cc: EC Budget

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

ATHENS EUROPEAN COUNCIL: UK NET CONTRIBUTION

We are to meet on Thursday to discuss the Cabinet Office paper on our approach to the Athens European Council. However, in the light of developments at the Special Council in Brussels yesterday I should like to set down what I now believe our priorities and tactics should be, in particular on the question of the UK's net contribution. I enclose with this minute an analysis of various possible solutions and non-solutions, including our own safety-net; it also contains a diagram illustrating the various measurements of budgetary burden which have been suggested.

2. We approach Athens against a background of increasingly vocal criticism, not just from the Opposition but also from many of our own supporters, both inside and outside Parliament, of the workings of the Community and in particular the increasingly heavy level of expenditure on CAP surpluses. Many of our own people sincerely believe that the only way to remedy the Community's defects is to sit tight on the one per cent VAT limit and use that to enforce reform. This message emerged clearly when Ian Stewart appeared before the Scrutiny Committee early last week. We shall therefore need to be able to demonstrate convincingly to Parliament that any package that emerges from Athens will protect us against any future Community spending excesses.

3. Against this background our overriding objective must be to achieve a really satisfactory "safety-net" for budgetary imbalances. By this I mean an arrangement which:-

(a) measures our budgetary burden correctly, ie our excessive gross contributions as well as our inadequate receipts;

(b) provides relief for both sides of the problem on a scale reflecting our ability to pay. This means a limit (subject to (c) below) on our net contribution as close as possible to 0.1 per cent of our GDP (480 mecu (£280 million) for 1982);

(c) involves as low as possible a rate of contribution at the margin to increases in our uncorrected net contributions;

(d) can be relied upon to work, and produce satisfactory results, over time, without significant risks for the UK.

4. If these requirements are to be met, we must have a solution either along the lines of our own safety-net or one of the other "alpha-class" variants described in the note below. If, because of the sensitivity of our partners to the "net contributions" concept, the solution has to be dressed up, that can be done, as long as the entirety of the problem is dealt with (see alpha 2 in the note).

5. If we can achieve our objective, as defined above, of an alpha-class solution on budgetary imbalances, I believe that we could settle for a financial guideline for agricultural spending that does not match up precisely to our own strict guideline proposal. The

most promising possibility here seems to be the French proposal, tabled in Brussels by Jacques Delors yesterday, for an overall expenditure control (imposed by Finance Ministers setting a maximum VAT call within the overall ceiling at the beginning of each year) provided, as seems to be the French intention, it incorporates a rigorous agricultural spending control. But we should not trade in our demands on the safety-net even for an improved version of the strict financial guideline. We can explain to our supporters that a really good safety-net solution is also the best way to ensure agricultural reform, because the main burden of financing the CAP will be transferred to other member states.

6. I feel strongly that, if we are to contemplate conceding any increase in own resources, the package described in the previous paragraph must be our minimum requirement. However, as the Cabinet Office note suggests, we may be offered a "solution" based on compensation for the gap between our share of receipts from the Community Budget and our share of Community VAT, possibly with the addition of some measure of relief on the own resources side (the Commission's original "modulated VAT" proposal was a possibility here, but I doubt whether it is any longer a runner).

7. I do not think we should be prepared to concede any increase in own resources for this or any other "beta-class" solutions that do not deal adequately with the problem of our excessive payments of customs duties and agricultural levies (some 350 mecus (£200 million) a year on average over the past few years). Although modulated VAT happens to give a good result for 1982, that is because our share of VAT was particularly high in that year. There can be no security that it would consistently produce a satisfactory result, over time, for our net contributions. The same applies to a solution based on the expenditure/VAT share gap with no additional measure of relief on the own resources side, even though, if this

were sufficiently generous (ie guaranteeing that we should pay no more than around 100-150 mecu (£60-90 million) on top of our 'excess' payments of levies and duties) the outcome could be similar, in the short-term at least, to that from an "alpha-class" package. As table 3 to the note shows, our share of contributions of customs duties and levies has risen recently and the absolute amounts remain very substantial. If we were to accept a solution on these lines we would run the risk of finding ourselves back in an unacceptable situation in a few years' time.

8. As I see it, if we were offered such a "beta-class" safety net at Athens, together with an acceptable agricultural spending control, it only would be worth taking it provided we did not concede any increase in own resources. To refuse to trade an own resource increase for such a second class package would be entirely consistent with the position you clearly defined at Stuttgart. In such circumstances the onus would be on our partners to decide whether to accept no early increase in own resources, or to concede an "alpha-class" safety net as the price of one.

9. To get a satisfactory "alpha-class" solution as early as Athens will be extremely difficult. But I am sure that without it there should be no question of our giving up the leverage of the one per cent VAT ceiling. We should agree to neither the timing, nor the amount of any increase in the own resources ceiling, nor even the principle. Any statement of our readiness to move on own resources would have to be quite clearly conditional on the details of the safety-net and other parts of the package being satisfactorily and simultaneously put into place: otherwise I foresee major problems in the House and the country.

10. My judgement is that the key to success at Athens - ie either an "alpha-class" solution, or a broad agreement on the principles of

one, with the details to be worked up later - will lie in keeping close to the French and the Germans. The Germans, as the other net contributors, have been our natural allies throughout, and the French have moved a long way, as Delors' proposal yesterday showed. If this tripartite alliance holds - and Geoffrey Howe has done much to cement it - the problems for you will be greatly eased, and it is relevant that neither the French nor the Germans are pressing for an early increase in own resources.

11. If we cannot get agreement at Athens (whether in detail or in principle) to a satisfactory solution to the budgetary imbalances problem, then I believe we should give no ground whatsoever and hold out for the March European Council. In such a situation it would of course be necessary to consider how to deal with the question of our 1983 refunds. A judgement on this will depend on the precise circumstances at Athens. My own inclination is to suggest that you should make clear to our partners that we expect to receive the bulk of our Stuttgart refunds for 1983 by March (the end of our financial year), in accordance with the precedents of recent years. If this is challenged, eg by President Mitterrand, I believe that it would be right to warn that, if we have to do so, we will take the necessary action to protect our financial position from the 1st April.

12. I am sending copies of this minute to the Foreign and Commonwealth Secretary, the Minister of Agriculture and Sir Robert Armstrong.

pp. N.L.

29 November 1983

BUDGETARY IMBALANCES

This note and tables illustrate some of the budgetary imbalances packages which might feature at the Athens European Council. The actual outcome for the UK and other member states would, of course, depend critically on the measurement of burden, the limits formula, the parameters and the financing shares chosen.

Measurements of budgetary burden

2. The bar-chart at the end illustrates the relationship between our net contribution and the rival measurements of budgetary burden suggested by others. The net contribution can be defined as either (a) our gross contribution to , less our receipts from, the allocated budget or - which comes to the same thing - (b) the 'gap' between our percentage shares in Community expenditure and own resources, multiplied by the allocated budget total. The rival measures suggested by others all substitute a different share (VAT share, GDP share or population share) for our share of the Community's own resources. They all understate the true burden on the UK, since no account is taken of our net trading losses outside the budget.

Limits formulae or 'thresholds'

3. The UK's 'safety-net' formula would limit our budgetary burden to a percentage of our GDP, that percentage being an increasing linear function of relative prosperity in the enlarged Community. All the packages illustrated in the tables assume a formula of this kind, which the Germans and the Commission took over in their proposals. Others have suggested different formulae which would reimburse us a given percentage of the budgetary burden, as measured. These other formulae are unsatisfactory: they do not measure ability to pay and would expose us to any increases in our uncorrected net contribution.

Financing of reliefs

4. There are two important points. First, we should not contribute to our own reliefs or anyone else's . This would require us to contribute to increases in our uncorrected net contribution at a marginal rate of 20 per cent or more. Second, we need to find a pattern of sharing the cost of our reliefs that is acceptable for other member states. Financing in accordance with VAT shares would put heavy burdens on Germany and France. An alternative would be for

NB : 1 ecu = £0.58

the more prosperous member states to contribute to the reliefs by a key based on 'headroom' inside their safety-net limits - ie the difference between their actual budgetary positions and their safety-net limits or thresholds. The less prosperous countries would have to contribute rather heavily under such a key and might contribute instead in accordance with their VAT shares.

Package Alpha 1 (Net contribution and safety net)

6. The only type of package fully satisfactory for the UK would be one close to our safety-net proposal, like package alpha 1. It differs from our earlier proposal only in providing that member states would make small contributions at the margin to excesses in their net contributions over their safety-net limits.

7. These marginal contributions could, like the safety-net itself, reflect relative prosperity, rising from some 5 per cent for a country with 103 per cent of average prosperity in the enlarged Community (the UK) to some 25 per cent for a country with 135 per cent of Community average prosperity (Germany). (Example: if our uncorrected net contribution rose by 1 billion ecu (£580m) we would contribute in round terms an extra 50 mecu (£30 million).) To compensate for this, package Alpha 1 makes the safety-net limits formula more favourable to the UK. It would have left us with a corrected net contribution of 485 mecu (£280m) for 1982 (almost exactly 0.1 per cent of our GDP). Using a 'headroom' financing key, the UK and France would have had similar corrected net contributions for that year, though this would not necessarily be repeated in later years.

Package Alpha 2 (Net contributions for UK, expenditure/VAT for others)

8. This would go some way to meet the objections of other member states to the net contributions concept by basing the generalised relief system on the gap between member states' receipts and VAT shares, while giving the UK additional relief to cover the whole of our net contribution.

9. Member states with an unfavourable expenditure/VAT shares gap would be allowed to add to their measured burden their own resources/VAT shares gap (ie their excess of levies and duties over VAT), where this too was unfavourable. In practice only the UK would qualify. So the arrangement would cover net contributions for the UK but VAT/expenditure shares for everyone else. It could be called 'transitional' in the same sense as the Commission's modulated VAT purports to be transitional. If and when the levies and duties problem fades away, it would cease to have any significance.

10. An arrangement on these lines would have the same advantages for the UK as alpha 1. For other member states, it could be presented as being essentially an expenditure/VAT shares arrangement; the fact that the UK's relief would be based on the whole of our net contribution would be somewhat disguised; and France in particular would benefit from the fact that her budgetary burdens would be substantially overstated on an expenditure/VAT gap basis of measurement, because French levies and duties are so low.

11. A variant of this package would be one which placed a limit on our expenditure/GDP shares gap and allowed us to add to our measured burden the difference between our shares of GDP and own resources, on the precedent of the 1975 'Dublin' financial mechanism (but without the small print which debarred us from qualifying).

Packages beta 1 and beta 2 (Expenditure/VAT gap with Commission's modulated VAT)

12. These packages are less satisfactory than the alpha class packages. They would not provide any relief for our levies and duties payments: the Commission's modulated VAT would be intended as a substitute for this. The gains to the UK from modulated VAT are compared in the table below for the past four years with the losses from scoring levies and duties as if they were VAT. As the table shows, we would have gained on balance from such an arrangement over the past four years; but the results for 1980 and 1981 would have been unfavourable and the average result over the four years depends importantly on 1982, when our ordinary VAT rate was unusually high.

mecu

	1979	1980	1981	1982
Gains from modulated VAT	+408	+335	+318	+537
Losses from measuring burden as VAT/ expenditure gap (ie scoring levies and duties as if they were VAT)	-364	-442	-350	-251
Net gains (+), losses (-)	+ 44	-107	- 32	+286
(£m)	25	- 62	- 19	166

13. The attraction of such a package for other member states would be that it would avoid the net contributions concept and meet their desire not to compensate us for levies and duties. But several member states (including France and Italy) have opposed modulated VAT strongly and it now seems an unlikely runner.

14. For the UK, the main problem would be that, although it could be so constructed as to provide enough compensation in the short term to cover the levies and duties, it would do so by accident, rather than design. We could not be sure, therefore, that it would provide an acceptable result over time in terms of our net contribution. Things might go 'right'! But they might also go wrong and the problems if they went wrong would doubtless exceed the satisfaction if they went right.

15. The main risk is that while levies and duties are likely to remain substantial (as table 3 illustrates), our gains from modulated VAT could diminish considerably if the Community's non-agricultural expenditure rose faster than agricultural expenditure (as is possible); or our share of the Community's agricultural production rose; or our net operating surplus rose. If, as is possible, our share of the latter rose to the same level as our share of Community GDP, our net gains from modulated VAT could be halved.

16. As tables 1 and 2 illustrate, coupling modulated VAT with a safety-net limits formula similar to those under packages alpha 2 but applied to the expenditure/VAT shares gap, would have produced a rather favourable outcome for the UK for 1982. For 1981, on the other hand, the outcome would have been substantially less favourable.

17. In practice, other member states would doubtless react to the favourable result for 1982 by seeking to make the modulated VAT formula less favourable to the UK. Package beta 2 illustrates accordingly a formula with a higher budget percentage threshold which would have produced the same outcome for the UK for 1982 as packages alpha 1 and alpha 2. With this formula the relatively bad result for 1981 would have been accentuated.

<u>Package beta 3 (very generous limits on expenditure/VAT gap alone)</u>

18. Another less satisfactory package would be one which gave us a more favourable limits formula, applied to the expenditure/VAT gap, without any relief for levies and duties. This, too, could in principle provide an outcome in the short term similar to that from the alpha-class packages, and the uncertainty over the amount of benefit we would receive from modulated VAT would be removed. However, in order to give us an outcome on our net contribution close to 0.1 per cent of our GDP, the limits formula would have to give us an extremely low limit of 100-150 mecu (£60-90 million).

'Unattractive'packages

19. The lower part of table 1 shows the effects of applying less generous safety-net limits, similar to those at alpha 1 and alpha 2 above, to measures of the budgetary burden which do not fully cover the net contribution.

20. Package gamma 1 is a less generous version of package beta 3, which would apply to the expenditure/VAT gap, without the Commission's modulated VAT. The excess of our levies and duties relative to our VAT share would not qualify for relief. Package gamma 2 would apply to the expenditure/GDP gap (the Danish measurement of burden). The excess of our levies and duties and VAT, compared with our GDP shares, would not qualify for relief.

21. The signs are that other member states will urge the UK to accept packages along these lines. As table 1 shows however, the outcome for the UK would be likely to be far above 0.1 per cent of our GDP and distinctly less favourable even than the 66 per cent of our uncorrected net contribution formula which underlay the 30 May 1980 arrangements.

TABLE 1

ILLUSTRATIVE PACKAGES : NET CONTRIBUTIONS AFTER CORRECTION

mecu

ALPHA PACKAGES

		1981	1982
α1	Safety-net limits on net contributions, with surcharge		
	UK	- 185	- 485
	Germany	-1820	-2157
	France	121	- 537
α2	Safety-net limits on expenditure/VAT shares gap plus any positive own resources/VAT gap (where earlier gap is unfavourable) with surcharge		
	UK	- 185	- 485
	Germany	-1962	-2166
	France	226	- 447

BETA PACKAGES

		1981	1982
β1	Safety-net limits on expenditure/VAT shares gap, with srcharge, plus Commission's modulated VAT		
	UK	- 294	- 266
	Germany	-1687	-2058
	France	104	- 421
β2	Less generous version of β1		
	UK	- 416	- 485
	Germany	-1711	-2063
	France	194	- 346
β3	Very generous safety-net limits on VAT/expenditure gap alone, with surcharge		
	UK	- 402	- 477
	Germany	-1803	-2144
	France	320	- 282

GAMMA PACKAGES

		1981	1982
γ1	Less generous safety-net limits on expenditure/VAT shares gap alone, with surcharge		
	UK	- 612	- 803
	Germany	-1967	-2045
	France	329	- 603
γ2	Safety-net limits on expenditure/GDP shares gap alone, with surcharge		
	UK	- 392	-1171
	Germany	-2003	-1849
	France	242	- 524
γ3	Safety-net limits on expenditure/population shares gap alone	Less favourable to UK, after enlargement, than γ2 if our prosperity is above average	

MEMORANDUM ITEM

		1981	1982
Original UK safety-net proposal	UK	-219	-440
	Germany	-1784	-2095
	France	+124	-551

ILLUSTRATIVE PACKAGES : EFFECTS ON OTHER MEMBER STATES

(Corrected net contributions, mecu)

	Uncorrected net contributions	$\alpha 1$ (Headroom financing)	$\alpha 2$ (Special key financing)	$\beta 1$ (Headroom financing)	$\beta 3$ (Headroom financing)	$\gamma 1$ (VAT financing)	$\gamma 2$ (VAT financing)
1981							
Belgium	276	163	156	181	134	236	221
Denmark	279	169	207	111	185	258	251
France	576	121	226	104	320	329	242
Germany	-1684	-1820	-1962	-1687	-1803	-1967	-2003
Greece	173	148	148	175	153	156	151
Ireland	582	57-	571	566	572	574	571
Italy	788	581	581	653	617	653	605
Luxembourg	239	181	209	223	194	237	237
Netherlands	190	72	49	-81	30	136	117
UK	-1419	-185	-185	-294	-402	-612	-392
1982							
Belgium	253	109	53	126	-15	167	178
Denmark	295	118	160	36	98	244	251
France	-19	-537	-447	-421	-282	-603	-524
Germany	-2086	-2157	-2166	-2058	-2144	-2045	-1849
Greece	685	654	649	661	654	644	650
Ireland	732	712	708	706	712	707	710
Italy	1616	1345	1297	1104	1343	1266	1313
Luxembourg	256	161	197	225	158	251	252
Netherlands	304	81	34	-113	- 47	172	190
UK	-2036	-485	-485	-266	-477	-803	-1171

TABLE 3

CUSTOMS DUTIES AND AGRICULTURE LEVIES

Amounts collected in UK — £ million

	Customs Duties		Agriculture Levies		Total	
	Cash	Constant 1973-74 prices	Cash	Constant 1973-74 prices	Cash	Constant 1973-74 prices
1973-74*	437	437	25	25	463	463
1974-75*	501	466	25	24	526	490
1975-76*	513	375	45	33	558	408
1976-77*	676	436	53	34	729	470
1977-78	682	392	178	102	860	494
1978-79	736	381	230	119	966	500
1979-80	937	412	241	106	1178	518
1980-81	817	304	220	82	1037	386
1981-82	959	325	238	81	1197	406
1982-83	1028	325	200	63	1228	388

UK shares in EC totals

%

	Customs duties	Agriculture levies	Total
1978	24.3	18.1	22.4
1979	25.9	21.0	24.7
1980	24.4	26.1	24.7
1981	24.3	27.6	24.8
1982	26.2	31.3	27.1
1983	26.1	21.5	25.6

Source: Customs and Excise Annual Reports, Commission figures.

Constant price figures use GDP deflator

*For these years, less than 100 per cent of the duties and levies were paid over to the Community.

RIVAL MEASUREMENTS OF UK'S BUDGETARY BURDEN

The UK's budgetary burden, on the various definitions discussed in the Council, is shown by the height of the bars:-