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CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

EEC BUDGET: POST STRASBOURG STRATEGY

Memorandum by the Chancellor of the Exchequer

The outcome of the European Council was satisfactory for the UK. Some other members of the Community are still not fully ready to concede our case and act on it. All of them underestimate the scale of action required. But a procedure and a remit to the Commission were accepted which can lead to favourable decisions at the next European Council at Dublin.

2. But there is still a lot for us to do, and not much time in which to do it. We have the opportunity: we must now decide what we want, and how we can best go about getting it.

3. As to what we want, I suggest that we should be guided by the following principles:

(a) We need a solution which is automatic, rapidly effective, and on an adequate scale. The note by officials, below, makes it clear that such a solution can only take the form of a corrective mechanism, which will automatically give us a substantial refund after the end of each year. The solution must also be durable. Although it may suit us to present our requirements as "interim", until Community policies themselves result in a sensible outcome, we should not in fact be prepared to accept any solution that does not last as long as the problem, or which has in it the sort of time limit contained in the present Financial Mechanism.

(b) We are looking for a solution which removes the inequity of our present Budget contribution. An appeal to equity is our most powerful argument. We should not as yet precisely define our ultimate aims in terms of money. We have to recognise that other members will try to minimize the cost of any solution, which they will have to meet, particularly with enlargement in mind. They will therefore want only to reduce, not to eliminate, our net contributions. We can only judge at a later stage how much adjustment will be acceptable to us, and we should not expose our hand as yet. But it is clear that the figures at present in the minds of our partners are far too low. To correct this we need to establish a negotiating position which compels them to contemplate corrective action on a scale far exceeding anything they have so far envisaged. Our starting point could be that Member States with below average GNP per head should ideally be net recipients. We ought then to insist that the effects of the Budget should at least be broadly neutral for a country in our position.

(c) The remit from the European Council asks us to put forward concrete requests at the ECO/FIN Council when the Commission's "reference paper" is available. The demand for "concrete requests" was made at German insistence. It is now essential that we should go some way further than hitherto in telling our partners and the Commission what we have in mind. We must therefore dispel the notion that our problem in 1980 and the immediately following years can be solved by any foreseeable adjustments to the CAP, by increases in the net benefits which we currently gain from the various Community funds, or by minor adjustments to the present Financial Mechanism. A corrective mechanism, adequate to deal with the adverse financial consequences arising from both our excessive gross contribution and our inadequate receipts, is the only solution likely to be effective in the time scale needed. It is unlikely that this approach will be explicitly endorsed at the ECO/FIN Council, but the objective must be to get agreement that an unacceptable situation exists, and that the Commission should produce proposals which will be effective immediately.

The partner countries may well react adversely against the idea of a new kind of corrective mechanism, or against anything other than minor tinkering with the existing Financial Mechanism. But this risk will have to be faced sometime in any case. We cannot rely on the Commission to produce the right proposals unless the idea of a radical corrective mechanism is in the air by the time of the ECO/FIN Council discussion.

(d) We need not at this stage be precise as to the form the corrective mechanism might take, so long as it is clear in any discussion that it will have the effect of transforming the UK's Budget contribution.

(e) Italy is a special problem. The Italians have been very helpful allies in getting the whole exercise to the present point. We want to maintain this alliance and so do they. But whilst we have been concentrating increasingly on our net budgetary contribution, they have been stressing the resource losses they suffer as a result of the CAP in its present form. For a solution they are looking either to measures (like compensation for tariff concessions on Mediterranean agricultural products) which have no bearing on the UK problem and are contrary to our interest or to additional Community expenditure. It may be possible to negotiate a corrective mechanism for ourselves and for Italy to be helped in other ways. We should certainly encourage them in the thought that we should continue to consult and support each other, though the eventual solutions may be different for each of us. But in the meantime we should be wary of too close involvement in Italian solutions.

(f) Finally, we may increasingly encounter suggestions that any corrective mechanism for the UK should be part of some "wider arrangement", in which we would be expected to make counter-concessions of some kind. Any fully satisfactory solution to our budgetary problem is bound to be financially painful to our partners, and they will no doubt want to be able to point to progress in other fields to help them to sell any concessions on the Budget to their domestic audiences. But although we should not reject suggestions that the European Council might deal with issues other than the Budget if they are ripe for decision, we should avoid any explicit linkage, and should continue to insist that, for the sake both of the UK and of the Community, the need to solve the budget problem is urgent.

4. On tactics and timing, there are two immediate needs.

5. First, I believe we should press for the Commission study to be completed as soon as possible. It is, unfortunately, too much to expect that the work can be carried very far by the time of the July Finance Council, if only because the necessary forecast of net transfers in 1980 must await the draft 1980 budget figures which will not be established until the Budget Council on 23 July. There follows the holiday season, and there is no August Finance Council. But it is most desirable that the Commission should have completed as much of its work as possible in time for the September Council. The Prime Minister has urged this on the President of the Commission. He used the argument that it might not be wise to give too much time for member governments to take up hard positions, and get at the Commission's suggested solution. But he agreed that he would do his best to get his reference paper, at least, to the Finance Council in September, though his proposals for remedies would be likely to follow in October. We should continue to urge that this September/October timetable should not slip. Meanwhile, we must ensure that the July Finance Council does not attempt to produce "guidelines" which would dilute or unbalance the conclusions of the Strasbourg European Council.

6 Second, it is vital that we organise a programme of bilateral approaches, based on the principles in paragraph 3 above. This should start at once and should take place at both official and ministerial level. The Foreign Affairs Council on 24 July, for example, would provide the Foreign Secretary with an opportunity, which we should on no account miss, to discuss our problem and the possible solutions to it with the President of the Commission. The aim of these discussions would be to make clear to our partners the scale

of relief that we regard as necessary. In talking to the Commission we should also, at an appropriate stage and keeping all options open, discuss the mechanisms referred to in paragraph 7 below and in the annex to this note, so that the Commission's proposals can encompass them.

7. As background to this note, I attach a summary of the material on options which was covered in greater detail in the papers circulated as OD(E)(79)19. This briefly rehearses (in paragraph 14) the four forms of corrective mechanism which we have already identified:- radical reform of the existing Financial Mechanism; an enhanced receipts mechanism; an override mechanism acting directly on our net contribution; and a hybrid mechanism incorporating elements of the first two approaches.

8. I invite my colleagues:

(a) to endorse the principles which I have suggested in paragraph 3 above;

(b) to endorse the proposals on tactics and timing in paragraphs 5 and 6 above; and

(c) to agree that we should immediately set in hand a programme of bi-lateral contacts on the lines set out in paragraph 6 above.

(G.H.)

HM TREASURY
5 July 1979

ANNEX A

EEC BUDGET: POST STRASBOURG STRATEGY

Calendar of relevant events

5/6 July	Anglo/German Economic talks (officials)
11 July	Foreign and Commonwealth Secretary's visit to Dublin
July/early September	French Foreign Minister's visit to London
23 July	Budget Council (establishment of draft Budget)
23/24 July	Foreign Affairs Council
17 September	Finance Council
17 September	Foreign Affairs Council
15 October	Finance Council
20/21 October	Informal meeting of Foreign Ministers
29/30 October	Foreign Affairs Council
early November	Anglo/German Summit
mid November	Anglo/French Summit
19 November	Finance Council
26/27 November	Foreign Affairs Council
29/30 November	European Council (Dublin)

ANNEX B

REDUCING THE UK'S NET CONTRIBUTION TO THE COMMUNITY BUDGET: AN ASSESSMENT OF POSSIBLE APPROACHES

NOTE BY OFFICIALS

This note outlines various possible methods of reducing the UK's net contribution to the Community Budget to a tolerable level, considers their merits and drawbacks, and comments on their likely acceptability to other Member States.

THE NATURE OF THE UK PROBLEM

2. It is the UK's net budgetary contribution that is the problem. Its gross contribution, which will in 1980 amount to about 20 per cent of total Community revenue, is considerably greater than its share (about 15 per cent of the Community's total gross national product (Community GDP). But still more important as a cause of its excessive net contribution is the low level of Community expenditure in the UK - only 8 per cent of the total. Because of this, the UK receives only 16 EUA per head gross from Community policies, as against a Community-wide average of 44 EUA per head.

INCREASING COMMUNITY EXPENDITURE ON POLICIES OF NET BENEFIT TO THE UK

3. As the table below shows, the main reason for the low level of UK receipts is the predominance of CAP expenditure in the Community Budget. As a major food importer, contributing only marginally to the Community's agricultural surpluses, the UK can recoup only a small proportion of its contribution to the cost of the CAP.

	Share of Budget* %	Share of expenditure+ incurred in UK %
CAP Guarantee	69	3
CAP Guidance	4	14
Social Fund	5	33
Regional Fund	5	27
Own Resources Refunds	5	19
Other	12	not available

* Based on 1978 Budget Commitments

\+ Based on 1977 Budget Expenditure

4. Some Member States argue that the right, "communautaire", way to reduce the UK's net contribution is to extend the range of Community activity and to increase Community expenditure on policies which yield a new benefit to the UK. Closer study shows, however, that this approach cannot provide more than a partial and relatively inefficient solution. It requires most extreme assumptions, well beyond the bounds of possibility, even to halve the UK's present net contribution by this route.

5. The category of Community expenditure from which the UK normally benefits least is the CAP Guarantee Section (3 per cent of total expenditure). At the other end of the scale comes the Quota Section of the Regional Development Fund, in which it has a guaranteed share of 27 per cent (its share of Social Fund receipts fluctuates considerably). If expenditure from the Guarantee Section of the CAP were reduced by 25 per cent and the funds reallocated en bloc to the Quota Section of the RDF, the UK's net contribution in 1978 would have been £315 million lower. This is a significant sum. But the assumptions needed to produce it are quite unrealistic.

6. From a UK point of view the approach is not effective, as the benefit to the UK would accrue slowly, in proportion to the excess of its receipts over its marginal share in contributions. The additional expenditure would arise under policies applicable to all Member

States. There is no obvious field which is both large enough to yield significant benefits to the UK, and narrow enough to yield little for the other Member States, including the acceding countries.

THE NECESSITY FOR A CORRECTIVE MECHANISM

7. There is therefore no prospect of solving the UK's budgetary problem in the foreseeable future by changes in existing Community policies, or the development of new ones.

8. Likewise, there is no question of altering significantly the present Own Resources System, which is embodied in the Treaty and formally accepted by the UK. There are historical and legal reasons for the proceeds of customs duties and agricultural levies belonging to the Community. The Commission has put forward proposals for complementing the VAT element in Own Resources by a more progressive tax related to ability to pay, but only as part of a plan to increase Own Resources once the present 1 per cent ceiling on VAT contributions is reached. The idea has in any case met with strong resistance from many Member States. The decisions on farm prices taken at the last Agricultural Council may bring forward the debate in the Community on the need for additional revenue and some Member States may argue that this issue and the question of the UK's contribution should be considered together. The UK should try to prevent this connection being made, but it is of course true that the bigger the refund to the UK the more difficult it will be to finance it from a Budget constrained by the 1 per cent ceiling.

9. The conclusion is inescapable that the UK's net contribution can only be reduced substantially in the short-term by means of a "corrective mechanism", operating directly to override the financial effects of present policies and to refund some or all of our excessive net contribution. Presentationally, however, it would no doubt be prudent to describe such a mechanism as lasting only until the evolution of Community policies itself provided a remedy. This would accord with the spirit of a proposition endorsed by the Six during the

UK's entry negotiations. In a Commission Communication entitled "The Financial Arrangements in an enlarged Community" they acknowledged that "should unacceptable situations arise within the present Community or an Enlarged Community, the very survival of the Community would demand that the Institutions find equitable solutions".

THE 1974-75 FINANCIAL MECHANISM

10. The principle of a corrective mechanism was established with the Financial Mechanism, negotiated by the previous Administration in 1974-75. This mechanism is directed solely at a Member State's <u>gross</u> contribution. If, on the basis of a number of specified criteria, this is adjudged excessive, the mechanism provides for a partial refund of the excess in the following year.

11. The criteria were carefully designed to ensure that only the UK was ever likelyto qualify. To qualify for a refund, a Member State has to satisfy all the following conditions:-

a. Based on the average of the 3 immediately preceding years,

i. its per capita GNP must be less than 85 per cent of the Community average; and

ii. the rate of growth of its per capita GNP in real terms must be less than 120 per cent of the Community average.

b. Its gross contribution to the Budget as a proportion to total Community revenues must exceed by 10 per cent or more its share in Community GNP.

12. The size of the refund depends on the Member State's balance of payments performance over the three immediately preceding years. If there is a net deficit on current account over this period, the refund is very much larger than if there is a surplus. Even if this balance of payments criterion is met, there are several other provisions which limit any refund. Amongst the most important are:

i. the tranche system, under which any excess contribution of up to 30 per cent over a Member State's share of Community GNP is refunded only in part;

ii. the overall ceiling on refunds, limiting the total amount paid to 3 per cent of the total Budget; and

iii. a ceiling on payments to individual Member States, which may not exceed the lower of two quantities: the Member State's "net transfer" to the Community in the current year (i.e. roughly its net contribution to the Budget) and the VAT component of its Own Resources contribution. In calculating the "net transfer" Monetary Compensatory Amounts (MCAs) paid by other Member States on goods exported to the Member State in question are counted as receipts.

13. These restrictions, together with the fact that it is concerned only with an excessive <u>gross</u> contribution, mean that the Financial Mechanism in its present form cannot meet the UK's needs. At best it might give us a gross rebate of about £290m a year even if we satisfied the balance of payments criterion. The net refund, after deducting our own contribution to the cost, would be around £240m. And if we failed to satisfy the balance of payments condition even the gross refund would be negligible, at perhaps £30m.

POSSIBILITIES FOR A NEW CORRECTIVE MECHANISM

14. The possibilities for a new mechanism are:

i. a radically improved Financial Mechanism. A list of possible improvements to the Financial Mechanism, ranked in approximate order of importance is annexed to this note, together with a chart illustrating the cumulative impact of the various changes suggested. It might be possible to negotiate the removal of the first three limitations listed, since they would leave intact the concept of a Mechanism directed at gross contributions. But as the chart shows this would only yield a refund of about £550m gross (£450m net). (This explains French interest in the idea, which they no doubt see as possible ready means of buying off UK pressure at limited cost.) £450m is a substantial sum, but it is not enough to meet UK needs. By introducing progressivity into the Mechanism and abolishing the other constraints it would in theory be possible to produce a refund of whatever size was desired. But this approach effectively abandons the original concept of a Mechanism to correct an excessive gross contribution, and would be very hard to negotiate.

ii. A mechanism designed to increase gross receipts from the Community Budget, irrespective of the effect of Community policies; for example a rebate calculated to raise our gross receipts per head arbitrarily from the present level of 16.1 EUA to the current Community average of 44 EUA. Full receipts equalisation for the UK on these lines would produce a rebate of £1,000 million per year. Anything of this magnitude is unlikely to be negotiable, but the figure indicates the potential of this approach.

iii. A mechanism designed to operate on both the gross contribution and the receipts side, e.g. the existing financial mechanism with the first three constraints removed and an enhanced receipts mechanism designed to bring our receipts up to the level of our share of community GNP;

iv. Finally, a straightforward rule limiting the UK's net contribution and laying down a procedure for making good the consequent shortfall in Community revenues. This would be the most direct solution, but might be even more difficult to negotiate than (i) to (iii) above.

NEGOTIATING CONSIDERATIONS

15. A number of points must be borne in mind, as follows:

i. Total Cost

16. The total cost of the mechanism to other Member States should be minimised so far as this is consistent with our own objectives. This points to a measure providing relief only to Member States which are net contributors to the Community Budget and whose GNP per head is below the Community average.

ii. Incidence of Cost

17. The distribution of the cost to other Member States will be important. In principle the method of financing is separable from the choice of mechanism. The mechanism might be financed under special provisions outside the Budget or through the Budget in proportion to Members' VAT bases.

18. Naturally the costs will not be welcome, whatever the method. And the choice of method will be complicated by the discrepancy between resource costs and budgetary costs. This issue would arise particularly in relation to one financing possibility, namely that above average

recipients should return a proportion of their receipts. By financing refunds outside the Community Budget, this would avoid the problem posed by the Own Resources ceiling (see paragraph 8 above). It would place a greater burden on Denmark, the Netherlands and Belgium, who are the largest net recipients.

19. The Danes and Belgians would be particularly resistant. They argue that net budgetary receipts are not an accurate guide to the resource transfers that arise from Community policies. The Danes say that all Community producers benefit from the export refunds which enable Danish farmers to sell their agricultural products in third countries rather than within the Community. The Belgians argue that they do not benefit from the cost of the Brussels bureaucracy. All the other Member States deny that they benefit from the UK and Italian MCAs which they administer. So the argument will not be plain sailing.

20. The main alternative would be to finance the refund one year in arrears in line with Member States' contributions to the VAT element of Own Resources, as with the present financial mechanism. Financing on this basis could be either within the Community Budget or outside it. The question would arise whether the UK should contribute towards its refund, as in the case of the Financial Mechanism, or not, as with the EMS Interest Rate Subsidy scheme. The principal contributors would be Germany and France. This might be the least unacceptable solution at the end of the day.

iii. Vulnerability to erosion

21. The net benefit to the UK from the various mechanisms would be sensitive to the detailed provisions. Limiting the benefits to those with net budget contributions (paragraph 16 above) would help to ensure that the UK remained a net beneficiary after enlargement, though on this criterion Portugal might also qualify.

iv. Defining the aims

22. In order to preserve UK interest in Community policy developments

and budget probity - which in a sense would disappear if the financial effects of policies were to be blanketed by an override mechanism - other Member States would want the mechanism to avoid a situation in which the UK marginal contribution to any additional Community expenditure approached zero. They would want it only to reduce, not to eliminate, the unadjusted net contribution. This has a bearing on the precise definition of the UK aim.

v. Presentation

23. The other countries may find it preferable to describe an agreed outcome as an amendment to the existing Financial Mechanism, even if we in the end opt for the very different solutions in paragraphs 14(ii) to (iv) above.

vi. Coverage

24. The mechanisms outlined above deal only with the UK's net budgetary transfers to the Community and not with the wider resource costs of the CAP. Only the net budgetary figures are readily available. We may assume that it would be impossible to reach agreement with other Member States on quantifying the resource costs or on how they should be offset, though as indicated above, the Danes might seek to divert the argument in this direction for their own ends. Fortunately, in 1977 and 1978, the UK's net budgetary contribution was a reasonable minimum assessment of its net resource loss, provided that the MCAs paid on UK imports are attributed to the exporting country.

CONCLUSIONS

25. This paper has shown that in the foreseeable future there is no prospect of an adequate solution to the UK's budgetary problem through a restructuring and expansion of the Community Budget. Nor can the present Financial Mechanism afford more than marginal relief. A new corrective mechanism of some kind will be a necessary constituent of an satisfactory solution.

26. This paper has set out four possible lines on which a corrective mechanism might be constructed. All four models are capable of variation. Types (ii), (iii) and (iv) could be tailored to yield any specifically desired outcome. The Financial Mechanism can in principle be tailored with every chance of reaching a substantial outcome of the required order, but, as it embodies a series of tests, cannot be set up with a single specific figure as its aim. Any eventual solution may well involve a combination of these approaches.

27. The quetion of the type of mechanism is separable from its financing.

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APPENDIX

POSSIBLE IMPROVEMENTS TO THE FINANCIAL MECHANISM

The following list shows, in approximate order of importance, the various improvements to the Financial Mechanism that would be of benefit to the UK:

i. Removal of the balance of payments limitation;

ii. abolition of the 3% ceiling;

iii. abolition of the tranche system;

iv. introduction of an element of progressivity into the calculation of excess contributions;

v. removal of provision limiting refunds to VAT contributions;

vi. removal of the provision attributing exporter-pays MCAs as UK receipts;

vii. introduction of a further element of progressivity;

viii. abolition of net contribution ceiling on refunds.

Note:

. For a more detailed explanation of the effects of these various measures, and in particular for a description of the progressivity elements mentioned in (iv) and (vii) above, see the Note by H M Treasury "The European Communities' Financial Mechanism" attached as Annex C to OD(E)(79)19.

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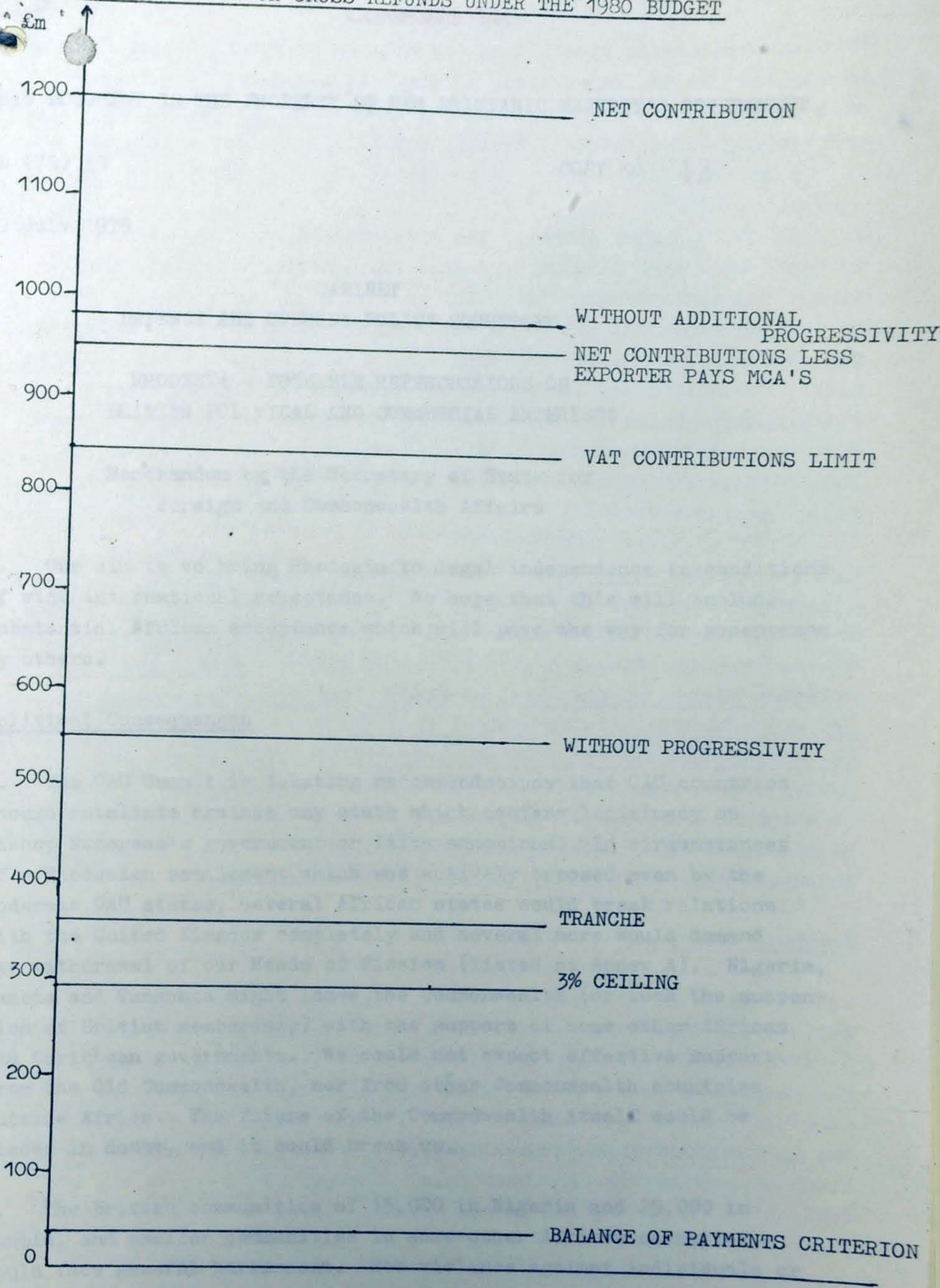
RESTRAINTS ON UK GROSS REFUNDS UNDER THE 1980 BUDGET



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