



10 DOWNING STREET

*MS*

Prime Minister

E.E.C.

1. I lunched with Christopher Tugendhat on Friday.
2. He handed to me an internal Memorandum dated 14th May from his Chef de Cabinet addressed to Roy Jenkins' Chef de Cabinet, and this I attach.
3. Christopher is, of course, a Euro fanatic. His view is that it is probable (by by no means certain) that you will get an acceptable settlement at Venice.
4. So far as his own future is concerned, he confirmed his own preference, which I have reported to you already.
5. So far as a successor as a "Labour Commissioner" is concerned, he suggested the names of Joel Barnett or Eric Varley.
5. He said that, at Venice, a decision would have to be taken about the next President of the Commission. He suggested the name of an Italian, Pandolfi.

19th May, 1980

*Ian Gow*  
Ian Gow

14 May, 1980

FINANCING THE COMMUNITY BUDGET : THE RELEVANCE OF FRENCH IDEAS

1. During the Luxembourg European Council the French Government suggested that, as part of the decisions concerning the UK, the Commission and the Council should be invited to examine the manner in which the Community Budget could appropriately be financed and also to consider what were termed "durable mechanisms" to deal with the problem of unacceptable situations. President Giscard is reported to have said that the position should be examined not only of net deficit countries but also of net beneficiaries.

2. The French Government have of course subsequently removed their financial offer from the table and have also said that the whole approach, i.e. that of tackling the question of financing from the point of view of the net position of the Member States has been abandoned. The Belgians, joined by the Danes, have protested that such an approach would in any case be contrary to the Own Resources system. Against this background it is perhaps unlikely that the Commission will be asked to do the sort of study previously suggested by the French. Nevertheless, given the intractability of the problem of the disproportionate shares of Member States in Community financing, it seems worth examining a little further French ideas which are relevant to it and to assess whether there is any substance in the view that they are contrary to the doctrine of Own Resources.

3. In this note I shall not attempt to examine systematically the vast question of possible changes in the Community financial system but focus rather on the problem of dealing with "unacceptable situations".

The problem of imbalance in the Budget

4. As is known the disproportionate burden of financing borne by the UK arises less from an unfair share in the revenue side of the Budget (as compared, for instance, with its GNP share) than from the small share of Community expenditure which takes place in the UK as a result of the present pattern of Community policies. Moreover the tendency is for the problem to diminish on the revenue side and to increase on the expenditure side. This being the case, for the UK problem to be appreciably assisted in the foreseeable future, either much more draconian control of agricultural expenditure than has hitherto occurred will have to take place or special measures in favour of the UK will have to be instituted and continue.

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5. The illustrative exercise on the Regional Fund done in connection with the Budget Reference Paper of last September illustrates the point. There we posited in payments an increase of 234% in payments for the Regional, Social and FEOGA Guidance Funds for 1980, i.e. adding 5000 MEUA to the 1498 MEUA already in the Budget. Even with a massive increase of this kind, the UK net benefit derived from this increase in the structural funds was still only 305 MEUA thus reducing the then projected total UK Budget deficit from -1552 MEUA to -1274 MEUA. Since heroic increases in the sizes of the Structural Funds are not financially possible within the 1% ceiling and since, if one is being realistic, they are unlikely to take place except over a long period even after there has been an increase in Own Resources, early relief to the UK Budget problem is not in sight merely via an increase in "structural" spending. On the contrary, the likelihood of "structural" spending offering the UK much relief will diminish with the entry of Greece and subsequent poor Member States. To take the Regional Fund as an example, the projected Greek quota is 14.5%. This means that all other Member States' quotas will have to be brought down pro rata. In such a situation the UK, instead of getting a 29% quota out of the Regional Fund for every 20% funding put in ( $\pm$  17% on the marginal rate) the UK will only get out about 24% for every 20% put in. With the entry of Spain and Portugal, the likelihood is that the UK will become a net contributor to the Regional and other Funds.

6. This shows that attempting to outstrip increases in the rate of agricultural expenditure by increases in other funds will not provide the solution to the net deficit problem in either the short or the long-term. There is no substitute for control of agricultural expenditure. Within the 1% limit it is fairly clear that the slender margin of Own Resources available after inevitable commitments have been met is not such as to allow increases in structural funds of an extent sufficient to make any appreciable dent in on the proportion of the budget consumed by agriculture which is still likely to be above 70% in payments in 1982 (it will be somewhat lower in commitments).

7. One is driven to the conclusion that if the Community wishes seriously to tackle the question of unacceptable situations in the foreseeable future some hitherto sacred principle of the Community will have to be breached. Which should it be? Should we cease to finance, in part or in whole certain activities now borne on the Budget - in other words debudgetisation? For common policies this would breach the principle of financial solidarity. Should we lay down guidelines as to the proportion of the Budget which certain activities will be allowed to take up? For example

we could say that above the 1% ceiling and between say 1.0% and 1.1% of VAT, agriculture should only be allowed to consume 65% of the slice : between 1.1% and 1.2%, 60% of the slice and so on. This would be disguised hypothecation - also something which our present doctrines do not permit.

8. There are a number of variants on such themes. If none of these is acceptable - and certainly none is desirable - one is forced to look again at compensating mechanisms. In this connection the ideas recently advanced by the French Government are of interest.

9. In suggesting that the position of net beneficiaries as well as net contributor states should be looked at in connection with unacceptable situations, the French were almost certainly not proposing that action should take place on the revenue side of the Budget. In other words it is doubtful whether they were proposing some glorified financial mechanism whose internal criteria would enable it to apply to more than one Member State. They are more likely to have been thinking in terms of a mechanism applying on the expenditure side of the Budget. It would be possible - and from the technical point of view relatively easy, to construct a mechanism of this type to apply retrospectively to the Budget outturn of the previous year. It could operate as follows.

10. Community finance would be raised according to the normal rules and spent in a normal manner on agreed Community policies. At the end of each Budget year, the resulting net position of Member States would be examined. A mechanism of the following kind could then if necessary be applied. The median of Community GNP per capita would be established. A factor would then be applied to the net position of any or all Member States to produce any or all of the following - results (depending on how drastic a change from the actual situation was wanted) :

a) Limit the benefit derived from the Budget of those Member States above the median GNP per caput and limit any deficit of those below ;

b) Abolish completely the net benefit of those Member States above a certain tranche, e.g. 20% above the median limit and ditto below the line. (This sort of action could of course be symmetrical or asymmetrical above and below the line) ;

c) Actually change the sign attaching to the net position of a Member State i.e. apply a factor as a result of which Member States with above average GNP per caput all became net contributors while those below all became net beneficiaries ;

and so on.

11. The proceeds of the money taken from net beneficiaries above the line would of course be redistributed on a chosen key to net contributors below the line. This could be done through the Budget and proceeds could also be spent on Community projects within the beneficiary Member States - thus avoiding the suggestion that the Budget was a mere clearing house for financial transfers between Member States.

12. The possible permutations of such an "override" mechanism are of course virtually unlimited. They can range from mild correction of net deficits to, if the Community wished it - an unlikely eventuality - exact "juste retour" to a situation in which Member States radically change position in the league table of debtors and creditors. Actually changing the position of Member States from significant profit to serious loss would of course be politically difficult. Short of so drastic a result such a system, once accepted, could however be made to provide a guarantee of limitations on the extent of the profit gained or the loss suffered by any given Member State or States.

13. One may speculate on French motives for airing ideas which could lead to schemes of the sort outlined in paragraphs 10 to 12 above. It is likely that they are concerned about the financial effects of enlargement. At the moment France is broadly in balance in relation to the Community Budget but with the entry of the three Mediterranean countries this is bound to change. One of the attractions of establishing the principle of looking at net profit situations is that it enables rich countries like Denmark who have only a small share in the financing of the Community Budget (and who are thus exposed to only limited risk on this side of the account) to be brought more effectively within the net of those who have to contribute to helping the poorer Member States. (In the absence of this the burden of course falls extremely heavily on rich countries with a large financing share like Germany.)

14. Against this background, the hostility of countries like Denmark (and the other five small Member States who in varying degrees all benefit from the Budget) is readily comprehensible. Are they chiefly protecting a real material interest or is it fair for them to say, as they do, that French ideas are contrary to the principles of Own Resources?

#### The Principles of Own Resources

15. The system of Own Resources provides the Community with its own revenues raised according to Treaty rules for the purpose of financing Community policies. By Community policies is meant policies commonly agreed and financed through the Community Budget. It is part of the Community's general doctrine as regards the Budget that it is there to give

financing effect to policy objectives and that it is not designed to simply act as a financial clearing house between Member States or as a mere redistributor of financial resources. This view of the Community Budget has been vigorously upheld to fend off those who would have wished to promote the notion of the "juste retour". It has however also been invoked as a means of resisting the suggestion that the Budget could and should be made more redistributive insofar as this was consonant with existing Community policy objectives.

16. Community Budget doctrine has thus been used for both good and less good purposes. There is no doubt that the weight of Community doctrine has hitherto been against the net position of the Member State becoming the legitimate object of policy requiring possible remedy but there is nothing in the rules themselves of Community financing which actually forbids this. And the existing financial mechanism does of course take account of the net position. Indeed the notion of "unacceptable situations" enshrined in Community language in connection with the Financial mechanism implies that Community financing and expenditure are capable of producing anomalous situations which require correction. The principles of Own Resources, therefore, cannot be regarded as being beyond interference if circumstances so require. In reality the question that arises now is not so much whether the existing financing system should remain completely unaltered as whether the limitations on its "pure" application should only be temporary or whether they should become a permanent or semi-permanent part of the system. Those who are not willing to see Community financing adapted may find the alternative - the destruction of certain Community policies in their present form - less acceptable.

Pauline Neville-Jones