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Foreign and Commonwealth Office

London SW1A 2AH

27 June 1980

This is serious.

It's a pity we hadn't sorted it out for ourselves.

We must resolve the problem quickly. MT

Prime Minister

It looks as though Chancellor Schmidt's point might have some foundation.

[illegible]

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Dear Clive,

Also see X [illegible]

Prime Minister's Meeting with Chancellor Schmidt: 1% ceiling

In your letter of 12 June you requested a note on the point raised with the Prime Minister by Chancellor Schmidt about the extent to which we could rely on the 1% VAT ceiling to control the growth of Community expenditure.

This question raises issues of great complexity. I attach a preliminary note which we have prepared in consultation with the Treasury, MAFF and Cabinet Office. You will see that it concludes in paragraph 11 that, even if claims against national paying agencies could be legally enforced in the absence of provision for these claims in the Community Budget, chaos would result if significant payments were in fact made. This makes it virtually inevitable that the issue would come to the Council for the relevant decision - to restructure the Budget so that the 1% VAT ceiling could be maintained, or to raise the ceiling - before any substantial excess spending could take place. The Council would thus not be taken unawares.

Nobody suggested the Council would be.

Further study is needed and is being put in hand in the context of working out our general approach to the problems raised by the 1% VAT ceiling. Papers will be brought before Ministers as soon as possible.

The Foreign and Commonwealth Secretary was interested to note Chancellor Schmidt's suggestion that Member Governments should set up small bilateral task forces to work up ideas on restructuring the Community Budget and that there should be Anglo-German cooperation on this basis. He is attracted by the idea and will shortly be sending a recommendation for a positive response to Chancellor Schmidt.

I am sending copies of this letter with its enclosure to Martin Hall (Treasury) and David Wright (Cabinet Office) and also to Garth Waters (MAFF).

Yours ever

Paul

(P Lever)
Private Secretary

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COMMUNITY BUDGET : EFFECTIVENESS OF THE 1% VAT CEILING

In his conversation with the Prime Minister in Venice on 12 June, Chancellor Schmidt said that he had been advised that the 1% ceiling was not as robust as he had previously supposed. This was because, once the 1% ceiling had been reached and Community funds thereby exhausted, those entitled to receive payments under existing Community law would be able to apply to their national Governments for payments in place of those which would otherwise have been made by the Community.

Scope of the Paper

This paper concentrates on CAP expenditure because this absorbs roughly three-quarters of the budget and is most likely to give rise to claims against national Governments by the large number of farmers, traders and organisations who benefit under the CAP. The Community has other financial obligations, notably:

(a) under the Regional Development Fund and Social Fund, and

(b) for paying its staff wages.

However the majority of payments under (a) go to Governments and Governmental organisations rather than to individuals so the number of likely significant claims against national governments is small. On (b), staff would have a claim in the first instance against the Commission/Council/European Parliament, not against member governments.

How ceiling might be reached

The ceiling might be reached in one of two ways:

(i) It might be clear at the time the budget is drawn up that the ceiling would be reached during the course of the year;

(ii) Alternatively the ceiling might be reached during a budget year as a result of a shortfall of revenue or because inadequate funds were available to meet expenditure obligations fully. This would not be likely to happen until towards the end of a year.

In each case the Council or Commission would have an opportunity to take remedial action. In the case of (i) the budget could not be adopted without Council agreement. In the case of (ii), either a supplementary budget would be needed; which would require Council agreement; or payments could be deferred until the following year (when they would be a first charge on the new budget) or transfers made from underspent parts of the budget (there is in fact considerable flexibility in the timing of payments by the Commission). In other words, in either case the problem would not overtake the Community without the Council having a chance to consider its position.

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Even if the Council failed to agree on what to do in such a situation, the cumulative chaos which would arise as Member States tried to tackle the problem in different ways and claims against national governments and the Commission proliferated, or as payments deferred to the following year mounted up, would result in a rising level of political pressure on governments to find solutions. So the scenario which the German Chancellor appeared to envisage of Member States watching helplessly as existing obligations gobbled up national money is not likely to occur in practice.

Legal Position and Precedents

Nevertheless, the basis of Schmidt's argument is well-founded. The CAP Regulations, which have direct force of law in Member States, confer a legal entitlement to be paid on all persons fulfilling stated conditions. These payments must be funded from the Community Budget and for this purpose the Commission makes a monthly transfer to each national paying agency (the Intervention Board in our case) to finance forecast payments in the month ahead.

However, because such a case has never been brought it has never been established whether, during any such period, claimants could legally enforce a claim against the national paying agencies to be paid from national funds, or whether they would have to wait until Community funds were again available. A full legal study of this aspect will be needed. It is certain, however, that the Commission would incur legal liabilities whether at the instance of claimants or at the instance of the paying agencies.

X! This is news to me. Under what authority?

These are precedents for the Community running out of funds in mid year. For example, in November 1979, the Parliament delayed approval of a Supplementary Budget to meet increases in agricultural spending that had arisen during the Budget year. On that occasion we continued to pay claimants from national funds, but, because of the doubt as to the legal correctness of substituting national funds for Community funds and to avoid any risk that the Commission would refuse to reimburse these payments from the Budget, they were disguised as temporary interest-free loans. The Germans, we understand, simply suspended payments. But this case is not strictly analogous to the case cited by Chancellor Schmidt since money could be advanced in the knowledge that there was room under the 1% ceiling to raise the necessary funds.

Effects of reaching ceiling

If, when the 1% ceiling was reached, the Community simply allowed CAP expenditure to go on growing at current rates, the situation might temporarily be relieved by borrowing. But soon larger and larger sums would have to be carried over from one year to the next; and Governments would inevitably be forced into

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using national funds to tide claimants over for the increasingly long period each year when no funds were available from Brussels. Given the disparity between our share of CAP payments and our VAT contribution, such a state of affairs would obviously be better for us than raising the 1% ceiling, since the latter would involve us in contributing to the cost of payments in other Member States as well.

Maintaining the ceiling

This scenario, however, would only be likely to develop if the Council had reached a stalemate on the question of increasing the 1% ceiling and were not prepared to change the CAP regulations with a view to keeping expenditure within the ceiling. Changes of various kinds could be made:

(i) postponing expenditure in particular by reducing subsidies for the disposal of current surpluses and allowing intervention stocks to accumulate;

(ii) genuine reductions in expenditure (which could be pro rata or at the expense of non obligatory expenditure);

(iii) raising additional revenue through "co-responsibility levies" (these do not fall within the definition of own resources, and are treated as direct offsets to CAP expenditure); or

(iv) some degree of "national financing", ie financing a part of expenditure on CAP policy from the Community budget and the balance from the national funds.

The effects of these measures would be various and it is not the purpose of this paper to discuss them. It will however be necessary to examine them in detail in preparation for the 1981 budget review.

CONCLUSION

We draw the following tentative conclusions.

(1) The problem will not overtake the Community without the Council having a chance to consider its position.

(2) The legal position is not clear. It has never been established whether, if funds were not available from the Community Budget, claimants could legally enforce a claim against the national paying agencies to be paid from national funds.

(3) In the short term the problem could be postponed until the following year when the sums concerned would become a first charge on that year's budget.

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(4) But other expenditure could suffer. And the problem would get cumulatively worse in subsequent years. The resultant chaos would generate political pressure for agreement on restructuring the budget.

(5) The problem would in any case only arise if the Council could <u>neither</u> agree on an increase in the 1% ceiling <u>nor</u> on changes to the CAP Regulations with a view to keeping expenditure within the ceiling.

(6) Our ability to use the 1% ceiling as an effective instrument in getting the budget restructured will be strengthened by the maintenance of the German commitment to it. We could otherwise find ourselves isolated. Bilateral talks with the Germans would be valuable in exploring German thinking on this subject.

Foreign and Commonwealth Office

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