of services provisions of the Treaty.

In the first case the residents of any one Member State should be free to address themselves to the suppliers of financial services and products in any other Member State on the same terms and conditions as residents in that Member State. In doing so, the client or purchaser of financial services is deemed to place himself under the regulatory framework of the Member State of the supplier and accordingly he cannot invoke the rules of his country of residence to protect himself. Banking and other savings institutions in all Member States of the Community are in general subject to strict regulation by the national authorities both as regards their solvency and liquidity and as regards the protection of investors and depositors.

To deal with the second case, the Commission has initiated a substantial programme of legislation to harmonise national rules for the prudential supervision of financial institutions and for the protection and information of investors. Many of these measures have already been adopted or are under discussion by the Council; the remaining proposals will be put forward by the Commission before end of 1988. The objectives of the measures proposed are:

(a) the removal of the remaining obstacles (i.e. other than exchange controls) to the freedom of establishment and freedom of services;

(b) harmonising prudential rules to ensure the solvency and financial stability of financial institutions;

(c) ensuring equivalent standards of investor, depositor and consumer information and protection.

The method of approach in the legislation as set out in the White Paper comprises three main elements:

(i) the harmonisation of the essential elements of prudential rules and standards;

(ii) the mutual recognition of the way in which these standards are applied in the different Member States;

(iii) based on (i) and (ii), the principle of "home country control", i.e the principle that all the activities of banks (and other financial institutions) throughout the Community, whether carried out through a branch or by cross-frontier provision of services, will be supervised by the authorities of the Member States of the head office.

//Although it is important that rapid progress should be made in the adoption of the harmonising measures described above, their adoption should not be regarded as a precondition for the final phase of liberalisation of capital movements. Many of the measures in question indeed relate to transactions which have already been liberalised. In the view of the Commission this programme provides a sufficient level of protection for savers and depositors; no further specific prudential measures are required for the completion of the liberalisation of capital movements.

2. Taxation questions

The liberalisation of capital movements highlights the following four issues in the field of direct taxation:

- harmonisation of company taxation;
- tax evasion;
- discriminatory provisions in national tax systems that provide an incentive for private individuals to invest in national securities.
- restrictions on investments by pension funds in Member States.

2.1 Harmonisation of company taxation

The full benefits of the liberalisation of capital movements will not be obtained if investment decisions are distorted by significant differences in company taxation between Member States. Such decisions include not only decisions by companies as to where to set up their head office and where to do business, but also decisions by shareholders and individual investors as to where to place their funds.

The Commission takes the view that these distortions should be substantially reduced by a closer approximation of the systems, the taxable base and, tax rates of company taxation in the different Member States. Its approach to this issue will be set out fully in a White Paper on the taxation of enterprises to be issued before the end of this year. The Commission will take as the starting point the Directive for the harmonization of company taxation systems which it put forward in August 1975. This proposal will be complemented by a proposal to harmonise the tax base and some aspects of the 1975 proposals will be amended. In particular, the bracket of tax rates then proposed (45%-55%) is now too high in view of recent and prospective developments in Member States.

2.2 Tax Evasion

Already true for UK

The final stage of liberalisation of capital movements carries with it a risk of increased tax evasion. This is because investors in all Member States will be able to have investment income paid into bank accounts held by them outside their country of residence and this will heighten the risk that this income will not be declared in their country of residence. The Commission takes the view that an increase in tax evasion would be a matter of serious concern both because of the loss of budgetary revenue and because of the damage to fiscal equity, and that practical measures should be taken to minimise this risk.

This risk is less in the case of income arising from dividends than from interest from bonds or bank deposits. In the former case, in a large majority of Member States a substantial part of the tax due from the shareholder is deducted at source (usually through a withholding tax) by the company. The proposals in the Commission's 1975 Directive for the harmonisation of corporate taxation would ensure a common Community system for ensuring such a deduction.

The risk is greater in the case of interest income, because most industrial countries either impose no withholding tax at all on such income or exempt non-residents from its application.

Tax evasion already takes place, even where exchange controls have not been removed, and the extent of any increase in evasion, when these controls are removed, must be uncertain. If, as capital movements become completely liberalised throughout the Community, the threat of increased evasion proves substantial two main types of remedy (which are not mutually exclusive) could be considered:

- a generalised withholding tax applied either to all residents and non-residents alike or at least to all Community residents;

- an obligation on banks to disclose information about interest income, received by Community residents, to their tax authorities.

Either of these solutions would ensure that any interest income paid into a bank account within the Community would be taxed. The withholding tax would be administratively more simple. But it would probably have to be levied at a relatively low rate and the revenue would accrue to the country where the income arises. The obligation on banks to declare income would ensure that the taxpayers concerned paid the full tax due to their country of residence. But it could only be operated if banking secrecy requirements, applying in several Member States, were removed.

The problem of fiscal evasion presents Member States with a dilemma. The more effective are any measures taken within the Community to combat such evasion, the greater the risk of capital movements to third countries. A fully effective solution can therefore only be achieved through international agreements either for the more general extension of a withholding tax on interest or for stronger cooperation between fiscal administrations. So far as a generalized withholding tax is concerned, the prospects for such an agreement seem remote at present. As regards stronger cooperation between tax authorities, prospects seem somewhat brighter, since a Convention has now been negotiated in the Council of Europe and in OECD and will soon be open for signature.

OK?

Conclusions

The final phase of liberalisation of capital movements entails a risk of increased fiscal evasion. There is no watertight solution to this problem, but everything possible must be done to minimise the risks.

OK? Action to strengthen cooperation between fiscal administrations, e.g. in cases of suspected fraud, would be helpful and should in any case be set in hand. The other two main options are a withholding tax on all forms of interest payment to be paid at least by all Community residents and/or a general obligation on all banks to declare interest income to Community fiscal authorities.

The Council is invited to give its views on these solutions and on any other solutions which may be considered feasible.

2.3 Discriminatory provisions in national tax systems that provide an incentive for private individuals to invest in national securities

PEPs? There has been an increasing tendency in Member States in recent years to introduce tax incentives for the purchase of domestic securities (shares and bonds). These measures could be regarded as discriminatory and might lead to distortions in capital movements and to a misallocation of capital investment. Such measures may take the form of a deduction from taxable income of sums invested in such securities, generally up to a specific ceiling, and/or of an exemption, likewise normally subject to a specific ceiling, for income arising from such securities. They are normally limited over time.

The Commision takes the view that such distortions should be eliminated. It is proposing to open discussions with the Member States concerned with the view to imposing a standstill and gradually removing any distortion or discrimination. In the latter case Member States would have the choice of discontinuing the tax concession or extending it to securities issued in other Member States.

2.4 Restrictions on investments by pension funds in Member States

hhh Some Member States do not allow pension funds to invest in foreign securities, or restrict their scope for doing so, thereby impeding the free movement of capital.

The Commission is aware that some form of prudential supervision might be justified in the case of pension funds. However, the restrictions are, in its view, excessive. It is planning to start discussions with the Member States concerned with a view to their gradual removal.

Goal?

3. The Relationship between liberalisation of capital movements and the EMS

Full participation in the exchange rate mechanism of the EMS and liberalisation of capital movements are complementary. On the one hand liberalisation can be undertaken because of the support given by the System to the stabilisation of exchange rates. On the other hand, liberalisation increases the need to fully co-ordinate policies and hence requires a strengthened System. Those countries which do not fully participate and which have not liberalised capital movements should complete the two processes in parallel.

Sterling present a different case. The UK has fully liberalised capital movements but does not participate in the exchange rate mechanism. This has a number of disadvantages both for the UK, its closest partners, and for the Community as a whole.

- For the UK it has been recognised that the exchange rate is a valuable policy target and the authorities maintain a degree of stability vis-à-vis the Community currencies. The credibility of this policy would however be enhanced if it were formalised.

- For its closest partners, Ireland especially, which has very close commercial and financial links with the UK, sterling's non-participation causes problems. The very large potential for capital flows between the two countries has made it more difficult for Ireland to move fully towards liberalisation of capital movements.

Made worse if £ joined the ELM

- For the Community as a whole, the overall purpose is to complete a large internal market. This goes beyond the establishment of a free trade area and a zone of unimpeded capital mobility and requires exchange rate stability throughout the European financial area. The creation of an integrated financial area implies a degree of joint management through a reasonably homogeneous regulatory and supervisory framework and close and structured co-ordination between monetary authorities.

SEC (87) 1660

PROPOSAL FOR A COUNCIL DIRECTIVE FOR THE IMPLEMENTATION OF ARTICLE 67 OF THE EEC TREATY

(Liberalization of capital movements)

(presented by the Commission to the Council)

PROPOSAL FOR A COUNCIL DIRECTIVE

for the implementation of Article 67 of the Treaty.
Liberalization of capital movements

EXPLANATORY MEMORANDUM

I. General aims

1. This proposal for a Directive is the main element implementing the second phase of the programme for the liberalization of capital movements, which the Commission set out in its communication to the Council of 21 May 1986 (1).

Its aim is to lay down arrangements for the complete liberalization of capital movements in accordance with the objective of completing the internal market set by the Single Act.

A further two proposals which the Commission regards as closely complementing the present one are being presented to the Council at the same time. They concern :

- revision of the provisions governing the Community instruments for providing medium-term support for Member States' balances of payments and the widening of their scope (2);

- amendment of the Directive of 21 March 1972 on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity (3).

2. The present proposal forms part of a broader approach involving the implementation at Community level of two other types of measure :

a) Full convertibility of the Community currencies as between themselves represents a vital step towards monetary integration in the Community. In that context, maintenance of exchange rate stability, which is also necessary for the completion and viability of the large internal market, calls for closer coordination and convergence of Member States' economic policies. The package of measures to strengthen the EMS agreed by the Central Bank Governors and the Ministers for Economic and Financial Affairs in September will contribute to greater cohesion of the system in a financial environment which has become much more fluid.

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(1) Doc. COM(86) 292 final
(2) Doc. COM(..) ...
(3) Doc. COM(..) ...

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b) Free movement of capital is a necessary but not a sufficient condition for setting up an efficient, stable and attractive Community financial system. Though not a prerequisite, it is important that a framework of harmonized rules - proposals for which have, incidentally, been put forward by the Commission - should be established by 1992 in the prudential and tax fields. The aim in these fields is to bring about effective freedom to provide financial services while at the same time guaranteeing an adequate level of protection for savers, satisfactory competitive conditions and tax systems which are sufficiently close as to rule out the danger that the functioning of the capital market will be unduly distorted.

3. Free movement of capital will impose a more pronounced external constraint on the conduct of Member States' monetary policies. The effect of this will be attenuated by cooperation within the EMS. Some room for manoeuvre must be retained, however, to allow Member States to maintain adequate control of monetary regulation when faced with major financial disburbances. The safeguard clauses in the Treaty are not enough.

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In the financial integration process, not all States are starting from the same position. This might be because they have only recently joined the Community, because of difficulties with their balance of payments, because of a high level of external debt, or because their domestic financial system is less developed. Transitional arrangements must be made for those with the greatest leeway to make up.

4. In accordance with Article 69 of the Treaty, the Commission has consulted the Monetary Commitee on this proposal for a Directive, the content and scope of which are explained below.

II. <u>Extension of the requirement to liberalize capital movements</u>

1. The proposal aims to extend the <u>liberalization requirement to all capital movements</u>.

The unconditional liberalization requirement, which currently applies to the capital movements contained in List A of Annex I to the Directive in force (as last amended by Directive 86/566/EEC of 17 November 1987), would therefore be extended to :

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- the capital movements contained in Annex I, List B, which are currently subject to conditional liberalization in the sense that Member States may, if the liberalization of those operations is such as to form an obstacle to the achievement of their economic policy objective, continue to apply or reintroduce exchange restrictions on such capital movements, provided that they were operative on the date of entry into force of the Directive or on the date of accession;

- the capital movements which are contained in Annex I List C, and which Member States are not required to liberalize.

2. The possible approach of breaking down the last stage of the liberalization of capital movements into a number of phases, depending on the nature of the operations in question, did not seem justified in terms of exchange-rate policy.

a) The present border line between liberalized and non-liberalized operations corresponds to threshold beyond which it is difficult to differentiate between groups of operations which are both significant and coherent enough to permit gradual liberalization.

b) Some Member States have admittedly gone beyond current Community obligations, taking measures which partially and selectively liberalize short-term capital movements. But those measures are essentially a relaxation of the supervisory procedures applying to such operations when they are directly linked to current transactions or to liberalized capital movements. Although such measures relaxation may have considerable practical significance, it would be difficult to consolidate their use at Community level without establishing rules which were very detailed and hence very rigid in their application.

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3. Imposition of the same liberalization requirement in respect of all capital movements obviates the need for different lists. The Commission considers, however, that it would be useful to retain a general nomenclature of capital movements, together with explanatory notes, in order to define the various categories of capital movement and to have available a convenient source of references for the possible application of derogations from the liberalization arrangements (1). This annex is referred to in Article I of the proposed Directive.

III. Formulation and general scope of the liberalization requirement

1. The Commission proposes that Article 1 of the Directive contains a general, composite formulation of the liberalization requirement based directly on Article 67 (1) of the Treaty.

Article 1 also stipulates that transfers in respect of movements of capital must be effected on the same exchange-rate conditions as those ruling for current payments. A two-tier exchange-market system could therefore be introduced or maintained only under the conditions and according to the procedures relating to the use of a safeguard clause, laid down in the provisions of the Treaty or in those of the present proposal for a Directive (see point IV-3 below).

2. Notwithstanding the extension of the scope of the liberalization requirement to all capital movements, the proposed change in wording does not, in the Commission's view, alter its nature. It should, however, provide the opportunity of removing any ambiguity which might remain despite the decisions of the Court of Justice on this subject.

Mainly?

a) The liberalization requirement implies not only the abolition of restrictions on transfers in respect of movements of capital (actual exchange restrictions) but also the abolition of any measure which limits the possibility of the underlying transaction being concluded or performed between residents of different Member States.

b) Without prejudice to the measures for coordinating national provisions at Community level to facilitate the effective exercise of the free movement of capital, each Member State applies its own domestic rules and regulations to the operations in question in a non-discriminatory fashion.

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(1) The proposed technical amendments to this Nomenclature are set out at point VI below.

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The liberalization of capital movements therefore gives a resident of one Member State the right to access to the financial system of another Member State in order to conclude investment, placement, lending or borrowing operations there. It must be accepted that, in so doing, he agrees to comply with the regulatory framework of the financial market or financial institutions with which he is dealing and that the rules of his country of residence cannot be invoked in order to protect him (1).

c) Financial institutions should be able to benefit from the free movement of capital in the same way as other residents of the Community. As they manage funds entrusted to them and draw on the savings of the public, however, there may be some justification for imposing certain rules on their investments or borrowings in order to protect those savings. Such rules will cover, for example, the composition of the assets that a collective investment undertaking or an institutional investor may hold in its portfolio, the various ratios imposed on credit institutions or the amount and nature of insurance company reserves.

The Commission's position is that these rules should not as a matter of principle, discriminate between operations according to whether they take place between residents of the same Member States or with residents of other Member States. Restrictions on capital movements to and from other countries would be permissible only in exceptional circumstances and if they are essential for the attainment of the objective in view. Each case must be assessed individually in the light of the activity engaged in by each type of financial institution, although two general criteria can be adopted to begin with :

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(1) A resident's right of access, under the rules governing the free movement of capital, to the financial system of another Member State should be distinguished from the conditions under which a financial institution established in one Member State may provide services in another Member State. Those conditions are governed by the provisions of the Treaty and of secondary Community legislation relating to freedom of establishment and freedom to provide services, as interpreted by the decisions of the Court of Justice in that field.

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- The exchange risk : for example, the setting of rules concerning the exchange position of credit institutions seems justified, since institutions which incur exchange risks in connection with the funds which they raise find themselves in such a position for reasons which are not directly connected with the nature of their activities.

- The guarantee offered by the various investments : here the assessment should depend on the nature of the investment (shares or bonds; public or private securities; the question of whether or not securities are dealt in on a stock exchange) rather than on the place where the investment is made.

While such measures have an impact on capital movements, they essentially fall within the scope of work to harmonize the prudential rules undertaken with a view to facilitating effective freedom to provide financial services.

d) In accordance with Article 67 § 1 of the Treaty, the free movement of capital implies the abolition of all restrictions on the movement of capital and hence, in particular, the elimination of any discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested.

In a recent decision (1), the Court of Justice adopted in this connection the interpretation that Article 67 §1 applied in full to capital operations unconditionally liberalized by the Directive in force. Afterall, it is certain that the objective of fully liberalizing capital movements could not be attained if the administrative and tax authorities were to continue to apply discriminatory measures which reintroduce the segmentation of national markets by indirect means.

However, most Member States have put into effect tax schemes to promote savings and to develop certain forms of investment. Such measures have usually been adopted in pursuit of legitimate economic objectives; they may nevertheless have discriminatory effects.

In the Commission's opinion, a pragmatic approach should be adopted with a view to adapting national tax schemes to the requirements of Community law; this would involve closer monitoring of the tax measures having a bearing on the formation of, and income from, savings and a case-by-case examination of the nature and extent of their discriminatory effects.

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(1) Judgment of 24.6.1987 in Case 157/85 (Brugnoni-Ruffinengo)

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3. Article 4 of the proposal for a Directive confirms the right of Member States to take all requisite measures to prevent infringements of their laws and regulations. They will be free to establish declaration procedures to enable them to keep track of capital movements to or from other countries, e.g. for tax reasons or simply for statistical purposes. It is stipulated, however, that such measures must not have the effect of impeding the capital movements in question.

IV. Provisions governing the regulation of capital movements on grounds of domestic monetary policy

1. All the Member States will have to adapt their conduct of monetary policy, albeit to differing degrees, to the new requirements created by the complete liberalization of capital movements. In order to facilitate that adaptation while complying with exchange-rate disipline, the Commission feels that Member States need to be allowed some room for manoeuvre and, to this end, has included two types of provision in the proposal for a Directive.

2. In order to regulate bank liquidity, Member States may be obliged to take measures affecting capital movements to and from other countries carried out by credit institutions : rules governing their net external position or the setting of specific reserve ratios for their assets or liabilities.

Article 2 of the proposal empowers Member States to deploy such monetary policy instruments subject to a posteriori Community monitoring : any measures taken are to be notified to the Commission, the Monetary Committee and the Committee of Central Bank Governors; possibility open to the Commission to ascertain whether such measures go beyond what is necessary for purposes of domestic monetary regulation and, if so, to institute any procedure for removing or amending them that is provided for in the Treaty.

3. Article 3 of the proposal constitutes a specific safeguard clause permitting Member States to take limited and temporary protective measures where short-term capital movements on an exceptional scale seriously disrupt the conduct of monetary and exchange-rate policies. The safeguard clause may not be applied or continue to be applied if the disruption in question stems from a marked divergence in economic fundamentals necessitating a shift in economic policy on the part of the Member State concerned and/or more extensive exchange-control measures.

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The case for authorizing measures to regulate short-term capital movements will have to be assessed in the light of the possibilities offered by other means, in particular monetary cooperation, of dealing with the disturbances observed : coordinated changes in interest rates, intervention on foreign exchange markets, and realignment of central rates if necessary.

a) The Commission considers it necessary to incorporate into the Directive itself a special safeguard clause, since the safeguard provisions of the Treaty (Articles 108 - 109 and Article 73) do not provide the appropriate procedures for a precise response to the situation in question without there being a danger of circumvention.

- The safeguard clauses in the Treaty cover :

  . situations where a Member State is in difficulties or is seriously threatened with difficulties as regards its balance of payments (Articles 108 and 109); the conduct of a Member State's monetary and exchange-rate policy may, however, be disrupted by short-term capital movements without the overall balance-of payments situation being affected;

  . situations in which the functioning of the capital market is disturbed (Article 73); this concept of the "functioning of capital market" cannot, without taking risks with the law, be interpreted widely to include monetary or exchange rate difficulties connected with short-term operations.

- The safeguard clauses in the Treaty are not a priori limited as to scope or length of application. In the Commission's view, it is necessary, in the situation under consideration, to impose such limitations in order to guarantee the credibility and convergence of Member States' monetary policies.

- The procedure for implementing Articles 108 and 109 is relatively cumbersome, whereas rapid measures are required to deal with the strains on monetary and exchange rate policy resulting from short-term capital movements. These measures must fit in closely with all the coordinating procedures existing between monetary authorities, and in the Commission's view, this means that the Committee of Central Bank Governors must also be consulted (there is no provision for this in Article 73).

b) Annex II to the proposal for a Directive lists the operations to which the specific safeguard clause may apply. For the reasons given above and in order that its introduction does not constitute a step backwards in relation to existing Community provisions, it is proposed that the scope of the specific safeguard clause be confined to short-term operations for which liberalization is not at present required :

- short-term financial loans and credits;

- current or deposit account operations;

- operations in units of undertakings for collective investment, investing in securities or other short-term instruments;

- short-term operations in securities (1) or in other instruments normally dealt in on the money market;

- personal loan operations;

- the physical import and export of financial assets (securities referred to above, means of payments).

The measures taken to control these operations may comprise rules on procedures for payment for current operations (forward cover for imports and exports, periods laid down for the acquisition of the foreign currency required to pay for imports or for the surrender of foreign currency derived from exports). This type of rule should not, however, infringe the provisions of Articles 30, 34 and 106 §2 of the Treaty by impeding the smooth functioning of intra-Community trade.

c) With regard to procedure, it is proposed that, at the request of the Member State concerned, the Commission should, after consulting the Monetary Committee and the Committee of Central Bank Governors, authorize, under the circumstances and for the operations indicated above, the application of protective measures the conditions and details of which it would determine.

In urgent cases, the Member State may itself take the measures after informing the Commission and the other Member States, with the Commission having to decide, after consulting the two Committees concerned, whether the Member State in question should amend or discontinue them.

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(1) Unlike bonds, these would normally be securities issued for a period of under two years.

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d) Whatever the method of activating the safeguard clause, the proposal is that it should be applied for not more than a maximum of six months. The Commission considers that, if the disruption to the Member State's monetary and exchange rate policies were to continue beyond that point, this would indicate the existence of more fundamental economic divergences and hence the need for other corrective measures or more extensive controls.

Furthermore, the limited scope of this safeguard clause is likely to mean that the measures taken will become less effective in time because of the induced effects of disintermediation, the migration of such operations or their spillover into longer-term operations.

V. Transitional arrangements for certain Member States

1. It is proposed that the Directive should come into force three months after its adoption by the Council.

2. Not all the Member States, however, are starting from the same position when it comes to embarking upon this last phase in the complete liberalization of capital movements. Four of them - Spain, Portugal, Greece and Ireland - are currently lagging behind in the process of financial integration in the Community for a variety of reasons such as their recent accession to the Community, a precarious current account position, very high external indebtedness or a less-developed domestic financial system.

Under the terms of the 1985 Act of Accession, Spain and Portugal are to benefit from the transitional arrangements for the liberalization of capital movements until the end of 1990 and 1992 respectively. When Directive 86/566/CEE of 17 November 1986 was adopted, it was agreed to extend those transitional arrangements to the newly liberalized operations.

On expiry of the transitional arrangements that were also introduced for them on their accession to the Community, Ireland and Greece were obliged, in response to balance-of-payments difficulties, to invoke the safeguard clause in Article 108 of the Treaty in order to defer liberalization of a number of categories of capital movements. Protective measures are still in force on the date of this proposal's transmission to the Council.

3. In order that those Member States may continue their efforts to adapt to the constraints imposed by the complete liberalization of capital movements, and in accordance with

Article 8 C of the Treaty, it is proposed that the Directive should grant them more time to implement the new liberalization requirements arising from it (Article 6).

By analogy with the duration of the transitional arrangements provided for in the Act of Accession and in view of the economic situation in each of those countries, it is proposed that the following deadlines be set :

- end of 1990 for Spain and Ireland;
- end of 1992 for Portugal and Greece.

These deadlines are still compatible with the timetable laid down by the Single Act for completing the internal market.

The transitional arrangements provided for in Directive 86/566/CEE in respect of Spain and Portugal have been incorporated unchanged into the new proposal. Those benefiting Ireland and Greece should apply without prejudice to decisions adopted by the Commission under Article 108 §3 of the EEC Treaty. The resulting arrangements for the four Member States concerned are set out in Annex IV.

4. The references to the 1960 Directive in the 1985 Act of Accession will have to be interpreted as relating to the provisions of the new directive in view of the proposed amendments to the nomenclature of capital movements and the abolition of the breakdown by list.

In the interests of transparency, it is proposed to indicate in the Directive (Annex II, referred to in Article 5) the scope for Spain and Portugal of the provisions of the 1985 Act of Accession in the new Nomenclature of capital movements.

VI. Technical amendments to the Nomenclature of capital movements and the Explanatory Notes (Annex I to the proposal for a Directive)

1. The application of uniform liberalization arrangements to all capital movements reduces the need for a detailed nomenclature and a precise definition of the various categories of operation. The Commission considers, however, that such a nomenclature should be retained in the Directive, since it would enable its scope to be clarified - the concept of capital movement not being defined by the Treaty - and the exceptional arrangements that may be made for certain Member States to be administered more easily.

The proposed amendments are intended to simplify or supplement the existing nomenclature in the light of experience.

2. The nomenclature of capital movements would be preceded by an introduction setting out common rules governing the scope of the various categories of operations.

3. It is proposed that operations in securities should be grouped, according to their nature, under three headings:

a) Operations in securities normally dealt in on the capital market : shares and other securities of a participating nature and bonds, whether or not dealt in on a stock exchange. The present definition of bonds would be retained, i.e. the one based on the criterion of a life on issue of two years or more;

b) Operations in units of collective investment undertakings : it would seem appropriate to take the opportunity presented by the revision of the nomenclature to introduce, along the lines of the OECD Code of liberalization of capital movements, a special heading for this category of security. This heading would be further subdivided into :

   - undertakings for investment in capital-market securities (shares and bonds);

   - undertakings for investment in money-market securities and instruments;

   - undertakings for investment in other assets (real estate, commodities, etc.);

c) Operations in securities normally dealt in on the money market, together with other non-securitized money-market instruments. This heading covers in particular Treasury bills, certificates of deposit, commercial paper and bank acceptances. The other non-securitized instruments consist mainly of interbank operations or operations with the central bank.

Each of these headings would be broken down into subheadings so as to distinguish between operations involving admission to the market in question, on the one hand, and operations involving the acquisition (or liquidation) of such securities, on the other.

4. In the Commission's view, there is no need to include new headings or items in the nomenclature to take account of the wide variety of new financial products which have appeared since the first Directive was drafted. The purpose of the nomenclature is to ensure transparency of national arrangements applicable to capital movements and not to draw up a complete list of the financial products in

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use, which would, in any case, rapidly be overtaken by events. Exchange-control systems are based more on a classification of capital movements according to their economic nature and their impact on the balance of payments than on technical operational details. Consequently, the new financial products can, generally speaking, be included under existing nomenclature headings or may be a combination of various basic capital movements.

Thus, "issue facilities" (of the NIF or RUF type) rank as operations in money-market securities or loan operations, as the case may be. More generally, commitments, whether conditional or not, to grant loans should be regarded as falling within the heading corresponding to the type of loan concerned; the heading "sureties, other guarantees", relates to commitments to cover the risk of default by a debtor.

The various techniques nowadays available for trading in different financial instruments (subscription rights, warrants, options, forward contracts, swaps) should be regarded as coming under the heading corresponding to the underlying financial instrument.

Cash purchases and sales of foreign currency do not constitute a specific form of capital movement and cannot be divorced from the underlying (current or capital) operation of which they represent the settlement. The other methods of dealing in currencies - forward operations, options, forward contracts, swaps - can also be treated as special techniques for constituting monetary assets.

The introduction to the nomenclature would make it clear that the various categories of capital movement listed also cover all the financial techniques available for a particular operation on the market used by the borrower or lender.

5. It is proposed that the following amendments be made to the heading "Personal capital movements" :

a) Subheadings F and G, which are difficult to distinguish from each other, would be combined under the title : "Transfers of assets constituted by residents, in the event of emigration, at the time of their installation or during their period of stay abroad".

b) Subheading H would be supplemented as follows : "Transfers, during their period of stay, of immigrants' savings to their previous country of residence".

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c) Subheading M "Transfers of minor amounts abroad" would be deleted. Such transfers do not constitute a specific capital operation but are simply a facility available under a restrictive exchange-control system.

d) For the same reason, subheadings I and L relating to transfers of blocked funds would also be deleted. It would be made clear in the introduction to the nomenclature, however, that the immediate use on the spot or the repatriation of the proceeds of the liquidation of assets belonging to non-residents is unrestricted, since the constitution of such assets is liberalized under the present proposal for a Directive. The opening of blocked accounts for exchange-control reasons should no longer normally occur in operations between Community residents, although the transfer of funds could be suspended temporarily pending the outcome of legal proceedings, particularly in cases in which Article 4 of the proposal for a Directive is applied (infringements of national laws and regulations).

COUNCIL DIRECTIVE

of ....

for the implementation of Article 67 of the Treaty

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 69 thereof,

Having regard to the proposal from the Commission, which consulted the Monetary Committee for this purpose (1),

Having regard to the Opinion of the European Parliament (2),

Whereas Article 8A of the Treaty stipulates that the internal market shall comprise an area without internal frontiers in which the free movement of capital is ensured;

Whereas Member States should be able to take, within the framework of appropriate Community procedures, the requisite measures to regulate bank liquidity and, if necessary, to restrict temporarily short-term capital movements which, even where there is no appreciable divergence in economic fundamentals, seriously disrupt the conduct of their monetary and exchange-rate policies;

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(1)

(2)

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Whereas, in the interests of transparency, it is adbvisable to indicate the scope, in accordance with the Nomenclature laid down in this Directive, of the transitional measures adopted for the benefit of the Kingdom of Spain and the Portuguese Republic by the 1985 Act of Accession in the field of capital movements;

Whereas the Kingdom of Spain and the Portuguese Republic may, under the terms of Articles 61 to 66 and 222 to 232 respectively of the 1985 Act of Accession, postpone the liberalization of certain capital movements in derogation from the obligations of the Directive of 11 May 1960; whereas Council Directive 86/566/EEC of 17 November 1986 also provides for transitional arrangements to be applied for the benefit of those two Member States in respect of their obligations to liberalize capital movements; whereas it is appropriate for those two Member States to be able to postpone the application of the new liberalization obligations resulting from this Directive for the same periods and for the same conomic reasons;

Whereas the Hellenic Republic and Ireland are faced, albeit to differing degrees, with difficult balance-of-payments situations and high levels of external indebtedness; whereas the immediate and complete liberalization of capital movements by those two Member States would make it more difficult for them to continue to apply the measures they have taken to improve their external positions and to reinforce the capacity of their financial systems to adapt to the requirements of an integrated financial market in the Community; whereas it is appropriate, in accordance with Article 8C of the Treaty, to grant to those two Member States, in the light of their specific circumstances, further time in which to comply with the obligations arising from this Directive,

HAS ADOPTED THIS DIRECTIVE :

Article 1

1. Without prejudice to the following provisions, Member States shall abolish restrictions on the movement of capital taking place between persons resident in Member States. The different categories of capital movement are set out in Annex I to this Directive.

2. Transfers in respect of capital movements shall be made on the same exchange-rate conditions as those ruling for payments relating to current transactions.

Article 2

Member States shall notify the Commission, the Monetary Committee and the Committee of Governors of Central Banks, by the date of the entry into force at the latest, of measures to regulate bank liquidity which have a specific impact on capital operations carried out by credit institutions with non-residents and which involve regulation of the net external positions of such institutions or of the setting of compulsory reserve ratios on their external assets or liabilities.

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Such measures shall be confined to what is necessary for the purposes of domestic monetary regulation.

Article 3

1. Where short-term capital movements of exceptional magnitude impose severe strains on foreign-exchange markets and lead to serious disturbances in the conduct of a Member State's monetary and exchange-rate policies, being reflected in particular in substantial variations in domestic liquidity, the Commission may, after consulting the Monetary Committee and the Committee of Governors of Central Banks, authorize that Member State to take in respect of the capital movements listed in Annex II to this Directive, protective measures the conditions and details of which the Commission shall determine.

2. The Member State concerned may itself take the protective measures referred to above, on grounds of urgency, should these measures be necessary. The Commission and the other Member States shall be informed of such measures by the date of their entry into force at the latest. The Commission may, after consulting the Monetary Committee and the Committee of Governors of Central Banks, decide that the Member State concerned shall amend or abolish the measures.

3. The period of application of protective measures taken pursuant to this Article shall not exceed six months.

Article 4

The provisions of this Directive shall not prejudice the right of Member States to take all requisite measures to prevent infringements of their laws and regulations or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information.

Application of those measures and procedures may not have the effect of impeding the capital movements in question.

Article 5

For the Kingdom of Spain and the Portuguese Republic, the scope, in accordance with the Nomenclature of capital movements contained in Annex I to this Directive, of the provisions of the 1985 Act of Accession in the field of capital movements shall be as indicated in Annex III.

Article 6

1. The Member States shall take the measures necessary for them to comply with this Directive no later than .... They shall forthwith inform the Commission thereof. They shall also make known, by the date of their entry into force at the latest, any new measure or any amendment made to the provisions governing the capital movements listed in Annex I to this Directive.

2. The Kingdom of Spain and the Portuguese Republic, without prejudice for these two Member States to Articles 61 to 66 and 222 to 232 of the 1985 Act of Accession, and the Hellenic Republic and Ireland may temporarily continue to apply restrictions on the capital movements listed in Annex IV to this Directive, subject to the conditions and time limits laid down in that Annex.

Article 7

The Nomenclature of capital movements and the Explanatory Notes in Annex I, together with Annexes II, III and IV, form an integral part of this Directive.

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Article 8

The Council Directive of 11 Mai 1960, as last amended by Council Directive 86/566/CEE of 17 November 1986, is hereby repealed.

Article 9

This Directive is addressed to the Member States.

Done at Brussels,

For the Council
The President

ANNEX I

NOMENCLATURE OF THE CAPITAL MOVEMENTS REFERRED TO IN ARTICLE I OF THE DIRECTIVE

In this Nomenclature, capital movements are classified according to the economic nature of the assets and liabilities they concern, denominated either in national currency or in foreign exchange.

The capital movements listed in this Nomenclature are taken to cover:

- all the operations necessary for the purposes of capital movements: conclusion and performance of the transaction and related transfers. The transaction is generally between residents of different Member States although some capital movements are carried out by a single person for his own account (e.g. transfers of assets belonging to emigrants);

- operations carried out by any natural or legal person*, including operations in respect of the assets or liabilities of Member States or of other public administrations and agencies, subject to the provisions of Article 68 (3) of the Treaty;

- access for the economic operator to all the financial techniques available on the market approached for the purpose of carrying out the operation in question. For example, the concept of acquisition of securities and other financial instruments covers not only spot transactions but also all the dealing techniques available: forward transactions, transactions carrying an option or warrant, swaps against other assets, etc. Similarly, the concept of operations in current and deposit accounts with financial institutions, includes not only the opening and placing of

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* See Explanatory Notes below.

funds on accounts but also forward foreign exchange transactions, irrespective of whether these are intended to cover an exchange risk or to take an open foreign exchange position;

- operations to liquidate or assign assets built up, repatriation of the proceeds of liquidation thereof* or immediate use of such proceeds within the limits of Community obligations;

- operations to repay credits or loans.

I - DIRECT INVESTMENTS *

1. Establishment and extension of branches or new undertakings belonging solely to the person providing the capital, and the acquisition in full of existing undertakings.

2. Participation in new or existing undertakings with a view to establishing or maintaining lasting economic links.

3. Long-term loans with a view to establishing or maintaining lasting economic links.

4. Reinvestment of profits with a view to maintaining lasting economic links.

A - Direct investments on national territory by non-residents *

B - Direct investments abroad by residents *

II - INVESTMENTS IN REAL ESTATE (not included under I) *

A - Investments in real estate on national territory by non-residents

B - Investments in real estate abroad by residents

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* See Explanatory Notes below.

III - OPERATIONS IN SECURITIES NORMALLY DEALT IN ON THE CAPITAL MARKET (not included under I, IV et V)

(a) Shares and other securities of a participating nature*.

(b) Bonds*.

A - Transactions in securities on the capital market

1. Acquisition by non-residents of domesic securities dealt in on a stock exchange*.

2. Acquisition by residents of foreign securities dealt in on a stock exchange.

3. Acquisition by non-residents of domestic securities not dealt in on a stock exchange*.

4. Acquisition by residents of foreign securities not dealt in on a stock exchange.

B - Admission of securities to the capital market *

(i) Introduction on a stock exchange*.

(ii) Issue and placing on a capital market*.

1. Admission of domestic securities to a foreign capital market.

2. Admission of foreign securities to the domestic capital market.

IV - OPERATIONS IN UNITS OF COLLECTIVE INVESTMENT UNDERTAKINGS *

(a) Units of undertakings for collective investment in securities normally dealt in on the capital market (shares, other equities and bonds).

(b) Units of undertakings for collective investment in securities or instruments normally dealt in on the money market.

(c) Units of undertakings for collective investment in other assets.

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* See Explanatory Notes below.

A - Transactions in units of collective investment undertakings

1. Acquisition by non-residents of units of national undertakings dealt in on a stock exchange.

2. Acquisition by residents of units of foreign undertakings dealt in on a stock exchange.

3. Acquisition by non-residents of units of national undertakings not dealt in on a stock exchange.

4. Acquisition by residents of units of foreign undertakings not dealt in on a stock exchange.

B - Admission of units of collective investment undertakings to the capial market

(i) Introduction on a stock exchange.

(ii) Issue and placing on a capital market.

1. Admission of units of national collective investment undertakings to a foreign capital market.

2. Admission of units of foreign collective investment undertakings to the domestic capital market.

V - OPERATIONS IN SECURITIES AND OTHER INSTRUMENTS NORMALLY DEALT IN ON THE MONEY MARKET *

A - Transactions in securities and other instruments on the money market

1. Acquisition by non-residents of domestic money market securities and instruments.

2. Acquisition by residents of foreign money market securities and instruments.

B - Admission of securities and other instruments to the money market

(i) Introduction on a recognized money market*.

(ii) Issue and placing on a recognized money market.

1. Admission of domestic securities and instruments to a foreign money market.

2. Admission of foreign securities and instruments to the domestic money market.

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* See Explanatory Notes below.

VI - OPERATIONS IN CURRENT AND DEPOSIT ACCOUNTS WITH FINANCIAL INSTITUTIONS *

A - Operations carried out by non-residents with domestic financial institutions

B - Operations carried out by residents with foreign financial institutions

VII - CREDITS RELATED TO COMMERCIAL TRANSACTIONS OR TO THE PROVISION OF SERVICES IN WHICH A RESIDENT IS PARTICIPATING *

1. Short-term (less than one year).

2. Medium-term (from one to five years).

3. Long-term (five years or more).

A - Credits granted by non-residents to residents

B - Credits granted by residents to non-residents

VIII - FINANCIAL LOANS AND CREDITS (not included under I, VII and XI) *

1. Short-term (less than one year).

2. Medium-term (from one to five years).

3. Long-term (five years or more).

A - Loans and credits granted by non-residents to residents

B - Loans and credits granted by residents to non-residents

IX - SURETIES, OTHER GUARANTEES AND RIGHTS OF PLEDGE

A - Granted by non-residents to residents

B - Granted by residents to non-residents

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* See Explanatory Notes below.

X - TRANSFERS IN PERFORMANCE OF INSURANCE CONTRACTS

A - Premiums and payments in respect of life assurance

1. Contracts concluded between domestic life assurance companies and non-residents.

2 Contracts concluded between foreign life assurance companies and residents.

B - Premiums and payments in respect of credit insurance

1. Contracts concluded between domestic credit insurance companies and non-residents.

2. Contracts concluded between foreign credit insurance companies and residents.

C - Other transfers of capital in respect of insurance contracts

XI - PERSONAL CAPITAL MOVEMENTS

A - Loans

B - Gifts and endowments

C - Dowries

D - Inheritances and legacies

E - Settlement of debts by immigrants in their previous country of residence

F - Transfers of assets constituted by residents, in the event of emigration, at the time of their installation or during their period of stay abroad

G - Transfers, during their period of stay, of immigrants' savings to their previous country of residence

XII - PHYSICAL IMPORT AND EXPORT OF FINANCIAL ASSETS

A - Securities

B - Means of payment of every kind

XIII - OTHER CAPITAL MOVEMENTS

A - Death duties

B - Damages (where these can be considered as capital)

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C - Refunds in the case of cancellation of contracts and refunds of uncalled-for payments (where these can be considered as capital)

D - Authors' royalties: patents, designs, trade marks and inventions (assignments and transfers arising out of such assignments)

E - Transfers of the moneys required for the provision of services (not included under VI)

F - Miscellaneous

EXPLANATORY NOTES

For the purposes of this Nomenclature, the following expressions have the meanings assigned to them respectively:

Direct investments

Investments of all kinds by natural persons or commercial, industrial or financial undertakings, and which serve to establish or to maintain lasting and direct links between the person providing the capital and the entrepreneur to whom or the undertaking to which the capital is made available in order to carry on an economic activity. This concept must therefore be understood in its widest sense.

The undertakings mentioned under I-1 of the Nomenclature include legally independent undertakings (wholly-owned subsidiaries) and branches.

As regards those undertakings mentioned under I-2 of the Nomenclature which have the status of companies limited by shares, there is participation in the nature of direct investment where the block of shares held by a natural person or another undertaking or any other holder enables the shareholder, either pursuant to the provisions of national laws relating to companies limited by shares or otherwise, to participate effectively in the management of the company or in its control.

Long-term loans of a participating nature, mentioned under I-3 of the Nomenclature, means loans for a period of more than five years which are made for the purpose of establishing or maintaining lasting economic links. The main examples which may be cited are loans granted by a company to its subsidiaries or to companies in which it has a share, and loans linked with a profit-sharing arrangement. Loans granted by financial institutions with a view to establishing or maintaining lasting economic links are also included under this heading.

Investments in real estate

Purchases of buildings and land and the construction of buildings by private persons for gain or personal use. This category also includes rights of usufruct, easements and building rights.

Introduction on a stock exchange or on a recognized money market

Access - in accordance with a specified procedure - for securities and other negotiable instruments to dealings, whether controlled officially or unofficially, on an officially recognized stock exchange or in an officially recognized segment of the money market.

Securities dealt in on a stock exchange (quoted or unquoted)

Securities the dealings in which are controlled by regulations, the prices for which are regularly published, either by official stock exchanges (quoted securities) or by other bodies attached to a stock exchange - e.g. committees of banks (unquoted securities).

Issue of securities and other negotiable instruments

Sale by way of an offer to the public.

Placing of securities and other negotiable instruments

The direct sale of securities by the issuer or by the consortium which the issuer has instructed to sell them, with no offer being made to the public.

Domestic or foreign securities and other instruments

Securities according to the country in which the issuer has his principal place of business. Acquisition by residents of domestic securities and other instruments issued on a foreign market ranks as the acquisition of foreign securities.

Shares and other securities of a participating nature

Including rights to subscribe to new issues of shares.

Bonds

Negotiable securities with a maturity of two years or more from issue for which the interest rate and the terms for the repayment of the principal and the payment of interest are determined at the time of issue.

Collective investment undertakings

Undertakings:

- the object of which is the collective investment in transferable securities or other assets of the capital they raise and which operate on the principle of risk-spreading, and

- the units of which are, at the request of holders, under the legal, contractual or statutory conditions governing them, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a collective investment undertaking to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.

Such undertakings may be constituted according to law either under the law of contract (as common funds managed by management companies) or trust law (as unit trusts) or under statute (as investment companies).

For the purposes of this Directive, "common funds" shall also include unit trusts.

Securities and other instruments normally dealt in on the money market

Treasury bills and other negotiable bills, certificates of deposit, bankers' acceptances, commercial paper and other like instruments.

Credits related to commercial transactions or to the provision of services

Contractual trade credits (advances or payments by instalment in respect of work in progress or on order and extended payment terms, whether or not involving subscription to a commercial bill) and their financing by credits provided by credit institutions. This category also includes factoring operations.

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Financial loans and credits

Financing of every kind granted by financial institutions, including financing related to commercial transactions or to the provision of services in which no resident is participating.

This category also includes mortgage loans, consumer credit and financial leasing, as well as back-up facilities and other note-issuance facilities.

Residents or non-residents

Natural and legal persons according to the definitions laid down in the exchange control regulations in force in each Member State.

Proceeds of liquidation (of investments, securities, etc.)

Proceeds of sale including any capital appreciation, amount of repayments, proceeds of execution of judgements, etc.

Natural or legal persons

As defined by the national rules.

Financial institutions

Banks, savings banks and institutions specializing in the provision of short-term, medium-term and long-term credit, and insurance companies, building societies, investment companies and other institutions of like character.

Credit institutions

Banks, savings banks and institutions specializing in the provision of short-term, medium-term and long-term credit.

ANNEX II

LIST OF OPERATIONS REFERRED TO IN ARTICLE 3 OF THE DIRECTIVE

Nature of operation	Heading
Operations in securities and other instruments normally dealt in on the money market	V
Operations in current and deposit accounts with financial institutions	VI
Operations in units of collective investment undertakings	IV-A and B(c)
- underakings for investment in securities or instruments normally dealt in on the money market	
Financial loans and credits	VIII-A and B-1
- short-term	
Personal capital movements	XI-A
- loans	
Physical import and export of financial assets	XII
- securities normally dealt in on the money market	
- means of payment	

ANNEX III

REFERRED TO IN ARTICLE 5 OF THE DIRECTIVE

Scope of the provisions of the 1985 Act of Accession relating to capital movements, in accordance with the nomenclature of capital movements set out in Annex I to the Directive

Articles of the Act of Accession (dates of expiry of transitional provisions)	Nature of operation	Heading
	(a) Provisions concerning the Kingdom of Spain	
Art. 62 (31.12.1990)	Direct investments abroad by residents	I-B
Art. 63 (31.12.1990)	Investments in real estate abroad by residents	II-B
Art. 64 (31.12.1988)	Operations in securities normally dealt in on the capital market	
	- Acquisition by residents of foreign securities dealt in on a stock exchange	III-A-2
	. excluding bonds issued on a foreign market and denominated in national currency	
	Operations in units of collective investment undertakings	
	- Acquisition by residents of units of collective investment undertakings dealt in on a stock exchange	IV-A-2
	. excluding units of undertakings taking the form of common funds	

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Articles of the Act of Accession (dates of expiry of transitional provisions)	Nature of operation	Heading
	(b) Provisions concerning the Portuguese Republic	
Art. 222 (31.12.1989)	Direct investments on national territory by non-residents	I-A
Art. 224 (31.12.1992)	Direct investments abroad by residents	I-B
Art. 225 & 226 (31.12.1990)	Investments in real estate on national territory by non-residents	II-A
Art. 227 (31.12.1992)	Investments in real estate abroad by residents	II-B
Art. 228 (31.12.1990)	Personal capital movements	
	(i) for the purpose of applying the higher amounts specified in Article 228 (2):	
	- Dowries	XI-C
	- Inheritances and legacies	XI-D
	- Transfers of assets built up by residents in case of emigration at the time of their installation or during their period of stay abroad	XI-F
	(ii) for the purpose of applying the lower amounts specified in Article 228 (2):	
	- Gifts and endowments	XI-B
	- Settlement of debts by immigrants in their previous country of residence	XI-E
	- Transfers of immigrants' savings to their previous country of residence during their period of stay	XI-G

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Articles of the Act of Accession (dates of expiry of transitional provisions)	Nature of operation	Heading
(cont'd)	**(b) Provisions concerning the Portuguese Republic**	
Art. 229 (31.12.1990)	Operations in securities normally dealt in on the capital market	
	- Acquisition by residents of foreign securities dealt in on a stock exchange	III-A-2
	. excluding bonds issued on a foreign market and denominated in national currency	
	Operations in units of collective investment undertakings	
	- Acquisition by residents of units of foreign collective investment undertakings dealt in on a stock exchange	IV-A-2
	. excluding units of undertakings taking the form of common funds	

ANNEX IV

REFERRED TO IN ARTICLE 6 (2) OF THE DIRECTIVE

I. The Kingdom of Spain and the Portuguese Republic may continue to apply or reintroduce, until 1 October 1989 and 31 December 1990 respectively, restrictions existing on the date of entry into force of this Directive on capital movements given in List I below:

LIST I

Nature of operation	Heading
Operations in units of collective investment undertakings	
- Acquisition by residents of units of foreign collective investment undertakings dealt in on a stock exchange	IV-A-2(a)
. undertakings subject to Directive 85/611/EEC [1] and taking the form of common funds	
- Acquisition by residents of units of foreign collective investment undertakings not dealt in on a stock exchange	IV-A-4(a)
. undertakings subject to Directive 85/611/EEC [1]	

[1] Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ No L 375, 31.12.1985)

II. The Kingdom of Spain and the Portuguese Republic may continue to apply or reintroduce, until 31 December 1990 and 31 December 1992 respectively, restrictions existing on the date of entry into force of this Directive on capital movements given in List II below:

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LIST II

Nature of operation	Heading
Operations in securities normally dealt in on the capital market	
- Acquisition by residents of foreign securities dealt in on a stock exchange	III-A-2(b)
• bonds issued on a foreign market and denominated in national currency	
- Acquisition by residents (non-residents) of foreign (domestic) securities not dealt in on a stock exchange	III-A-3 and 4
- Admission of securities to the capital market	III-B-1 and 2
• where they are dealt in on or in the process of introduction to a stock exchange in a Member State	
Operations in units of collective investment undertakings	
- Acquisition by residents of units of foreign collective investment undertakings dealt in on a stock exchange	IV-A-2
• undertakings not subject to Directive 85/611/EEC [1] and taking the form of common funds	
- Acquisition by residents (non-residents) of units of foreign (domestic) collective investment undertakings not dealt in on a stock exchange	IV-A-3 and 4
• undertakings not subject to Directive 85/611/EEC [1] and the sole object of which is the acquisition of assets that have been liberalized	
- Admission to the capital market of units of collective investment undertakings	IV-B-1 and 2(a)
• undertakings subject to Directive 85/611/EEC [1]	
Credits related to commercial transactions or to the provision of services in which a resident is participating	VII-A and B-3
- Long-term credits	

1 See footnote to List I

III. The Kingdom of Spain and Ireland, until 31 December 1990, and the Hellenic Republic and the Portuguese Republic, until 31 December 1992, may continue to apply or reintroduce restrictions existing at the date of entry into force of this Directive on capital movements given in List III below:

LIST III

Nature of operation	Heading
Operations in securities dealt in on the capital market	
- Admission of securities to the capital market	III-B-1 and 2
• where they are not dealt in on or in the process of introduction to a stock exchange in a Member State	
Operations in units of collective investment undertakings	
- Admission to the capital market of units of collective investment undertakings	IV-B-1 and 2
• undertakings not subject to Directive 85/611/EEC [1] and the sole object of which is the acquisition of assets that have been liberalized	
Financial loans and credits	VIII-A, B-2 et 3
- medium-term and long-term	

1 See footnote to List I

IV. The Kingdom of Spain and Ireland, until 31 December 1990, and the Hellenic Republic and the Portuguese Republic, until 31 December 1992, may defer liberalization of the capital movements given in List IV below:

LIST IV

Nature of operation	Heading
Operations in securities and other instruments normally dealt in on the money market	V
Operations in current and deposit accounts with financial institutions	VI
Operations in units of collective investment undertakings	IV-A and B(c)
- undertakings for investment in securities or instruments normally dealt in on the money market	
Financial loans and credits	VIII-A and B-1
- short-term	
Personal capital movements	XI-A
- loans	
Physical import and export of financial assets	XII
- securities normally dealt in on the money market	
- means of payment	

SEC (87) 1659

PROPOSAL FOR A DIRECTIVE AMENDING DIRECTIVE 72/156/EEC ON REGULATING INTERNATIONAL CAPITAL FLOWS AND NEUTRALIZING THEIR UNDESIRABLE EFFECTS ON DOMESTIC LIQUIDITY

(Presented by the Commission to the Council)

PROPOSAL FOR A DIRECTIVE AMENDING DIRECTIVE 72/156/ECC ON REGULATING INTERNATIONAL CAPITAL FLOWS AND NEUTRALIZING THEIR UNDESIRABLE EFFECTS ON DOMESTIC LIQUIDITY

EXPLANATORY MEMORANDUM

I - General objectives

1. The recitals of Directive 72/156/EEC on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity are based on two fundamental concerns :

- the Member States must have available a set of protective instruments for the purpose of discouraging, if they consider it appropriate, untimely flows of short-term capital (in particular to and from third countries) and a set of monetary policy instruments to neutralize their undesirable effects on domestic liquidity;

- they must be able to put these regulatory instruments into operation immediately, without further enabling measures, either individually or within the framework of concerted action by the Member States.

2. These concerns will remain relevant in a situation in which the freedom of capital movements becomes the rule for the Community, the stability of exchange rates between the Community currencies becomes an important aspect for the completion of the internal market and the scale of international capital flows continues to grow. The Community and its Member States must retain the means of taking coordinated action vis-à-vis third countries, in particular in the event of the EMS being subject to violent external monetary shocks. Even though the stability of monetary relationships must first be based on the convergence of monetary policies and the integration of national financial systems, the Member States must still have the technical possibility, if need be, and within the framework of a Community safeguard procedure, of rapid recourse to measures regulating short term capital movements.

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3. With this in view, the amendments to the 1972 Directive are proposed with two objectives in view :

- to ensure that its provisions are consistent with the safeguard provisions of the Directive relating to the liberalization of capital movements (1);
- to specify the conditions for the concerted implementation of the regulatory instruments provided for therein in response to external monetary shocks.

4. The content and the scope of the proposed amendments are presented below.

II - Degree of liberalization vis-à-vis third countries

1. It is proposed that the text of the Directive (the new Article 1) shall include a declaration of intent, which would state that in the arrangements they apply to the conclusion or perfomance of transactions and to transfers in respect of capital movements with third countries, the Member States will endeavour to attain the same degree of liberalization as for operations taking place with residents of the other Member States of the Community.

2. Even though it does not contain a strict legal obligation, such a provision would confirm the wish expressed at Community level for the European financial area to be wide open to the outside world and the practice already very widely followed in this respect by the Member States.

The statement of this principle would mean, in concrete terms, that the Commission would have to be informed of any specific arrangements which the Member States might apply to capital movements to or from third countries and that, as far as necessary, it would use, in this area, the right which it possesses in general to make recommendations to the Member States (Article 1 (2) and (3)).

3. From the Commission's point of view, this solution is preferable to the introduction into Community law, for the Member States to liberalize "erga omnes". Such a commitment - which afterall would be tantamount to granting the Community sole power over capital movements to or from third countries - would have two major disadvantages :

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(1) Proposal for a Council Directive for the implementation of Article 67 (EEC). Doc. COM (87)

a) This commitment entered into unilaterally would be difficult to reverse (unanimity would be required in order to amend the Directive accordingly) and would considerably reduce the room for manoeuvre and negotiation of the Community as a whole, or of the Member States taken separately, in their relations in this area with third countries.

b) The liberalization of capital movements forms part of a larger process of creating an integrated finanial area in the Community. The obligation for Member States to liberalize capital movements vis-à-vis one another can and must be more extensive and more exacting, from certain points of view, than is the case for capital movements to or from third countries (e.g. with respect to the non-discriminatory application of domestic rules on taxation or prudential surveillance).

III - Modification, in terms of their scope, of the instruments regulating international capital flows referred to in the Directive

1. It is proposed (Article 2 (a) of the amended Directive) to supplement the set of instruments regulating short-term financial flows which the Member States must have available, so that the coverage of these instruments is the same as that of the specific safeguard clause laid down in the proposal for a Directive liberalizing capital movements.

2. The regulatory instruments referred to in the 1972 Directive, in its original exacting terms, concern inflows capital almost exclusively. This can be explained by the situation which prevailed at the time, characterized by an inflow of funds into certain European currencies and by the fact that most of the Member States maintained permanent restrictions on outflows of capital of the same nature. In a situation in which the complete freedom of capital movements is the rule , provision must be made for the symmetrical use of regulatory instruments so that, in all cases, a response can be made to short-term capital movements of great magnitude which might lead to serious disturbances in the conduct of the monetary and exchange rate policies of the Member States or threaten the cohesion of the EMS.

3. This adjustment of the scope of the instruments referred to in the Directive would make it possible to guarantee that all the Member States are technically able, if they feel the need or if coordinated action proves necessary, to take the requisite temporary protective measures rapidly.

The monetary authorities must be able to react immediately if they are to be effective in combating the onset of a bout of speculation.

IV - Amendment of the procedures for implementing the instruments regulating international capital flows

1. The operations to which the regulatory instruments referred to in the Directive can apply will be subject to an unconditional Community obligation for liberalization. It therefore becomes necessary to stipulate (Article 3 (2) of the amended Directive) that these instruments may be put into operation in the case of capital movements between residents of the Member States, only on the conditions and according to the procedures of Community law permitting the restriction of the free movement of capital, the relevant provisions on this matter being :

- in general, the safeguard clauses laid down in the Treaty;
- more specifically,
  - Article 2 of the Directive for the liberalization of capital movements with respect to the instruments neutralizing the undesirable effect on domestic liquidity of international capital flows (rules covering the net external position of the credit institutions, the fixing of compulsory reserve ratios),
  - Article 3 of the same Directive with respect to the instruments regulating the short term assets or liabilities of residents placed with non-residents.

2. According to the present exacting terms of the 1972 Directive, the regulatory instruments to which it refers are put into operation chiefly on the individual initiative of the Member States. The latter must nevertheless take account of the interests of their partners and the Commission, in cooperation with the Monetary Committee and the Committee of Governors, must ensure the necessary coordination.

It is proposed introducing into the amended Directive (Article 2 (a)) the possibility of the regulatory instruments being activated on a recommendation from the Commission to the Member States and or to some of them, in the event of short-term capital movements to or from third countries leading to serious disturbances to the stability of exchange rate relationships in the European Monetary System.

If this recommendation cannot be implemented without also affecting movements of capital between the residents of the Member States, the above mentioned provisions of the liberalization Directive would apply, in particular the maximum length of time for which such measures can be maintained.

V - For the sake of clarity, it has been considered preferable to consolidate into a single text the original exacting terms of Directive 72/156/EEC and the amendments which are made to it by this proposal.

PROPOSAL FOR A COUNCIL DIRECTIVE

amending Directive 72/156/EEC on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

having regard to the Treaty establishing the European Community, and in particular Article 70 (1) therof,

having regard to the proposal from the Commission, which consulted the Monetary Committee for this purpose,

having regard to the Opinion of the European Parliament (1),

whereas by Directive / /EEC (2) for the implementation of Article 67 of the Treaty, the Council established the free movement of capital between the residents of the Member States;

whereas the Member States shall endeavour to attain the highest possible degree of liberalization in respect of movement of capital between the residents of the Community and those of third countries;

whereas by Directive 72/156/EEC (3), the Council established a set of instruments for regulating international capital flows and neutralizing their undesirable effects on domestic liquidity; whereas in view of the fact that the free movement of capital within the Community has been established,

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(1) OJ N° of

(2) OJ N° of

(3) OJ N° L 91 of 18.4.1972, p.13

these instruments may be put into operation in order to regulate short-term capital movements between residents of the Member States of the Community only on the conditions and according to the safeguard procedures laid down in the Treaty and in Directive / /EEC; whereas Directive 72/156/EEC must be amended accordingly;

whereas it must be possible for these instruments to be used on a recommendation from the Commission, in order to ensure coordinated action by the Member States, in the event of short-term capital flows to or from third countries leading to serious disturbances in their domestic monetary situation and in the stability of exchange rate relationships in the European Monetary System;

whereas for the sake of clarity, it is advisable to present in a single text all the exacting terms of Directive 72/156/EEC, as amended by this Directive,

HAS ADOPTED THIS DIRECTIVE :

ARTICLE 1

?? The exacting terms of Directive 72/156/EEC shall be replaced by the following :

"Article 1

1. In the arrangements which they apply to the conclusion or performance of transactions and to transfers in respect of capital movements with third countries, the Member States shall endeavour to attain the same degree of liberalization as in the case of operations taking place with residents of the other Member States of the Community.

2. The Member States shall inform the Commission of the restrictions which they impose on movements of capital to or from third countries at the date of entry into force of this Directive, and of any subsequent change to these provisions.

3. The Commission may make recommendations to Member States on this subject.

Article 2

The Member States shall take all necessary measures to ensure that the monetary authorities have available the following instruments and are able, where necessary, to put them into operation immediately without further enabling measures :

Why?

a) for effective regulation of international capital flows :

- rules governing the constitution of short-term assets or liabilities placed with non-residents and payment of interest on the short-term holdings of non-residents;

- regulation of short-term financial loans and credits granted to or contracted with non-residents;

b) for the neutralization of those effects produced by international capital flows on domestic liquidity which are considered undesirable :

- regulation of the net external position of credit institutions,

- fixing minimum reserve ratios, in particular for the holdings of non-residents.

Article 3

1. The Member States shall forthwith adopt the necessary measures to comply with this Directive. They shall forthwith inform the Commission thereof.

2. Each Member State shall, where necessary, and taking account of the interests of the other Member States, apply all or some of the instruments mentioned in Article 2.

When these instruments apply to movements of capital occurring between residents of the Member States of the Community, they may be put into operation only on the conditions and according to the procedures laid down in the provisions of the Treaty relating to the use of a safeguard clause or in the provisions of Article 2 and 3 of Directive / /EEC for the implementation of Article 67 of the Treaty.

(?) Without prejudice to these provisions, the Commission may recommend to the Member States that all or some of the instruments mentioned in Article 2 be put into operation, in the event of short-term capital flows to or from third countries leading to serious disturbances in the domestic monetary situation and in the stability of exchange rate relationships in the European Monetary System.

3. When the instruments mentioned in Article 2 are applied, the Commission shall ensure close coordination between the authorities of the Member States.

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Article 4

In exercising the powers which are conferred upon it by this Directive, the Commission shall act in consultation with the Monetary Committee and the Committee of Governors of Central Banks.

Article 5

This Directive is addressed to the Member States."

ARTICLE 2

This Directive is addresse! to the Member States.

Done at Brussels,

For the Council,

The President

SEC (87)1661

PROPOSAL FOR A COUNCIL REGULATION

establishing a single facility providing
medium-term financial support for
Member States' balances of payments

(Presented by the Commission to the Council)

PROPOSAL FOR A COUNCIL REGULATION

establishing a single facility providing
medium-term financial support for
Member States' balances of payments

EXPLANATORY MEMORANDUM

In December 1984, when extending for a further two years the machinery for medium-term financial assistance (MTFA), the Council, in a statement, expressed the opinion that opportunities for the combined use of that machinery with the other instrument for medium-term balance-of-payments support, the Community loan mechanism, should be exploited.

On adoption of Regulation (EEC) No 1131/85 of 30 April 1985, which raised the ceiling on Community loans, the Commission followed up Parliament's opinion by issuing a statement announcing to the Council its intention of examining the two Community facilities for medium-term balance-of-payments support with a view to:

(i) assessing their purposes and the arrangements for applying them;

(ii) exploring possibilities for improving the links between them or even for merging them into a single facility;

(iii) complying with the Council's desire, expressed in its statement of December 1984, for a reduction of 2 000 million ECU in the amount available under the MTFA machinery in view of the corresponding increase in the ceiling on Community loans.

In December 1986, on the occasion of the last two-year extension of the MTFA machinery, the Council adopted a Commission proposal putting into effect the aforementioned reduction (see Decision 86/656/EEC of 22 December 1986) and took the opportunity to reaffirm the desirability of establishing a link between the MTFA machinery and Community loans.

Furthermore, in its programme for the liberalization of capital movements in the Community (see the Commission's communication to the Council: COM (86) 292 Final of 23 May 1986), the Commission stated that the Community, through its instruments for supporting balances of payments, must be able to offer Member States which are faced with special constraints the means of overcoming these difficulties so as to enable them to take part in the full process of capital liberalization.

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For the past two years, Commission departments, along with the Monetary Committee, have been able to examine the operation of those two Community facilities, the conditions and the financing arrangements attaching to each of them, and the reasons for the relatively infrequent use of the MTFA machinery. Their work, together with experience in granting balance-of-payments loans and the prospect of embarking on the final stage in the liberalization of capital movements, has enabled the Commission to identify the conditions and arrangements that should govern the facilities in future.

The Commission has decided to propose to the Council the establishment of a single medium-term financial support (MTFS) facility that will serve a wider purpose, combining the two existing mechanisms while retaining their specific financing arrangements.

The main features of the proposed facility are described below.

1. The MTFS facility as a means of supporting balances of payments

Medium-term financial support would still be basically a conditional financing facility to be deployed if a Member State were experiencing or seriously threatened with balance-of-payments difficulties. It would to that extent constitute the main form of the mutual assistance provided for in Article 108 of the EEC Treaty and could thus be activated by a Commission recommendation. That is the procedure in the case of the present MTFA machinery.

Nevertheless, a Member State experiencing or foreseeing serious balance-of-payments problems could take the initiative in seeking Community assistance, as long as it submitted a recovery programme in support of its application. That is the present procedure for Community loans.

Pursuant to Article 108, the facility itself could be activated only by a decision of the Council, acting by qualified majority on a Commission proposal adopted after consultation with the Monetary Committee and specifying the amount, duration and techniques for disbursing the loan (single payment or by instalments) and the economic policy conditions attaching to it.

2. The MTFS facility as a means of providing back-up for the liberalization of capital movements

The Commission proposes that it should also be possible to activate the MTFS facility for the benefit of a Member State committing itself to implementing a programme of capital liberalization despite a fragile external situation.

The facility would be activated on the basis of this commitment and provided that the Member State put forward a coherent back-up programme focussing primarily on the main thrust of monetary and budgetary policy and on whatever measures might be required to adapt the national financial system. If the Member State does not participate in the EMS exchange-rate mechanism, support may be made subject to its accepting some degree of exchange-rate discipline.

The purpose of granting financial support would be to discourage speculation and to guarantee the beneficiary Member State access to Community financing, if need be.

To this end, it is proposed that appropriate changes be made to the techniques for disbursing financial support. Assistance would take the form either of a credit line or of an undertaking to grant a loan, both valid for a fixed period (specified in the grant decision but not normally exceeding one year), with the resources being made available at the request of the beneficiary Member State when they were actually needed. Loan maturities would be fairly short: one year, with the possibility of a further one year renewal.

If exchange controls were introduced (or reintroduced) during the term of the loan, consolidation would be possible only within the framework of a longer-term conditional balance-of-payments loan granted under the mutual assistance procedure of Article 108, i.e. examination of the situation by the Commission, economic policy recommendations for the Member State concerned, and the introduction of a recovery programme.

3. Sources of finance for the facility

As a general rule, loans granted under the renovated facility would be financed as a priority, from Community borrowings on capital markets. This method of financing, at present used for Community loans, is extremely flexible and provides scope for exploiting all the financial innovations available on international markets.

However, for the Community, the transaction would be financially neutral: there would be no transaction cost, no exchange-rate or interest-rate risk, and no cash management.

In view of the Community's borrowing capacity and its credit rating, the market should generally prove to be a satisfactory source of financing for all Community lending fulfilling MTFS criteria. If, however, circumstances are such that recourse to the market is not deemed appropriate, the arrangements for the new facility include provision for Community loans granted in case of balance-of-payments difficulties to be financed from credits specifically advanced for that purpose by Member States. This is the financing method used at present for the MTFA machinery, which represents the consolidation of the credit mechanisms associated with the EMS and must, therefore, be retained.

If financing from the Member States were required, the arrangements for the MTFS facility provide for the Council to lay down in its decision granting the loan the amount of the Member States' contributions as well as the financial conditions relating to the loan.

4. Ceilings for the facility

The outstanding amount of borrowing on capital markets for the purposes of the MTFS facility would be limited to ... 000 million ECU in principal. This is considerably higher than the present ceiling of 8 000 million ECU on Community loans; the increase is justified because:

(i) under the new facility, market borrowing takes precedence as the method of financing Community support, with Member States' contributions acting only as a safety net; the financing available under the present MTFA machinery (13 925 million ECU) is considered to be interchangeable with the financing available under the Community loan mechanism;

(ii) the recent enlargement of the Community has increased the potential need for balance-of-payments support for Member States;

(iii) the facility needs to be endowed with sufficient resources for it to fulfil its wider purpose; insofar as the measure accompanies the liberalization of capital movements, it must be able to play fully its role in discouraging potential speculation.

The new facility also sets a commitment ceiling for each Member State, the aim being to limit a priori their contributions, if any, to one or more MTFS loans. The sum of the individual quotas and their apportionment between the Member States is the same as under the present MTFA machinery.

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Finally, as under the existing instruments, there will be a rule limiting each individual Member State's recourse to the MTFS facility: in principle, no Member State may borrow more than 50% of the ceiling on market borrowings authorized for the facility.

5. Arrangements for economic monitoring

The Commission proposes that the arrangements for economic monitoring associated with the present Community loan mechanism should be generalized. The Commission, in collaboration with the Monetary Committee, would verify at regular intervals that the recipient Member State was complying with the economic policy conditions attaching to loans under the MTFS facility. Successive instalments would be released by the Commission - or, where appropriate, the Member States - on the basis of the findings of such verification. The Council could decide on any adjustments to be made to the initial economic policy conditions.

6. Duration, financial techniques and loan management

The Commission proposes that the duration of the loans should be laid down in the relevant Council decisions. As a rule, it could not be less than one year, so that the new facility would, without giving rise to any duplication, guarantee a measure of continuity with the other credit facilities available under the EMS. Specific mention would be made of the possibility that MTFS could be made available to consolidate short-term monetary support. Moreover, loans could be granted with the option of early repayment.

Where the loan was financed by market borrowing, it is further proposed that the recipient Member State should be able, in appropriate circumstances, to apply for restructuring of the financial conditions imposed or even refinancing (i.e. a change in lenders). The Commission, after consulting the Monetary Committee, would take all the appropriate steps to oblige, although the original amount and the average duration of the borrowing could not be changed.

There is nothing in the basic Regulation governing the Community loan mechanism to prevent such operations, and experience has shown how useful they can be. The Commission feels that it is worth taking the opportunity afforded by this revision of the rules to introduce explicit arrangements for them.

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Under the new facility, the Commission proposes simplifying the present MTFA procedures, according to which a Member State can be exempted from contributing to the financing of Community support or can mobilize its claim.

A Member State which maintains that difficulties exist or can be foreseen as regards its balance of payments could be exempted from contributing to the financing of the MTFS facility by a Council decision taken on the basis of a proposal from the Commission which, to that end, would consult the Monetary Committee. Similarly, a Member State experiencing balance-of-payment difficulties or a sudden contraction in its foreign currency reserves could request mobilization of its claim. On a proposal from the Commission, which would have consulted the Monetary Committee, the Council would decide on the principle of mobilization; mobilization would be effected by refinancing from Community borrowings on the financial markets or, failing that, by a transfer of claims to other creditor Member States or by early repayment by the debtor Member State. However, the procedures under the existing MTFA machinery which explicitly provide and arrange for the possibility of concerted action with other international organizations for the purpose of mobilization would appear to be superfluous in the present situation.

PROPOSAL FOR A COUNCIL REGULATION

establishing a single facility providing
medium-term financial support for
Member States' balances of payments

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Articles 108 and 235 thereof,

Having regard to the proposal from the Commission, which consulted the Monetary Committee for this purpose,

Having regard to the Opinion of the European Parliament,[1]

Whereas Article 108 of the Treaty provides for the granting of mutual assistance, to be decided by the Council on a proposal from the Commission, to a Member State in difficulties or seriously threatened with difficulties as regards its balance of payments; whereas the Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters confirmed the need for a Community facility for medium-term financial assistance of balances of payments;

Whereas it should be possible for the operation of lending to a Member State to take place soon enough in order to encourage that Member State to adopt, in good time, measures likely to prevent the occurence of an acute balance-of-payments crisis;

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1 O.J. No...... of ....

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Whereas a financing facility, in the form of a credit line or a loan commitment to a Member State undertaking to implement a capital liberalization programme despite a fragile balance-of-payments situation, should provide back-up for such a programme in orderly exchange-rate conditions;

Whereas each loan to a Member State must be linked to the adoption by that Member State of economic policy measures designed to re-establish or to ensure a sustainable balance-of-payments situation and adapted to the gravity of the balance-of-payments situation in that State and to the way in which it develops;

Whereas appropriate procedures and instruments should be provided for in advance to enable the Community and Member States to ensure that, if required, medium-term financial support is provided quickly, especially where circumstances call for immediate action;

Whereas, in order to finance the support granted, the Community needs to be able to use its creditworthiness to borrow resources that will be placed at the disposal of the Member States concerned in the form of loans; whereas operations of this kind are necessary to the achievement of the objectives of the Community as defined in the Treaty, especially the harmonious development of economic activities in the Community as a whole; whereas the Treaty makes no provision for the specific powers of action required for this purpose;

Whereas by Decision 71/143/EEC [1], as amended by Decision 86/656/EEC [2], the Council set up machinery for providing medium-term financial assistance that was initially valid for

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1 O.J. No L 73 of 27.3.1971, p. 15.

2 O.J. No L 382 of 31.12.1986, p. 28.

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a period of four years from 1 January 1972; whereas this machinery has since been renewed and extended, on the last occasion for two years until 31 December 1988 by Decision 86/656/EEC; whereas this machinery provides for the Member States to grant medium-term loans, within certain limits, to one or more Member States experiencing balance-of-payments difficulties;

Whereas by Regulation (EEC) No 682/81 [1], as amended by Regulation (EEC) No 1131/85 [2], the Council set up a Community loan mechanism designed to support the balances of payments of the Member States; whereas this mechanism provides for the Community to contract loans, according to needs and within the limits set on outstanding borrowing, in order to on-lend the proceeds to one or more Member States experiencing balance-of-payments difficulties;

Whereas the Community loan mechanism has demonstrated its effectiveness; whereas its general design and the arrangements for implementing it still meet the needs of the Community; whereas, in view of the Community's borrowing capacity and of the conditions available to it for borrowing from financial institutions or on capital markets, the mechanism could constitute the main form of mutual assistance provided for under Article 108 of the Treaty; whereas it could also constitute, under certain conditions and in an appropriate form, an instrument to provide back-up for a programme of capital liberalization; whereas the ceiling on amounts outstanding under the mechanism should be adjusted accordingly;

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1 O.J. No L 73 du 19.3.1981, p. 1
2 O.J. No L 118 du 1.5.1985, p. 59

Whereas, however, it is appropriate that the obligation on Member States to finance mutual assistance under the machinery for medium-term financial assistance stay in force until the final stage of the European Monetary System so as to ensure that System's cohesion and stability, irrespective of the conditions prevailing on international capital markets; whereas the present procedures for exempting a Member State from contributing or for mobilizing Member States' claims should, nevertheless, be simplified;

Whereas it is appropriate to merge medium-term financial assistance and the Community loan mechanism into a single facility for medium-term financial support, while retaining their specific methods of financing;

HAS ADOPTED THIS REGULATION:

Article 1

1. In accordance with the decision adopted by the Council pursuant to Articles 3 or 4 and after consulting the Monetary Committee, the Commission shall be empowered to contract loans on the capital markets on behalf of the European Economic Community, with the aim of lending the proceeds to one or more Member States which are experiencing or seriously threatened with balance-of-payments difficulties or which have undertaken to implement a programme of capital liberalization despite a fragile balance-of-payments situation.

2. The outstanding amount of loans to be granted to Member States pursuant to paragraph 1 shall be limited to ... 000 million ECU in principal.

Article 2

Where a Member State proposes to call upon sources of conditional financing outside the Community, it shall first consult the Commission and the other Member States in order to examine, among other things, the possibilities available under the Community facility for medium-term financial support. Such consultations shall be held within the Monetary Committee.

Article 3

1. On the initiative of the Commission acting pursuant to Article 108 of the Treaty or of the Member State experiencing balance-of-payments difficulties and seeking a Community loan, the Council, after examining the situation in that Member State and the adjustment programme that it has undertaken to implement, shall decide, as a rule during the same meeting:

   - whether to grant the loan, and the amount of the loan;

   - the average duration of, and the techniques for disbursing the loan, which may be paid in one amount or in several instalments;

   - the economic policy conditions attaching to the loan, with a view to re-establishing a sustainable balance-of-payments situation.

2. If the amount available under the ceiling referred to in Article 1 (2) is insufficient, or if the conditions available on international capital markets are unsatisfactory, Community loans to Member States experiencing balance-of-payments difficulties shall be financed in full or in part by the other Member States, whose contributions in principal may not exeed the ceilings specified in the Annex.

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3. In cases where restrictions on capital movements are introduced or re-introduced during the term of the loan, the latter may be consolidated only within the framework of a longer-term loan granted as mutual assistance pursuant to Article 108 of the Treaty.

Article 5

The Commission shall take the necessary measures to verify at regular intervals, in collaboration with the Monetary Committee, that the economic policy of the Member State in receipt of a Community loan accords with the adjustment or back-up programme and with any other conditions laid down by the Council pursuant to Articles 3 or 4. To this end, the Member State shall place all the necessary information at the disposal of the Commission. On the basis of the findings of such verification, the Commission and, where appropriate, the Member States holding claims under the facility shall release further instalments. The Council shall decide on any adjustment to be made to the initial economic policy conditions.

Article 6

1. Loans granted as medium-term financial support shall have a term of one year or more. They may be granted as consolidation of short-term monetary support made available by the central banks of the Member States.

2. At the request of the beneficiary Member State, such loans may carry the option of early repayment.

3. Normally, no Member State may draw on this facility to the extent of more than 50% of the ceiling referred to in Article 1 (2).

Article 7

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and shall not involve the Community in the transformation of maturities or in any exchange or interest-rate risk.

   When the borrowings are expressed, payable or repayable in the currency of a Member State, they may be concluded only after consultation with the competent authorities of that Member State.

   Where a Member State receives a loan carrying an early repayment clause and decides to invoke this option, the Commission shall take the necessary steps after consulting the Monetary Committee.

2. At the request of the debtor Member State and where circumstances permit an improvement in the interest rate on the loans, the Commission may, after consulting the Monetary Committee, refinance all or part of its initial borrowings or restructure the corresponding financial conditions.

   Refinancing or restructuring shall not have the effect of extending the average duration of the borrowings concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.

3. The costs incurred by the Community in concluding and carrying out each operation shall be borne by the beneficiary Member State.

Article 8

1. If one or more Member States that are creditors under this facility experience difficulties as regards their balance-of-payments and/or a sudden decline in their foreign currency reserves, they may request mobilization of their claims. The Council, having due regard to the circumstances, shall decide to mobilize such claims, in particular in accordance with one of the following procedures, or a combination thereof:

   - by refinancing from Community borrowings from financial institutions or on capital markets;

   - by a transfer of the claim to other creditor Member States;

   - by early repayment in full or in part by the debtor Member State or States.

2. Where refinancing takes place in accordance with paragraph 1, the debtor Member State shall agree that its debt, originally denominated in one currency, shall be replaced by a debt denominated in the currency used for the refinancing. Where applicable, the debtor Member State shall bear any additional cost resulting from an alteration in the interest rate and the costs incurred by the Community in concluding and carrying out the operation.

3. Any creditor Member State may arrange with one or more other Member States for the partial or total transfer of its claims. The Member States concerned shall notify the Commission and the other Member States of the transfer.

4. Any Member State that is a creditor in respect of a loan carrying an early repayment clause shall take the requisite steps where the debtor Member State decides to invoke this option. The Member States concerned shall notify the Commission and the other Member States of the operation.

Article 9

For the application of the ceilings referred to in Articles 1 (2) and 3 (2), the loan operations shall be recorded at the exchange rate of the day on which they are concluded. The repayment operations shall be recorded at the exchange rate of the day on which the corresponding loan was concluded.

Article 10

The Council shall adopt the decisions referred to in Articles 3, 4, 5 and 8, acting by qualified majority on a proposal from the Commission, made after consulting the Monetary Committee on the matter.

Article 11

The European Monetary Cooperation Fund shall make the necessary arrangements for the administration of the loans.

The funds shall be paid only to central banks and shall be used only for the purposes indicated in Article 1.

Article 12

No later than five years after the adoption of this Regulation, the Council shall examine, on the basis of a report from the Commission, after delivery of an opinion by the Monetary Committee and following consultation with the European Parliament, whether the facility established still meets, in its principle, its arrangements and its ceiling, the needs which led to its creation.

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Article 13

1. Regulation (EEC) No 682/81 and Decision 71/143/EEC are hereby repealed.

2. Amounts not yet repaid under outstanding Community loan operations concluded pursuant to Regulation (EEC) No 682/81 before the date of entry into force of this Regulation shall count against the ceiling referred to in Article 1 (2) at their initial value in ECUs.

3. References to the instruments repealed by virtue of paragraph 1 shall be deemed to be references to this Regulation.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Council

The President

ANNEX

The ceilings for credits provided for in Article 3 (2) shall be as follows:

Member State	Million ECU	% of total
Belgium	875	6.28
Denmark	407	2.92
Germany	2 715	19.50
Greece	235	1.69
Spain	1 132	8.13
France	2 715	19.50
Ireland	158	1.13
Italy	1 810	13.00
Luxembourg	31	0.22
Netherlands	905	6.50
Portugal	227	1.63
United Kingdom	2 715	19.50
Total	13 925	100.00

CONFIDENTIAL

FROM: A J C EDWARDS
DATE: 27 October 1987

CHANCELLOR

Mr [illegible] (also [illegible])

cc: Chief Secretary
Paymaster General
Sir P Middleton
Sir G Littler o/r
Mr F E R Butler
Mr Bonney
Mr Mercer
Mr Mortimer
Mr Donnelly
Mr C B Evans

EC FUTURE FINANCING:
PRIME MINISTER'S MEETING, 28 OCTOBER

The Prime Minister's meeting will have before it two main papers:

(a) Sir Geoffrey Howe's minute of 26 October and summary paper (prepared by the Cabinet Office with our help), and

(b) the Treasury paper, which Mr Taylor sent on your behalf to the Prime Minister on 20 October (but which Mr Lavelle fears the Prime Minister has not yet seen).

[illegible] must [illegible] [illegible] 30/10

Sir Geoffrey Howe also sent (c) an earlier minute on 12 October reporting the outcome of the early October OD(E) meeting.

2. Sir Geoffrey Howe's minute suggests that the Prime Minister's discussion should concentrate on two issues: agriculture and the structure of own resources. There are some even more fundamental questions, which the Prime Minister may also wish to explore, about what sort of deal the UK should be aiming at or willing to settle for.

UK aims in the negotiation

3. From the Treasury standpoint, the Community is becoming an ever-greater financial disaster area. The facts are, briefly:

- our underlying net contribution is now running at 1¼ to 1½ becu (around £1 billion) a year, even after abatement, and rising inexorably;
- the Commission's expenditure proposals would add perhaps 350-400 mecu (£275 million) a year to this by 1992;
- their alternative correction system/fourth resource proposals would add a further sum of perhaps 800-900 mecu (£600 million) a year by 1992, on our estimates;
- together with the continuing deterioration which we would foresee anyway, we would expect these proposals to result in a UK net contribution after abatement of some 2½ becu (£1¾ billion) a year by 1992.

On top of this we lose about 400 mecu a year from paying Community rather than world prices for our net imports of agricultural products from the rest of the Community.

4. The subsidy which, on these proposals, we would be providing to other member states in the Community (many more prosperous than we are) would significantly exceed our overseas development aid of some £1¼-1½ billion a year. Meanwhile, other member states would mostly be making still greater net profits out of the Community (particularly Greece, Spain and Ireland, but also the Benelux countries). The French would continue to gain more from intra-Community trade in agricultural products than they lose on the budget. The Germans would suffer even more than ourselves; but their wounds are self-inflicted.

?

5. The deterioration in the UK's net contribution since Fontainebleau, the present position and the prospect are all so bad that it seems necessary to consider any possible means of lessening the deterioration. The main possibilities, in theory at least, are:

(i) restraining the growth of expenditure through the minimum realistic increase in the own resources ceiling, made sustainable by improved budget discipline in agriculture and non-obligatory expenditure;

(ii) obtaining some improvement in the own resources structure/UK abatement area.

These two possibilities correspond roughly to the areas recommended for discussion by Sir Geoffrey Howe.

Agricultural budget discipline

6. Our general posture has been throughout to insist on the need for more effective and binding budget discipline. If there is nothing to show in this sense at the end of the negotiation, it will clearly be hard to defend any decision to raise the own resources ceiling.

7. The problem is that increases in the agricultural guideline limit beyond present budget discipline levels will be unavoidable in the context of an increase in the own resources ceiling. It is precisely because of their desire for increased agricultural expenditure that the Northern member states (with considerable support in the South) want a higher own resources ceiling. The Northern member states are willing, moreover, to pay for a higher guideline by conceding increased non-obligatory expenditure.

8. The discussions in Brussels so far have not been encouraging. The Agriculture Council will probably achieve little at its meeting on stabilisers on 16-17 November. Meanwhile there are some indications that France and Germany may be trying to hatch up a deal on agriculture between them, as they did on the agrimonetary system in the June European Council.

9. Against this background, the UK's broad aim should continue to be to make future budget discipline limits as constraining and effective as possible so that future own resources ceilings

can be respected. This means that we shall want on the one hand a foolproof, or near-foolproof, limit on the Community's agricultural spending and on the other a range of production stabilisers and budgetary control instruments to ensure that such a limit can be respected. We have to bear in mind, as explained in the Treasury paper, that production stabilisers on their own will not suffice to ensure that any future guideline is respected. There is an absolute need for effective budgetary control instruments and procedures, regime by regime, as well.

10. So far as the Copenhagen Council is concerned, we should insist on:

(i) a legally binding guideline limit, set at the lowest realistic level and preferably with a rate of growth below the growth of GNP (possibly in line with prices). The guideline should probably incorporate provision for systematic depreciation of stocks in future. There is nothing to be said on the numbers for the time being beyond what is in the Treasury paper. We do need to bear in mind, however, that attempts to set the ceiling too low would exacerbate the pressures for an oils and fats tax;

(ii) production stabilisers with agreement on numbers, not just generalities, which can then be enshrined in regulations: we could perhaps live at Copenhagen with agreement on numbers for the main big-spending regimes, on the basis that the others must be agreed before any new own resources decision can be finally agreed;

(iii) budgetary control procedures, including discretionary powers for the Commission, designed to ensure that the Commission can contain levels of expenditure regime by regime within the budget profile;

(iv) the guideline to be an absolute limit, respected by means of the instruments at (ii) and (iii) above, with no exceptional circumstances or, failing that, a safety-valve.

Safety-valve

11. As Sir Geoffrey Howe's letter implies, Ministers will need to take a provisional view now on whether to float the idea of a safety-valve at this month's Foreign Affairs Council on 23-24 November.

12. Our own view is that the UK should float this idea at the November Council. We should be careful to present it, not as a brilliant scheme for solving the problems of the CAP at a stroke, but rather as an element within the totality of agricultural measures which will be needed if member states are not prepared to go along with the idea of an absolute limit on agricultural spending.

13. We should aim, in other words, at a Morton's fork presentation. The Community (we would argue) must have:

- *either* an absolute limit on agricultural expenditure, with no exceptional circumstances (but possibly softened by some discretion for nationally financed income aids)
- *or* an absolute limit on the Community's expenditure, while allowing for an element of nationally financed overspill in certain tightly circumscribed circumstances (modelled on M Delors' proposals earlier this year).

We should make quite clear that none of this would be a substitute for stabilisers and control procedures. On the contrary, the fundamental and overriding aim must be to contain total expenditure within the guideline limit, with the help of stabilisers and budget control procedures.

14. Sir G Howe paved the way at the last Foreign Affairs Council for a presentation along these lines. The Germans too have voiced thoughts in Brussels about a safety-valve on approximately these lines, admittedly in the context of unwelcome proposals for a generalisation of quotas.

15. The case <u>for</u> including the safety-valve in this way is in our wider presentation at this month's Foreign Affairs Council is:

(i) it will show that we <u>mean business</u> when we say that the agricultural expenditure limit must be a limit (and that there has to be a lid on the extent to which we can go on subsidising other member states' farmers);

(ii) it is not impossible that other member states might finally come to see the safety-valve as something they could live with if they thought that we would not agree to increase the own resources ceiling without either this or an absolute limit on total agricultural expenditure;

(iii) the horror of the Morton's fork could have the useful effect of moving the Commission and others to agree to circumscribe "exceptional circumstances" so tightly that we could seriously consider this alternative approach;

(iv) if we do not include the idea of the safety-valve as part of our general stance at the November Foreign Affairs Council, I suspect that its time will pass and we shall have lost the potential benefits which it may bring (whether in terms of being agreed or of causing others to improve their alternative proposals).

16. Ourlatest information is that Sir Geoffrey Howe, whose officials tend to see the safety-valve as a purely tactical device, probably <u>will</u> be prepared to include it, <u>sotto voce</u> perhaps, in his November presentation. We must hope that the <u>sotto voce</u> will not be overdone.

Income-aids No good if they don't take any tricks

17. Mr MacGregor has expressed concern to you about the Treasury's alleged attachment to income aids. We do not think that he has any grounds for such concerns, which would better be directed

at the FCO. We have always been clear that income aids are not something to be put forward as being desirable in their own right. Rather, they are something which we might be prepared to concede as a means of enabling other member states to agree on satisfactory budget discipline for agriculture and satisfactory means for implementing it and provided also that they are nationally financed (or substantially so). The Treasury paper mentions the possibility of income aids only in the context of softening slightly the concept of a binding and absolute guideline limit with no exceptional circumstances.

Conclusions on agriculture

18. We suggest that you should press at the Prime Minister's meeting for agreement to the following points:

(i) a provisional decision to float the safety-valve idea at the 23-24 November FAC in the context of a Morton's fork presentation along the lines sketched above;

Pr [illegible] [illegible] no circs, or S-V

(ii) MAFF should urgently circulate a table of our desired numbers for the individual stabiliser regimes (preferably distinguishing between our opening position and where we might be prepared to settle) and then press hard for these at the November Agricultural Council on the basis that agreement on these will be essential if there is to be any wider agreement at Copenhagen;

(iii) we should continue to insist on the paramount need for effective budgetary control powers and procedures so that the guideline can be respected; and

(iv) ? officials should study further whether any formula for circumscribing exceptional circumstances might be acceptable.

Non-obligatory expenditure

19. Sir G Howe may well, in spite of his disclaimers, mention this briefly. Clearly we must maintain our existing line that

the maximum rate discipline should continue to apply to this expenditure. The problem is that the Southerners and Ireland will loudly demand much more than this and the other Northern member states will be so anxious to obtain agreement to extra agricultural expenditure that they will be inclined to go a considerable way to meet these demands.

20. Sir G Howe may suggest that officials do further work on what fallback positions we might contemplate. We suggest that you could agree to this but only on the basis that no hint of such possibilities should be allowed to emerge in our dealings with other member states.

Own resources structure/abatement nexus

21. In view of the latest deterioration in the UK's budgetary imbalance, which implementation of the Commission's future financing proposals or anything similar would make much worse, the UK's objective should arguably be to secure some improvement in the UK's position in the own resources/abatement area so as to reduce in some degree the progressive deterioration in our overall imbalance. This is, in effect, a rather more positive reformulation of our existing policy of supporting the Commission's proposed fourth resource (the "diff tax") while maintaining that any changes in the Fontainebleau abatement system must be for the better.

22. As to possible means of improvement, raising the abatement percentage is probably not realistic in the context of the limited increase in own resources which we hope to secure. Contrariwise, if the UK should feel obliged in the last analysis to go along with an increase in our own resources going beyond immediate requirements, it could then become more practicable to insist on improvements in the abatement system as a quid pro quo.

23. A more promising approach, at this stage, will be to secure some improvement through adoption of the Commission's diff tax proposal, in which the UK's share would be less than our VAT share. As explained in the Treasury paper, we would almost certainly have to agree to a matching adjustment in the Fontainebleau formula which would relate our abatement to the difference between our share of VAT and the diff tax taken together and our share of Community expenditure, rather than the present VAT/expenditure gap. The benefits from the diff tax would then probably build up to some 130 mecu a year by 1992, even after this change, on the Commission's expenditure projections, though substantially less if the growth of expenditure is more restrained (as we hope it will be).

24. In practice the Commission are coming under much pressure in Brussels to alter the fourth resource proposal so as to soften the effects on Italy and others. UKREP tend to argue that some concession will have to be made to the Italians, whose net receipts would otherwise be significantly reduced. We do not share this view. The Italians probably contribute substantially too little under the VAT system because of the black economy problem. They are anxious to raise the own resources ceiling. They do not need to be bought off. It is the UK to whom concessions should be made, not Italy.

25. In our view the UK should try hard to prevent erosion of the benefits to the UK from the Commission's diff tax proposal. We should try hard to secure whatever mitigation we can of our increasing budgetary burden by this means. 130 mecu a year, or even half of that, would be well worth having. It could also help considerably with the problem of domestic presentation subsequently.

26. Sir G Howe's paper notes, with some justice, that introduction of a fourth resource based on the difference between the VAT base and GNP will be linked in practice to the proposal that the own resources ceiling should be expressed in terms of GNP and grow in line with GNP (as other member states have

already agreed it should). We think that this will inevitably form part of the final deal. The advantage of a more buoyant ceiling is that the pressures to raise it every few years will be somewhat reduced. The UK should not therefore feel inhibited by this from arguing for a diff tax along the lines proposed by the Commission or (better still) GNP contributions to replace VAT altogether.

27. The Prime Minister's meeting might usefully conclude that, in view of the appalling and ever-worsening financial situation in which the UK finds itself in the Community, we should try hard to secure the full improvement in our budgetary position implicit in the Commission's diff tax proposal so as to offset in some degree the further worsening in our position which will inevitably result from adoption of a future financing package.

AJCE

A J C EDWARDS

2.15

FROM: M E DONNELLY
DATE: 9 November 1987

1. **MR EDWARDS** seen in draft
2. **PS/CHANCELLOR**

Presumably [illegible] (for contacts with MEPs, not just with [illegible]) [illegible] (PM)

cc: PS/Chief Secretary
PS/Paymaster General
Sir P Middleton
Sir G Littler
Mr F E R Butler
Mr Bonney
Mr Mercer
Mr Mortimer
Mr Evans

[illegible]

OD(E) 12 NOVEMBER: FCO NOTE ON THE EUROPEAN PARLIAMENT AND UK INTERESTS

Background

The Foreign Secretary sent to the Chancellor a FCO note reviewing how we could best promote our interests in the European Parliament. Relevant developments since the last review include:

(a) Parliament's increased powers in (non-financial) areas under the Single European Act cooperation procedure; and

(b) the prospect of the next European Parliament elections in June 1989.

In his covering minute the Foreign Secretary proposes a short discussion of the paper at the end of OD(E) on Thursday.

Lines to take

2. The paper is straightforward and non-contentious. You need not reply before OD(E); some suggested brief points to make at the meeting, drawing on Treasury experience of negotiation with the Parliament during the budget procedure, are attached.

Martin Donnelly
M E DONNELLY

Points to make

- Agree with paper's broad conclusion

- Support more contacts with the Parliament by relevant Ministers on specific subjects or draft reports. General liason best handled by FCO.

- Parliament works largely through committees and it is important that on specific issues effective lobbying of committee chairmen and the spokesman for the main political groups takes place. Treasury Ministers have made a point (not fully reflected in the paper's list of visits) of maintaining contact both with EDG MEPs and also with other influential MEPs on the Budgets Committee; a strategy which helped us maintain good relations with the Parliament on budget issues throughout our Presidency.

- Need to give detailed briefing to sympathetic MEPs on relevant subject committees. This can often be done most effectively in London; we need to avoid offending the Presidency by too overt lobbying in Strasbourg. Need to encourage British EDG MEPs to seek detailed Government briefing as a matter of course before the Parliament's committees report. Much easier to get amendments made at that stage.

Boards of Governors

[redacted]

WORLD BANK

1. Must stick to max. rate
disruption

2. Any target inc. a structure funds shd
be confined to Spain & Portugal

3. Confirm "incentives" to ORSF (not SF)

4. Agree fallback as per para 12 -
Contingency   but last visit

Reservations:

7(E): Wd not initially conclude X:
more work on Sp/Por first.
(This wd help Greece/Italy)

85/17

1. Mr Edwards

2. Chancellor

I agree. The point at para 3 (i) is especially important.
AJCE
11 xi

I think / it's the vital point

FROM: M C MERCER
DATE: 11 NOVEMBER 1987

cc: Paymaster General
Sir P Middleton
Sir G Littler
Mr Edwards
Mr Bonney
Mr Mortimer
Mr Donnelly
Mr Evans
Mr Tyrie

OD(E), 12 NOVEMBER AT 8.45

EC FUTURE FINANCING: THE STRUCTURAL FUNDS

OD(E)(87)21, LORD YOUNG'S PAPER

Purpose

The purpose of the meeting - which will last for only 45 minutes - is to consider the broad lines of our negotiating position on the reform of the Structural Funds. You have commented that any expansion of the Funds must be kept as small as possible.

2. The meeting is a follow-up to OD(E) on 1 October which supported your view that we should (a) take a strong line on maintaining the maximum rate discipline for non-obligatory expenditure; and (b) seek to transform the proposed financial objective for the growth of the Funds by 1992 into a less damaging target for an increase in the real take of Spain and Portugal from the regional fund (ERDF). Officials have since examined the implications of various options for concentrating resources on Spain and Portugal, taking as a starting point the figures in the Treasury's "Overview" paper which was sent to the Prime Minister on 20 October. The results of this work are set out (not very clearly) in Annex B of Lord Young's paper.

Objectives

3. The paper is reasonably satisfactory from our point of view. We suggest that your objective should be to support its broad thrust, not least on the importance of budget discipline, subject to:

i) contesting the notion in paragraphs 6 (first tiret) and 8 that we shall have to concede more on concentration of resources and on our net contribution in order to restrain overall growth of the Funds. This is a <u>false antithesis</u>. Some concentration is probably inevitable and will not be avoided by conceding a larger increase overall; — Won't say that

ii) consistently with this, following the <u>twin</u> objectives of minimising any increase in the total <u>and</u> any reduction in the UK's share;

iii) seeking to confine concentration to the ERDF.

<u>Points to make</u>

i) The UK must continue to insist on the strengthening of budget discipline (an objective to which the other 11 member states signed up at the June European Council). We should not therefore indicate willingness to go along with any increase in the Structural Funds which was inconsistent with sticking to the maximum rate. If the UK should think it necessary at the end of the negotiations to bow to pressure for growth in non-obligatory expenditure above the maximum rate, there would be no way of disguising the fact that the 1984 Budget Discipline conclusions had been relaxed.

ii) Any global financial objective for the Funds which was acceptable to other member states would be bound to breach budget discipline limits. So we must persevere with the aim of transforming such an objective into a less damaging target for the growth of Spanish and Portuguese receipts.

iii) Agree with the paper that we should be prepared in due course to give an indication of the sort of increase in the Funds, both overall and for particular countries, which might be available within the maximum rate. But we must attach a clear health warning to any figures, given the uncertainty about:

- the future level of the maximum rate;

- the growth of other non-obligatory expenditure.

In particular, we must make clear that expenditure on new policies would have to be kept rigorously in check if any significant real increase in the Funds were to be affordable.

iv) The deal may have to involve some increase in the UK's net contribution to the Funds. But the paper goes too far in defining protection of the UK's take from the Funds as a "second order priority". As the tables indicate, the price of concentration, in terms of our annual net contribution, is potentially high, even after abatement. We could well find ourselves being obliged to provide an extra 150 mecu net a year. We must seek to minimise this by:

- confining any target to Spain and Portugal (Greece and Ireland are already major beneficiaries of EC aid);
- restricting concentration to the ERDF and continuing to oppose any regionalisation of the Social Fund (which would not, in any case, benefit Spain);
- adopting a more reserved position than suggested in the paper on the Commission's proposal to concentrate up to 80% of the Funds on the "less developed regions."

v) It is not necessary, at least at this stage, to discuss fallback positions in any detail. Officials have work in hand. However, the broad thrust of paragraphs 11-12 of the paper seem about right - ie the least damaging option would probably be rather more concentration on the poorest member states than we have envisaged up till now, as the price of a settlement consistent with the maximum rate; and beyond that, a limited programme for Spain and Portugal.

BACKGROUND

Commission proposals

4. These are:

- Doubling of Structural Funds in real terms by 1992.

Five priority objectives:

i. helping less developed regions (ERDF, ESF, agricultural guidance);

ii. helping areas of industrial decline (ERDF, ESF);

iii. combating long term unemployment (ESF);

iv. occupational integration of young people (ESF);

v. adjusting agricultural structures and developing rural areas (agricultural guidance, ESF, ERDF).

- Resources (including up to 80% of ERDF) would be concentrated on objective i.

- The ratio of EC to national financing for particular projects could vary according to the importance of the projects and the prosperity of the countries concerned (so-called "modulation").

Main issues in Lord Young's paper

5. The recommendations are summarised in paragraph 2 of the paper. The main points to note in relation to the paper as a whole are:

i) Size of Funds

The Funds this year total around 6 becu (payments) and 7 becu (commitments). The paper is largely in terms of payments. It is based on the assumption - consistent with the Treasury overview paper of 20 October - that growth by 1992 of around 2000 mecu (in money terms) or some 900 mecu (in 1987 prices) would be possible within the maximum rate provided that other non-obligatory expenditure, especially on new policies, was kept under control.

ii) Options for concentrating the funds on the poorest member states

Annex B of the paper outlines a number of options for concentrating spending on Spain and Portugal and, to some extent, Greece and Ireland. The estimated effects on the UK's net contribution can be summarised as follows (the 1987 position has also been added for comparison, though it may if anything be an over-estimate of our current net contribution to the funds because of our unusually high VAT share this year);

Degree of concentration	**UK net contribution after abatement: mecu, 1987 prices**
A. 1987 position	**70**
B. Real increase of 30-70% by 1992 in Iberian take from the ERDF	80-135 (in 1992)
C. As B, but with ESF also skewed to poorer regions	115-170 (in 1992)

iii) Concentrating 80% of ERDF on less developed regions

The paper argues that we should now accept such concentration. The present figure is 73 per cent. Moving to 80 per cent would decrease the UK's share of ERDF receipts and more work is needed on options for concentrating help on Spain and Portugal before we decide that 80 per cent is acceptable as a final outcome, let alone as an opening negotiating position.

iv) Differential grant rates for different projects

This is not an objective in itself, but it could be a means of delivering greater Structural Fund expenditure to Spain and Portugal. It should, however, be restricted to the ERDF.

v) Geographical coverage of the ERDF in the UK

The paper recommends (para 10 and Annex C) that we should not accept the Commission's proposal to create a separate category of rural areas for the ERDF since, while this could help areas such as the Highlands and Islands, it would also bring in many other European rural areas and our overall receipts would actually drop. The UK is making a separate attempt to have the Highlands and Islands classified under a different category, as a less developed region, but if, as seems likely, that is unsucessful, the paper recommends that the matter should rest there. We would support this approach.

vi) Fallback position

Officials are carrying out preliminary work on the options which might need to be considered in the event of agreement proving impossible on a solution along the lines recommended in Lord Young's paper. The least bad alternative would probably be to remain within the maximum rate but to increase further the concentration on the poorer member states, possibly involving the ESF in this process as well (although it should be noted that the options in the paper for greater concentration for the ESF do not actually bring added benefits to Spain). Beyond that, any options look unattractive, but the least damaging might be to admit as an addition to the maximum rate a special programme for Spain and Portugal. We would have to ensure that this would not necessitate going beyond 1½ times the maximum rate (and preferably not as far as that). At this stage however it is more important for OD(E) to concentrate on options which respect the maximum rate and protect as far as possible the UK's net contribution.

M.C.Mercer

M C MERCER

037 1151
DRAFT

CONFIDENTIAL

1. MR EDWARDS seen in draft
2. CHANCELLOR

FROM R J BONNEY
DATE 13 NOVEMBER 1987

cc Chief Secretary
Paymaster General
Mr F E R Butler
Mr Burgner
Mr Mortimer
Mr Mercer
Mrs Imber
Mr Dodds
Mr Tyrie

Ch, / Send note to PM? 13/11

OK as

EC FINANCING REVIEW: AGRICULTURAL STOCKS

1. Mr Taylor's minute of 2 November asked for a note on the Prime Minister's idea that the proposed once for all stock write offs should be nationally financed and not fall on the Community Budget.

2. The stocks issue is likely to be a particularly intractable element of the EC financing negotiations. A progressive and orderly reduction in the current excessive levels of physical stocks will be an essential part of reforming the CAP. The treatment of stocks expenditure (both on existing and new stocks) will be critical for the negotiation on the future size and slope of the guideline on agricultural expenditure. Paragraphs 22-29 of the Treasury's long paper sent to No.10 contained some preliminary analysis of the issues. The attached note attempts to fill out this analysis somewhat and considers various options for the UK's position including the Prime Minister's suggestion. Our general conclusion is that, although quite attractive from the UK point of view, the idea of national write offs is unlikely to be a serious runner because of its differential impact on other Member States.

3. If you agree with the analysis you may wish to send the note (which has been discussed with MAFF officials) to the Prime Minister under a shorter covering minute which deals particualrly with her thought about national financing. I attach a draft.

R J BONNEY

CONFIDENTIAL

please copy for EY

DRAFT MINUTE

FROM: CHANCELLOR
TO: PRIME MINISTER

COPIES TO: FOREIGN SECRETARY
MINISTER OF AGRICULTURE

EC FINANCING REVIEW: AGRICULTURAL STOCKS

You suggested recently that one option for dealing with the problem of the excessive levels of the Community's agricultural stocks would be to propose a once and for all write-off at national expense so that no costs fall on the Community Budget. I have asked officials to look at this and the attached paper (not obligatory reading) discusses at some length this option along with others for dealing with agricultural stocks in the context of the future financing negotiation.

2. I think that I can best summarise the position as follows. A national write off would have considerable attractions from the UK's point of view:

- First, on the most plausible assumption that a write off would be confined to existing stocks (excluding the butter disposals for which special financing arrangements were agreed last year) the UK would stand to lose 522 mecu in EC receipts from a write off but our gross VAT contribution would be 746 mecu less giving a one for all net benefit of some £155 million before and £50 million after the Fontainebleau abatements.

- Secondly, relieving the Community Budget of some 4.4 becu expenditure in this way (most of which would normally fall in 1988 and 1989) would strengthen our arguments for a lower base and/or growth rate for the financial guideline on agricultural expenditure in future years.

- Thirdly, it would make some sense to start off the new guideline with a clean sheet excluding the costs of past excesses, provided of course that the Commission stands both their resistance on the present agrimonetary agreement and

by its stated intention of preventing stocks rebuilding to excessive levels in the future.

3. On the other hand, we need to recognise that ~~many~~ a number of our partners ~~will~~ would not find the idea very attractive. As the note by officials indicates, stock holdings are very unevenly distributed between the Member States. Spain and Portugal would welcome a write off, as this would relieve them of contributing to the costs of stocks acquired before they joined the Community. Otherwise the main beneficiaries would be ourselves and Italy and to a lesser extent Belgium, France and Greece. The major losers would be Ireland (because of their very low share of budget contributions) and Germany (because of their disproportionately high share of stocks due to the high DM intervention prices) and to a lesser extent the Netherlands and Denmark. I fear that the losers would be bound to attack the suggestion as breaching the fundamental CAP principle of common financing: they would be asked, in effect, to foreswear their right to receipts at present properly due to them. Although ~~there might~~ there would undoubtedly be ~~some~~ rough justice in making the Germans pay for their refusal to allow the CAP to be reformed, it would be ~~much~~ more difficult to defend the differential impact on Ireland as one of the poorest Member States (although it might be possible to find a way of buying them off in some way).

4. On balance therefore I would ~~regretfully~~ (sadly) conclude that, while the idea of a national write off is ~~not likely~~ unlikely to be a serious runner, ~~but that~~ we should (still) keep in mind the possibility of arguing for it at the European Council or elsewhere if the context seems propitious.

5. As regards what we should be aiming for in this area, the note by officials attempts to fill out the analysis in paragraphs 22-29 of the long Treasury paper which my office sent to yours on 20 October. First we should aim to get into the European Council conclusions a clear commitment that the Council and the Commission will do what is necessary to reduce stocks to normal levels before 1992. As the paper indicates,

this should be reinforced by a clear statement of the Commission's plans for running down stocks and explicit recognition in the Agriculture Council's conclusions on stabilisers of the need to improve the system of automatic adjustments to intervention buying-in prices in the light of the development of stocks where it is already applied (e.g. for butter) and to extend it to other sectors.

6. Secondly, we need to press for specific amendments to the EAGGF Financing Regulation to provide for the systematic depreciation of new stocks to their disposal value at the time of purchase, with subsequent annual adjustments to reflect market values. The aim would be to prevent the present overhang of expenditure commitments and save on reimbursements of the Member States' financing costs.

7. Thirdly, we need to ensure that expenditure on depreciation of new stocks is included within the financial guideline for agricultural expenditure in the future. We should for the time being keep a more open position on whether the future guideline should also cover the costs of disposing of existing stocks. My present view is that inclusion of this expenditure within the guideline is likely to be preferable unless either we succeed in getting a national write off or else we secure a full compensating reduction in the guideline base or growth factor. My officials calculate that it would be worth considering excluding this expenditure from the guideline, only if we could reduce the base by some 1 becu or the growth rate by 66% of GNP (or a combination of the two; say, a reduction of 500 mecu in the base and 33% in the growth rate). In view of the pressures on expenditure in 1988, it will probably be necessary to find some way of smoothing the expenditure on existing stocks (using the precedent of the 1986 decisions on butter stocks) in order to keep this expenditure within a reasonable guideline limit.

8. I hope that you and other colleagues will be content with this approach.

9. I am sending copies of this minute to Geoffrey Howe and John MacGregor.

NL

EC FINANCING REVIEW: AGRICULTURAL STOCKS

1. This note considers the Commission's proposals in the EC financing review for a revised treatment of expenditure relating to agricultural stocks. It attempts to fill out the analysis in paragraphs 22-29 of the Treasury's long paper of 19 October (EC financing review: overview and scoresheet) and examines a number of options for the UK position including the Prime Minister's suggestion that the costs of disposing of existing stocks should be written off at national expense.

2. Recommendations for the UK line on the three main elements of the Commission's proposals are set out in paragraphs 11, 14 and 22 below.

BACKGROUND

Stock Levels

3. The table below gives the latest available figures for current stocks of the major intervention commodities as of 30 September 1987 compared with what the Commission regard as "normal"; our best estimate of the cost of writing down all of these stocks (i.e. book value less likely disposal proceeds assumed in the 1988 Preliminary Draft Budget) and the costs of writing down stocks in excess of "normal" levels:

commodity	current stock (mt)	"normal" stock (mt)	full write down (mecu)	write down to "normal" level (mecu)
cereals	13.27	5	1751	1091
olive oil	0.22	0.1	-	-
alcohol (ooohl)	0.48	0	44	44
skimmed milk powder	0.74	0.2	-	-
butter	1.04	0.2	1251*	715*
beef carcases	0.44	0.05	640	568
beef boned	0.18	0.05	243	176
			3929	2594

* excluding costs of special disposals programmed agreed in 1986 (3.6 becu)

The current distribution of stocks between the Member States is set out in Annex A. It is the Commission's stated intention to reduce stocks of all commodities to "normal" levels before 1992.

Stocks expenditure

4. Under the present system the Member States are responsible in the first instance for expenditure on intervention purchases and they are only fully reimbursed by the Community Budget for any losses incurred in intervention buying when the stocks are sold or otherwise disposed of. In the meantime the EC Budget reimburses Member States' storage and financing costs at standard rates which (for most countries) do not fully reflect the costs incurred. In the 1986 Price Fixing it was agreed that the reimbursement rate for technical storage costs should be reduced to 3/4 of the average costs in the Community; and that the reimbursement rate for financing costs should be set at 7%, except for Germany and the Netherlands which would receive 6% on the grounds that their national interest rates are below the Community average.

5. There is no systematic provision for depreciating stocks except for beef where 20% of the purchase price is reimbursed immediately to take account of the loss value from freezing. In practice, however, the disposal value of the stocks is likely to be very considerably less than their purchase price because excess stocks can only be sold at world market prices for export or with equivalent subsidies for disposal as animal feed: typically the loss on sale is about 40% of the intervention price for beef carcases, 66% for cereals and 87% for butter. However, the Commission estimate that it will be possible to dispose of stocks of other commodities such as olive oil and skimmed milk powder without incurring significant losses. Earlier this year the Commission estimated that the potential expenditure commitment involved in fulfilling their intention to reduce stocks from the volumes held in November 1986 to "normal" levels was of the order of 6.8 becu. MAFF now calculate that a full

write off of all existing stocks (as of September 1987) including the special butter disposals would cost some 7.5 becu. (There has been some reduction in stocks of cereals, butter and beef since last November).

Special butter disposals

6. It should be noted that both these figures include the costs of disposing of butter stocks for which special arrangements were agreed in the context of the December 1986 decisions on reducing milk production. It was agreed at that time that the Commission should undertake an exceptional disposal programme to reduce Community butter stocks by 1 million tonnes during 1987 and 1988 but that the consequential reimbursements to the Member States (totalling some 3.6 becu) should be spread over four years starting in 1989. We agreed to this procedure as part of the overall package of decisions on the milk sector which were intended to reduce Community milk production by some 9½% over two years. The decision to delay reimbursement of disposal costs was taken in recognition of the fact that it would take some time for the savings from reduced production to flow through to the Community Budget. Member States will continue to receive interest payments at the standard rates until the losses have been finally reimbursed.

Commission proposals

7. Against that background the Commission have made the following proposals for dealing with stocks and stocks expenditure in the financing review. They propose:

(i) to reduce stocks of all intervention commodities before 1992 to the "normal" levels set out above;

(ii) to introduce a system of stock depreciation with payments made regularly in the first half of the budget year; and

(iii) to pay for both (i) and (ii) within the rebased guideline limit for agricultural expenditure.

In formulating the UK position on these proposals it is useful to look at each of these elements separately.

Financial implications

8. Annex B sets out our latest assessment of expenditure on stock disposals and depreciation consistent with the Commission's intention of reducing stocks to "normal" levels by 1992. It considers a number of financing options ranging from the present arrangements for financing losses on disposal without prior depreciation (option 1); depreciation of new stocks on entry combined with traditional financing for existing stocks (option 2); and various options for phasing expenditure either related to the existing stocks (option 3) or to the new depreciation policy (option 4) or to both (option 5). All the options assume that no change is made to the special arrangements agreed in 1986 for financing butter disposals. The effect of writing off the disposal costs of existing stocks would be to relieve the EC Budget of the costs in line(b) of Options 1 and 2.

PROPOSED UK POSITION

(i) reduction in physical stocks

9. There is no doubt that the UK should fully support the first leg of the Commission's proposals that physical stocks should be reduced to "normal" levels before 1992. Unless all developed countries take action to reduce current excessive stock levels in an orderly way, there is little prospect for any improvement in world agricultural markets which would reduce the budgetary cost of agricultural support measures. There is room for argument about what should be regarded as normal in this context. But the Commission's suggested numbers are all well below current

stock levels and will serve as a reasonable target in the short term. It would be desirable if the Commission set themselves specific targets for average stock levels for each commodity in the intervening years between now and 1992. In practice their progress towards achieving these targets will depend not only on their success in finding markets for current surplus stocks but also on the steps they are prepared to take to prevent stocks rebuilding.

10. Some progress was achieved in the context of the December 1986 decisions in reducing potential surplus production of milk products and in providing that if stocks intake increased above specified threshold levels intervention buying in prices would be automatically reduced. The Commission hope that as a result intervention purchases of skimmed milk powder and subsequently of beef will fall off considerably. However, similar action has yet to be taken for other commodities such as cereals and wine alcohol and the 1986 milk decisions may not be fully effective in achieving the desired reduction in stocks, as at current levels EC milk quotas still exceed unsubsidised consumption by some 20 per cent.

11. It is recommended that on this aspect of the Commission's proposals the UK should seek to include a firm commitment in the European Council's conclusions binding the Commission and the Council to take "the necessary measures to ensure that public intervention stocks are reduced to normal levels as the Commission have defined them over the period to 1992". Consistently with the UK's July note on agricultural stabilisers, we should also press for recognition that in order to honour that commitment the system of automatic adjustments to intervention buying-in prices in the light of the development of stocks may need to be reinforced where it is already applied (eg for butter) and extended to other sectors. We should also seek a fuller statement of the Commission's plans for running down stocks over the period to 1992, although the timing of stock disposals

particular will depend on market conditions.

(ii) depreciation

12. More systematic provision for depreciation in the EC Budget would be highly desirable for a number of reasons: first, it would remove the problem of the overhanging expenditure commitment with which we are now faced; secondly, it would reduce the need for interest payments to the Member States and, thirdly, it would remove the present temptation to treat stock building as a cheap option in Community terms because under the present system the costs affect the EC Budget later than alternative options such as export subsidies. The Commission proposal is, however, rather imprecise about exactly how they would operate depreciation in the future: they appear to have in mind allocating a fairly arbitrary figure for depreciation each year and hoping that by 1992 all their existing stocks will have been fully depreciated.

13. In discussion of this issue in Brussels the UK line has been to encourage the Commission to flesh out their proposal by making a specific amendment to the EAGGF Financing Regulations to provide for systematic depreciation of new stocks on purchase to their current market value with annual adjustments to reflect changes in market value thereafter. Inevitably a policy of systematic full depreciation on entry will involve a substantial front end cost in the first year (estimated at about 2 becu, if, as we recommend, it is confined to new stocks), although over time it should save expenditure on financing costs. However, we consider this to be a price worth paying for the advantages discussed in the previous paragraph. It would be highly desirable for any new depreciation policy to be introduced as soon as decisions have been taken in the financing review generally: i.e. preferably in 1988. It would be possible to delay introduction until 1989 if this was necessary to secure sufficient offsetting savings or (less desirably) to introduce depreciation by stages (e.g. 20% in 1988 rising by 20% steps to 100% in 1992)

if this was necessary to spread the costs. But a preferable course would be to spread the costs of disposing of existing stocks on entry from a specified date.

14. We recommend that we should argue that the European Council conclusions should provide for a specific amendment to the EAGGF Financing Regulations to provide for the systematic depreciation of new stocks from a specified date.

(iii) financing within the guideline

15. We have at present not committed ourselves on whether stocks expenditure should be financed inside or outside the financial guideline. In our view it is necessary to distinguish between expenditure on depreciating new stocks and the cost of disposing of existing stocks. Depreciation of new stocks is an ongoing cost of the CAP: although if the Commission succeed in their intention of reducing stocks to normal levels, this expenditure should decline over time, it is never likely to be eliminated completely. It would in our view be wrong in principle to exclude this expenditure from the guideline.

16. The arguments for and against financing the disposal of existing undepreciated stocks within the guideline are more finely balanced. Arguments for inclusion within the guideline include:

(a) any further exclusions from the guideline will create a bad precedent for the future;

(b) stocks built up under current CAP policies are an integral part of the cost of those policies and should be paid for from the agricultural section of the budget;

(c) if the guideline works as an effective constraint and this element has to be found within it, that will itself exert a desirable squeeze on other elements of agricultural expenditure; and

(d) it is not clear how expenditure in excess of the guideline could be financed within the new own resources ceiling, if this is set at a sensible level.

On the other hand it would be possible to argue against inclusion within the guideline on the following grounds:

(a) existing stocks represent a cost of the past: it is not unreasonable to look for some way of writing them off <u>provided that</u> the policy which gave rise to them has been reformed;

(b) we can more plausibly argue for a lower guideline base and growth rate if substantial past costs are excluded; and

(c) the costs relating to the disposal of existing stocks can be fairly rigorously defined to minimise the risk of setting a precedent for the future.

17. Although at present inclusion within the guideline seems likely to be the best buy, we consider that it is sensible to keep our options open on the treatment of disposal costs of existing stocks at this stage. Whether or not they are included in the guideline will have a clear implication for the size and growth rate of the new guideline. If we could achieve a significant reduction in the Commission's proposals for the guideline base (now likely to be 26.9 becu) and growth factor (GNP growth), it would be worth considering exclusion from the guideline. But this is not likely to be easy to negotiate, as most other delegations will be anxious to satisfy their farming interests with as large a guideline as possible. If on the other hand disposal costs are included in the guideline, it is virtually inevitable that we will have to agree to some form

of smoothing (ie postponement) of expenditure over the period to 1992 (on the lines already agreed for butter stocks) to remove an unacceptable peak of expenditure in 1988. Annex B illustrates a number of ways in which this might be done.

Write off at national expense

18. As the Prime Minister has pointed out, it would be possible to deal with the overhang of expenditure on existing stocks by agreement to write off at national expense. In its favour of this it would be possible to argue that:

(a) writing off disposal costs in this way would enable the new budget discipline arrangements for agriculture to start off with a clean sheet unencumbered with the mistakes of the past;

(b) the new guideline could thus realistically be set somewhat below the level the Commission has proposed and/or with a lower growth rate;

(c) as Member States have been largely responsible for the policies which have allowed stocks to build so high, it is not unreasonable that they should bear some share of the costs which they have in any case already incurred; and

(d) there is an element of natural justice in the fact that one of the main losers in financial terms would be Germany (which has often been the Member State least willing to accept responsible reform of the CAP).

If we were making the suggestion it might belp presentationally that it is not too blatantly self-interested from the UK viewpoint, as our share of current stocks by value at 17% including butter or 13% excluding butter is much higher than our normal share of EAGGF receipts, although it is rather less than our current share of gross VAT contributions.

19. The problem is that there are likely to be considerable difficulties in persuading other Member States of the virtues of a write off, not least because of the differential financial impact. In broad terms we calculate that if the write off were confined to existing stocks other than the butter disposals for which financing terms were agreed in December 1986 the pattern of winners and losers in budget contribution terms would be as follows:

Country	Net cost (+) or savings (-) (mecu)
Belgium	- 70
Denmark	+ 42
Germany	+ 308
Greece	- 36
Spain	- 104
France	- 46
Ireland	+ 311
Italy	- 212
Luxembourg	- 9
Netherlands	+ 71
Portugal	- 31
UK	- 224 (-76 after Fontainebleau abatement)

(These figures are based on the loss of receipts from disposals expenditure for each Member State less the reduction in its gross (VAT) contributions before Fontainebleau adjustments).

20. As these numbers illustrate there is a very uneven pattern of stockholding between the Member States which reflect not only the pattern of surplus production in each country (e.g. tobacco in Greece, olive oil in Spain and Italy, wine alcohol in France and Italy, butter and beef in Ireland) but also the relative attractiveness of the national intervention price:

ANNEX A:
DISTRIBUTION OF INTERVENTION STOCKS BETWEEN MEMBER STATES

Table 1: percentage of volume of stocks at 30 September 1987

	Cereals	Olive oil	Skim milk	Butter	Beef		Wine alcohol
					carcase	boned	
Belgium	.6	.0	.0	2.3	1.7	.0	.0
Denmark	4.3	.0	.7	1.4	.5	11.3	.0
Germany	43.3	.0	95.6	27.3	32.6	1.8	.0
Greece	.0	.0	.0	.0	.0	.0	.0
Spain	6.4	62.2	2.1	2.1	4.0	.0	3.6
France	16.9	.0	.0	16.2	24.5	32.5	46.7
Ireland	.1	.0	.5	15.1	8.0	33.5	.0
Italy	11.8	35.9	.0	.2	15.6	3.3	49.7
Luxembourg	.0	.0	.0	.1	.0	.0	.0
Netherlands	.0	.0	.0	15.5	8.5	.1	.0
Portugal	.0	1.9	.0	.0	.0	.0	.0
United Kingdom	16.5	.0	1.2	19.8	4.5	17.5	.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Table 2 Relative contributions to and receipts from stock disposal programme (percentage)

	Receipts		Contributions	
	with special butter@	without special butter	VAT*	Diff tax
Belgium	1.6	1.3	3.0	3.6
Denmark	2.6	3.2	2.1	2.5
Germany	31.4	34.2	26.3	26.7
Greece	0.1	0.1	1.0	1.0
Spain	3.5	4.3	6.9	6.2
France	18.2	19.6	20.8	19.6
Ireland	10.5	8.7	0.8	0.4
Italy	5.8	8.7	14.1	21.7
Luxembourg	0.0	0.0	0.3	0.2
Netherlands	9.4	6.8	5.0	4.9
Portugal	0.0	0.0	0.8	0.9
UK	16.9	13.3	19.0	12.4
TOTAL	**100.0**	**100.0**	**100.0**	**100.0**

Note:@ physically in stock 30.9.87
* before Fontainebleau abatments

ANNEX B

STOC[illegible]PRECIATION AND DISPOSALS EXPENDITURE

Stocks declining to "normal" levels by 1992

	FEOGA (mecu)					Prog 2.7 (£ million)				
	1988	1989	1990	1991	1992	1987-88	1988-89	1989-90	1990-91	1991-92
Option 1										
a. traditional disposal of new stocks	120	1630	1120	1100	990	-1	-10	-24	-11	16
b. traditional disposal of old stocks	2630	1270	300	140	90	13	45	18	-1	-6
c. special butter disposals	0	1000	900	900	800	0	0	0	0	0
Total	2750	3900	2320	2140	1880	12	35	-6	-12	10
Option 2										
a. full depreciation of new stocks on	2080	1380	810	770	650	-24	-63	31	26	7
b. traditional disposal of old stocks	2630	1270	300	140	90	13	45	18	-1	-6
c. special butter disposals	0	1000	900	900	800	0	0	0	0	0
Total	4710	3650	2010	1810	1540	-11	-18	49	25	1
Option 3										
a. full depreciation of new stocks on	2080	1380	810	770	650	-24	-63	31	26	7
b. phased reimbursement for old stocks	970	970	970	970	970	5	21	25	24	16
c. special butter disposals	0	1000	900	900	800	0	0	0	0	0
Total	3050	3350	2680	2640	2420	-19	-42	56	50	23
Option 4										
a. phased depreciation of new stocks	320	1780	1540	1210	1110	-3	-17	-25	-6	22
b. traditional disposal of old stocks	2630	1270	300	140	90	13	45	18	-1	-6
c. special butter disposals	0	1000	900	900	800	0	0	0	0	0
Total	2950	4050	2740	2250	2000	10	28	-7	-7	16
Option 5										
a. phased depreciation of new stocks	320	1780	1540	1210	1110	-3	-17	-25	-6	22
b. phased reimbursement for old stocks	970	970	970	970	970	5	21	25	24	16
c. special butter disposals	0	1000	900	900	800	0	0	0	0	0
Total	1290	3750	3410	3080	2880	2	4	0	18	38

Extract from Long paper to P.M

includes provision of 27 becu for agriculture consistently with the new ~~guideline proposal) the Commission has indicated~~ that their unconstrained forecast of expenditure in 1988 is no less than 30.2 becu on the assumption that the oils and fats tax is not adopted. This is nearly 2 becu above the figure of 28.4 becu in cash terms obtained by adding a GNP growth factor to their revised assessment of real needs in 1987.

21. If an oils and fats tax were introduced, expenditure could probably be brought within the re-based guideline limit proposed by the Commission. Some member states will doubtless seize the opportunity, therefore, to argue that this clinches the case for the oils and fats tax. Without it, they will argue, a much higher guideline limit will be unavoidable. Our answer should be, presumably, that the oilseeds regime should be reformed in accordance with our own and the Commission's proposals, viz:

i. remove the price-reduction cut-off if production exceeds the specified maximum guaranteed quantities; and preferably

ii. substitute a flat-rate payment per tonne of oil (or per hectare of production land) for the existing deficiency payments linked to world prices.

We can argue that, with the introduction of these changes to the oilseeds regime and other necessary changes and stabilisation mechanisms throughout the other regimes (notably cereals, milk, wine and olive oil), the proposed guideline limit ~~should~~ be adequate.

22. Second, there is the problem of <u>stock depreciation and disposal</u>: how should the UK respond to the Commission's proposal for a new system for depreciation of stocks, and should disposals of existing stocks be financed inside or outside the guideline limit?

23. The Commission have not yet spelled out their proposal in any detail. In principle, however, the idea of depreciating stocks in future in line with their market value in the year of purchase is worthy of strong support. The existing lack of systematic

depreciation is clearly unsatisfactory and tends to result in large overhangs of expenditure. Making the change is likely, however, to be expensive in the short term. The new system will involve paying member states for the loss in value of new stocks on entry into intervention and then in line with their declining value rather than postponing these payments until the time of disposal. This will inevitably involve a temporary increase in expenditure. The costs of disposing of existing, undepreciated stocks (where the Commission envisage substantial destocking) will have to be combined over a transitional period with depreciation of the new stocks, and the savings associated with this depreciation will take a little time to build up.

24. The size of the temporary increase in expenditure will depend crucially on how the new system is phased in. The two obvious possibilities, both illustrated in Table 2, are:

i. a "big-bang" introduction with effect from 1988 (or possibly 1989), and

ii. a phased introduction, designed to spread the extra costs fairly evenly over (say) the five years 1988-92. Phasing could be applied either to the new depreciation policy or to the costs of running down existing stocks or to both.

25. The preliminary calculations reflected in Table 2 suggest that the net cost of the new depreciation system, in the sense of the amount of expenditure brought forward to earlier years, will be of the order of 2 becu net at current stock levels (more if stocks rise). On the "big-bang" approach the extra expenditure would be likely to be some 1.8 becu in 1988, falling to some 0.3 becu in 1989, zero in 1990 and small gains thereafter. Alternatively, introduction of the new system, and hence the costs profile, could be postponed for a year. The cost of disposing of existing stocks would show a similar profile: some 3.1 becu in 1988 and 0.6 becu in 1989, followed by small sums thereafter (see Table 2 again).

26. As these figures imply, a "big-bang" introduction of systematic stock depreciation in 1988 would produce a hump of expenditure in 1988 and a smaller hump in 1989 (though the whole timetable could be postponed by one year). The excess over "normal" levels would reflect partly the heavy initial costs of the new system and partly the accelerated programme for disposal of old stocks assumed by the Commission (though how realistic this programme is may be open to question). The Commission have said that all stock disposal and depreciation costs should be contained within the guideline, and their latest forecast of 30.2 becu for guarantee expenditure in 1988 includes 3.5 becu for depreciation and losses on disposal (comparable with the 4.9 becu big-bang figure for 1988 in table 2). As noted above, however, this figure lies some 2 becu above their proposed guideline figure for 1988. If savings on the lines indicated in paragraph 9 above cannot be achieved, there will be a hump of expenditure of some 3.5 becu in 1988, and the question will arise how best to deal with it.

27. There is no obviously satisfactory way. There would clearly be some attractions from the UK's point of view in financing the hump outside the guideline limit and setting a lower guideline limit as a result. If the guideline is set high enough to include the hump, it will in effect be ratcheted forward, with a GNP growth rate attached to it, into all future years or to 1992 at least. If however the hump is treated as outside the guideline limit, the dilemma then arises whether it should be financed from within the new own resources ceiling or outside the ceiling as an IGA. The former approach would be likely to involve setting the new own resources ceiling at a level higher than Ministers would wish to see. The latter approach, an IGA, would be an extremely unwelcome complication, though presentationally it could be related to a crash disposals programme. Further anxieties are (a) the possible difficulty of ensuring that the guideline limit actually is set lower than otherwise as a result of taking out the hump and (b) the dangerous precedent which hiving off one of the components of agricultural market support expenditure outside the guideline limit would set.

28. Alternatively, the costs of the new depreciation system or the destocking programme or both could be phased over the period 1988-1992 so that the expenditure would be spread over five years rather than concentrated on one. The hump problem would be greatly reduced, and the Commission's principle of containing all market support expenditure within the guideline could then be respected. It may be that this approach, which would avoid the precedent problem and the dilemma of a higher own resources ceiling versus an IGA, would be preferable. Table 2 illustrates a possible pattern, based on smoothing out the costs of disposing of existing stocks.

29. We shall need further information on the Commission's ideas and further study of their implications before reaching firm and final views on the best way ahead. As of now, however, there would seem a presumption in favour of:

(A) arguing initially for a 1987 base for the guideline limit below 25.8 or 26.9 becu so as to maximise the chances of ending up with the Commission's figure;

(B) pressing for genuine savings along the lines of paragraph 21 above to bring down the 1988 figures to a level consistent with (and indeed below) the 1987 base of 25.8 or 26.9 becu (ie below 27.3 or 28.4 becu at 1988 prices);

(C) supporting in principle a formal change to a new system for annual depreciation of stocks, subject to studying the detailed proposals, including the timing, and the financial implications;

(D) subject to further information and analysis, including all stock disposal and depreciation expenditure, as recommended by the Commission, within a guideline limit consistent with (or below) the 25.8 or 26.9 becu 1987 base;

(E) if there is no prospect of agreement on this, we should aim to hold down the guideline figure by spreading over the period 1988-92 the costs of running the new stock depreciation system in tandem with disposals of existing stocks (or conceivably by financing off-guideline the cost of disposal of the old stocks).

Agricultural expenditure guideline : growth over time

30. If the UK were to concede that the own resources base should grow in line with GNP, as the other eleven member states agreed at the June European Council, the GNP growth rate would on past precedent and on the Commission's proposals apply to the agricultural guideline limit from year to year as well. It will doubtless be difficult to resist this change. The change would however mean that agricultural expenditure would be permitted to grow perhaps 1½ times as fast in real terms as under the existing formula (which has not, of course been observed in practice). The extra resources for agriculture would over time become extremely substantial (3.7 becu by 1992 compared with a guideline which increases in line with inflation and 1.6 becu compared with the present own resources basis). Alternative approaches which the UK might consider canvassing include the following:

(i) the guideline should grow in line with prices, thus remaining constant in real terms (implying 3.7 becu less expenditure, at 1987 prices, by 1992 on the Commission's figures); or

(ii) it should grow by (say) one-half of the rate of growth of Community GNP rather than by the full amount (this would probably entail a real rate of growth close to zero and hence expenditure savings similar to (a) above). We canvassed a similar fraction in 1983-84 before the Fontainebleau agreement but did not finally press the point.

There are good "Communautaire" arguments for keeping the rate of growth of agricultural spending below the rate of growth of own resources. We should be prepared to deploy such arguments for the time being at least. If a GNP growth rate should eventually be conceded, it should be unnecessary to make any extra provision for Spain and Portugal as they become fully integrated into the CAP. This would however need to be part of any agreement.

31. Our main conclusion is that:

(F) the UK should not commit itself at this stage to a GNP growth factor for the guideline limit (any more than for the own resources limit) but should argue for a rate of growth in the limit substantially <u>below</u> that of Community GNP.

<u>Making the guideline stick</u>

32. The Commission have correctly recognised the importance of making the guideline effective. To this end they have proposed that:

i. their own price fixing proposals should be "within" the guideline limit;

ii. the main principles of agricultural budget discipline should be enshrined in a European Council decision, with stablisers, trigger mechanisms and changes to a reimbursement system being enshrined in regulations;

iii. stabilisers should be introduced throughout the CAP regimes, together with trigger mechanisms and expenditure monitoring procedures on a regime by regime basis: there should be time limits for Council decisions to activate stabilisers and increased Commission powers to take interim measures pending these decisions;

iv. a "monetary reserve" should be established to deal with adverse currency movements;

Re X, not only was Ciampi - wrongly - not present, but FRG has three representatives: Stoltenberg, Tietmeyer & Schlesinger. Then vs Italian & women. (Others also thought so & so gone). M..

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FRAME ECONOMIC
COREPER (AMBASSADORS) 17 NOVEMBER
FOLLOW-UP TO 16 NOVEMBER ECOFIN AND PREPARATION FOR 7 DECEMBER ECOFIN

SUMMARY

1. NO FOLLOW-UP TO 16 NOVEMBER ECOFIN.

2. PRESIDENCY'S PROVISIONAL AGENDA FOR 7 DECEMBER ECOFIN DISTRIBUTED.

3. OPPOSITION TO INCLUSION OF TAX APPROXIMATION PACKAGE (IN ADVANCE OF AN EPC REPORT) AND TO PROSPECTUSES AND CHANGES IN MAJOR SHAREHOLDINGS DIRECTIVES.

DETAIL

4. ESPER LARSEN (PRESIDENCY) CONFIRMED THERE WAS LITTLE FOLLOW-UP FROM YESTERDAY'S ECOFIN COUNCIL : THE ECONOMIC POLICY COMMITTEE (EPC) WOULD BE CONSIDERING THE TAX APPROXIMATION PACKAGE, THE MONETARY COMMITTEE AND COMMITTEE OF CENTRAL BANK GOVERNORS WOULD BE STUDYING THE CAPITAL LIBERALISATION PROPOSALS AND COREPER (DEPUTIES) WOULD BE LOOKING AT THE 18TH VAT DIRECTIVE AGAIN.

5. THE PROVISIONAL AGENDA FOR THE DECEMBER ECOFIN WAS THEN DISTRIBUTED AND CONSISTS OF THE FOLLOWING:-

I) FOLLOW-UP TO THE EUROPEAN COUNCIL
II) ANNUAL ECONOMIC REPORT 1987/8
III) ABOLITION OF FISCAL FRONTIERS (TAX APPROXIMATION)
IV) THE 18TH VAT DIRECTIVE
V) PROSPECTUSES
VI) DIRECTIVE ON CHANGES IN MAJOR SHAREHOLDINGS

6. ON TAX APPROXIMATION I SAID OUR UNDERSTANDING FROM YESTERDAY'S ECOFIN DISCUSSION WAS THAT THE PACKAGE WOULD ONLY BE DISCUSSED AGAIN AT ECOFIN AFTER THE EPC HAD PRODUCED ITS REPORT: I DOUBTED WHETHER THIS COULD POSSIBLY BE IN TIME FOR THE DECEMBER ECOFIN. AFTER SIMILAR COMMENTS FROM CALAMIA (ITALY) AND THE PORTUGUESE

REPRESENTATIVE, ESPER LARSEN CONFIRMED THAT THIS ITEM WOULD ONLY BE ON THE AGENDA IF AN EPC REPORT HAD SURFACED BEFOREHAND.

7. I ALSO QUESTIONED THE INCLUSION AT THIS STAGE OF THE PROSPECTUSES AND CHANGES IN MAJOR SHAREHOLDINGS DIRECTIVES, GIVEN THAT NEITHER HAD YET REACHED COREPER, BUT ALSO THAT IN THE CASE OF PROSPECTUSES, THE DEFINITION OF EUROSECURITIES HAD NOT YET BEEN SETTLED, AND WITH THE CHANGES IN MAJOR SHAREHOLDINGS PROPOSAL, THE COUNCIL WORKING GROUP HAD ONLY RECENTLY STARTED ITS DELIBERATIONS.

8. I RECEIVED SUPPORT FROM UNGERER (GERMANY) AND SCHEER (FRANCE) AND SPECIFICALLY ON THE MAJOR SHAREHOLDINGS PROPOSAL ALSO BY HILBERS (NETHERLANDS) AND THE PORTUGUESE REPRESENTATIVE. ESPER LARSEN THOUGHT THAT IN THE LIGHT OF THESE REACTIONS, THERE WAS LITTLE CHANCE OF THE MAJOR SHAREHOLDINGS PROPOSAL BEING PRESENTED TO MINISTERS ON 7 DECEMBER. HE DID NOT COMMENT ON PROSPECTUSES, HOWEVER.

9. UNGERER THEN ASKED THE PRESIDENCY TO CONSIDER A LUNCH START ON 7 DECEMBER, AS STOLTENBERG HAD AN IMPORTANT ENGAGEMENT THAT MORNING. ESPER LARSEN TOOK NOTE.

10. FINALLY CALAMIA MADE A PLEA THAT IN FUTURE THE CHAIRMAN OF THE COMMITTEE OF CENTRAL BANK GOVERNORS - IF INVITED BY THE PRESIDENCY TO THE ECOFIN LUNCH - BE INCLUDED IN THE TOP TABLE WITH MINISTERS: IT APPEARS THAT AT YESTERDAY'S LUNCH CIAMPI INADVERTENTLY WAS RELEGATED. ESPER LARSEN AGREED THAT CLEAR RULES HAD TO BE ESTABLISHED BUT THOUGHT IT BEST FOR PERMANENT REPRESENTATIVES TO CONSIDER THESE MORE INFORMALLY AT TOMORROW'S LUNCH.

HANNAY

YYYY

DISTRIBUTION 38

ADVANCE 38

FRAME ECONOMIC	PS/PAYMASTER GENERAL TSY
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HD/ERD	PERETZ TSY
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MR PARKER CAB OFF	RESIDENT CLERK
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SIR GEOFFREY LITTLER TRSY	WORMAN DTI
MR J E MORTIMER TRSY	NEWMAN DTI
MR C D CRABBIE TRSY	KIRBY BANK
PS/CHANCELLOR TSY	ARROWSMITH BANK

NNNN

1. ~~Jonde~~
2 pus

PERSONAL

From: Sir G.Littler
Date: 17 November 1987

MR ALEX ALLAN

ATTENDANCE AT ECOFIN LUNCH

Against the unlikely possibility that this might be mentioned by somebody in the margins of the next ECOFIN, I record the Danish cock-up yesterday and the sensible eventual outcome.

2. I (as Monetary Committee Chairman) and Ciampi (as Chairman of Governors) were invited to the Ministerial lunch yesterday in the expectation that discussion would include the world market situation as well as future Community financing. The Danes then decided to confine the discussion to the second item; therefore quite properly they cut me and Ciampi from their table plan; <u>but</u> they failed to tell us of either the agenda or the seating change! When I protested at having no place, I was given one with minimal fuss and still without having the change of plan explained, while Ciampi failed to get in! There have been ructions in COREPER circles in Brussels today - David Hannay assures me that there is no criticism of me but quite a lot of complaint about Presidency mismanagement.

3. The satisfactory outcome is an agreement that in future the lunch will be Ministers only <u>except</u> (quite frequently) when Ciampi and I are both invited because of the likely agenda - and we will both be told clearly in advance!

GL

(Geoffrey Littler)

1. MR EDWARDS ✓ See below
2. CHANCELLOR OF THE EXCHEQUER

FROM: J E MORTIMER
DATE: 18 November 1987

cc Paymaster General
Sir Geoffrey Littler
Mr Mercer
Mr Bonney
Mr Evans
Mr Donnelly

OK as proposed

Ch/ Content to write as proposed? 18/11

EUROPEAN COUNCIL: COMBINING THE DIFF TAX WITH THE FONTAINEBLEAU ABATEMENT SYSTEM

1. In his letter of 12 November (flag A), Mr Powell at No 10 records that the Prime Minister would like to see an illustration of how the proposed diff tax could be combined with the Fontainebleau abatement system.

2. The attached note and covering minute (flag B) responds to this remit. The note (cleared with Cabinet Office and the FCO) shows that a combination of the diff tax and a <u>modified</u> Fontainebleau system - based on our share of total VAT and diff tax payments rather than VAT alone - would leave the UK better off by up to 130 mecu in 1992 than with a continuation of the present financing arrangements, but an increase in the VAT ceiling. It argues that this might be the only realistic way of changing the financing arrangements so as to make them less onerous to us, and that we should therefore try to secure this improvement.

3. We understand that the Prime Minister will be holding a further briefing meeting on Friday with Sir D Hannay and Mr Lavelle about future financing matters. If you are content with the attached note and covering minute, it would be helpful if they could be sent to the Prime Minister tomorrow so that she would have a chance to look at them before the meeting.

JEM.

J E MORTIMER

ENC

This reflects discussion with me. It is, I think, important that the Prime Minister should be seized of the important points made in the draft covering minute, which reflect discussion with Mr Lavelle.

AJCE

DRAFT

Pse type for Ch orig.

FROM: CHANCELLOR

TO: PRIME MINISTER

EUROPEAN COUNCIL

COMBINING THE COMMISSION'S PROPOSED FOURTH RESOURCE WITH A MODIFIED FOUNTAINEBLEAU ABATEMENT SYSTEM

The short note by Treasury officials attached responds to your request in Charles Powell's letter of 12 November.

2. In view of the large net budgetary contribution which we make already, and the serious deterioration since Fontainebleau, I think we should not only reject as inadequate the Commission's proposed alternative to the Fontainebleau abatement system but also try to secure if we can some improvement in our position to offset against the further worsening which an increase in the own resources ceiling would bring.

3. I would therefore favour trying judiciously to secure agreement to as large a "diff tax"/fourth resource as possible within as small as possible an overall increase in the own resources ceiling. Present indications are that the other member states will be willing to accept a diff tax, though the Italians and others will try to keep it as small as possible in relation to VAT.

4. We would not, in my view, run any significant risk by pursuing this objective. Since the other member states cannot change the existing own resources or abatement systems without our agreement, and since it is they and not we who want to raise the own resources ceiling, we should be well placed to reject any rival proposals for change which would leave us worse off.

5. As described in the accompanying note, we would doubtless have to accept that our Fontainebleau abatement would in future be adjusted to reflect our share in VAT and diff tax taken together

rather than our share in VAT. I do not think, however, that we need be in any hurry to acknowledge this.

6. I am copying this minute to Geoffrey Howe and to Sir Robert Armstrong.

Whilst the jargon of 'diff tax' and 'fourth resource' is pretty odious, what we are considering here is not in truth either a new tax or a new resource, but an adjustment of the existing method of financing the Community which is of ~~considerable potential benefit~~ real advantage to us.

ps3/39T

CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 19 November 1987

SIR G LITTLER

cc Mr A J C Edwards

ECOFIN LUNCH

The Chancellor has noted Calamia's (Italy) plea at COREPER (Ambassadors) that the Chairman of the Committee of Central Bank Governors should be included in the top table with Ministers at ECOFIN lunches. He has commented that not only was Ciampi not present, but the Federal Republic of Germany had three representatives: Stoltenberg, Tietmeyer, and Schlecht. This is ridiculous and wrong. (Delors also thinks so, and has told the Chancellor).

JT

J M G TAYLOR

Mr Taylor

Hannay says there is widespread ill-feeling about the German trio – he hopes rules can be agreed to stop it, but the imminence of the German presidency period may be a problem.

JL 19/11

but must get it fixed before 31/12!

CONFIDENTIAL

CH/EXCHEQUER 28/11
REC. 23 NOV 1987
MR WYNN-OWEN
COPIES TO PS/CST PS/FST PS/PMG PS/EST
MR MONCK
MR A J C EDWARDS
MR BURGNER
MR LOMAX
MR FRAY

FCS/87/242

Ch, Action behind (and pp. you asked to see). 23/11

SECRETARY OF STATE FOR TRADE AND INDUSTRY

EC Merger Control Regulation

1. Thank you for your letter of 20 November about the Commission's proposals for dealing with Community mergers.

2. I support the line you propose to take at the 30 November Internal Market Council, which seems to me to be right tactically and in substance.

3. I am copying this minute to other members of OD(E) and Sir Robert Armstrong.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
22 November 1987

For minute [illegible]

Have we [illegible] Articles 85 & 86, the [illegible] closer to the (subject to any contrary advice from the Law Officers) [illegible] Mr Wynn-Owen's advice is mistaken & that we should [illegible] support the proposed regulation, which [illegible] the threat or practice of Articles 85 & 86 [illegible]

causes no trouble for the past 29 years & are unlikely to do so. This [illegible] FCO [illegible]

CONFIDENTIAL

HOWE → YOUNG 22/11

From: Sir G.Littler
Date: 23 November 1987

MR J M G TAYLOR

ECOFIN LUNCH ARRANGEMENTS

The Chancellor may like to see that this has been settled - the rules to be followed are set out in the attached note.

2. It appears that Ciampi and I are to be invited regularly. It also appears that another attempt is to be made to restrict national representatives to one Minister (or acting head of delegation) per country!

(Geoffrey Littler)

RULES GOVERNING THE PRESENCE AT ECO/FIN WORKING LUNCHES

- The President of the Council
- The President of the Commission or his representative
- Ministers: One minister per delegation including that of the Presidency

  (in the absence of a minister, the person acting as head of delegation)
- The President of COREPER
- The Secretary General of the Council
- The Secretary General of the Commission
- The Chairman of the Committee of Central Bank Governors
- The Chairman of the Monetary Committee

Depending on the subjects chosen by the President of the Council for discussion at lunch, other participants such as Chairmen of other Committees or the representative of The European Investment Bank may be invited to participate in lunches. They will then be informed in advance of the meeting that their presence at lunch will be required.

83/G/MAD/1319/13

DRAFT LETTER TO LORD YOUNG

THE SINGLE EUROPEAN MARKET

Thank you for your letter of 30 November about your forthcoming visit to Paris. I am content with the broad aims of your visit, and with the line you propose to take with Madelin. I am however surprised that you intend to have discussions with Balladur about proposals affecting banking and financial services, before we have had an opportunity to ~~sharpen up~~ clarify our own objectives in this key area. As you will recall, it was agreed at the OD(E) meeting on the Internal Market on 1 October, that great care would be needed in the handling of proposals in the financial services sector.

In particular, I should like to discuss the scope and likely content of a directive on investment services, before agreeing that it should be a matter of high priority for the UK. I understand there has been virtually no discussion at official level. The Commission have not yet formulated their ideas and, as far as we are aware, no other country is pressing for action on this front. From a UK standpoint we have a clear interest in opening up the market for financial services. But I would have serious reservations about a European initiative that sought to embed in Community legislation the approach to financial regulation enshrined in our own Financial Services Act, until we are far more confident that we have devised a practical and workable system.

As I said at OD(E) it is essential to remember that the introduction of harmonising legislation at the EC level could easily lead to London, and the Community as a whole, losing business to New York and Tokyo. Onno Ruding, the Dutch Finance Minister, has recently complained to me about the Commission's predilection for seeking harmonisation of national securities regulations that have nothing to do with either the internal or the common market. I have some sympathy for this general proposition. We must take care not to fall into the same trap.

As you say, proposals in the banking field are much further advanced. We expect a draft of the Second Banking Coordination Directive to be published as a Commission proposal before the end of the year. This will be an important initiative, but, until we see the draft, I doubt if there is a great deal that you can profitably discuss with Balladur, beyond indicating our support for the general principles underlying the directive. I have no objection to the line you propose to take on capital adequacy and position risk, which is that agreed between your officials and mine for use in recent discussions in Brussels. But it has not proved contentious either with the Commission or other Member States, and we have every reason to expect that it will be fully reflected in the draft Banking Directive, when it emerges. As a result, we are not expecting ~~anticipating~~ serious tension between this directive and the Financial Services Act, though my officials will of course continue to keep yours closely in touch with developments.

I am copying this letter to the Prime Minister, Geoffrey Howe, the Governor and Sir Robert Armstrong.

NIGEL LAWSON

014/75

CONFIDENTIAL

From: P WYNN OWEN
Date: 23 November 1987

1 MR ~~GRAY~~ FRCG 23/11

2 CHANCELLOR OF THE EXCHEQUER

Chy Pps. attached.

Chy Content to write as proposed? 23/11

I cannot agree this without even having read Articles 85 & 86. Pse let me see them. I am very reluctant to concede the principle of a regulation, unless I am satisfied that we are clear we are worst off without one. N. 23/11

cc PS/Chief Secretary
PS/Paymaster General
Mr Monck
Mr Burgner
Mr Edwards
Mrs Lomax
Mr Mercer
Mr Mortimer
Mr Donnelly

EC MERGER CONTROL REGULATIONS

We received the attached letter from Lord Young to the Foreign Secretary late on Friday. Lord Young says it would be helpful to know before be meets Commissioner Sutherland tomorrow whether colleagues are content with the line on EC Merger Control regulation which he proposes to take.

2. This submission suggests you send a short reply to him today, agreeing to his line but making it clear that the UK must remain free to oppose an EC Mergers Regulation at the end of the day if our major concerns cannot be met.

BACKGROUND

3. Under Articles 85 and 86 of the Treaty of Rome the Commission have the power to take action against anti-competitive mergers after the event. These have rarely been tested, since the Commission have been seeking to agree for some time the text of a Merger Control Regulation with member states, which would give the Commission powers to investigate and to take action on proposed mergers.

4. Ministers last corresponded on this a year ago. The then Secretary of State, Mr Channon wrote on 1 October saying the UK should "retain as much control as possible over mergers involving UK

companies". The Chief Secretary, Mr MacGregor, replied on 15 October agreeing to this approach.

5. The Commission have recently begun to force the pace. They are threatening to start making practical use of Articles 85 and 86 unless Member States endorse the principle of a Regulation at the Internal Market Council meeting on 30 November. If the Commission emerge from that meeting feeling totally spurned, they might, for instance, seek to investigate a merger such as BA/B.Cal if and when it takes place.

ASSESSMENT

6. Lord Young now has to choose between the lesser of two evils. If the Commission begin to make forceful and apparently indiscriminate use of Articles 85 and 86 it could create great uncertainty for businesses engaged in mergers, with large potential fines in prospect after the event, possibly combined with the EC reopening cases already looked at by national competition authorities and potentially overturning their judgements. This could prove costly and embarrassing all round. On the other hand, a Regulation, if it was anything like the present Commission draft, could cover a much wider field of mergers, including nearly all major cases; could result in the existing powers of national competition authorities in many cases effectively being replaced by EC judgements; could mean that (EC) merger reviews could take considerable periods of time (Commissioner Sutherland has been able to promise no less than 9 months per case); could be complemented by continued use of Articles 85 and 86, at least in the form of private actions.

7. DTI have consulted the CBI, who on balance now favour the greater certainty which they believe a Regulation would provide. But it is not clear about the extent to which they consulted members, nor indeed how many CBI members are active in the takeovers and mergers field.

PROPOSED LINE

8. Lord Young correctly identifies the major problems with the alternatives. For instance, he notes that the biggest and most controversial cases would virtually be certain to be taken by the Commission under a Regulation. If in such cases the Commission prohibited a merger, the UK authorities could not reverse that decision. If the Commission exempted a merger, again the UK authorities would

probably not be able to prohibit it on competition grounds though "[illegible] might be able to do so on other grounds such as national security". The picture is by no means clear, but it seems likely that in a number of the most significant mergers cases, the Commission would get in first and there would effectively be no scope for domestic competition authorities to overturn EC judgements. It would also, of course, mean a very different regime from that envisaged when we gave various assurances about potential use of the public interest criteria under existing UK compeition law during the passage of the recent Banking Bill. One could imagine initial difficulties, at least, for the Secretary of State in explaining to the House of Commons that sovereignty had in effect been ceded to the Commission in this area.

9. In the second and third paragraphs of page 3 of his letter, Lord Young proposes a UK line for the Internal Market Council. Namely, that we are not opposed in principle to a merger control Regulation, but the present draft is unsatisfactory in several fundamental respects - the scope of the Regultion is too wide; the demarcation between the responsibilities of the Commission and national authorities is too vague; and the timescales for investigation are too long. These problems would need to be resolved before the UK could support a Regulation, but we would be ready to consider any new proposals the Commission put forward. This amounts to offering to negotiate constructively, "while still being able to oppose a Regulation at the end of the day if our major concerns cannot be met."

CONCLUSION

10. I recommend you send Lord Young a short letter today agreeing with his proposed line before he meets Commissioner Sutherland tomorrow. But you might note that there will be significant difficulties in settling the demarcation between the responsibilities of the Commission and national authorities and that you therefore think it vital that negotiations be conducted in such a way that, as he says, the option is left open of opposing a Regulation at the end of the day if our major concerns cannot be met.

11. I attach a draft.

Philip Wynn Owen

P WYNN OWEN

CONFIDENTIAL

DRAFT LETTER FROM CHANCELLOR TO:

Lord Young of Graffham
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
London
SW1H OET

EC MERGER CONTROL REGULATIONS

Your letter of 20 November to Geoffrey Howe said it would be helpful to know before you met Commissioner Sutherland tomorrow whether colleagues were content with your proposed line for next Monday's Internal Market Council.

2. I am content with the line you propose, but note there are likely to be significant difficulties in agreeing a Regulation with the Commission which would be acceptable to us. In particular, the demarcation between the Commission and national authorities will have to be clearly established and we will have to consider the implications of this further once credible proposals emerge. The timescale for investigations proposed by the Commission is also clearly far too long. So I endorse your proposal that we should negotiate constructively, while still being able to oppose a Regulation at the end of the day if our major concerns cannot be met.

3. I am copying this letter to Geoffrey Howe, members of ODE and Sir Robert Armstrong.

[NL]

circumstances, on which Ministers have not so far had a proper paper: we hope to submit these notes to you on Wednesday evening, with a short draft covering minute from you to the Prime Minister;

(iv) (we hope) a note by MAFF explaining what might be involved in the kind of set-aside scheme which the Germans, apparently with French support, now wish to make a condition of any agreement; and

(v) a note by the Treasury about the UK's position on the 1988 Community budget, on the alternative assumptions of success or failure at Copenhagen, incorporating advice just received from the Law Officers. This subject is certain to come up at the European Council. Here too we hope to submit the note to you on Wednesday, with a short covering minute to the Prime Minister.

3. On the fourth resource/diff tax, the Prime Minister seems not fully to have taken the points made in your earlier minute. It is common ground that in no circumstances should the UK settle for anything less favourable than Fontainebleau. Since however the Fontainebleau formula cannot be changed without our agreement, there should be no particular difficulty about achieving this, and it does not follow that our opening position should be to insist on sticking exactly to Fontainebleau. I would agree with your point that the better course is to make clear that we support the Commission's ideas for a diff tax/fourth resource (though not their idea for an agricultural correction mechanism). We would doubtless have to accept a matching change in the Fontainebleau formula (from a VAT/expenditure gap to a VAT and diff tax/expenditure gap) since member states would otherwise regard the net benefits to the UK as being excessive. If the other member states should persist in rejecting even this, we could then say, as you suggest, that in that case we must stick to Fontainebleau.

PKemp

pp A J C EDWARDS

FROM: S P JUDGE
DATE: 25 November 1987

PS/CHANCELLOR OF THE EXCHEQUER

cc Mr Tyrie

CABINET: 26 NOVEMBER: EUROPEAN COMMUNITY FINANCING

There was some discussion at Prayers on 20 November about backbench opinion.

The Paymaster General would like to discuss with the Chancellor in the margin of Cabinet tomorrow whether Central Office should circulate the brief prepared for last week's EC debate to all Conservative MPs. The Paymaster does not think that the Chancellor needs to read this (11 page) document beforehand.

B/PMG will take forward

(briefing is behind. The main brief looks OK. But the Q+A contains some odd assertions (e.g that EC revenues have not risen fast in the last 5 years)

25
25/11

SPS

S P JUDGE
Private Secretary

Discussed with PMG. It is poss. a good idea to let all Cons. MPs have a composite brief on the European Community's finances on this; but officials will need to look v. carefully at the — esp (as JT pts out) the Q&A. N.

CONFIDENTIAL

Conservative Research Department Brief

MOTION TO TAKE NOTE OF EC DOCUMENTS
RELATING TO THE
FUTURE FINANCING OF THE COMMUNITY

Prepared For:
Debate in the House of Commons on
Thursday, 19th November 1987

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Enquiries to: Alastair Graham
32, Smith Square, London SW1
01-222 9511

Ref: EU (87) 4
16th November 1987

FUTURE FINANCING OF THE COMMUNITY

1. What the Future Financing Negotiations are all about

The future financing negotiations are essentially about:

- the financing of the European Community budget;
- laying down rules for controlling the growth of Community expenditure, particularly agricultural expenditure;
- reforming the CAP;
- the correction of the UK's budget imbalance - ie. its excessive net contribution to the Community budget.

2. The Fontainebleau Agreement

The present arrangements for financing the Community budget were agreed by Heads of Government at the European Council in Fontainebleau in June 1984.

Under these arrangements:

- the Community budget is financed out of agricultural levies (charged on imports of certain agricultural products from the rest on the world), customs duties (levied on other imports from the rest of the world) and 'VAT contributions' which are determined by applying a rate of VAT to a notional, harmonised VAT base (very roughly equivalent to consumers' expenditure) in each Member State. At Fontainebleau, it was agreed that, as from 1st January 1986, the highest rate of VAT to be applied to any Member State would be 1.4 per cent (previously 1 per cent);
- in order to reduce the UK's excessive net contribution, it was agreed to introduce the 'Fontainebleau abatement system'. This provides that each year the UK's VAT contribution should be reduced or abated by a sum equal to 66 per cent of the gap in the previous year between, on the one hand, what our contributions to the 'allocated budget' (broadly, the total budget minus overseas aid) would have been if the budget had been entirely financed out of VAT and, on the other, our receipts from the budget;
- there should be budget discipline. Except in 'exceptional circumstances', agricultural expenditure (which accounts for some two-thirds of all Community spending) should grow no faster than the 'own resources base' (ie. the maximum amount of revenue available to the Community each year). 'Non-obligatory expenditure' (basically non-agricultural spending) should, in principle, grow no faster than allowed by the 'maximum rate' provisions of the Treaty of Rome (which reflect changes in prices, GNP and the level of Member States' public expenditure).

3. nat has happened since Fontainebleau

In practice, the Fontainebleau agreement has had mixed results:

- the UK abatement mechanism has worked as intended, with the result that our VAT contributions each year have been abated by large amounts. In 1987, for example, our abatement will be worth about £1140 million;

- but the budget discipline arrangements have been less effective. Agricultural expenditure has grown faster than the own resources base, partly because of the decline in the dollar, which has reduced world food prices and hence increased the subsidies required to sell surplus CAP produce on world markets, and partly because the Community has not made sufficient progress in reforming the CAP itself;

- non-obligatory expenditure has also grown faster than allowed by the so-called 'maximum rate' provisions of the Treaty of Rome (since the maximum rate can itself be increased in any year by agreement between the Council and the Parliament). One reason for this stems from enlargement (the accession of Spain and Portugal to the Community on 1st January 1986). A second reason concerns the need to pay off the 'cost of the past' - expenditure commitments which the Community entered into in the past and which have now come forward for payment;

- as a result, the Community budget used up all available revenue within the new 1.4 per cent VAT ceiling in both 1986 and 1987. Indeed, the 'underlying' level of expenditure in 1987 exceeds 1.4 per cent. In other words, the Community does not have enough money this year to meet all the claims made on it. To get by, it has had to resort to a number of devices including switching from paying for agricultural expenditure in advance to paying in arrears (or by reimbursement), thus saving some 2 months' worth of expenditure.

4. The Commission's Proposals

The conclusions of the Fontainebleau European Council provided that one year before the new VAT ceiling was reached, the Commission would conduct an 'ex novo' review of the entire budgetary situation: the state of play on budgetary discipline, the Community's financial needs, and the correction of budget imbalances.

The Commission responded by producing in February 1987 two documents COM (87) 100 and 101 - 'Making a Success of the Single Act: A New Frontier for Europe' and the 'Report by the Commission to the Council and Parliament on the Financing of the Community Budget' which reviewed the policies embodied in the Community Budget and made proposals for increasing and restructuring it. The two documents have become known as the 'Delors package', after the President of the Commission, who has led the campaign for the Commission's proposals. It is the Delors package which is the subject of this debate.

The Commission took into account not only the acute financial crisis caused by the failure of the system of budgetary discipline and the unremitting growth of agricultural production, with the concomitant build-up of excess stocks to be dumped in export markets, but also three major developments in the Community since 1984: the programme to complete the Community's internal market by 1992, set out in the Commission's White Paper of June 1985 (COM (85) 310); the admission of Spain and Portugal, on 1st January 1986; and the ratification of the Single European Act, a treaty amending the Treaty of Rome, which came into force on 1st July 1987.

5. Summary of the Delors Package

Its main recommendations were:

- that the ceiling on own resources should be increased to 1.4 per cent of total Community GNP (equivalent to an increase of 45 per cent in the revenue available to the Community in 1992);

- that VAT contributions should be at a standard rate of 1 per cent, but that a new tax should be introduced on the difference in each Member State between GNP and the VAT base;

- that the UK's corrective mechanism should be changed. A new mechanism should be introduced which would give the UK 50 per cent of the difference between its GNP and receipts shares of agricultural expenditure;

- that agricultural expenditure should grow no faster than GNP;

- that the CAP should be reformed, in particular by the introduction of 'automatic stabilisers' designed to ensure that agricultural expenditure on particular product regimes does not exceed planned levels;

- that expenditure on the structural funds (the regional, social and agricultural guidance funds) should be doubled in real terms between 1987 and 1992, and that a larger proportion of such spending should be devoted to the more backward regions of the Community.

6. The Delors Package in Detail

A. 'Making a Success of the Single Act: A New Frontier for Europe'

This document sets out the Commission's assessment of the wide-ranging reforms needed for the successful implementation of Community policies following the adoption of the Single European Act (SEA), and their implications for the future financing of the Community.

The Commission identifies five inter-related goals: the creation of a common economic area; more vigorous economic growth; greater effectiveness on the part of the Community Institutions; more discipline over the Community Budget; and a strong common external economic policy (especially in relation to the current Uruguay round of the General Agreement on Tarriffs and Trade (GATT).

For these goals to be achieved, the Commission has identified five major areas where it believes reforms are required:

a) Common Agricultural Policy. Whilst underlining the basic principles of the CAP (Community preference, a single market and financial solidarity) the Commission emphasises the need for changes to eliminate surpluses and to check the resulting budgetary burden. It calls for a restrictive pricing policy, more flexibility in guarantees and intervention mechanisms, and a greater degree of producer co-responsibility. The Commission expresses its aim as being to return intervention to its original role of short-term market adjustment. Reference is made to the Commission's proposals for price stabilisation measures in the oils and fats sector and reforms in the agri-monetary system. The Commission also proposes supplementary mechanisms for both national and Community income support for small farmers.

b) Community Policies with real economic impact. Referring to Community policies on the development of Science and Technology, Research and Development, transport infra-structure and the environment, the Commission proposes that the structural funds (European Social Fund (ESF), European Regional Development Fund (ERDF) and the Guidance Section of the European Agricultural Guidance and Guarantee Fund (EAGGF)) be used to pursue a limited number of objectives stemming from the SEA, including assisting backward regions, redeveloping declining industrial regions, combatting long-term unemployment, integrating young people into the workforce and adjusting agricultural production structures. The Commission argue that, to achieve these aims, the structural funds need to be doubled in real terms by 1992, and be concentrated on the least favoured regions.

The Commission's remaining proposals for reform concern the shape and size of the Community Budget, budgetary discipline and budget management:

B. 'Report by the Commission to the Council and the Parliament on the Financing of the Community Budget'

a) Financial Resources. The Commission proposes a new system of own resources comprising:

i) customs duties and agricultural levies (including the 10 per cent currently reimbursed to Member States to cover administrative costs, and duties on coal and steel products (covered by the Treaty of Paris (ECSC));

ii) a 1 per cent levy on the actual VAT base (including, as now, zero-rated items); and

iii) a levy on the difference between Member States' GNP and actual VAT base.

These resources would be subject to a ceiling set at 1.4 per cent of the Community's GNP (or 2.1 per cent VAT) until at least 1992. The Commission also proposes replacement of the existing Fontainebleau abatement system by a 50 per cent refund of the burden to the United Kingdom arising from the CAP. This refund would be paid on the expenditure side of the budget and be financed (in proportion to their GNP and relative prosperity) by Belgium, Denmark, France, Germany, Italy, Luxembourg and the Netherlands.

b) Budgetary Discipline. The Commission proposes (strengthening budget discipline by):

i) establishing annual expenditure ceilings;

ii) an inter-institutional agreement to approve a 1988-1992 multi-annual expenditure forecast;

iii) disposing of agricultural surpluses and past commitments within the annual expenditure ceilings;

iv) agriculture expenditure increasing no faster than the own resources base;

v) the creation of a reserve to meet exceptional circumstances, such as exchange rate movements, affecting expenditure on agriculture.

c) Budget Management. To facilitate budget discipline, the Commission proposes revision of the Financial Regulation to strengthen annuality, (keeping revenue and expenditure in balance within the year, and avoiding borrowing to meet current expenditure) and avoid over-budgetisation (over estimation of opportunities to spend money on individual budget lines).

The document concludes with the Commission's forecasts for expenditure and revenue for the years up to 1992, on the basis of these proposals, which set a target in 1992 for 51 per cent of budget commitments to be spent on the Agricultural Guarantee Fund, 25 per cent on the Structural Funds, 3 per cent on Research and 5 per cent on new policies. The Commission also proposes that the European Development Fund be included in the budget.

7. Progress so far: the European Council in Brussels, 29-30th June 1987

The Commission's proposals have been the subject of discussion within the Community throughout 1987. The Delors package was discussed by the European Council in Brussels on 29th-30th June 1987. The British Government made it clear that it would be premature to consider raising the Community's existing own resources ceiling before agreeing measures on effective and binding control of Community expenditure, particularly agricultural spending. Second, Britain could not accept that the level from which agricultural spending for the future is calculated should be simply revised upwards to include every element in agricultural overspending in 1987. Consequently, no final decisions were taken at Brussels on the more fundamental longer-term financial issues, including the size of the Community's resources. All the other Member States agreed to a document endorsing the package in general terms, and encouraging the Commission and the specialist Councils to do all the work necessary to enable the next European Council, in Copenhagen on 4-5th December, to reach final agreement.

New guidelines on budget discipline and on agriculture were agreed at the Brussels Summit which should lead to the necessary decisions at Copenhagen to restore the Community to solvency, building legally binding controls over Community spending into the system. For it was agreed that the Community's resources should be subject to effective and binding budgetary discipline; and that this must apply to all expenditure. On agriculture, the Summit accepted that additional measures are required - including the introduction of stabilisers (automatic arrangements into each CAP regime to curb overproduction) and so reduce costs and keep expenditure within the budget framework.

The Prime Minister said:

> 'We went to the Council determined to make progess in bringing Community spending under more effective control than in the past, and thus to ensure that the Community lives within its means. There are now clear guidelines for better control of the Community's finances. The priority task is for the Community to do the detailed work necessary to make those guidelines enforceable. The United Kingdom ... has been the driving force behind this approach. We shall continue our efforts to achieve the necessary decisions in the interests of a soundly financed and strong Community' (Hansard, 1st July 1987), Col.494).

8. The British Government's Approach

The Government is determined that Community spending should be made subject to the same discipline as national expenditure and that revenue should determine expenditure, not the other way round. Since the CAP takes up some two-thirds of the Community budget (£12.4 billion of expenditure in the 1987 budget is to be used for the storage and disposal of agricultural supluses), reform of agricultural spending is central to the Community's longer-term finances. Agreement will be required on all aspects of the 'ex novo' dossier including the details of the automatic stabilisers, in order to ensure that budget discipline in the future really will be effected. Partial agreement will not do.

The Government has already made clear that:

- an increase in the own resources ceiling to 1.4 per cent of GNP proposed by the Commission is unrealistic. Before the question of additional own resources can be addressed, agreement on effective and binding control over Community spending is needed, particularly agricultural spending;

- the essential requirement for reform of the CAP is the introduction of automatic stabilisers together with other provisions to ensure that any given limits on agricultural expenditure can be respected;

- more generally, the agricultural guideline must become a real limit on total agricultural spending. There is also need to ensure that effective budget discipline applies to non-agricultural spending. The proposal by the Commission for a doubling of the structural funds is totally unacceptable;

- the Commission's proposal for a new tax based on the difference between GNP and the VAT base deserves further consideration.

Britain's Abatement. The Government has made clear that it would only be prepared to contemplate changes in the system (as agreed at Fontainebleau in June 1984) for compensating the United Kingdom for its excessive net contribution to the EC Budget if they left the UK better off than under the present arrangements.

Conservative Research Dept.
32 Smith Square, London SW1

11th November 1987
ADG/CMC

CONFIDENTIAL

Conservative Research Department Brief

Questions and Answers on the
EC Budget and the CAP

Prepared For:
Background Briefing

Contents Page

Enquiries to: Alastair Graham
32, Smith Square, London SW1
01-222 9511

Ref: EU (87) 3
5th November 1987

1. Is the EC budget enormous?

No.

Total 1987 budget is 37.4 billion ecu or about £26 billion. This should be compared to total 1987 UK budget of around £147 billion (£158 billion estimated for 1988).

It is:

- about 3 per cent of national government budgets, accounting for per capita expenditure of 117 ecu p.a. or 22p each day for every Briton.

- less than 1 per cent GDP of EC Member States. This percentage, contrary to public perception, has remained roughly constant over the past decade - 0.8 per cent % in 1979, 0.9 per cent in 1985.

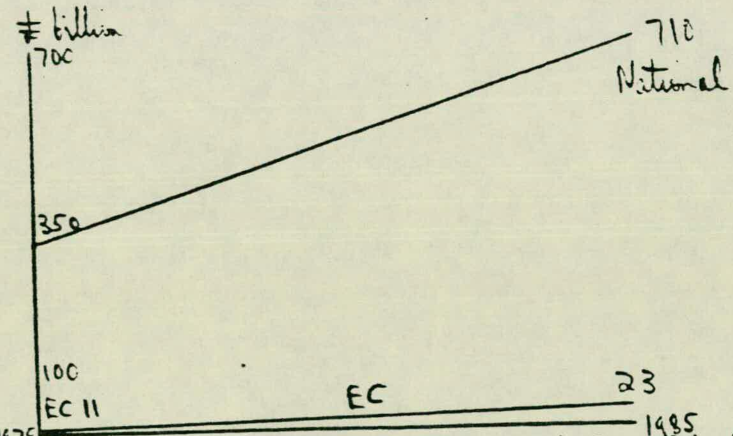
2. Has EC budget grown faster than national budgets?

No.

Every comparison between EC budget and national budget reveals that both roughly doubled in absolute terms in the period between 1979-1985.

Note that simplistic comparisons should be avoided since the EC budget starts from a much smaller base: the EC has enlarged three times in the past 15 years.

EC policies are still developing, leading to supplementary EC expenditure and subsequent savings in national budgets.



3. Does EC spend large sums on R & D and social policies?

No.

R & D expenditure takes up less than 3 per cent of the EC budget and represents only about 2 per cent of the EC Member States' public expenditure in this sector. (Similar figures for social fund are less than 8 per cent compared to roughly 0.5 per cent).

4. Has the net UK contribution to the EC budget grown remorselessly over the past decade?

Not conclusively.

The British net contribution over recent years has fluctuated due to several factors: a fall in our projected share of agricultural receipts and an increase in our share of gross contributions, reflecting higher customs duties and levies and a revised forecast of the UK's VAT base.

Fiscal year: Amount of UK Contribution: (£ million)

1984-5	1985-6	1986-7	1987-8*	1988-9*	1989-90*
971	831	1088	1400	800	1470

*estimated

(Autumn Statement 1987)

The profile shows a drop in payments in 1988-89 followed by an increase in 1989-90, mainly because the UK is expected to benefit from an exceptionally large abatement (£1,750 million) during 1988.

Note that Germany is by far the biggest net contributor (over £2 billion in 1986-87), while France, Italy and Spain are now also small net contributors.

5. Has EC revenue risen rapidly over the past 5 years?

No.

While VAT resources were raised from 1 per cent to 1.4 per cent VAT on 1st January 1986 (VAT contributes about 60 per cent of EC revenue), other traditional revenue sources (from levies and duties on EC imports), have been declining.

Coupled with the abatement mechanism whereby Britain only contibutes 0.67 per cent VAT (compared to 1.4 per cent for France, 1.33 per cent for Germany in 1986), the effective net increase in revenue available for the enlarged Community including Spain and Portugal from 1st January 1986 was only 15 per cent, not 40 per cent as often perceived.

6. Has revenue been sufficient to cover essential expenditure in the past 5 years?

No.

The 1.4 per cent VAT ceiling was already reached in real terms in 1985. The agreement to increase to 1.4 per cent was therefore not a sudden provision of extra resources but simply a recognition of the existing real level of Community spending.

The following table shows how a false perception of available resources has arisen:

ACTUAL BUDGET & 'TRUE' BUDGET AS % OF VAT REQUIRED FOR FINANCING

	1983	1984	1985	1986	1987
1. Actual budget VAT rate	1.00	1.14	1.23	1.40	1.39
2. Non budgeted expenditure*					
- current deficit	-	-	-	0.10	0.23
- non depreciation of agricultural stocks	0.13	0.08	0.08	0.10	-
- 'cost of the past'	0.09	0.06	0.09	-	-
3. VAT rate required for proper financing	1.22	1.28	1.40	1.60	1.65

Source: COM (86)/101

It is time for budgetary truth in current discussions, not another quick fix.

7. Is CAP expenditure under tight control?

No.

Despite ambitious devices to control aricultural expenditure through guidelines on budgetary discipline introduced in 1984, the EC expenditure on agriculture has risen from £12 billion to nearly £17 billion in the past three years. Increases in CAP expenditure in 1986-87 were effectively equivalent to the amount needed for doubling structural funds between 1988-1992.

This situation would have been worse had tough measures not been introduced to control CAP spending which have saved about £5 billion since 1984 (in particular with milk quotas).

Note that supplementary expenditure of over £3 billion is still required for agriculture in 1987 and is almost principally due to the fall in the value of the dollar. Every 1 per cent fall in the dollar adds about £50 million to the EC budget.

8. Is the CAP hugely expensive compared to similar policies of major trading partners?

No.

Recent OECD figures underline the international nature of the crisis in agriculture. US support costs have more than doubled over the past 7 years (£19 billion in 1980, £40 billion in 1985 compared to total EC support - both European and national - of around £30 billion in 1985). Note that the EC has nearly 5 times as many farmers as the US.

At a conservative estimate the US and EFTA countries, like Norway, spend as much, if not more, than the EC per farmer in agriculture.

9. Are EC stock levels still growing?

No.

In most sectors stock levels are beginning to decline. Butter stocks, for example, have now declined from 1.3 million to under 1 million tonnes, and skimmed milk powder has declined from 900,000 to 700,000 tonnes. Stock levels are going down but are still well above normal indicative levels which the European Parliament is now calling on the Commission to observe.

10. Is the EC doing anything to make the CAP more market orientated?

Yes.

The EC is now urgently examining reforms in almost all the major sectors to curb costs looking, in particular, for budgetary limits or 'stabilisers' in each sector.

The European Parliament, as joint budgetary authority with the Council of Ministers, is insisting on a legalised framework to have binding rules for budgetary discipline on agricultural expenditure. Such control is essential for the future development of the European Community.

For such a framework to be applied successfully, there must be tight production controls in each major product sector. Progress has been made in some sectors (eg. with milk quotas); more progress is needed in others (eg. cereals). The European Parliament will continue to press tha Council of Ministers to take the necessary decisions to put the building blocks in place to see that budgetary discipline can become a reality.

5th November 1987

Conservative Research Office
32, Smith Square
LONDON SW1

ADG/CMC

26/11/87.

An awkward one, based on a grossly negligent 1977 decision. The PS's option seems most unlikely to lead anywhere: why on earth should other EC countries agree to take on additional costs?

Prime Minister

FUSION: JET

The Council of Ministers will need to take a decision in the next few months on whether to endorse the extension of the life of the Joint Undertaking of the JET Fusion Project from 1990 to the end of 1992, to give time for the JET experiment with tritium. There is widespread expectation in Europe that the project will be extended. But our approach to the decision needs to be taken in the light of the large increase in the latest estimates of the cost of decommissioning the JET plant.

26/11/87.

Work in the Community, like that elsewhere in the world, is directed to establishing the scientific feasibility of fusion as an energy source. Even if this is established, the earliest date at which fusion might be commercially available is 2040-2050. I share Lord Marshall's doubts as to whether fusion will be economically competitive even then, or whether it will be needed to ensure security of supply, if Fast Reactors are available. The energy policy case for continuing with JET is therefore very weak indeed.

Nonetheless successive Governments have been committed to the JET Project at Culham and it was always envisaged that tritium would be used in the experiments. I should, therefore, have been prepared to accept the proposed extension, although I should have wished to reduce the amounts available for expenditure before 1992 from 1006 mecu to about 900 mecu as part of our agreed strategy of holding down expenditure on the Framework R&D Programme. This would reduce the Departmental EUROPES by £7 million or so (10 mecu) over the period to end 1991.

The AEA's latest estimates of the costs of decommissioning JET, however, create a new dimension to this issue. As part of the major effort undertaken in 1977 to secure that JET was located in the UK, the then Government accepted responsibility for the decommissioning of JET. Separately, Oxfordshire County Council, the local planning authority, imposed a planning condition requiring the site to be returned to a green field state by the year 2000.

The original estimate of the cost of decommissioning was £7.5 million or £20 million in current terms. This sum was largely for dismantling the machine and the buildings. With the disposal routes (including sea dumping) then available, little was required for processing, packaging and storage of waste in the way now envisaged. By 1986 the estimated cost had risen to some £90 million to allow for storage, transport and disposal through NIREX. In the past year the estimate has increased to some £150 million because of NIREX's revised view of disposal costs announced during the year, an increase in the estimated quantity of material to be disposed of, and the generally greater expense of the routes now anticipated for the disposal of low and intermediate level waste. The whole of these costs will fall to the UK. They could be substantially reduced either if JET did not operate with tritium (and so reduced the irradiation of the machine) and/or the local planning authority could be persuaded to defer the restoration of the site to green field by 15-20 years.

I have considered both possibilities carefully. I am sure that we should, through the UKAEA, urge the County Council to postpone decommissioning. I hope that they will be co-operative, especially if some other source of continuing employment on the site can be found.

An attempt to prevent tritium operation would be more difficult, although it would halve the decommissioning costs, if successful. This was envisaged from the outset as the culmination of JET's scientific programme. There is no prospect of persuading JET's Governing Council to abandon this part of the programme. Our only mechanism would be to veto the extension of JET in the Council of Ministers. I have concluded that we should not attempt to do so. We would have little defence against charges of wrecking a world leader actually located in the UK, which is regarded as one of the Community's flagship scientific projects. We should inevitably find that our good faith would be called in question and have little defence. I believe that the political damage would be very great.

We should, however, attempt to persuade our partners in JET to shoulder part of the decommissioning costs. The negotiations would not be easy. Our partners can be expected to argue simply that we should stick to our original bargain. Nonetheless, we should make the attempt. I have therefore asked my officials to work up a case, and to open discussions with the Commission as early as possible next year.

In the longer term, expectations are already building up in the scientific community that JET will be successful and that the Community should then decide to build a next step reactor (NET), whether or not in collaboration with the USA and others. I very much doubt whether such a decision, or UK participation in any successor device to JET could be justified in terms of energy policy. It must be for Kenneth Baker to consider whether it could be justified as a contribution to science. My provisional view is, therefore, that the UK should not participate in any successor project to JET. A formal decision is not needed at this stage, but we must make it clear that decisions on a next step device cannot be taken for granted, and that the UK does not regard itself as committed.

We are faced with 3 options:

(a) to accept the extention of JET unconditionally;

(b) to accept the extension of JET, but to make every effort to persuade Oxford County Council to extend the deadline for decommissioning and our partners to contribute to the decommissioning costs of JET;

(c) to veto the extension of JET, thus probably halving the decommissioning costs.

I believe we should adopt option (b). I hope you and other colleagues will agree.

I am sending copies of this minute to Nigel Lawson, Geoffrey Howe, Kenneth Baker, as well as to John Fairclough at the Cabinet Office.

C.P.

Secretary of State for Energy
26 November 1987

026/75

CONFIDENTIAL

From: P WYNN OWEN
Date: 26 November 1987

1 MR GRAY ✓ Discussed in draft.

2 PS/CHANCELLOR

Ch / Content for me to write as suggested? 26 26/11

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Monck
Mr Burgner
Mr A J C Edwards
Mrs Lomax
Mr Mercer
Mr Mortimer
Mr Donnelly

PWO → PS/CH 26/11

EC MERGER CONTROL REGULATIONS

You minuted me on 24 November with the Chancellor's response to my minute of 23 November.

2. We have consulted Treasury Solicitors (Miss Wheldon), who agrees with the Chancellor that, assuming one wishes to minimise Commission involvement in mergers, it is difficult to imagine the Commission proposing a regulation which will not make matters worse than they are under Articles 85 and 86. A regulation might lead to greater "certainty" but it would be the certainty of increased Commission intervention.

3. Having said that, T.Sols have noted that Articles 85 and 86 are not innocuous. If a merger allows the Commission to argue that there is an abuse by an undertaking of a dominant position in the EEC the Commission can intervene. Moreover the Court has accepted in the recent case of BAT and Reynolds v. Commission (Cases 142 and 156/84) that an agreement for the acquisistion of shares in a competitor is capable of being caught by Article 85 and has laid down some rather wide and unclear considerations to be taken into account in deciding whether a breach has occurred. Where there is a breach the agreement is automatically void. Companies threatened with action by the Commission will obviously be nervous and if the Commission can be dissuaded from adopting too interventionist a

position under Articles 85 and 86 this would clearly be desirable. The dissuasion should not however be at the cost of an unsatisfactory regulation.

4. However, the legal position seems unclear, particularly about the potential scope of Articles 85 and 86 if the Commission sought to make more use of them. The attached article from Tuesday's FT suggests that not too much should be read into the European Court's recent decision.

5. This uncertainty suggests that Law Officers advice might well help to clarify the potential threat of Articles 85 and 86. It would be better if their advice were sought by DTI than ourselves. We have already suggested to DTI that they do so, though we doubt this has been done.

6. We understand that when Lord Young met Commissioner Sutherland on Tuesday, Sutherland pressed the threat of more active use of Articles 85 and 86, and that Lord Young simply noted what he said. But Sutherland tabled the sort of conclusions he hoped to see from next Monday's Council, which began from the premise that a Regulation was acceptable in principle and went on to outline details.

7. DTI have been asked for a record of the Sutherland meeting but this has not yet arrived. Lord Young and his officials may be tempted to accept the principle of a Regulation, while seeking to make significant criticisms on points of detail. This potential acceptance of the principle of a Regulation seems to be at odds with the Chancellor's line in your minute of 24 November.

CONCLUSION

8. It is possible that Lord Young will write again proposing a revised line in the light of his meeting with Sutherland, which could well include the acceptance of the principle of a Regulation. But he may simply wait to see if we comment on the line proposed in his original letter. The Foreign Secretary, in his minute of 22 November, has already commented that Lord Young's letter seemed to be right tactically and in substance.

9. The Chancellor may well think it worth you writing to record his views, making it clear that the principle of a Regulation should not be agreed to and seeking to flush out the Attorney General's opinion as a member of ODE.

10. I attach a short draft letter for you to send.

Philip Wynn Owen.

P WYNN OWEN

Please type for signature

DRAFT LETTER FROM MR J M G TAYLOR TO:

~~Dr T Walker~~ Ms. A Brimelow

Principal Private Secretary/Secretary of State for Trade and Industry
1-15 Victoria Street

EC MERGER CONTROL REGULATIONS

The Chancellor of the Exchequer has seen Lord Young's letter to ~~Sir Geoffrey Howe~~ the Foreign Secretary of 20 November.

2. The Chancellor has looked at Articles 85 and 86 of the Treaty of Rome. Subject to any contrary advice from the Law Officers, he thinks we should on no account support the proposed Regulation. It would be a far greater threat in practice than Articles 85 and 86, which have caused little or no trouble for the past 29 years, and which, he thinks, are unlikely to do so. He therefore concludes that it would be a serious mistake to endorse the principle of a Regulation at the Internal Market Council next Monday.

3. I am copying this letter to Private Secretaries ~~of~~ to members of ODE and to PS/Sir Robert Armstrong.

[JMGT]

8.4

Draft

FROM: M E DONNELLY
DATE: 26 November 1987

agreed in draft
1. MR ~~EDWARDS~~
2. PAYMASTER GENERAL

cc: PS/Chancellor
Mr Mercer
Mr Mortimer
Mr Evans
Miss Bogan

Ch/ content?

MPW.
26/11

OK subject to views of PMG.

COMMUNITY FINANCES IN 1988 - NOTE FOR PRIME MINISTER

The attached paper sets out officials' analysis of the problems we are likely to face in financing the Community during 1988, whether or not agreement is reached in Copenhagen.

2. If you agree, we propose to submit early tomorrow a draft cover note under which you might send the paper to the Prime Minister and colleagues as background to the European Council discussions. The cover note would say that the paper itself was not required reading and would simply set out the conclusions which currently form paragraph 47 of the paper. This would allow us to highlight concisely the main areas of 1988 financing which will require early decision.

Martin Donnelly
M E DONNELLY

A6/37

RESTRICTED

COMMUNITY FINANCES IN 1988

Introduction

This note considers the prospects for Community financing in 1988, when on present trends existing Community resources within the 1.4% VAT ceiling are bound to be significantly less than Community expenditure.

2. The Council's failure to establish a draft 1988 budget by the 5 October Treaty deadline has delayed the budget procedure and means that the Community will almost certainly have to start 1988 under the provisional twelfths regime. The key influence on finances during the rest of 1988 will be whether a decision to increase the ceiling on Community Own Resources is taken at the Copenhagen European Council or shortly thereafter. The consequences of both lack of agreement and of agreement are discussed below.

(a) No agreement at Copenhagen

i) Presidency strategies

3. If there is no agreement on future financing at the Copenhagen European Council, the Danish Presidency are certain to press hard at the Council for agreement in principle on a budget for 1988, quite possibly with additional resources going beyond the 1.4 per cent VAT ceiling. There are two main approaches which they may pursue:

(i) a budget above the 1.4 per cent VAT ceiling, with the excess financed by an IGA of around 4 becu; or

(ii) a budget nominally within the 1.4 per cent VAT ceiling, but with a large negative reserve of a similar amount.

4. The first approach, a budget above the 1.4 per cent VAT ceiling with the excess financed by an IGA of perhaps 4 becu, would have the considerable advantage, from the point of view of the Presidency and most other member states, that the European Parliament would be more likely to adopt such a budget than a budget which appeared to respect the 1.4 per cent VAT ceiling. It would be seen as prejudicing the final outcome of the future financing negotiations much more effectively than the alternative option. The Presidency may well therefore press for this solution first, in preference to a budget with a large negative reserve.

5. The problem about an IGA, again from the Presidency's point of view, is that in practice it would have to be agreed by unanimity. The UK would therefore be in a position to block it.

6. We assume that Ministers would in fact wish to do just this. We assume that they would not in any circumstances wish to agree to an IGA in 1988 without prior agreement having been reached in the future financing negotiations. Any such agreement would prejudge the final outcome of the future financing negotiations and take the pressure off other member states to agree on effective and binding budgetary discipline. It would also run counter to the logic of our position that agreement on additional resources can only follow agreement on the other elements of the future financing package. The lower UK financing share of additional resources if agreement is reached on a diff tax provides a further reason for not agreeing to an IGA before there is agreement on future financing.

7. The alternative option, a budget within the 1.4 per cent VAT ceiling but with a negative reserve of perhaps 4 becu, would in effect revive the "balancing factor" budget proposal which the Presidency have been commending to the Budget Council throughout the Autumn but which the UK, Spain and Greece have blocked. The difference would be that, whereas the balancing factor was due to be extinguished before adoption of the budget by agreement on extra resources during 1988, the negative reserve would be included in the adopted budget itself. The Presidency might argue that the 1.4 per cent VAT ceiling would nominally be respected, and the Community would not be able to spend beyond this level

without our agreement. In spite of that, however, the Community would in effect launch its spending programmes in 1988 on the assumption that a specific extra amount of own resources, represented by the negative reserve, would become available during the year, so undermining the Article 199 Treaty requirement that revenue and expenditure in the budget should balance.

8. If the Presidency were unable, if only because of UK objections, to secure agreement on an IGA at Copenhagen, they would probably try hard as a second-best solution to persuade the Spanish and/or the Greeks to rally to a 1.4 per cent VAT plus negative reserve budget. We have to recognise that, in the context of an impasse on longer term future financing at Copenhagen, the Presidency might well succeed in rallying such support and thus obtaining a qualified majority in principle at least for a draft budget along these lines. On the basis that the draft budget would nominally respect the 1.4 per cent VAT ceiling, the Council could be expected to establish it by qualified majority, despite the UK's objections.

9. How the European Parliament would respond to a 1.4 per cent VAT/negative reserve budget is uncertain. They would undoubtedly criticise the Council loudly for failing to agree on extra resources. They would say with some justice that negative reserves were no substitute for extra revenues. Whether they would reject the draft budget or amend it would be a nice decision for them.

10. If the Council did establish a draft budget on these lines, and the European Parliament then adopted it, the UK would have to consider seriously challenging the budget before the European Court. The basis for such a challenge would be that, whereas a small negative reserve of up to (say) 200 mecu along 1986 and 1987 lines could be assumed to be capable of being offset by identifying savings during the year and making the necessary transfers, there would be no realistic hope of offsetting a massive negative reserve of 4 becu or more in this way. The Community would have accepted a budget containing an imbalance between revenue and expenditure, in direct contravention of Article 199 and potentially undermining the effectiveness of the own resources

ceiling. At the Copenhagen Council itself UK Ministers may need to give advance warning of what legal steps we would be obliged to take in such circumstances. The Law Officers' advice about what should be said in the event of various threats to our legal rights is attached (Annex A).

ii) <u>Provisional Twelfths</u>

11. As noted earlier, the most likely practical outcome for the early months of 1988 is a provisional twelfths regime. This will come about if there is no agreement in principle on the 1988 budget at Copenhagen. It would also come about if there were agreement on a negative reserve budget which <u>either</u> the European Parliament then rejected or amended so that there was no agreement between the institutions <u>or</u> which the European Parliament adopted but the UK or others then contested before the European Court; at any rate if on the 1986 precedent an application for interim measures suspending the disputed budget was granted.

12. The Commission will argue that provisional twelfths do not provide the Community with the funds necessary for its effective functioning. Most other member states will support this allegation. We do not think however that such a view is objectively justified. Relevant figures for 1988 financing are set out in the following table.

Funds available during 1988 under

		mecu
(a)	provisional twelfths	36,200
(b)	1.4% VAT	35,373
(c)	1.6% VAT	39,100
(d)	1.7% VAT = 1.2% GNP	40,700
	compare with:	
(e)	Estimate of needs in 1988 on Commission figures	42,850

13. As these figures indicate, the Community should be able to function normally under provisional twelfths for the first few months of 1988 if, as is usually the case, the budgetary authority is prepared to agree the additional twelfths needed

to allow routine expenditure to continue. By the early autumn, however, in the absence of major savings from policy decisions all available funds are likely to be exhausted. If there was still no agreement the Community would be unable to meet its financial obligations, most immediately in relation to agricultural guarantee spending. This note does not consider the legal and practical difficulties which would arise in such a situation. We would, however, need to review our contingency plans for national payments well in advance.

14. It should be noted in this context that UK payments under a provisional twelfths regime would be some 114 mecu (£80 million) higher each month than under a budget at the 1.4% VAT ceiling. This is due to the effects of the large UK abatement in the 1988 budget. However when a budget containing the abatement was adopted the UK would be refunded the difference between its higher payments under provisional twelfths and its contribution rate to the budget. The net effect would be an interest free loan by the United Kingdom to the Community of £80 million per month for as long as provisional twelfths lasted.

iii) Article 175 proceedings

15. If the Council does not succeed at Copenhagen or shortly thereafter in patching up a draft budget for 1988, we have to assume that the Commission and the Parliament would proceed with their Article 175 action before the European Court, notice of which they have already given, to have the Council's infringement of the Treaty procedure established. Such proceedings would add to the pressures on the Council. If the Court rules that the Council has failed to act then under Article 176 the institution at fault is required to take the necessary measures to comply with the Court's ruling. Our impression is, however, that this would not fundamentally alter the situation except that member states in favour of an immediate own resources increase would argue that there was an intensified obligation on the Council to conclude the future financing discussions as rapidly as possible.

iv) Possible threat to UK abatement

16. If the UK's general stance is perceived as unnecessarily

obstructive, there is a risk that other member states may seek to retaliate by attacking all or part of the UK abatement provision in the 1988 budget, as being a convenient source of economies. This risk would increase if the Community found itself still without a future financing settlement by mid-1988, when the funds available under provisional twelfths would be almost exhausted. Eliminating the abatement provision altogether would release an extra 3.6 becu of resources in expenditure equivalent terms.

17. Other member states would have no respectable legal grounds for taking such a step. The ORD makes quite clear how our abatement should be calculated and that it should be paid one year in arrears. Therefore we would have to take the matter before the European Court if a budget without proper provision for our abatement were adopted. If the European Council sought to undermine the legal basis on which the abatement operated we would need to withhold our agreement to any increase in own resources until a completely satisfactory text of a new Own Resources Decision had been negotiated.

18. It would however be much better that other member states should not be tempted to attack our abatement in the first place. That is an added reason why the UK should be ready to stress its concern to reach agreement on the future financing package at an early stage and support moves for a rapid timetable of continuing discussion after Copenhagen if this proves necessary.

(b) <u>Agreement on additional own resources at Copenhagen or subsequently</u>

i) <u>Timing of ratification of ORD</u>

19. On the assumption that the Copenhagen European Council reaches agreement on new Own Resources the question of how the Community is to be financed during 1988 will immediately arise.

20. If there is a clear prospect of all twelve member states ratifying the necessary new Own Resources Decision by the end of 1988 it would be possible to adopt a 1988 Budget <u>on a dual revenue basis</u> ie permitting immediate adoption of a budget going beyond the 1.4 per cent ceiling on the basis that a defined section

of the expenditure in the budget could only take place when the new Own Resources Decision had been ratified. Until then actual expenditure from the budget would continue to be limited to the 1.4 per cent ceiling. There is some precedent for this in the form of the 1985 budget, under which payment of the 1985 1000 mecu UK abatement was linked to ratification of the new Own Resources Decision, and revenue payments to the budget by the other eleven member states were effectively on a dual basis; though total spending in the budget was not at issue in this case.

21. However it may not be possible for all member states to ratify by the end of 1988, and this deadline would almost certainly be missed if an agreement on future financing slipped beyond March 1988. Work on the detail of the text would take several months and possibly longer, depending on how many detailed points required to be resolved. The additional funds would, we think, be needed by the Commission no later than September, so even ratification in October or November 1988 could leave the Community with difficulty in meeting its financial obligations in the interim.

22. In this context it is worth noting that the timetable in the 1984/85 negotiations was as follows:

<u>June 1984</u> - Agreement in principle on increased Community Resources at the Fontainebleau European Council;

<u>December 1984</u> - agreement on detailed budget discipline conclusions which were a condition of implementation of new Own Resources;

<u>May 1985</u> - agreement on text of new ORD;

<u>June 1985</u> - 1985 budget agreed, including IGA and with dual revenue base;

<u>December 1985</u> - Final ratification of new ORD.

23. Thus there was a delay of eighteen months between agreement in principle and the entry into effect of the relevant legislation. In addition to the various technical delays experienced in the

1984-85 ORD negotiation, consultation with the Parliament is likely to be a more time-consuming process than in 1985.

24. By comparison the timescales for implementation of previous IGAs have been much shorter, as shown below (though the issues and arithmetic were also much more straightforward).

	Agreement in principle	Funds paid
1984 IGA	October 1984	January 1985
1985 IGA	March 1985	November 1985

The domestic procedures required to allow approval of an IGA are easier in some member states than in others. Denmark, Germany, Italy, Luxembourg, Netherlands and the UK required Parliamentary approval for the 1985 IGA; the other member states paid by executive decision. Annex B sets out the timing of payments in 1985 following agreement in April 1985 on the precise figure; we have no reason to think that the position will have changed significantly since then.

25. A further reason why an IGA could be more convenient is that, in contrast with the dual base budget discussed above, there would be no need to distinguish on the expenditure side of the budget between expenditure which would be incurred in any event and expenditure conditional on further resources being available.

26. Against this background, it is likely that agreement on a 1988 IGA would be considered tactically wise by the Commission and many member states in order to provide the maximum assurance that the financing of the Community in 1988 would take place smoothly. Indeed the Commission have already foreshadowed a 1988 IGA in their introduction to the 1988 PDB earlier this year.

ii) UK attitude to IGA

27. Assuming agreement on additional resources as part of a wider future financing settlement, and that an IGA would facilitate implementation without affecting the substance of that agreement, we assume that Ministers would accept a third IGA provided that our contribution was no greater than it would have been had the

new system of own resources come into effect immediately and, in particular, that our abatement entitlement was unaffected.

28. If those conditions were satisfied, an IGA could then be presented to Parliament as simply the most convenient way of providing interim financing in 1988 pending ratification of the new ORD. Politically there could of course be no question of the UK making any extra revenue available until after Parliamentary approval of the IGA. We would also wish to ensure that all member states contributed their shares of an IGA at the same time.

29. Our public line in these circumstances should emphasise the following points:

i) A decision to increase Community Resources has now been taken as part of the wider future financing negotiations;

ii) An IGA is simply the most convenient way of carrying out that decision in 1988;

iii) Agreement to the IGA does not involve the UK in any more expense than if the new Own Resources system was already in place; in particular the UK's abatement entitlement will not be affected;

iv) the extra resources will not be made available until after Parliamentary approval of the IGA where that is required, including in the United Kingdom;

v) all member states are due to pay together, so there is no question of discrimination.

30. We should therefore work on the basis that the IGA would be an attempt to replicate the situation which would have existed if it had been possible to implement the new Own Resources Decision straightaway.

(c) <u>Procedure for agreement on an IGA</u>

i) <u>Decision making body</u>

31. It is likely that, following the precedents of the 1984

and 1985 IGAs, agreement on the principle of an IGA in 1988 would be reached either by the European Council or by the Foreign Affairs Council subsequently. The indivisibility of the Council in legal terms means that this decision could be taken by any Council; in practice it may well feature as one of the subsidiary points to be settled by the Foreign Affairs Council following a decision by Heads of Government on the principle of new Own Resources.

ii) Amount

32. As part of any outline agreement at Copenhagen or subsequently, the Council would need to set an upper limit on the size of the budget including IGA; otherwise the potential would exist for an effective breach of the new ceiling before it entered into effect. This might simply take the form of a declaration that the 1988 budget must be within the new Own Resources ceiling. Some member states may argue for an IGA allowing total resources to go beyond the new ceiling to allow for eg additional one-off stock depreciation. We should resist this as setting an unacceptable precedent.

33. It will not be possible to reach agreement on the precise figure to be financed through the IGA before further progress has been made in the 1988 budgetary procedure. The final amount of the IGA should be that necessary to bridge the gap between currently available Own Resources under the 1.4% ceiling (35373 mecu) and the 1988 Budget as finally adopted (or alternatively between VAT at 1% and the budget as adopted if that approach proved acceptable). To decide on that figure before a draft 1988 Budget had even been established would be seen by the European Parliament as an unacceptable curtailment of its budgetary powers under the Treaty. This would in practice lead to a further budgetary conflict between Council and Parliament and delay the adoption of the 1988 Budget.

34. It would be preferable therefore, for the precise amount of the IGA to be agreed late in the Budget Procedure, probably at the Council's second reading, after which the Parliament would be faced with the choice of adoption or rejection of a Budget already incorporating its half maximum rate margin. It would

however be appropriate for the UK to make clear at an early stage that any 1988 Budget containing an IGA should:

i) be fully compatible with the revised budget discipline procedures agreed in the future financing package; and

ii) could under no circumstances go beyond the new Own Resources ceiling agreed.

35. Consequently if the 1988 budget including IGA was at the new ceiling there would be no scope for a subsequent supplementary budget.

36. The need for unanimous agreement on the IGA means that the United Kingdom would have a technical veto on the amount to be so financed and hence on the 1988 budgetary procedure. In practice the scope for its use would be limited. After the initial agreement in principle we would doubtless have to accept that, within the parameters laid down above, a decision on the precise amount of the IGA within the new own resources ceiling, like the decision on the budget itself, would be a matter for qualified majority voting in the Budget Council. We should however insist that precise and binding arrangements are made on this occasion for the timing of the IGA payment and the exchange rate to be used. There was considerable confusion on these points in relation to the 1985 IGA, with different exchange rate conventions being used and some uncertainty over the appropriate date for payment. These points should be settled when agreement is reached on the amount to be paid.

37. The total budget agreed for 1988 is unlikely to be less than 39-40 becu; ie at least 4 becu above the current level of Own Resources. The IGA would therefore represent an increase of about this size on current Own Resources. But it should be recognised that discussions on the 1988 Budget will in any case be extremely difficult. Agricultural expenditure if unchecked is likely to be beyond any conceivable guideline adopted; the southern member states will wish to see at least the full provision for DNO expenditure proposed by the Commission; and there is

an exceptionally large provision for the UK abatement. If the new Own Resources ceiling is set tightly it may be difficult to reconcile these priorities within the resources available. Consequently final decisions on the IGA may be delayed until at least the middle of 1988. Domestic Parliamentary approval would not be required until after agreement was reached on the amount of the IGA and the text could be finalised.

iv) Financing Key

38. The decision as to the most appropriate IGA financing key is likely to be the first key issue requiring agreement. The IGA would be additional to available resources under the current 1.4% VAT ceiling, which continues in force until superseded. The 1984 and 1985 precedents imply that payments to the IGA would be made under the normal VAT contributions key.

39. Any change in the structure of own resources would, however, complicate matters. The natural way ahead, which would be preferable from the UK's point of view to VAT-shares financing, would be to replicate as closely as possible what would have happened had the agreed new Own Resources system taken effect immediately. On this basis, the main options for financing an IGA would be:

i) VAT limited to 1% and an IGA financed in accordance with diff tax shares; the IGA would be the diff tax in all but name; or

ii) VAT at 1.4% plus a smaller IGA financed so as to produce the same overall result as the agreed new Own Resources structure.

40. Option (i) is neatest. But it raises the problem that the IGA required would be very large - some 11-12 becu; and there would be a risk that the Community would exceed the 1% VAT rate subsequently. We need to ensure that the IGA is additional to all currently available resources - ie up to 1.4% VAT - to prevent any additional spending taking place in 1988 beyond that agreed as the basis for the IGA. Option (ii) although less immediately

transparent avoids both of these difficulties. We should therefore support this option and not accept the large IGA approach unless we could be completely sure that there was no risk of additional spending taking place later in the year. This implies a more complex distribution of IGA payments to replicate the effects of the new own resources system. As this would involve others, notably Italy, contributing correspondingly more they will doubtless argue that the most simple and transparent arrangement would be financing based on VAT shares, and the revised arrangements should only apply after the ORD was ratified. Some hard bargaining will no doubt be necessary to ensure that we do benefit from the revised financing key. The saving involved for the United Kingdom would be some 340 mecu before abatement.

iii) Reimbursability

41. There is unlikely to be any pressure to make the 1988 IGA reimbursable. The 1985 IGA was not reimbursed and repayment of the 1984 IGA has become a complicating factor in the annual budgetary procedure. From the UK's point of view, the arguments against reimbursability are:

(1) Our argument that the IGA should replicate as closely as possible the new ORD would be undermined if we sought to make an IGA reimbursable. There would be no question of reimbursement of our contribution to a 1988 budget if the new ORD was already in place.

(2) Both the earlier IGAs related to the period before additional own resources were able to be provided whereas any agreement on own resources reached now would apply to 1988 onwards.

v) UK Parliamentary considerations

42. The IGA would need to be approved by Parliament before payment could be made. Technically there are three ways of doing this:

i) an Order in Council under Section 1(3) of the 1972 European Communities Act adding the IGA to the list of Community treaties in Section 1(2) of the Act, and allowing any resulting financial obligations to be a direct charge on the Consolidated Fund. This course would require approval by Resolution of each House;

ii) primary legislation in the form of a supplementary estimate and subsequent Consolidated Fund bill, as used in the 1984 IGA;

iii) specific primary legislation in the form of a short Bill to add the IGA to the list of Community treaties in Section 1(2) of the 1972 Act.

43. The option of subsidiary legislation, ie an order in Council under Section 1(3) of the EC Act, is probably not a practical proposition given the degree of opposition to this approach in 1984. Although the government won the court case brought on that occasion and has made clear its view that to do so would be compatible with assurances given to Mr Powell concerning the use of Section 1(3) when the 1972 Act was first debated by the House, there would inevitably be protests that proper Parliamentary scrutiny was being bypassed. A letter sent by the Leader of the House to Mr Powell in relation to the authorising procedure for the 1984 IGA is relevant in this context (Annex C).

44. A supplementary estimate would be more feasible. A supplementary estimate followed by a Consolidated Fund Bill would be reasonably straightforward as long as adequate notice was given to the Business Managers, and the usual timelimits between tabling of the Estimate and its debate were respected. The TCSC or Scrutiny Committee would doutless wish to take evidence from Ministers and officials on such an Estimate before it was debated by the House. The Government would probably be criticised for relying on the authority of the Estimates in this way however, especially given the unfortunate memories of the rather hurried procedure in early 1985, when this was used by the Government as an alternative to the Section 1(3) route.

45. It seems clear that, given the past history, specific primary legislation would be the least troublesome option. If at all

possible the best route would be to use the primary legislation required to approve the new ORD to cover the IGA as well, assuming that the ORD text is ready in time. This would follow the precedent of the 1985 IGA and ORD. Preparation of the detailed ORD text is likely to take place in parallel with the 1988 budgetary procedure so that work should be well advanced before a final figure for the IGA is agreed. The legislation could then be presented to Parliament as quickly as other priorities allow with a view to approval before the summer recess if possible. But if, as is quite likely, the ORD text is not finalised when the IGA is required, then <u>two</u> short, specific Bills would need to be considered, one for the IGA and a second for the new ORD.

vi) <u>Late Agreement</u>

46. If agreement on future financing is not reached before the June European Council the Community's finances will be in a critical condition. Agreement on a budget and therefore the amount of an IGA might not be possible before September and there would be considerable pressure on member states to allow their IGA contributions to be anticipated, through Article 12 of Reg 2891/77 overdraft facilities to the Commission. We cannot accept that IGAs represent revenue which can be anticipated in this way since this might mean IGA money being paid over to the Community before Parliamentary approval had been received: a highly sensitive issue vis a vis the UK Parliament. But we are far from certain of winning a European court case on this point and it is clear from discussions in 1985 that the Commission might well challenge a refusal to allow overdrafts. Our interest probably lies, therefore, in securing agreement that an IGA be approved by Parliament as rapidly as is feasible so that we are in a position to pay as soon as a budget is adopted and can thereby avoid the overdraft issue arising.

<u>Conclusions</u>

47. The following conclusions can be drawn at this stage.

i) If there is <u>no agreement</u> on future financing at the Copenhagen

European Council, the UK should not agree to provide additional resources to the Community in 1988 through an IGA.

ii) We should be ready to consider legal action to prevent implementation of a 1988 budget which seeks to go beyond the current own resources ceiling either overtly or by means of a large negative reserve.

iii) ~~Subject to the views of~~ In keeping with the advice received from the Law Officers, we should be ready to give due warning of (ii) above, as appropriate, at the European Council or subsequent Councils.

iv) If agreement is reached on the wider future financing issues, including the future structure of Community Own Resources, the UK could agree to an IGA in 1988 as a ~~means of~~ technical device for speeding implementation of the wider agreement, provided that the new own resources ceiling and discipline were fully respected and full provision made for the UK abatement.

v) The European Council could decide the principle and distribution of the IGA within the overall limit on 1988 expenditure set by the new own resources ceiling.

vi) Negotiations on the figure could then take place in parallel with, or as part of, the budgetary procedure. The UK should insist on a figure compatible with the revised budget discipline arrangements.

vii) Payment under any IGA should be consistent with the new ORD and not involve any additional expense for the UK. The technical details of this will need to be considered further.

viii) Parliamentary approval would best be sought through primary legislation, preferably as in 1985 in a Bill which also covered the new ORD. A final decision on procedure could be taken later; but the priority should be to ensure Parliamentary approval as rapidly as possible.

HM Treasury

November 1987.

CONFIDENTIAL

CHANCELLOR

FROM R J BONNEY
DATE 26 NOVEMBER 1987

cc Chief Secretary
Paymaster General
Mr Anson
Mr Monck
Mr Edwards
Mr Burgner
Mr Mortimer
Mr Mercer
Mrs Imber
Mr Dodds
Mr Bostock UKREP
Mr Tyrie

Ch/ Content for me to write as proposed? JF 26/11

OK

EC FINANCING REVIEW: AGRICULTURAL STOCKS

The Prime Minister has asked for some further analysis of ways of dealing with EC expenditure on agricultural stocks including her idea of a once for all operation to wipe the slate clean. (Mr Powell's letter of 20 November).

2. I attach a self explanatory draft letter covering a paper by officials which attempts to fulfil this remit. In view of its unavoidable length and the number of other issues on which the Prime Minister may need to receive advice in the next few days, we suggest that this material might be sent under a Private Secretary letter. It would, however, be desirable to get it into circulation as soon as possible (preferably today) so that UKREP and other Departments can use it in briefing.

3. The paper by officials and the ideas for potential savings on agricultural expenditure have been discussed with officials in other interested Departments including MAFF. The attachments to this submission have been discussed and agreed with Mr Edwards.

R J BONNEY

CONFIDENTIAL

DRAFT LETTER

FROM: ~~PRS~~ JMG TAYLOR

TO: CHARLES POWELL ESQ 10 DOWNING STREET

COPIES TO PS/Foreign Secretary
PS/Minister of Agriculture
PS/Cabinet Secretary
Mr Lavelle
Sir D. Hannay

FUTURE FINANCING: STOCKS AND AGRICULTURAL GUIDELINE

The Treasury has been giving some further thought to problems of stocks expenditure and its relationship to the guideline limit for future agricultural expenditure. The Chancellor has asked me to send you the attached paper by Treasury officials which considers a wide range of options including the clean slate approach suggested in your letter of 20 November.

It is clear that

2. Discussion in Brussels has so far been focussed on the choice between dealing with expenditure on existing stocks inside or outside the guideline. Sadly the idea of writing down the value of existing stocks at national expense has met with little enthusiasm and some downright hostility, and the Chancellor takes the view that, although the best solution, we must now conclude that it ~~will not~~ is most unlikely to run. The alternative of a once off depreciation exercise funded from the Community Budget has not yet been raised in the negotiation: although it should not encounter the same objections in principle as the national financing suggestion, it could well be that others will be unwilling to focus on a new idea of this sort at this stage in the negotiation, although it would be a pity to drop it altogether simply on this account.

3. In the Chancellor's view realistically the range of options listed in the officials' paper can be narrowed to a choice of three:

(i) a one-off depreciation exercise in 1988 for all existing stocks other than the special butter disposals for which we made financing provision in 1986. This would need to be financed by the Community through an Inter Governmental Agreement (IGA). (This is option 3B in the table);

(ii) spreading the costs of depreciation of existing stocks over the period until 1992 on the model of the 1986 butter agreement, but taking these costs outside the guideline (Option 4 in the table); and

(iii) the same as option (ii) but keeping all the costs within the guideline.

4. The first of these has many attractions in terms of wiping the slate clean of past mistakes and should make it easier to achieve a lower guideline limit for future years. For the UK there are also financial attractions, particularly if an IGA is financed on the so-called "diff" tax key (where our marginal contribution would be some 13%) rather than through VAT. Against that the financial benefits to us (and more markedly to the Germans and the Irish) will be parallelled by financial disbenefits to others (notably the Italians) and the idea of a substantial addition to Community spending above the new own resources ceiling in 1988 is unlikely to attract unanimous agreement. An IGA of perhaps 2-3 becu higher than otherwise would be needed to implement this option.

5. The other two options are precisely equivalent to each other in financial terms and are not too far removed from the Commission's

own thinking to judge from the papers they have circulated on stocks expenditure. Clearly there would be presentational benefits in achieving a lower guideline limit (whether this comes off the base or the growth rate), if we agree to take expenditure on existing stocks outside. But this will depend on the size of the reduction in the Commission's figures we can negotiate. If we cannot achieve the sort of adjustment suggested in paragraph 9 of the officials' paper, then we would be better off with stocks expenditure inside the guideline effectively exerting a tighter constraint on other agricultural expenditure.

6. Others will no doubt argue that it is unreasonable even to consider a reduction in the guideline provision when on the Commission's latest reckoning unconstrained expenditure in 1988 at 30.8 becu is likely to be some 2.6 becu higher than their own rebased guideline proposal of 28.2 becu. The Commission lose no opportunity to point out that part of the reason for this is that the Council has failed to adopt the proposal for an oils and fats tax which on the Commission's reckoning would net some 1.3 becu in receipts next year if adopted immediately. We ~~should~~ will of course continue to oppose the adoption of an oils and fats tax for all the reasons with which we are familiar, but we will need to be able to marshall some persuasive arguments to demonstrate that the rejection of the tax need not imply any addition to the guideline numbers which the Commission have proposed.

7. Treasury and MAFF officials have drawn up a considerable list of options for reducing the Commission's estimates for 1988. The

main categories and the financial effects can be summarised as follows:

		becu
Commission unconstrained forecast		30.8
<u>Potential reductions</u>		
(i)	<u>estimating savings</u> (based on views of MAFF commodity divisions <u>including</u> allowance for decline in dollar)	-1.5
(ii)	<u>stabilisers</u> (Commission proposals) (first year effect)	-0.6
(iii)	<u>management savings</u> (within Commission competence)	-0.5
(iv)	1988 Price Fixing (first year effect subject to Council decision)	-0.5
(v)	reduction in reimbursements for storage costs	-0.5
		-3.6

Although some of these estimates may prove to be rather ambitious, I suggest that they provide a reasonable basis for arguing that the Commission should at least be able to live within their new guideline provision in 1988 (28.2 becu or 27.8 becu on a growth rate of 2/3 GNP) and preferably within the provision already in the PDB (27 becu) based on the (~~077~~ COM (87)101) proposals.

8. There is currently some 4.1 becu within the Commission's estimates for 1988 for expenditure on stocks. Officials reckon that some 2.1 becu of this will be needed to operate the policy of depreciating new stocks on entry (less, if the decision is delayed until part way through 1988). That leaves a potential further saving of 2 becu in 1988 if expenditure on existing stocks is taken outside the guideline either by a one off depreciation or by a smoothing exercise. If stocks expenditure is kept within the guideline but spread forward the additional saving might be 1 becu.

9. On the basis of these calculations the main options for stocks expenditure and the guideline might look as follows:

		base	growth rate	1988	treatment of stocks
(i) Community write off (excluding butter) or	(a)	26	GNP	27.2	outside
	(b)	26.5	66% GNP	27.4	outside
(ii) phasing (outside guideline, <u>including</u> special butter)	(a)	25.5	GNP	26.7	outside
	(b)	26	66% GNP	26.8	outside
(iii) phasing (inside guide-line = current Commission proposal)		26.9	GNP	28.2	inside

In the Chancellor's view any outcome on the guideline which is consistent with these parameters would be reasonable, assuming of course that we have made satisfactory progress on stabilisers, budgetary control and our other key objectives. In fact the pressures from virtually all the other Member States, except the Netherlands, are likely to be in favour of higher guideline figures.

10. The Chancellor has concluded that, if we are able to insert the idea of a Community financed one-off depreciation exercise into the discussions at this stage, it would have considerable merit both in political terms (i.e. the clean slate approach) and also financially, particularly if we succeed in achieving the Commission's fourth resource proposal, even ~~al~~though it would involve an IGA in 1988 of perhaps 2-3 becu higher than would otherwise be necessary. If, however, others are not prepared to accept this more imaginative approach, we should fall back to the options involving phasing expenditure <u>either</u> outside the guideline (if by so doing we can achieve the reductions suggested above) <u>or</u> inside the guideline (if we are unable to negotiate a reduction in the Commission's

figures). We should continue to resist any suggestion by others than the Commission's figures are themselves too low by drawing on the examples of potential savings listed in paragraph 7 above.

11. I am copying this to ~~[illegible]~~ Lyn Parker (FCO), Shirley Stagg (MAFF), Trevor Woolley (Cabinet Office), Roger Lavelle (Cabinet Office) and Sir David Hannay (UKREP).

~~A C S ALLAN~~ pp TAYLOR

017 1155

EC FINANCING REVIEW: AGRICULTURAL STOCKS

1. The Prime Minister has asked for further work to be done on the scope for a once for all operation to wipe the slate clean on existing agricultural stocks. (Mr Powell's letter of 20 November refers). This note considers various options for dealing with the problem. The financial implications both in EC Budget and UK PES terms are set out in the Annexe.

2. As explained in the Chancellor's minute of 16 November, in any discussions of the stocks problem we must distinguish carefully between three separate aspects:

(i) the necessary reduction in physical stocks to "normal" levels which the Commission have undertaken to achieve by 1992;

(ii) the systematic depreciation of new stocks on entry to prevent an overhang of expenditure commitments building up in the future; and

(iii) the treatment of the costs of disposing of existing undepreciated stocks.

This note is concerned with only the last of these, as any one-off write off should logically be confined to the accumulated costs of past policies not the ongoing costs of the new depreciation policy. Moreover, there is no necessary link between liquidating the costs of existing stocks and their physical disposal, which should remain for the Commission to organise in accordance with market factors.

Options

3. Under the present financing conventions the costs of depreciating existing stocks will fall to be paid to the Member States from the Community Budget as and when the stocks are sold or otherwise

disposed of. The only exception to this rule so far agreed relates to the costs of the special disposals of 1 million tonnes of butter in 1987 and 1988 which will be paid off in equal tranches over the four years starting in 1989. This special arrangement was agreed by the Agriculture Council in 1986 as part of the package of reforms in the dairy sector in recognition of the fact that the reduction in milk production then agreed would not result in significant savings to the Community Budget until 1989. Option 1 in the Annex sets out the financial implications of the traditional financing pattern at the time of physical disposal but taking account of the special arrangements for butter.

4. The other main options for dealing with this expenditure include:

(i) one-off depreciation at national expense (national write off);

(ii) one-off depreciation financed through the Community budget (Community write off); and

(iii) phased depreciation financed through the Community budget.

The following paragraphs consider each of these main options and a number of variants of each in turn.

National write off

5. The Foreign Secretary referred to the possibility of a national write off of existing stocks at the Foreign Affairs Council on 23 November. The suggestion did not meet with much enthusiasm from other delegations and, as foreshadowed in the Chancellor's minute of 16 November, was attacked by the Commission as being contrary to the principle of common financing of the CAP. Whilst the idea of a national write off has considerable attractions for the UK (not least in terms of financial savings compared with the alternative hypothesis of Community financing if this continues on the basis of VAT contributions), the financial attractions are

significantly reduced if special butter disposals are included (we have a relatively high share of butter stocks) and if (as we could hardly avoid) we have to find some way of compensating the Irish for their loss of receipts (perhaps through a special programme funded through the EAGGF Guidance Section). Moreover, pursuing this option further after its hostile initial reception at the Foreign Affairs Council would risk antagonising both the Dutch and the Danes, whose support we will need to retain on other aspects of the financing review, without much hope that we will in the end succeed in achieving our objective.

Community write off (Off-guideline)

6. Although the suggestion of national financing has not received a very encouraging reception, this does not exhaust the possibilities of wiping the slate clean. An alternative approach would be to agree to write down the value of the existing stocks at Community expense. The winners and losers in financial terms from a Community write off would be the reverse of those benefitting/losing from a national write off. The Spanish and Portuguese would gain somewhat from having the expenditure on existing stocks brought forward to 1988 as their gross contributions are abated by 55% in that year (but by lower percentages in later years), although they might still cavil at bearing any part of the cost. The Irish and Germans would gain substantially from increased EC receipts in 1988.

7. The major problem involved in a Community write off would be to find sufficient resources in the Budget. The one off costs in 1988 would amount to some 4 becu if special butter disposals are excluded and 7.2 becu if they are included. In practice given the foreseeable pressures on agricultural expenditure in 1988 the necessary finance could only be provided through an Intergovernmental Agreement (IGA) in addition to whatever own resources ceiling is agreed. Although an IGA for stocks would be presentationally unattractive, it need not perhaps be ruled out totally on that account: an IGA will almost certainly be needed in 1988 (as in 1985 following the Fontainebleau agreement) pending the ratification

of any new own resources decision. The financing key for an IGA would depend on the outcome of the financing review: if there is no change in the make up of own resources, VAT contribution rates would be the normal choice but, if the Commission's proposals for a fourth resource are accepted, the "diff tax" key would be the logical choice (as the marginal source of Community revenue). The choice of financing key is important in assessing the financial implications for the UK. As Annex A shows our preference, if we go down this route, should be for an IGA to cover the costs of depreciating stocks (excluding butter) on the diff tax key.

8. We should not of course consider the option of a write off at all, unless we are able to secure an appropriate reduction in the size of the financial guideline for future years. This reduction can be secured through an adjustment either to the base (of 26.9 becu) proposed by the Commission or to the GNP growth rate or a combination of the two. Officials have calculated that the adjustments required to justify a full write off of expenditure on all existing stocks (ie some 7.2 becu) either at national or Community expense would be as follows:

	base (becu)	+	growth rate
Commission proposal	26.9		GNP growth
	- 1.5		GNP growth
	- 1.0		66% GNP
	- 0.75		50% GNP
	- 0.50		30% GNP

Similarly, for a partial write off excluding the special butter disposals the trade offs would be:

Base	+	growth rate
- 1.0		GNP growth
- 0.75		85% GNP
- 0.5		66% GNP

We should arguably attach more importance to reducing the base for the guideline rather than the growth rate as this will have a greater effect on expenditure over the period to 1992. There is in any event a strong case for making a sizeable adjustment to the base for future years, if we are taking a significant element of expenditure outside the guideline. We should certainly start by suggesting a reduction of at least 1.5 becu in the 1987 base pointing out that by writing off expenditure on existing stocks it should be possible to reduce the Commission's unconstrained forecast of agricultural expenditure in 1988 by some 2 becu even after providing for the first year costs of the new depreciation policy for new stocks.

<u>Phased depreciation</u> (inside or outside guideline)

9. The third main option is to phase the costs of writing down existing stocks over the period to 1992. This has already been agreed in 1986 for the special butter disposals. The simplest approach would therefore be to extend this principle to all other existing stocks but to leave the present arrangements for butter to stand. The main advantage of this approach is that it would help to smooth out a peak of expenditure in 1988 which will arise under any of the other options. For this reason it should also make it more realistic to finance this expenditure within the guideline. It would also be possible to take a fixed profile of expenditure outside the guideline under this option, provided that we achieve the necessary adjustments to the guideline base and growth rate set out in paragraph 8 above.

10. The Spanish and Portuguese would object (with some reason) to further smoothing of this sort as their own resources refunds decline as the transitional period progresses and they would therefore be contributing more to stocks accumulated by others if this expenditure is deferred. Some sweetener would probably be needed. All member states would expect reimbursement of interest costs (at the current standard rates of 6% for Germany and the Netherlands and 7% for the rest), as was agreed for the butter disposals programme. This increases the cost of this option in undiscounted terms by comparison with the once off write off

approach. However, from the UK point of view spreading the costs is little different from the traditional financing profile over the period.

Conclusions

11. We conclude that our immediate priority should be to press the Commission for an adequate assessment of the financial implications for the Community Budget of the alternative options for dealing with expenditure on existing stocks. We should keep an open position with regard to the various options at this stage. Our final choice will depend crucially on the trade offs which may be negotiable with the base and growth rate for the guideline for any of the options which involve finance outside the guideline. Provisionally, however, our financial interest would seem to be best served by advocating

- a Community funded write off of existing stocks in 1988 provided that the guideline base is reduced by 1 becu (if butter disposals are included) and by 500 mecu (if butter is excluded) and the growth rate reduced to 66% GNP;

- taking a fixed profile of stocks expenditure outside the guideline if the same adjustments to be guidline limit can be achieved;

- financing existing stocks within the guideline by spreading the costs over a five year period.

HM Treasury
25 November 1987
015 1155

ANNEX A

OPTIONS FOR EXPENDITURE ON EXISTING STOCKS

	FEOGA expenditure (becu)					UK net contribution (£ million)	
	1988	1989	1990	1991	1992	VAT	Diff tax after abatements
Option 1 (traditional financing and 1986 butter disposals programme)	2.6	2.3	1.2	1.0	.9	75	-65
Option 2 (National write off)							
2A (all stocks)	.0	.0	.0	.0	.0	0	0
2B (all stocks & special programme for Ireland)	.8	.0	.0	.0	.0	35	30
2C (stocks excluding butter)	.0	1.0	.9	.9	.8	0	-70
2D (stocks excluding butter & special programme for Ireland)	.3	1.0	.9	.9	.8	15	-55
Option 3 (Community write off)							
3A (all stocks)	7.3	.1	.0	.0	.0	65	-55
3B (stocks excluding butter)	4.0	1.1	.9	.9	.8	65	-70
Option 4 (phasing)	1.0	2.0	1.9	1.9	1.8	95	-65

Key assumptions:

UK share of VAT contributions : 19%
diff tax contributions : 13%
existing stocks including butter : 17%
existing stocks excluding butter : 13%

NB (i) precise rate of diff tax will be variable depending on overall own resources total and the limit on VAT contributions and the abatement methodology has yet to be decided.

(ii) UK PES figures show cumulative effect on net contribution over the period 1987-88 to 1992-93 discounted by 5 per cent per year.

The Hague, November 27, 1987

MINISTER
VAN
FINANCIËN

nr. 387-11062

The Right Honourable Nigel Lawson, MP.
Chancellor of the Exchequer
H.M.Treasury,
Great George Street
GB-London SW1P 3AG

CH/EXCHEQUER
REC. 27 NOV 1987
ACTION MR A J C EDWARDS
COPIES TO PS/PMG
SIR G. LITTLER
MR MORTIMER
MR MERCER
MR PARKINSON

At first sight, a good point.

Dear Nigel,

For the next Ecofin Council the Danish presidency is planning to place a proposal for a directive on information to be published on major holdings in listed companies on the agenda.

The Federal Republic and the Netherlands are very much opposed to such a directive. The delegations of the UK and the other Member States appear to be in favour of the idea. I find this very worrying indeed. It is not so much that I dislike the idea of being compelled to introduce new legislation. After all, that is one of the consequences of being a member of the E.C.
The reason for my concern over this particular proposal lies in the fact that the Commission is seeking harmonisation of national securities regulations which have nothing to do with either the internal or the common market. It is my conviction that the adoption of the directive at hand will stimulate the Commission to conceive further proposals in the securities field which bear no relation at all to the need for European integration.
This would not serve the interests of the UK and the Netherlands.
It is therefore my sincere hope that you would be amenable to taking the British view on this directive into reconsideration.

Best personal regards

Onno Ruding

H.Onno Ruding

010074
MDHIAN 8359

There must be collective discussion of this RM @ an early date. (I ~~have~~ would prefer @ Cabinet)

This [illegible] discussion

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FRAME INDUSTRIAL
INTERNAL MARKET COUNCIL, 30 NOVEMBER
MERGER CONTROL REGULATION

SUMMARY

1. IN THE LIGHT OF UNWILLINGNESS FROM FRANCE AND THE UK EXPLICITLY TO AGREE THE PRINCIPLE OF A REGULATION, SUTHERLAND DID NOT PRESS FOR WRITTEN COUNCIL CONCLUSIONS. ALL OTHER MINISTERS COULD SUPPORT A REGULATION, THOUGH MANY EXPRESSED CONCERN OVER ITS SCOPE AND THE CRITERIA FOR DECISIONS. CONCLUSION THAT DETAILED EXAMINATION OF PROPOSALS SHOULD BE RESUMED WITH A VIEW TO EARLIEST POSSIBLE AGREEMENT, AND A PROGRESS REPORT TO THE INTERNAL MARKET COUNCIL UNDER THE GERMAN PRESIDENCY.

DETAIL

2. PRELIMINARY DISCUSSION IN THE MARGINS AND OVER LUNCH CONFIRMED THAT THE FRENCH POSITION WAS THE SAME AS THAT OF THE UK IN RESISTING AN EXPLICIT AGREEMENT TO THE PRINCIPLE OF A REGULATION: AND THAT SUTHERLAND (COMMISSION), THOUGH INIIALLY UNHAPPY, HAD DECIDED TO MAKE THE BEST OF THE SITUATION.

3. AT THE COUNCIL, SUTHERLAND STRESSED THE IMPORTANCE OF A REGULATION FOR THE COMPLETION OF THE INTERNAL MARKET AND THE NEED FOR A POSITIVE SIGNAL FROM MEMBER STATES THAT THERE WAS A REASONABLE PROSPECT THAT A REGULATION WOULD BE ADOPTED. INTENSE DISCUSSIONS WITH MEMBER STATES SINCE THE 5 OCTOBER IMC HAD SHOWN A GENERAL OPEN-MINDEDNESS ON THE KEY PRINCIPLES, BUT A NUMBER OF TECHNICAL CONCERNS REMAINED. THE KEY ISSUES WERE THAT A REGULATION SHOULD COVER ONLY MAJOR MERGERS WITH AN EC DIMENSION, TO PREVENT THE CREATION OR ENLARGEMENT OF DOMINANT POSITIONS: THE NEED FOR LEGAL CERTAINTY FOR COMPANIES, WHICH REQUIRED TIGHT DECISION DEADLINES AND PRENOTIFICATION OF MERGERS: EXEMPTIONS BASED ON ARTICLE 85(3) OF THE TREATY USING THE CRITERIA DEVELOPED IN CONSULTATION WITH MEMBER STATES AND APPROVED BY THE COURT: AND INVOLVEMENT OF MEMBER STATES IN DECISION-MAKING. ON THIS BASIS, IT SHOULD BE POSSIBLE FOR THE COUNCIL TO ADOPT A REGULATION AT AN EARLY DATE.

4. SCHLECHT (GERMANY) STRONGLY FAVOURED AN EC-LEVEL REGULATION BASED ON CLEAR COMPETITION PRINCIPLES: IT WAS URGENT FOR THE INTERNAL MARKET. THE GERMAN PRESIDENCY WOULD DO ALL IT COULD TO FACILITATE PROGRESS.

5. BOSSON (FRANCE) WAS UNABLE TO AGREE IN PRINCIPLE TO A REGULATION, BUT DID NOT OPPOSE ONE A PRIORI. FRANCE COULD CONTRIBUTE POSITIVELY IF THE COMMISSION PUT FORWARD NEW PROPOSALS. MR MAUDE TOOK A SIMILAR LINE: WHILE NOT IN ANY WAY HOSTILE, HE COULD NOT GIVE AN UNQUALIFIED YES TO THE PRINCIPLE OF A REGULATION WITHOUT ADDRESSING THE CONTENTS OF THE CURRENT PROPOSALS, WHICH WERE TOO BROAD IN SCOPE SINCE THEY WERE NOT LIMITED TO MAJOR EC-SCALE MERGERS: AND PROVIDED FOR UP TO 12 MONTHS FOR DECISION-MAKING, WHICH WAS FAR TOO LONG TO BE OF VALUE IN PROVIDING CERTAINTY FOR COMPANIES. THE UK WOULD BE HAPPY TO PARTICIPATE CONSTRUCTIVELY IN FURTHER DISCUSSIONS ON A REVISED PROPOSAL, BUT IF PRESSED TO GIVE A VIEW IN PRINCIPLE NOW WOULD HAVE TO SAY NO.

6. VAN DER LINDEN (NETHERLANDS) WELCOMED SUTHERLAND'S APPROACH, BUT WANTED TO STUDY THE DETAILS CAREFULLY, PARTICULARLY ON THE OBJECTIVES OF A REGULATION, THE DEGREE OF LEGAL CERTAINTY AND THE SPEED OF DECISION-MAKING. BUT HIS INITIAL VIEW WAS FAVOURABLE. LAHURE (LUXEMBOURG) STRESSED THE IMPORTANCE FOR THE INTERNAL MARKET OF CLEAR RULES ON MERGERS. BRENNAN (IRELAND) AND LEPOIVRE (BELGIUM) WERE SIMILARLY POSITIVE, AS WAS MARTINS (PORTUGAL), WHO HOWEVER ADDED THAT IT SHOULD NOT HINDER SMALLER NATIONAL MERGERS NEEDED FOR INDUSTRIAL RESTRUCTURING. CASANOVA (SPAIN) ALSO AGREED IN PRINCIPLE, BUT STRESSED THAT IT MUST NOT CREATE PROBLEMS FOR FOREIGN INVESTMENT IN SPAIN. DECISION-MAKING ON MARKET-SENSITIVE ISSUES WOULD ALSO NEED CARE. LYMBEROPOULOS (GREECE) ACCEPTED THE PRINCIPLE, BUT SAI^ EXEMPTION CRITERIA AND THE OVERLAP WITH NATIONAL LEGISLATION SHOULD BE CLARIFIED. THE THRESHOLD FOR PRE-NOTIFICATION WOULD ALSO NEED EXAMINATION.

7. PERGOLA (ITALY) RECOGNISED THE NEED FOR A COMMUNITY-LEVEL MEASURE BUT POINTED TO A NUMBER OF AREAS OF CONCERN: THE RELATIONSHIP WITH NATIONAL MEASURES AND THE TREATMENT OF PURELY LOCAL DOMINANT POSITIONS: THE NEED TO CONFINE THE SCOPE OF MERGERS AFFECTING COMPETITION IN ONE SECTOR AND EXCLUDE CONGLOMERATE MERGERS: DETAILED CLARIFICATION OF EXEMPTION CRITERIA AND THE LEVEL OF THRESHOLDS: THE NEED FOR GUARANTEES OF THE FINAL JUDGE'S IMPARTIALITY AND THE ISSUE OF HOW TO INVOLVE MEMBER STATES IN DECISION MAKING. AN OUTRIGHT BAN ON A PROPOSED MERGER SHOULD BE A MEASURE OF LAST RESORT AFTER NEGOTIATION BETWEEN THE COMMISSION AND

THE PARTIES HAD FAILED TO RESOLVE PROBLEMS. ALL THIS ENTAILED A DETAILED AND POSSIBLY PROLONGED DISCUSSION WITH INDUSTRY, THE LEGAL PROFESSION AND COMMUNITY INSTITUTIONS.

8. SUTHERLAND REPLIED THAT HE COULD UNDERSTAND THOSE MEMBER STATES WITH RESERVES ON THE FINAL OUTCOME AND ADMITTED HIS APPROACH HAD BEEN UNUSUAL. BUT ALL MEMBER STATES HAD RECOGNISED THE NEED FOR A GENUINE DEBATE AND HE WAS SATISFIED WITH THE GENERALLY POSITIVE VIEWS EXPRESSED. THE COUNCIL'S CONCLUSIONS WOULD NO DOUBT REFLECT THIS AND HE WELCOMED GERMANY'S COMMITMENT TO HAVING A PROGRESS REPORT TO THE IMC DURING THEIR PRESIDENCY.

9. DYREMOSE (PRESIDENCY) ALSO CONCLUDED THAT RESPONSES HAD BEEN GENERALLY POSITIVE. DETAILED DISCUSSIONS SHOULD CONTINUE WITH THE AIM OF REACHING THE EARLIEST POSSIBLE CONCLUSIONS.

HANNAY

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EUROPEAN COUNCIL

7.5

CONFIDENTIAL

FROM: A J C EDWARDS
DATE: 24 November 1987

CHANCELLOR

cc: Paymaster General
Sir P Middleton
Sir G Littler
Mr Bonney
Mr Mortimer
Mr Mercer
Mr Donnelly
Mr C Evans
Mr Tyrie

EUROPEAN COUNCIL AND FUTURE FINANCING

I understand that you may have an opportunity tomorrow to discuss the future financing dossier briefly with the Prime Minister.

In preparation for this, you may like to know that we and others are planning to produce the following further notes on major issues in the course of this week:

(i) a report by Sir Geoffrey Howe to the Prime Minister on the Foreign Affairs Council just ended;

(ii) an interdepartmental note as requested by OD(E), mainly based on our own work here, about possible fallback positions on the structural funds, which Mr Lavelle will invite Sir Geoffrey Howe to send forward to the Prime Minister;

(iii) notes by the Treasury on (a) the agricultural stocks/ expenditure guideline problem (where the Commission and a number of other member states gave a predictably hostile response at the Foreign Affairs Council to the Prime Minister's idea of a national write-off), as requested by the Prime Minister, and (b) exceptional