CONFIDENTIAL

ANNEX I

Treasury Chambers, Parliament Street, SW1P 3AG
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PRIME MINISTER

SCHLOSS GYMNICH AND THE INTERIM SOLUTION

Although the Stuttgart Council is less than five weeks away, progress in Brussels towards an interim solution has been minimal. The Commission have not so far put forward specific proposals, and anything they did propose would be likely to be unfavourable to us. We also know in confidence that the German Foreign Office have drafted a Presidency compromise proposal, not yet agreed in Bonn, which would appear effectively to give us a fixed net refund for 1983 of only some 400 m ecus after settlement of the 'overpayment' for 1980 and 1981. The idea seems to be that we would receive a lump-sum net refund of only some 700 m ecus net for 1983 with no risk-sharing, and would simultaneously give up our risk-sharing entitlement for 1982 of some 300 m ecus net. This compares with our own objective of a basic refund of 1320 m ecus net for 1983 (66 per cent of an assumed net contribution of 2 billion ecus), together with risk-sharing, <u>less</u> a figure of up to 250 m ecus net for the 'overpayment'.

2. This is all very unsatisfactory. Francis Pym and I think that we must now aim -

i. to get serious negotiations started as a matter of urgency with a view to reaching agreement within the timescale foreseen at the last European Council - ie by Stuttgart;

ii. to pre-empt any unhelpful proposals by the German Presidency or the Commission; and

iii. to place ourselves in the best possible position in the event that no agreement is possible and we have to withhold.

3. With these objectives in mind, we believe that we should now move quickly to stake out our position. Specifically, we should take an early opportunity to

table in the Council our own ideas for an interim solution, in the form set out in the annex. The key points are (a) a 66 per cent rate of refund, as in the 30 May 1980 agreement; (b) symmetrical risk-sharing arrangements, up and down: those suggested in the annex lie halfway between the formulae for 1980 and 1981 in the 30 May agreement; and (c) provision for extending the formula to cover later years as well, pending a lasting solution. The amount and timing of any ex gratia payments in recognition of the 'overpayment' for 1980 and 1981 would be for negotiation: our line would continue to be that this needs to be settled at the political level, and that we are under no legal obligation to repay anything.

4. We should need to make it quite clear that what we are suggesting for our basic refund (66 per cent of our estimated net contribution) is the only basis we can see for a settlement and is in no sense an 'opening position' from which we could be expected to retreat in negotiation. As to risk-sharing, we should aim to avoid falling back on the asymmetrical 1982 formula if we can.

5. Francis Pym and I agree on this approach. If you too agree, he would propose to launch a pre-emptive strike on the above lines at the informal meeting of Foreign Ministers at Schloss Gymnich on 14/15 May. He would at the same time emphasise our interest in achieving a lasting reform of the budgetary system: this would pave the way for us to set out at the appropriate time the ideas on a lasting solution about which I wrote to you on 17 March. I myself would consider how best to pursue these matters with Stoltenberg.

6. Copies of this minute go to Francis Pym, Peter Walker and Sir Robert Armstrong.

GH

(G.H.)

5 May 1983

ANNEX

ELEMENTS FOR THE INTERIM SOLUTION

1.	Reference figure:	2000 mecu (as mentioned by M. Noel at COREPER)
2.	Basic refund:	1320 mecu (net)
3.	Risk-sharing upwards and downwards:	Differences in either direction from reference figure: (a) First 10 mecu: no change in refund. (b) 10-60 mecu: refund increased or reduced by 50 per cent of difference in excess of 10 mecu. (c) Beyond 60 mecu: refund increased or reduced by 25 mecu plus 75 per cent of difference in excess of 60 mecu.
4.	'Overpayment':	Amount in full and final settlement to be agreed and deducted from basic refund over agreed period.
5.	Later years:	Firm intention to apply long term solution in respect of 1984. If not possible, similar arrangement to 1983.
6.	Method of payments:	Gross sums equivalent to figure in 2 above to be entered in 1984 budget either under supplementary measures or under special programmes of Community interest in the UK for eg energy, transport. Flexibility within categories during budgetary procedure, subject to maintaining the total decided. Sums due under 3 above to be treated in an analogous fashion.

ANNEX II

COMMISSION PROPOSALS ON FUTURE FINANCING OF THE COMMUNITY

This note summarises and assesses the proposals in the Commission's communication of 5 May 1983 on "The Future Financing of the Community: Draft Decision on Own Resources".

Summary of the Commission's proposals

2. The Communication proposes a new Decision on "Own Resources" to replace the Decision of April 1970 which set up the present own resources system. The new Decision would include the following provisions:-

i. The VAT ceiling

3. The existing 1 per cent limit to be raised to the equivalent of 1.4 per cent of the VAT base for the Community as a whole. The Commission propose also that this new limit could be raised subsequently by further tranches of 0.4 per cent without the need for ratification by national parliaments. Proposals to raise the limit would be made by the Commission and be subject to unanimous agreement in the Council and a three-fifths majority of votes cast in the European Parliament.

ii. A modulated VAT key

4. Part of VAT own resources, within the new 1.4 per cent limit, to be raised on the basis of a special key reflecting shares in the Community's agricultural production and 'net operating surplus', modified to take some account of relative prosperity. The total amount to be raised by this means to be determined as the excess of CAP guarantee expenditure (less food aid and expenditure resulting from the ACP sugar protocol) over 33 per cent of the total budget. The contribution key for each country to be based on averaging its shares in (a) agricultural production subject to common market regimes and (b) the Community's "net operating surplus" (roughly gross profits plus income from self-employment less depreciation), the resulting average being multiplied by its index of relative prosperity (calculated by averaging its relative GDP per head measured at market exchange rates and purchasing power parities).

iii. ECSC import levies

5. The Community to retain as own resources the import levies on products covered by the European Coal and Steel Community (ECSC) treaty, which are currently kept by member states.

iv. Refunds of levies and duties for collection costs

6. The Community's budgetary authorities (the Council acting unanimously, the Parliament by three-fifth majority) to have discretion to reduce the rate of own resource refunds paid to member states in reimbursement of collection costs (currently 10 per cent of total levies and duties).

v. Surplus revenue

7. The Community to be able to keep any surplus of revenue over expenditure at the end of the financial year and carry it forward to finance the next year's budget rather than repay it to member states.

8. The Commission also says it is considering the possibility of introducing a tax on non-industrial energy consumption to finance expenditure on energy-related projects. It will be submitting a package of energy proposals next month.

General assessment

9. The Commission's proposals, if adopted, would increase the own resources available to the Community by some 25-30 per cent in the first instance, as well as enabling further increases without ratification by national parliaments. The latter aspect seems likely to cause insuperable difficulties for several member states, not just the UK. The 'modulated VAT' could reduce the UK's net contribution by around one-quarter if it were used to substitute for normal VAT without any increase in the ceiling on total own resources. The proposal is however so complicated and counter-intuitive that it seems unlikely to attract general support.

10. The paragraphs which follow comment on the proposals in more detail.

Effects of the proposals on own resources available

11. The proposal to raise the present VAT limit by 0.4 per cent would give the Community access to extra revenues of some 6 billion ecus in 1984, an increase in total own resources of the order of 25 per cent. The ECSC levies would raise 50 to 60 million ecus for the budget, while the 10 per cent refund of own resources for collection costs amounts to about 1 billion ecus. The maximum increase in total own resources available for expenditure on Community policies would thus, in the first instance, be some 25-30 per cent.

12. Under the Commission's proposals, the Community would in future be able to raise the VAT own resources limit without ratification by national parliaments. This proposal obviously has major constitutional significance. It would, however, have to be ratified by national parliaments, along with the other proposals made in this Communication, and it seems unlikely that all the 10 national parliaments would agree to deprive themselves of the= right to control and ratify future increases in own resources.

<u>Modulated VAT/agricultural key</u> (see tables A1 and A2)

13. The proposal for a new 'modulated VAT' key is the only element in the Commission's communication which would alleviate the UK's budget problem to any significant extent. This key is a development of the "agricultural own resource" idea put forward in the Commission's Green Paper published in February 1983. The earlier idea was to base the key simply on an agricultural indicator such as shares in Community production. The major beneficiary from such a key would have been Germany, although the UK's net contribution would also have been reduced significantly. Italy, Ireland and Greece would, however, have been heavy losers. In their current proposal therefore the Commission suggest the key based on agricultural production should be modified in two ways.

14. The use of relative prosperity indices as one of the modifiers to achieve some redistribution from richer to poorer countries can readily be justified. Indeed, it is a principle that the UK has been advocating for some years (albeit applied to net contributions rather than just gross). The proposal to use an average of relative prosperity measured at market exchange rates and at purchasing power parities is, however, somewhat curious given that all the other elements in the key are measured at market exchange rates, and that contributions to and receipts from the budget are of course effected at actual exchange rates. The Commission are in effect proposing that 'ability to pay' (as measured by relative prosperity indices) and budget contributions should be measured in different currencies.

15. In the Commission's latest proposal shares in "net operating surplus of the economy" are now given equal weight to shares in agricultural production. Thus one half of the CAP expenditure to be financed through contributions made on the new key can be regarded as being financed through an agricultural production key modulated by relative prosperity and one

half through a shares in "net operating surplus' key modulated by relative prosperity. It is difficult to see why the Commission should regard net operating surplus as a suitable tax base for financing the CAP, especially as they are implicitly saying that it should be used as a base for financing only CAP and not other budget expenditures.

16. The Commission envisage that the total yield of the new tax would be defined so as to equal CAP guarantee expenditure in excess of 33 per cent of the budget total. They have chosen, however, to redefine guarantee expenditure to exclude food aid (which has been running at 150-200 mecu a year) and expenditure resulting from the operation of the ACP sugar protocols (which could amount to some 400 mecu in 1983, although the amount varies widely from year to year with world sugar prices). This redefinitiion works to the UK's disadvantage as it reduces the amount of own resources to be raised on the basis of the new key. The proposed exclusions are also objectionable in principle. The expenditures in question arise directly or indirectly from the operation of the CAP and the surpluses it encourages by setting Community prices substantially above world prices. The UK and Germany have in fact been resisting for some years proposals to remove the food aid export refunds and the ACP sugar equivalent from the EAGGF guarantee part of the budget. Amongst other things, the impact of our agricultural expenditure guideline would be made even more blunt if the exclusions were allowed to take place.

17. The Commission propose that the revenue from the new tax should substitute for part of normal VAT. The amounts due would presumably be paid over at the same time as normal VAT payments. The result of the new key would be that member states would in effect pay VAT at different rates (some of which might be over 1.4 per cent even though total payments by all member states of normal VAT and the new tax were equivalent to less than 1.4 per cent of the Community VAT base). The Commission has suggested that, as with the present VAT regime, contributions on the new modulated key would be made in year n on the basis of forecasts agreed the previous year and would then be corrected in years n + 1 and n + 2 in the light of the actual outturn.

Budgetary gains and losses from the new contributions key

18. The UK's share of the modulated VAT would have varied between around 11 per cent and around 13 per cent over the last three years. It might have been around 12½ per cent this year. This is well below our VAT share of rather over 20 per cent. Estimates of the net budgetary gain for the UK if thi own resource had been used in partial substitution for VAT are set out in table 1 below. As a rough rule of thumb, introduction of this modulated tax on the basis proposed by the Commission might have reduced the UK's net contribution by about one quarter.

Table 1 : The Commission's modulated agriculture/VAT key - budgetary implications for the budget

mecu

	1980	1981	1982	1983
Total budget (net of UK refunds)	16000	17000	18620	23400*
33% threshold for CAP expenditures	5280	5610	6140	7720
EAGGF guarantee (less food aid and ACP sugar)	10930	10820	11910	15200*
Implied additional own resources	5650	5210	5770	7480
UK share on new key	11.4%	12.7%	[13.0%]	[12.5%]
UK VAT share (assiette basis)	19.3%	19.0%	[21.3%]	[20.7%]
Net gains to UK	450	330	[480]	[610]

Notes: * Assumes EAGGF Guarantee expenditure of 15.8 billion ecus, of which food aid and ACP sugar account for 0.6 billion.

19. As can be seen from table 2, there would also be significant effects on the net budgetary positions of other member states. Germany would gain, though to a lesser extent than the UK. France, the Netherlands, Denmark and Italy would be losers, but just as the gains for the UK and Germany are comparatively modest so would be the losses of others. The potential losers are all net gainers from the operation of the CAP and the budget at the moment.

Table 2 : Losses and gains from proposed partial substitution of modulated VAT/agriculture key for VAT own resources

	Average of 1980 and 1981 (mecu)
Gainers	
UK	+ 390
Germany	+ 140
Little change	
Belgium	0
Greece	-10
Ireland	0
Luxembourg	+10

TABLE 2 (continued)

Losers	
Denmark	-70
France	- 240
Italy	- 120
Netherlands	- 100

20. The inclusion of "net operating surplus" in the key has little effect on the benefit that would have been derived by the UK over this period. The UK's share of Community net operating surplus has varied in a fairly narrow range of 11 to 14 per cent through the past decade, much the same order of magnitude as its present share of agricultural production. Shares of agricultural production and net operating surplus are, however, rather different for other member states. Table 3 disaggregates contribution shares on the Commission's proposal for a new key into its component parts of "agricultural production" and "net operating surplus", both being modulated by relative prosperity. It can be seen that Germany would benefit from the exclusion of net operating surplus from the new key, but Denmark, France, Ireland and Italy would lose. French officials have told us that France's share of the Community's 'net operating suprlus' has fluctuated a great deal in recent years and that they consider it would not provide a stable basis for a new own resource.

Table 3 : Contribution shares under the Commission's proposal and its component parts

	Commission's Proposal			Agricultural Production			Net operating surplus		
	1979	1980	1981	1979	1980	1981	1979	1980	1981
Belgium	4.3	4.2	3.8	3.9	3.7	3.5	4.8	4.7	4.2
Denmark	3.9	3.4	3.6	5.0	4.5	4.6	2.9	2.5	2.8
France	27.6	27.8	27.6	30.7	30.5	30.0	24.6	25.1	25.2
Germany	30.4	28.1	26.9	24.1	22.5	21.4	36.6	33.4	32.2
Greece	1.8	1.8	2.0	2.3	2.2	2.5	1.4	1.4	1.6
Ireland	0.9	0.8	0.9	1.3	1.3	1.4	0.4	0.3	0.4
Italy	13.2	15.3	14.9	14.6	16.1	15.7	11.9	14.6	14.0
Lux.	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
NL	7.8	7.4	7.5	8.3	7.9	8.0	7.3	6.9	7.0
UK	9.9	11.2	12.7	9.8	11.2	12.8	9.9	11.0	12.5

21. Analysis of the effects of what changes in net contributions would have been produced in the past by the new modulated agriculture/VAT key can only be a partial guide to the future. The Commission are not proposing that the new key should simply substitute for part of VAT within the existing 1 per cent limit, but that the limit should also be raised by 0.4 per cent. Much will depend therefore on how these additional own resources are spent. Of particular importance is that the new key would not protect the UK from having to make a substantial contribution to any expansion of CAP expenditure. The reason for this is that total expenditure would increase as well. Hence one third of an expansion in CAP expenditure would still be financed from traditional VAT so that the UK's marginal financing share would be of the order of 14 to 15 per cent - far above our prospective share of receipts from most of the likely increases in CAP expenditure (eg on Mediterranean agriculture).

22. Increases in non-agricultural expenditure by the Community could be of greater benefit on the receipts side to the UK, but the operation of the modulated agriculture/VAT key would serve to increase our marginal contribution share to their financing. An increase in non-agricultural expenditure of 1000 mecu, for instance, would reduce the amount raised on the new key by 330 mecu. The UK's effective marginal contribution share would thus not be its simple VAT share, but this VAT share adjusted for the additional contribution that the UK would have to make to financing the CAP. This could raise our marginal contribution share for non-agricultural expenditure by 2 to 3 percentage points.

Energy consumption tax

23. The Commission have dropped the idea of a tax on imported energy. They now say they are considering the possibility of introducing a tax on non-industrial energy consumption.

24. Table B attached shows shares of member states in non-industrial energy consumption. The UK would clearly not benefit from the introduction of such a tax by comparison with its marginal VAT rate. Such a tax is unlikely to find much support among other member states.

Own resources refunds

25. Under present rules the Commission refunds to member states 10 per cent of their total contributions of levies and duties. The purpose is ostensibly to cover collection costs. Since the UK's share of total levies and duties is high, our share of these refunds is correspondingly high (about 24.4 per cent

in 1983, compared with Germany's 26.4 per cent, France's 16.5 per cent and Italy's 11.8 per cent), and giving up these refunds would therefore cost us more than providing an equivalent amount of extra VAT. On the other hand, agreement by member states to give up the refunds could be a useful expedient if a situation should arise in which there was no headroom for UK budget refunds within the own resources ceiling.

Customs duties on ECSC products

26. The Commission have proposed on previous occasions that these should be made own resources. The reason they are not is that they are collected under special variable tariffs rather than the CCT. The yield of ECSC customs duties is about 60 mecus, with Germany paying by far the largest share (nearly 50 per cent). Officials are studying the proposal further.

Retention of surpluses

27. The Commission have sought powers to retain surpluses before too. Under the present arrangements, all surpluses of revenue (eg arising from VAT adjustments, higher than expected receipts of levies and duties or under-spending) must be entered in a subsequent budget (hence reducing the VAT rate). The Commission wishes to have discretion to retain the revenue without entering it immediately in a budget. They are seeking changes accordingly in the relevant regulations. The proposal would clearly not be conducive to tight financial management.

H M TREASURY
13 May 1983

ANNEX

DETERMINATION OF MODULATED AGRICULTURAL KEY - 1980

TABLE A1

	(a) Share of "profits" %	(b) share of agricultural production %	(c) GDP/head EC10 average =100 Average of PPP and Market e.r. figure	(d) $\frac{(a)+(b)}{2}$ x (c)	(e) Scaled to sum to 100	(f) GDP shares
Germany	28.8	18.8	120	28·6	28·1	29.1
France	22.8	26.9	114	28·3	27·8	23.3
Italy	19.3	20.8	78	15·6	15·3	14.1
Netherlands	6.5	7.1	111	7·5	7·4	6.0
Belgium	4.4	3.3	111	4·3	4·2	4.2
Luxembourg	0.1	0.1	121	0·1	0·1	0.2
UK	12.4	12.3	92	11·4	11·2	18.7
Ireland	0.6	2.2	57	0·8	0·8	0.6
Denmark	2.2	3.8	118	3·5	3·4	2.4
Greece	2.9	4.6	48	1·8	1·8	1.4
				101·9	100	100

DETERMINATION OF MODULATED AGRICULTURAL KEY - 1981

	(a) Share of "profits" %	(b) Share of agricultural production %	(c) GDP/Head EC10 average = 100 Average of PPP + Market e.r. figure	(d) $\frac{(a) + (b)}{2}$ x (c)	(e) Scaled to sum to 100	(f) GDP shares
Germany	27.9	18.0	119	27.3	26.9	27.9
France	22.8	26.3	114	28.0	27.6	23.2
Italy	18.5	20.1	78	15.1	14.9	14.3
Netherlands	6.7	7.5	107	7.6	7.5	5.7
Belgium	4.1	3.3	106	3.9	3.8	3.9
Luxembourg	0.1	0.1	120	0.1	0.1	0.2
UK	13.6	13.5	95	12.9	12.7	20.3
Ireland	0.6	2.3	59	0.9	0.9	0.7
Denmark	2.4	3.9	119	3.7	3.6	2.4
Greece	3.3	5.0	49	2.0	2.0	1.5
				101.5	100	

TABLE B NATIONAL SHARES IN ENERGY CONSUMPTION

% of Total E.C. (1981)

	Non Industrial Uses of Energy	Total Final Consumption of Energy	GDP
Belgium	4.4	4.9	3.9
Denmark	2.7	2.1	2.4
France	19.9	19.9	23.2
Germany	27.8	28.1	27.9
Greece	1.6	1.6	1.5
Ireland	1.1	1.0	0.7
Italy	14.2	15.1	14.2
Luxembourg	0.3	0.4	0.2
Netherlands	6.8	7.0	5.7
UK	21.2	19.8	20.3
EC 10	100	100	100

EXTRACT OF CONCLUSIONS OF THE MARCH EUROPEAN COUNCIL

The Community's Financial Resources and Related Problems

"The European Council notes the report on work done on the Commission's communication on the future financing of the Community. The European Council further notes the Commission's intention to submit specific proposals as soon as possible. It expects these proposals to take account of the development of the Community's policies, the problems connected with enlargement, budgetary imbalances and the need to strengthen budgetary discipline. It invites the Council (General Affairs) to discuss those proposals and to report its conclusions to the June European Council.

The European Council agrees that this report will contain conclusions also concerning the so-called subsequent solution in accordance with the undertaking made by the Foreign Affairs Ministers on 25 May and 26 October 1982 regarding compensation to the United Kingdom. Consequential figures for 1983 will be incorporated in the draft Community budget for 1984."

ANNEX IV

24 MAY FOREIGN AFFAIRS COUNCIL: PROPOSED STATEMENT BY THE FOREIGN SECRETARY

1. I want to make clear at the outset today how important it is that our discussion should not follow the circular pattern of our meetings over the last few months but should lead to firm decisions. We have been charged by the European Council with reporting conclusions to Stuttgart. It is critical that we fulfil our remit so that the figures for 1983 which flow from these conclusions can be incorporated in the draft Community budget for 1984.

2. The problem of Britain's budgetary burden has long been recognised. Even before we joined the Community we were promised that an unacceptable situation would be remedied. That promise has been repeated time and again since - in 1974 during the so-called renegotiation, in 1980 when temporary refunds were agreed and we were promised a structural solution. When that was not forthcoming and further refunds were agreed for 1982 in May and October, we were promised a decision on the subsequent solution by the end of November 1982. After that deadline had been passed and no progress on the subsequent solution had been made in the interval, the European Council in March this year decided that we must report our conclusions on the subsequent solution to the next European Council.

3. Throughout this history the Community has failed to provide a lasting solution. We have received short-term compensation over the last 3 years, but the underlying problem remains. Now the Commission has made a proposal which could contribute to a long-term settlement, and we must make every effort to reach agreement / by the end of the year, but it cannot be implemented in time for 1983. So we have to fall back yet again on a temporary solution, as the only way in which the Community can fulfil its assurances.

4. Last November the Commission put forward its ideas for the framework of this temporary solution. No-one has come up with any alternative to that approach, and I hope that we can now take it as agreed. At Gymnich I tabled a piece of paper which put some figures to that framework. I set out the main elements of a solution on the basis of the agreements covering the last three years.

/5.

5. A key element is of course the size of the basic refund. My figure of 1320 mecu is calculated on the same basis as underlay our earlier agreements. I cannot see that there is any other basis on which we can agree today. I am not asking for a more favourable arrangement to the United Kingdon than the Community has agreed in the past. Equally, it would be unreasonable of you to expect me to accept anything less favourable.

6. I am of course ready to agree to an amount to be deducted in full and final settlement of the alleged "overpayment" for 1980-1981, but subject to your acceptance of the other key elements of the solution.

7. It is now 24 May and time to get this matter finally settled. I therefore hope very much that we can today reach agreement on these lines so that our conclusions can be reported to the European Council and the consequential figures for 1983 can be included in the draft Community Budget for 1984. A failure to meet that very specific commitment would have the most serious consequences.