V NJS seen.

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4th June 1980

R. Prescott Esq.
Private Secretary to the
Paymaster General
Cabinet Office
70 Whitehall
LONDON
SW1

Dear Richard,

EUROPEAN COMMUNITY BUDGET SETTLEMENT

In accordance with the conclusions of the Cabinet on 2 June (CC(80)21st meeting), I attach an explanatory note on the budgetary settlement.

Copies of this letter and enclosure go to No.10, to the Private Secretaries to all members of the Cabinet, the Minister of Transport and the Chief Whip, and to Sir Robert Armstrong.

Yours ever,

MH

M.A. HALL
Private Secretary

COMMUNITY BUDGET SETTLEMENT

A. Value of the Settlement

The settlement will yield a total rebate to the UK of at least £1,570 million over the two year period 1980-81. On Commission estimates this will reduce the UK's net contributions in those two years to £370 million and £440 million respectively. Any increase over those levels resulting from higher-than-expected Community spending will be much abated by a risk-sharing formula, under which the UK will bear only a fraction of the cost of any excess.

2. The settlement also provides for a radical review of the Community's budgetary arrangements and of the pattern of Community spending. If this review has not of itself solved the UK's budget problem by 1982, the Community is committed to extending the arrangements negotiated for 1980 and 1981. So the total value of the settlement over all three years is unlikely to be less than £2.5 billion.

(For a more detailed account of the settlement, see Annex A.)

B. Effect on public expenditure

3. As the latest Public Expenditure White Paper makes clear, the reduction in our Budget contribution will increase the savings in public spending which the Government has already achieved. The amount set aside for contributions to the Community Budget in Programme 2.7 of the White Paper will be reduced.

4. The settlement should not be seen as opening the way to increased expenditure on domestic programmes, although it reduces somewhat the risk that further reductions in these programmes will be needed in order to keep public expenditure and borrowing within acceptable limits.

C. Effect on the PSBR

5. The reduction in public spending that will follow from the settlement will certainly assist our efforts to contain the PSBR. The effect on the PSBR may be a little less than the overall change in our net contribution. This is because the associated agricultural price settlement, which will also produce a reduction in our net contribution in 1980-81, will involve a matching increase in doemstic public spending.

D. Effect on the balance of payments

6. The effect on the settlement will be to improve the current balance by slightly more than the value of the refund. This is because the extra sheepmeat and whisky receipts will probably exceed slightly the extra cost of our food imports from the Community.

E. Effect on the domestic money supply, and on the Government's need to sell gilts

7. A cut in our EC contribution which is used to reduce the PSBR will help to ease the pressure on the monetary target. With the exchange rate determined by market forces, the Government's need for sterling finance will be reduced. Its need to sell gilts to stay within the monetary target will be less. It should therefore be possible to meet the target with lower domestic interest rates than would otherwise have been necessary. It is not possible to say precisely what the size of this effect will be though it is likely to be small. But since we are not expecting the major part of the refund until the end of the year, it is not realistic to look for an immediate effect on domestic monetary conditions.

F. Effect on the exchange rate

8. The effect on the exchange rate is likely to be small. There are two influences which work in opposite directions:-

(a) the cut in the contribution will tend to push sterling up, because it will be improving the current account;

(b) lower interest rates (see E) will restrain the rise.

G. Method of payment

9. The money will be provided by improvements in the operation of the 1975 Financial Mechanism, and through supplementary Community spending in the UK, under a new Article 235 Regulation.

(For details of the existing Financial Mechanism and the proposed amendments to it, see Annex B.)

H. Operation of Article 235 arrangements

10. The new Article 235 regulation will enable the Community to participate in the financing of programmes designed to help with the problems of the disadvantaged regions of the UK and possibly of certain expenditures outside those regions. It has yet to be decided exactly which programmes will benefit from Community assistance.

11. The next step will be for the Commission to propose a draft regulation to the Council and to the European Parliament. This will lay down the broad criteria under which the programmes will attract Community assistance.

I. Undue Community influence over UK expenditure priorities and decisions?

12. The Commission are proposing that the Community should help to finance the UK's own national expenditure programmes, not that it should establish a new Community policy, comparable with the CAP.

13. The Council will approve the broad qualifying criteria which will be embodied in the Regulation. But it will be for the UK to decide which programmes to put forward for assistance within that framework. There is no reason to suppose that the Community will refuse to assist programmes which satisfy the agreed criteria.

J. Timing of payments

14. The main receipts will accrue to the UK in the first quarter of next year. We expect the bulk of what is due for 1980 to be paid before the end of the 1980-81 financial year.

(For details of payment arrangements see Annex C)

K. The review

15. In the long-term the commitment to review the development of Community policies and the operation of the Budget is perhaps the most important part of the package. Together with the constraints imposed by the 1% ceiling, it will enable the UK to press for the lasting reform needed to prevent any recurrence of the British budgetary problem.

16. The review therefore offers an opportunity which has never been available before, since we joined the Community, to work with our partners for financial arrangements, and Community policies, which are to the advantage of all Member States, as befits a Community of equals.

L. What happens if 1% ceiling is reached before 1982?

17. That would be a Community problem to which a Community solution would have to be found. The Council will need to take action to cut the increase in the expenditures which are causing the problem.

M. Would our refund be cut back?

18. Our refund is a prior commitment. But if the expenditures are contained, the cost of the refund will be contained too.

N. Effect of exchange rate movements on the settlement

19. The value of our settlement, expressed in European Units of Account, will not be greatly affected by any movement in the £/EUA exchange rate. The value in sterling terms will of course reflect any changes in this exchange rate.

20. The figures the Government has quoted are based on an £/EUA rate of 1:1.65.* If the £ falls against the EUA this sterling value will increase - by around £6 million for every 1 per cent rise in the sterling rate. If the £ rises, the sterling value will fall by a similar amount.

O. Comparison of figures with those published in the Public Expenditure White Paper

21. The figures quoted are the outcome of negotiations about transfers between the Member States. The figures in /Table 2.2.1 of/ the Public Expenditure White Paper include, in addition, our contribution to certain transfers to countries outside the Community which are financed through the Community Budget. These are perhaps best regarded as part of our aid programme rather than as part of our contribution to the Community.

22. There are other differences - for example, the latest figures are more up-to-date than those incorporated in PEWP, which was published in March, and the price bases of the estimates are different.

23. The exchange rates used are also different. The figures now quoted used 1.65EUA = £1 which is roughly the current market rate. The Public Expenditure White Paper used 1.55EUA = £1 because sterling was less strong when the Public Expenditure survey was carried out.

* roughly where it stands at present.

ANNEX A

SIZE OF REFUND : DETAILED FORMULA
(as announced by Lord Privy Seal on 2 June)

The first element in the solution is the following formula:

- for 1980, provided that our net contribution, before the formula is applied, does not exceed £1,080 million, there will be a ceiling on our net contribution, after adjustment, of £370 million.

- for 1981, provided that our net contribution, before the formula is applied, does not exceed £1,300 million, the ceiling will be £440 million. (All these sterling figures are converted at a rate of 1.65 European Units of Account to the £.)

2. This will result in a total rebate to Britain over the two year period of £1,570 million, implying a UK payment $\frac{1}{3}$ of what had been expected.

3. A further element of the solution is a risk-sharing formula. Should the amounts of the United Kingdom's uncorrected net contribution in 1980 and 1981, as estimated by the European Commission, in fact be exceeded, the arrangement is that in 1980 we will bear only one quarter of the cost of this excess.

4. For 1981 a more complex formula exists under which we would meet the first £12 million of any excess, the next £60 million would be shared between us and our partners equally,and thereafter we would meet only a quarter of the excess cost, as in 1980.

5. For 1982, it was envisaged that by this time the Council would have completed a radical review of the pattern of Community expenditure and the operation of the Budget.

6. However, if that had not by 1982 produced arrangements resolving the United Kingdom's budget problem, the Commission would put forward proposals along the lines of the 1980 and 1981 solutions and the Council would act accordingly.

7. We can therefore be sure that for 1982 as well there will be similar restrictions on the level of the United Kingdom's net contribution.

FINANCIAL MECHANISM : PROPOSED AMENDMENTS

The 1975 Financial Mechnism provides for payments to a Member State which is "forced to bear a disproportionate burden in the financing of the Community Budget" whilst its economy is "in a special situation". It provides that a Member State with:

i) a GNP per capita less than 85% of the Community average; and,

ii) a growth rate of real per capita GNP less than 120% of the Community average,

should, subject to certain further conditions, be entitled to a partial refund of any excess of its share in gross contributions over its share in Community GNP.

2. These further conditions have meant that so far the UK has received no benefit from this Mechanism although it has satisfied the main economic criteria for relief mentioned above. The improvements now proposed are designed to ensure that, provided the UK continues to satisfy the qualifying criteria, the Community will refund in full the excess of its share in gross contributions over its GNP share.

3. This entails a number of amendments to the existing Mechanism:

i) the removal of the balance of payments condition, under which the size of a Member State's refund depends critically on its aggregate balance of payment position over the preceding three years, with the refund being very much larger if this shows a deficit (however marginal) rather than a surplus;

ii) the abolition of the so-called "tranche system" under which any excess contribution less than 30% above a Member State's GNP share is refunded only in part; and,

iii) the removal of the provision limiting any refunds under the Mechanism to 3% of total Budget expenditure.

ANNEX C

TIMING OF PAYMENTS : DETAILED ARRANGEMENTS

The procedure for payment of Financial Mechanism refunds is already well-established. It involves payment of $\frac{3}{4}$ of the estimated entitlement in the first quarter of the calendar year following that to which the refund relates. Because of the difference in financial years, this is the final quarter of the UK's financial year. The balance of the refund is paid when the final entitlement can be calculated. This occurs when the Commission draws up its accounts in the middle of the year.

2. Following the precedent of the Financial Mechanism, the credits under the new Article 235 regulation will appear in the Community Budget for the following year, but with the possibility of advance payments in the current year. Precise details of the arrangements have yet to be settled.