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DEFENCE AND OVERSEA POLICY COMMITTEE

UK COMMUNITY BUDGET CONTRIBUTION : CORRECTIVE MECHANISMS

Note by the Secretaries

The attached Note by Officials is circulated in accordance with the Committee's instructions (OD(79)6th Meeting, Conclusion 2).

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Cabinet Office
27 September 1979

UK COMMUNITY BUDGET CONTRIBUTION : CORRECTIVE MECHANISMS

Note by Officials

At OD(79)6th Meeting, officials were instructed to report urgently on the method or methods which could best be relied upon to achieve broad balance in the United Kingdom's net contribution to the Community Budget, to show how they would work in practice, and to assess their merits and demerits. Net contributions to and receipts from the Community Budget of member states are shown in Table 1 below. The contributions and receipts figures in Table 1 and throughout this Note are taken from the Commission Reference Paper and relate to 1980. The figures for later years would be different and probably larger than those shown.

Table 1 : Net Transfers to (–) or Receipts from (+) the Community Budget in 1980

		B	DK	G	F	IRL	I	L	N	UK
Net Transfers in 1980	(a)*	+538	+283	–1107	–120	+436	+871	+292	+359	–1552
	(b)	+550	+370	–1048	– 19	+513	+734	+292	+422	–1814

*Note

(a) If United Kingdom and Italian import Monetary Compensatory Amounts (MCAs) are attributed as a benefit to the United Kingdom and Italy ("importer pays").

(b) If United Kingdom and Italian import MCAs are attributed as a benefit to the exporter ("exporter pays").

The Reference Paper supports version (a); we support version (b).

2. As indicated at the ECOFIN Council on 18 September we do not believe that our requirements can be met without a corrective mechanism. Those requirements can be formulated as follows:-

a. deal with both excess contributions and inadequate receipts and thus produce broad balance;

b. apply immediately, ie to the 1980 Budget;

c. last as long as our problem lasts and remain effective in the future even if there are major changes in the growth and pattern of Community expenditure and revenue;

d. not involve major increases in the Community Budget.

3. As against our objectives, other member states will be looking for as small an adjustment as possible. They will also have other requirements which we shall need to take into account. They (and the Commission) will object to our getting a 100 per cent refund of our net contribution irrespective of the size of the budget because we would then have no financial interest in the future development of Community policies, existing or prospective. There may also be objection to any refund exceeding our VAT contribution (1,400-1,500 MEUAs in 1980). Otherwise, we would be paying less than the total amount of our customs duties and levies, which they argue would be inconsistent with the concept of a customs union. In addition, Germany in particular will wish to negotiate a solution which does not involve a breach of the 1 per cent Own Resources ceiling (although there could be other countries like Denmark, Holland and Ireland who would take the opposite view, ie that in order to ensure the future of the Common Agricultural Policy (CAP) we should be ready to increase the 1 per cent ceiling). The Italians and the Irish, as less prosperous countries, will not want to contribute to the solution to our problem. France will want to preserve as far as possible her historic position as being a net beneficiary from the budget.

4. With these considerations in mind this note discusses the three main aspects to any mechanism: the conditions under which a member state would qualify, the nature of the mechanism itself, and the way in which it would be financed.

QUALIFYING CONDITIONS

5. What distinguishes the United Kingdom from other member states is that we both have a below-average GNP per head and are a net contributor. Germany (and France) have a GNP well above the Community average and Italy and Ireland are net beneficiaries. The three acceding states not covered by the Commission reference paper - Greece, Spain and Portugal - are not expected to be net contributors. The adoption of this double criterion would thus be a simple way of meeting the objective of limiting the benefit to the United Kingdom. To eliminate the possibility that unusual economic conditions in any one year could exclude us, the GNP per head criterion might be based on the average for the previous three years (averaging has already been incorporated in the Financial Mechanism.)

6. It is unlikely that in the foreseeable future United Kingdom GNP per head will rise above the Community average. Consequently, it would not be worth a great deal of negotiating capital in order to insure against this. As Table 2 shows, we are only close to the average even in an enlarged Community if the comparison is made on the basis of purchasing power parity (PPP) rather than market exchange rates, and we expect to be able to resist any suggestion that the comparison should be made in these terms. However, we would not wish to be disqualified if United Kingdom GNP per head were to rise above the Community average (and we were still large net contributors) particularly if this arose from a drastic decline in other countries growth rates or a sustained further appreciation of sterling rather than a genuine improvement in United Kingdom economic performance. The best way to provide for this contingency would probably be to provide that relief could only be phased out over a period of, say, three years. Combined with the averaging arrangements described in paragraph 6 above, this would ensure that once the United Kingdom had qualified for a refund, we could be sure that we should not be making a full net contribution for at least 4-5 years after we had ceased to be below average in GNP per head.

Table 2 : GNP per head as per cent of EC average (sensitivities for United Kingdom)

United Kingdom GDP per head as per cent of EC average on various assumptions 1980

		EC 9	EC 12
Market exchange rates	1978	73	81
at £1 = 1.54 EUA	1980	[78]	[87]
at £1 = 1.64 EUA	1980	[83]	[92]
PPP's	1978	94	99
	1980	[90]	[95]

[ ] Estimates

Market exchange rate after the recent European Monetary System realignment (25 September) was £1 = 1.53 EUA.

POSSIBLE MECHANISMS

7. The possible mechanisms set out in paragraph 16 of the Chancellor of the Exchequer's memorandum CD(79)24 were:-

i. an improved Financial Mechanism;
ii. a cash payment to raise United Kingdom receipts;
iii. a hybrid mechanism, combining (i) and (ii);
iv. a straightforward rule limiting our net contribution.

The Financial Mechanism

8. The Financial Mechanism, as negotiated in 1975, only applies to a country with less than 85 per cent of the Community's average GNP and a growth rate of less than 120 per cent of the Community average. As Table 2 shows, to guarantee that it would continue to apply to the United Kingdom in an enlarged Community we should need to have the 85 per cent raised to almost 100 per cent. The rate of growth criterion can be criticised as militating against convergence and preferably it should be removed, although this reform would be less important than reform of the 85 per cent rule and would justify the expenditure of less negotiating capital.

9. The amount of the refund payable is subject to various limitations. To yield significant sums in relation to our net contribution, we should need to obtain several important changes: (i) removal of the balance of payments criterion; (ii) elimination of the tranche system under which full refund is scaled down; and (iii) removal of the 3 per cent upper limit on the proportion of the Budget which may be refunded (this would have no effect in itself, but would be necessary to accommodate the effects of (i) and (ii)).

Table 3 : Refunds available from various revisions to the Financial Mechanism 1980

REVISED FINANCIAL MECHANISM	GROSS REFUND meua	NET GAIN IF FINANCED THROUGH BUDGET VAT RATES
a. Remove Balance of Payments constraint clause.	374	310
b. Remove Balance of Payments constraint clause and remove tranche system	412	340
c. As (b) but also remove 3 per cent upper limit from all contributions above GNP share	676	558
d. Introduce GNP per head "gearing" based on GNP share times GNP per head divided by EC average GNP per head	1285	1062

Table 3 (which is based on the Commission's reference paper) shows these reforms together should yield a gross amount of 676 MEUAs in respect of 1980, or 558 MEUAs after we had paid towards our own rebate through our share of the Budget contribution key. Line (d) of the table shows that it would be possible to almost double this amount if a fundamentally new principle of progressivity was introduced so that the amount of the refund was geared to the relative level of GNP per head. This however would be extremely difficult to negotiate; much more so than (i) - (iii) above.

10. The main advantages of using a revised Financial Mechanism rather than a completely new mechanism are that expectations in the Community centre on revisions to the Financial Mechanism, that the use of GNP per head at market exchange rates is incorporated in the mechanism, as is also the precedent of modifying own resources contributions by means of a refund system. Other member states are thought to be unwilling to write off completely the results of the lengthy bargaining in 1974/75 and simple though far-reaching revisions to the existing mechanism may be constitutionally preferable for them and therefore easier to negotiate. The main disadvantage is that the net return to the United Kingdom falls off very sharply if some clauses are not removed, and even on the best assumptions the Financial Mechanism could not achieve our objective alone. Line (c) of Table 3 shows the maximum yield unless the concept of progressivity were introduced, and this has been firmly rejected by other member states.

11. Refunds paid under the Financial Mechanism depend on the extent to which gross contributions exceed GNP share. As the United Kingdom import patterns continue to adapt to Community membership, our contribution is likely to fall with a corresponding reduction in the real value of our refunds. This tendency to fall would only be offset if Community expenditure rose rapidly.

Refund in Respect of Receipts

12. United Kingdom receipts from Community expenditure are low in relation to our share of Community GNP (and as a percentage of our gross contribution). Our receipts per head are likewise much lower than the Community average. This is brought out in Table 4 below.

Table 4 : Receipts from EC Budget in 1980*

MEUA

		B	DK	G	F	IRL	I	L	N	UK
Receipts	(a)	1460	651	3471	2917	573	2621	312	1629	1561
	(b)	1472	738	3530	3018	650	2484	312	1692	1299
Receipts Proportionate to share of GNP		705	431	4698	3701	102	2118	35	966	2437
Change in Receipts to bring to GNP share	(a)	-755	-220	+1227	+784	-471	-503	-277	-663	+876
	(b)	-767	-307	+1168	+683	-548	-366	-277	-726	+1138
Receipts per head as % of the Community Average	(a)	253	217	97	94	300	80	1478	198	48
	(b)	254	246	99	97	341	75	1478	206	39
Receipts per head	(a)	148	127	57	55	176	47	866	116	28
	(b)	149	144	58	57	200	44	866	121	23

*Note

(a) "Importer pays" MCAs

(b) "Exporter pays" MCAs

13. Table 5 shows that we could theoretically achieve almost the whole of our budget objective by operating on the receipts side alone if the Community made a rebate to bring us up to the Community average. Indeed if we were not required to contribute towards our refund, we would actually become net recipients. To avoid that we could seek a refund representing only a proportion of the deficiency. A 75 per cent refund would yield 1281-1489 meua gross, or 1057-1229 meua if we met our share of the cost. An alternative would be a refund to raise our share of Community receipts up to or towards our share of Community GNP.

Table 5 : Refunds in Respect of Deficient Receipts

	GROSS REFUND MEUA			
	(a) IMPORTER PAYS MCAs		(b) EXPORTER PAYS MCAs	
	Gross	Net	Gross	Net
i. Based on Receipts per head				
a. Make up receipts per head to 75 per cent of EC average	890	(734)	1169	(965)
b. Make up receipts per head to 100 per cent of EC average	1708	(1410)	1987	(1640)
c. Make up 50 per cent of receipts deficiency	854	(705)	993	(819)
d. As (c) but make up 75 per cent	1281	(1057)	1489	(1229)
ii. Based on GNP share				
e. Make up 50 per cent of the deficiency between actual UK receipts and UK share of Community receipts based on its share of Community GNP	438	(361)	569	(469)
f. Make up 75 per cent of the deficiency	657	(542)	853	(704)
g. Make up 100 per cent of the deficiency	876	(723)	1138	(939)

14. The advantage of a mechanism to raise UK receipts is that it focuses attention on the need to correct deficient receipts as well as our excessive contribution. It could solve our problem irrespective of the future pattern of Community expenditure. Such a mechanism might be made more acceptable to the Community by tieing the refunds to public expenditure projects in the United Kingdom which were consonant with Community objectives. But the United Kingdom could only agree to this as a purely cosmetic arrangement, ie if the public expenditure so financed would have taken place anyway. The main disadvantage is that the concept of a refund directly related to a receipt deficiency would be entirely new and would involve payments to the UK not based on Community policies. Isolating the United Kingdom completely from the financial effects of future Community policies would be particularly objectionable.

Hybrid Mechanisms

15. Clearly there are several combinations of reforms of the Financial Mechanism and a receipts refund that could be used to meet our objectives. A hybrid solution could involve building a receipts refund into the modified Financial Mechanism or it could involve two separate refund mechanisms. The refunds available from some likely combination are outlined in Table 6 below.

Table 6 : Gross and Net Refunds from various combinations of Financial Mechanism and Receipts Mechanism

	(a) Gross	(a) (Net)	(b) Gross	(b) (Net)
a. Financial Mechanism (c in table 3)	676	(558)	676	(558)
b. (a) plus refund bringing UK receipt to 75 per cent of Community average receipts	1566	(1292)	1845	(1523)
c. (a) plus refund of 50 per cent of receipts per head deficiency	1530	(1263)	1669	(1377)
d. (a) plus refund to raise receipts to GNP share	1552	(1281)	1814	(1497)

16. The main advantage of a combination of Financial Mechanism reforms together with a receipts mechanism is that a satisfactory scale of refunds can be built onto the existing Financial Mechanism without the need for introducing "progressivity" into the refund of contributions and without the need to claim full refund for our receipts per head deficiency. This in turn can be used to assure the Community of our continued interest in the development of policies and pressure against wasteful Community expenditure; by the same token, however, our net contribution would not necessarily be zero in the years beyond 1980. We could not expect to be allowed to become net recipients in any year, but there is the risk that in some years we would have to make some net contribution. Other disadvantages are the complication of two mechanisms and the difficulties of persuading our partners to accept the principle of a receipts refund.

Straightforward Rules

17. There are a number of straightforward rules or ceilings which could be used to limit our net contribution directly.

Line (c) shows the simple proposition that countries with below average GNP should not be net contributors; a refund under such a rule could be contributed to by a reformed Financial Mechanism. Lines (a) and (b) are simple rules which would achieve part of our objective, but not all of it. Refunds under such "override" mechanisms could be contributed to by a reformed Financial Mechanism, but the Financial Mechanism could not add to them. These two mechanisms, therefore, must be regarded essentially as possible fallbacks.

Table 7 : Straightforward Rules

	Refund MEUA (a) Gross	(a) (Net)	(b) Gross	(b) (Net)
(a) Net contribution not to exceed 20 per cent of gross contribution	930	(768)	1192	(784)
(b) Net contribution not to exceed 0.2 per cent of GNP	934	(772)	1197	(988)
(c) No net contributions : rule where GNP per head less than EC average	1552	(1552)	1814	(1814)

18. The main advantage of a net contribution rule is that it is conceptually simple; line (c) is the only mechanism which, provided that the qualifying criteria are met, guarantees that we would never have to make a net contribution. Its main disadvantage is that the introduction of the net contributions concept might be even less negotiable than the concept of a receipts deficiency.

FINANCING

19. We could not expect to negotiate a reduction in our net contribution based on merely retaining the "own resources" collected in the United Kingdom and transferred to the Community account. We shall have to proceed on the principle of a refund; and some time lag is inevitable before outturn figures for GNP etc become available. Our objective should be to make the time lag as short as possible. We should attempt to negotiate arrangements similar to those under Article 131, under which we receive payments quarterly in arrears, or to those under the Financial Mechanism, under which each year we are entitled to put in a claim based on estimates of the refund due to us - 75 per cent of the agreed claim is refunded in January of the following year and the remainder 25 per cent, including adjustments, is paid later.

20. On the method of financing the refund, there are basically two choices: within the normal Community Budget arrangements or outside them. The more removed from normal Budgetary processes the financing arrangements were, the more likely it would be that domestic Parliamentary processes would have to be gone through in Member States. Other member states will wish to avoid this and so will we: at best it will lead to delays and uncertainty. On the other hand, if refunds scored as normal Community expenditure, they could not be accommodated within the 1 per cent VAT ceiling and the contribution issue would inevitably become linked with the question of additional Own Resources. This entanglement might possibly be avoided by adopting an accounting convention reflecting the fact that a refund to the United Kingdom would be a transfer payment, affecting only the distribution of the budgetary burden, not the size of the Budget. We might explore with Commission experts whether a device can be devised which circumvents the need for ratification or other domestic Parliamentary processes. But it may not be in our interests to provoke too much discussion about this issue in advance of the Dublin meeting.

21. Finance within the budget will raise the issue of whether the United Kingdom should pay its contribution towards the cost of the refund. Under the Financial Mechanism this is the rule (though the regulation for granting interest rate subsidies to below average GNP countries participating fully in the EMS contains a provision for non-participants in the exchange rate mechanism not to contribute towards the subsidies). Italy and Ireland will probably wish to avoid contributing towards a refund for the United Kingdom and in these circumstances it would be difficult for us not to press for similar treatment. On the other hand, our readiness to make a contribution (estimated at 17 per cent of the refund) would help to avoid the criticism that we would have no interest in the future course of the Community budget. Ministers would need to consider whether making such contribution would be compatible with the objective of broad balance.

CONCLUSIONS

22. Our immediate objective is to get the Commission to make proposals which are consistent with the requirements we have already laid down. We shall, of course, remain free to put forward alternative proposals of our own if in the event the Commission's proposals are inadequate. The Commission seem likely to base their proposals on the existing Financial Mechanism. Such an approach would only be acceptable if it took account of our net position, ie our low level of receipts as well as our excessive gross contribution. A remedy for our excess contribution with the solution to the balance of our problem left vague or inadequate would not be acceptable. For the reasons set out in the paper an effective solution involving the Financial Mechanism would require:-

i. changing the qualifying criteria. Net contributors with below average GNP over a three-year period should qualify (and the rate of growth criterion if possible be dropped);

ii. removing the existing limits on the size of the refund in respect of excess contributions viz. the balance of payments criterion, the tranche system and the 3 per cent ceiling;

and iii. grafting on the Financial Mechanism an additional refund based either on bringing our receipts up to, say, 75 per cent of the Community average or a straightforward no net contribution rule.

23. We should continue to indicate that we are ready to consider alternatives which would achieve comparable results, including a simple rule under which we would pay no net contribution so long as our GNP per head remained below the Community average. We should let the Irish and the Italians make the running on excluding below average GNP countries from contributing towards the cost and not ourselves at this stage take the lead in suggesting how the refund should be financed. We should explore with the Commission whether it can be done within the Budget in such a way as not to affect the 1 per cent ceiling. We should ensure that the speed of repayment was not less favourable to us than under the existing Financial Mechanism.

24. Ministers are invited to say whether they endorse the conclusions in paragraphs 22 and 23 as the basis for further discussion with the Commission and subsequently with our Community partners.

Cabinet Office
27 September 1979