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

23 November 1983

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AJC : to see o.r.

DWB 23/11

D F Williamson Esq
Cabinet Office
70 Whitehall
LONDON SW1

Dear David,

EUROPEAN COMMUNITY: POST-STUGGART NEGOTIATIONS

with AJC

The Chancellor has read with interest your minute of 18 November about your discussions with Lautenschlager and Tietmeyer.

He agrees that, if the three options mentioned in your paragraph 8 were on the table at Athens, that would provide as good a point of departure as we could reasonably expect. He therefore fully supports the general approach which you have taken.

As between the three options, the Chancellor has no doubt that options i. and iii. would be preferable to option ii. Options i. and iii. would address the net contribution problem directly, including the levies and duties element (though with considerable camouflage in the case of option iii.) and could be relied on to solve it on a lasting basis.

Option ii., which would combine the Commission's modulated VAT with compensation for the gap between our expenditure and VAT shares, might quite possibly provide us in practice with a similar amount of relief. But it would not deal directly with the levies and duties element in our net contribution (the excess of our levies and duties share over our VAT share has been as much as 350 million ecus a year on average over the past four years). So although this hybrid approach could be so constructed that it would be likely to provide enough compensation to cover the levies and duties element, it would do so by accident, rather than by design. We could not be sure that it would provide an acceptable result over time in terms of our net contribution. There are several things which could go wrong. Our levies and duties could increase rather than decrease, for example, in an environment of higher world trade and UK import volumes; while our gains from modulated VAT could diminish considerably if the Community's non-agricultural expenditure were to rise faster than agricultural expenditure (as is very possible) or our share of the Community's agricultural production or net operating surplus were to rise. And the pain if things went wrong would exceed the pleasure if they went right. The Chancellor believes, moreover, that the task of persuading the House of Commons to go along with a deal which included an increase in own resources would be considerably more difficult if the imbalances mechanism could be seen to be one which might go wrong.

A further consideration is that, paradoxically, the fact that option ii. could have given us an unusually favourable outcome for 1982, because of our high VAT share for that year, is a disadvantage for the UK. This favourable result for 1982 would doubtless lead other member states to drive an even harder bargain than otherwise on the formula for limiting our VAT/expenditure shares gap.

Copies of this letter go to John Coles (No 10), Roger Bone (FCO), and Richard Hatfield in Sir Robert Armstrong's office.

Yours ever,

John Kerr.

J O KERR

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Budget
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MR BONE, FCO

EUROPEAN COMMUNITY: POST-STUTTGART NEGOTIATIONS

I had a long discussion yesterday with Herr Lautenschlager and Herr Tietmeyer, most of the time being spent on the central budget problem. I had set myself two objectives:-

(i) to persuade the Germans that the difficulty for other member states in financing the United Kingdom's relief was not as great as they believe and, in particular, that an understanding between Germany, France and the United Kingdom (under which the net contributions of France and the United Kingdom at the outset would be similar) would make a Community agreement more probable. The underlying objective is, of course, to reduce the incentive for the Germans to argue for a higher United Kingdom net contribution, which they will otherwise do so long as they believe that the figures resulting from our proposal are not negotiable with other member states;

(ii) while maintaining our own position unchanged, to improve to the maximum extent possible the various elements which are included in the proposals already made by others or which might be included in a revised German (or Presidency) proposal.

2. On point (i) I found, as I expected, Herr Lautenschlager and, to a considerable degree also, Herr Tietmeyer greatly concerned with what will, in their view, be negotiable. Using our own safety net scheme I stressed that, if at the outset the French and British net contributions were at about the same level (ie the level which results from our own document) and even assuming a German net contribution at or about the level which they themselves have implied in their paper, the resulting figures for the remaining member states are not in the least unreasonable. Of course, our relief has to be financed from somewhere but, applying this

system to the 1982 situation, all the other member states would remain net beneficiaries and the changes for the less prosperous are very modest. This special financing key is based on "headroom"; member states would finance reliefs in accordance with the "headroom" inside their limits, ie the differences between their actual net positions and their limits, but less prosperous countries would not have to pay more than their VAT shares after excluding beneficiary countries. The United Kingdom does not contribute to its own reliefs.

3. In the last resort the key under which the other member states finance the reliefs for the United Kingdom (and Germany) is not of great moment to us. The more acceptable, however, the distribution of the burden among other member states, the less the pressure against large relief to the United Kingdom. You will recall that many member states think in terms not of the effect of the new settlement on their net benefits, but in terms of their percentage contribution to the United Kingdom relief. Herr Tietmeyer noted very carefully what percentage each member state would contribute under the "headroom" special key and compared it with the special key proposed by the French. I hope that we have made at least some modest progress in persuading the Germans that the financing of reliefs on the scale we expect can be negotiated.

4. On point (ii), I discussed only on the basis that this was not the British but someone else's proposal. There are two conclusions to be drawn. First, the Germans are getting cold feet about modulated VAT (Commission's original proposal of 6 May). Although the Germans state that they themselves could see it in a final package, the French have been telling them that it is not acceptable. I said that we were well aware of the views of other member states now opposed to the Commission's modulated VAT proposal, but that we had not concluded that it was un-negotiable; this remained to be seen and the proposal should remain on the table.

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5. Secondly, and more importantly, Herr Tietmeyer advanced his personal idea for a solution based on the hypothesis that the (un-negotiable) modulated VAT would have to be replaced by something else for the United Kingdom. He suggested that the relief related to the payments gap should now relate to the difference between a member state's share of payments from the Community budget and its share of VAT (the payments/VAT share gap). This is more favourable for the United Kingdom than the earlier proposals. He also proposed that the safety net related to this gap should be established on the basis of German variant 1, ie the United Kingdom basis, as a percentage of GDP and that the system could be made more favourable to the United Kingdom and Germany by taking 0.006 rather than 0.007 in our limits formula. He estimated that the gap to which the United Kingdom's relief would relate would be about 1385 million ecu (1982 basis). I said that, irrespective of other points, this was not enough money. In my view the value of Herr Tietmeyer's personal suggestion is that, with each day that goes by, it becomes more probable that one element in the proposal to which other member states are laboriously moving, will be the payments/VAT share gap.

6. At this point, another element entered into Herr Tietmeyer's analysis: the German wish to defer the actual provision of more own resources until at least 1986. He suggested that, although relief related to the payments/VAT share gap should be the permanent system, two problems remained. The United Kingdom would have obtained substantial relief but not relief related to the whole of the net contribution and, in any event, something was needed in relation to 1984 and 1985. Furthermore, he argued that the burden falling on the United Kingdom from our high contribution of levies and customs duties would fall away as the unit rate of levies and duties fell. An interim solution was therefore necessary which would be based on relief related directly to the net contribution. This would be phased out and replaced by the permanent system based on the payments/VAT share gap. My advice is that this is quite unacceptable. We are not in the business of accepting a long term arrangement which is not good enough, with a short term supplement.

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7. After the meeting, however, I have reflected on a way in which we might be able to turn this to a significant advantage. If we called the German bluff about the alleged disappearance in the future of our excess contribution of levies and duties, it would be possible to have the following solution:

- <u>element 1</u>. Relief based on the difference between the share of payments from the Community budget and the share of VAT, as now suggested informally by the Germans. This takes care of our lack of adequate receipts from the Community.

- <u>element 2</u>. Relief based on the difference between own resources share and VAT share, this relief to last as long as a member state is contributing an excess amount of own resources (ie from levies and customs duties). In effect we should be saying to the Germans "you say that our problem of excess contributions of levies and duties will fade away. Alright, we shall have the relief until that happens". It is easy to add a condition ensuring that, although the scheme would be a Community scheme, only the United Kingdom would get relief on this element.

- elements 1 and 2 add up to relief on the net contribution.

8. To conclude, we might be able to manoeuvre towards the following menu:-

(i) The United Kingdom's safety net scheme.

(ii) Relief related to (a) the payments/VAT share gap and (b) the Commission's original proposal (with some amendments) for modulated VAT. This could give adequate relief to the United Kingdom (on the assumptions which we have taken in our own working document it would have resulted in a United Kingdom net contribution of 294 million ecu in 1981 and 266 million ecu in 1982). Strictly speaking, the modulated VAT, although it is likely to be a useful

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relief, does not deal directly with the question of our excess contribution of levies and duties.

(iii) Relief related to (a) the payments/VAT share gap and (b) the own resources/VAT share gap, element (b) being allegedly transitional, ie to remain in effect so long as the gap remains. This is the safety net related to net contributions in a different presentation. It could, however, have a different negotiating impact if we arrive at it by the German route rather than by repetition of our own position.

9. The atmosphere in my discussions was very good but I should indicate that in my view the German side was disappointed that I did not come with specific concessions or an indication of our willingness to agree to a higher net contribution than is implied in our safety net scheme. They will have to live with that disappointment.

10. I am sending copies of this minute to John Kerr (Treasury) and Sir Robert Armstrong.

D F Williamson

D F WILLIAMSON

18 November 1983

Cabinet Office