Prime Minister 1

(a) Would you like to discuss the attached paper with Cabinet Office and Treasury officials before any ministerial meeting?

Yes

(b) Would you like the final version of the paper to go to OD on Wednesday 17 March, or to a restricted group consisting of Lord Carrington, Sir Geoffrey Howe and Mr Walker?

Restricted group.

WR 1/3

Ref. A07653

MR COLES

30 May Mandate and Other Community Negotiations

Officials are preparing a note on the current negotiations about the 30 May Mandate, CAP prices and Fish as the basis for a Ministerial meeting to decide how the United Kingdom should handle these negotiations in the weeks ahead, and in particular at the following crucial meetings: the Anglo-German Summit on Friday 19 March, the Foreign Affairs Council on 22-23 March and the European Council on 29-30 March. The present intention is that this paper should be circulated in time for a meeting of Ministers on Wednesday 17 March. The discussion could either be held in OD or, if the Prime Minister preferred, in a more restricted group comprising the three other Ministers essentially concerned namely the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and the Minister of Agriculture.

2. The budget problem has a number of complex technical characteristics. We, therefore, thought it might help the Prime Minister to see, before the Ministerial discussion about policy, a note which makes no recommendations but explains what the basic issues are. The attached note accordingly covers the following ground:

(i) How the Commission scheme (objective indicators) might work out in practice.

(ii) The need to combine it with an improved version of the financial mechanism if it is to meet our requirements.

(iii) The gap that appears now to exist between the requirements of Her Majesty's Government and the most that the others seem willing to concede at this stage.

(iv) The problem of financing an adequate solution to the British budget problem within the 1 per cent VAT ceiling and the suggestions that have been made in informal discussions in Brussels for solving this problem.

3. The attached note will be the starting point for the draft of the relevant parts of the paper that officials are preparing for the Ministerial meeting on 17 March. The Prime Minister might find it helpful to discuss the contents of the attached note with Cabinet Office and Treasury officials before the Ministerial meeting. We should also be grateful to know whether the Prime Minister would prefer that meeting to take place in OD or as an ad hoc meeting of the four Ministers essentially concerned.

RtA

ROBERT ARMSTRONG

26 February 1982

UK Budget Problem and 1% Ceiling

1. This Note describes some of the technical background to the current negotiations about the British budget problem and the 1% ceiling.

SIZE OF THE BRITISH PROBLEM

2. The Commission are working on the figures. They will be examining very carefully the assumptions made because the 30 May Agreement estimates turned out to be so badly wrong. The new figures will be circulated to member states before the Foreign Affairs Council on 23 March. However the latest Commission working document we have shows that our net contribution to the allocated budget* for 1982, before refunds, may lie in the range 1950-2350 million ecus (say £1¼ billion). Forecasts for subsequent years are necessarily even more uncertain. We have realistically to assume, however, that this net contribution is likely to rise at least in line with inflation and probably in real terms as well - especially after enlargement.

3. The Commission and most other member states would like if they could to banish the whole concept of 'net contributions'. Consistently with this, the Commission have advocated looking separately at the shortfall in UK receipts and, possibly, the excess in our gross contributions. The criterion which they suggest for measuring these two components of the UK problem is our share of Community GDP, averaged over three years. The prospective split for 1982 is:

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*The 'allocated budget' was the basis of calculations in the 30 May Agreement. It should be remembered that the UK also contributes substantially - perhaps some £150 million in 1982 - to the unallocated budget (about two-thirds of which goes to overseas aid, including food aid); and that our losses outside the budget on agricultural trade with other Community countries are estimated to have been around £200 - 250 million in most recent years.

i. a 'receipts' side gap of 1250 - 1650 million ecus (say, £825 million), and

ii. a 'gross contributions' side gap of some 750 million ecus (say, £425 million).

In other years, the relative magnitudes of the two gaps could be very different, with a rise in our relative GDP increasing the 'receipts' gap and reducing the 'gross contributions' gap and a fall having the opposite effect.

THE COMMISSION SCHEME AND THE FINANCIAL MECHANISM

4. The Commission's proposal for solving the UK budget problem referred to in the draft guidelines considered by Foreign Ministers at their abortive meeting on 25 January is, as we understand it, that the UK should receive a refund of some agreed percentage of the difference between:

i. the UK's actual share of receipts from the Community budget in the year in question - roughly 11%;

ii. what the UK share would be if it were the same as our share of Community GDP averaged over 3 years (the current year and the 2 preceding years) - roughly 19%.

The difference is the 'receipts' side gap. It is clear that the other member states do not envisage repaying us the whole of this sum, but, even if they did, this method on its own would still leave us to meet the 'gross contributions' gap of some 750 million ecus for 1982 - and there would be risks both ways in later years of changes in the split between the receipts and the gross contributions sides of our net contribution. For that reason, the Commission scheme would need to be combined with a revised and improved version of the financial mechanism if it were to provide the basis for a solution. During the negotiations in January we did manage to insert a reference to the financial mechanism into the draft guidelines, but it is far from sure that the others will accept that it should continue. The new version of the financial mechanism that we have in mind would be stripped of the various limitations that have rendered it inapplicable in recent years. We envisage that, by analogy with the Commission scheme described above, the new financial

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mechanism should guarantee us a refund of some percentage of the difference between:

iii. Our share of gross contributions to the Community budget - roughly 23%; and

iv. What our share would be if it were the same as our share of Community GDP - roughly 19%.

Provided that the same definition of the Community budget were used in both cases, the same method of calculating GDP shares and a satisfactory common method of relating gross to net payments, then any given percentage of the gap between i. and ii. above plus the gap between iii. and iv. above would be mathematically equivalent to that same percentage of our unadjusted net contribution.

5. Thus, for example, if the Community agreed to give us a net refund of 90% of both the gaps defined above, then our net contribution for 1982 would be 10% of our unadjusted net contribution, or something in the range of 195-235 million ecu. Such figures would lie somewhat above the highest figures for our net contribution after refunds that Ministers have so far envisaged - ie, around 150 million ecu. We should need to get a refund of 95% in both cases to have a reasonable chance of staying within a figure of 150 million ecu throughout the whole of the 5 year period 1982-1986, to which we intend the agreement to apply.

6. It is unlikely that the other member states envisage a refund of more than two-thirds of our unadjusted net contribution - ie, the same proportion as would have resulted from the 30 May Agreement if the estimates had been borne out. A number of contacts have told us informally that in their view a repetition of the two thirds/one third division between the 'Community' and 'UK' shares of our unadjusted net contribution would be appropriate. We cannot be sure of getting agreement to a solution based on proportions. Some are still arguing for degressive refunds. But to illustrate the point, a two thirds refund would leave us with an adjusted net contribution of some 650-800 million ecus in 1982, a figure which is likely to rise over a five year period.

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7. If we got to the position of commiting the other member states to a clear offer of two thirds, we should still have to close the gap between the 650-800 million ecus apparently on offer, and the 150 million ecus that Ministers wish to see.

THE SIGNIFICANCE OF THE 1% CEILING

8. The problem of financing the refunds within the 1% ceiling has recently moved into the centre of the informal discussions in Brussels. It is generally accepted that Ireland and Greece should be let off from making anything larger than a token contribution to the refunds to the UK. The Italians have said they are happy to contribute to UK refunds but not to the relief of the German contribution. Germany has made it a condition of the agreement that her contribution should be relieved. Germany would contribute 35-40% of our refunds if they were financed through the normal operation of the own resources system and the budget. Statements by German Ministers could be interpreted in either of two ways: that Germany should in future pay only 25% of 35-40%, ie 9-10%; or that Germany should pay 25% instead of 35-40%. The difference between these two versions of German demands is substantial.

9. At present because of the operation of the own resources system all ten member states, including the UK, pay extra VAT in order to finance our refunds under the 30 May agreement, and we are reimbursed not only our net refunds but also our share of these extra contributions. If our future refunds are to be financed through own resources in the same way, but some countries are to be excused part of the cost, then they too will need reimbursement of contributions and a still higher rate of VAT contributions will be necessary.

10. The amount of headroom available within the 1% ceiling to finance refunds to the UK through the budget in the normal way depends not only on the extent to which the less prosperous countries and Germany are relieved, but also on the rate of growth of regular expenditure. So far as agricultural expenditure is concerned, it is our firm intention that the rate of growth be held within the rate of growth of own resources. For non-agricultural expenditure (from which we currently get and intend to continue to get a modest net benefit), given the general agreement that the structural funds should be expanded, it would be reasonable to expect a significantly higher rate of growth, say 20%.

/According

According to the latest Commission estimates, there seems little prospect that money would be available even in the 1983 budget to finance refunds sufficient to reduce our net contribution in respect of the 1982 Budget to about 150 million ecu, even on the optimistic assumptions that Italy pays in full and that Germany pays as much as 25%. We certainly cannot rely on enough money being available in 1984 and later years, and we cannot tolerate any agreement in which the eventual payment of refunds due to us might be constrained by shortage of budgetary provision within the 1% ceiling.

11. The agricultural countries are concerned lest the solution to the Budget problem inhibit the financing of agricultural policies; and Italy in particular is also concerned lest it should prevent the development of non-agricultural policies as envisaged in Chapter I of the provisional Mandate conclusions. The Commission shares these concerns and has suggested that the refunds to the UK should be financed, not through the own resources system, but by a special key of financial contributions by the member states decided by unanimous vote of the Council of Ministers acting under the provisions of Article 200 of the Treaty. The legality of this proposal has been disputed: many Community lawyers argue that Article 200 became a dead letter when the own resources decision was taken in 1970 under Article 201 of the Treaty. (The text of Article 200 and 201 is attached as an Annex. It will be noted that Article 201 refers to the replacement of the financial contributions by own resources. Hence the argument that Article 200 has now lapsed). However, the Commission's Legal Adviser has formally given his opinion that Article 200 can still be used and it is possible that other governments will supress their legal doubts if no better way can be found of financing the solution to the problem.

12. The use of Article 200 would provide a very much simpler way of relieving Ireland, Greece and Germany (and, if necessary, Italy) than the orthodox use of the own resources system. The latter would necessitate refunds to those countries as well as to the UK in order to pay them back some or all of the contribution they would make to the cost of the refunds through the operation of own resources. If a special key were agreed under Article 200, the relief to Ireland and the other countries could be made simply by adjusting the financial contribution accordingly.

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13. However, such an application of Article 200 would run up against a major political difficulty. The special financial contributions would have to be approved by the parliaments of the member states under their national budgetary arrangements and several member states have made it clear that they would have very great difficulty in seeking authority from their national parliaments for a special payment to finance a refund for the United Kingdom.

14. As a way round that difficulty, the following more elaborate use of Article 200 has been suggested in informal discussions in Brussels. Under this variant the UK refunds would be financed through own resources in the normal way up to the point where the 1% ceiling was reached. At that point, the Council of Ministers would agree to finance through Article 200 a block of expenditure equivalent in size to the cost of the refund scheme to the Community Budget (including the costs of the refunds to Ireland, Greece, Germany and possibly Italy). All the member states would subscribe financial contributions under Article 200 in the same proportions as their VAT share of own resources and the justification would be to enable the regular expenditure of the Community to go ahead while the future of the 1% ceiling was examined. This proposal is thus intended to disguise the fact that the recourse to Article 200 would be necessitated solely by the need to finance refunds to the UK.

15. Agreement to the use of Article 200 would raise a number of important issues for the UK. On the one hand, we share the legal doubts about the continued availability of the powers in this Article. We would also want to be quite sure that the use of this Article would not be treated as a precedent for normal expenditure because, if it were so used, it would bypass the discipline of the 1% ceiling which it is Government policy to enforce. On the other hand, even if the rate of agricultural expenditure were kept within the rate of growth of own resources, there might well not be enough money within the 1% ceiling to finance refunds to the UK on a sufficient scale for the whole of the 5 year period for which we are pressing. Ministers will therefore need to take a view on whether it would be better to acquiesce in the use of Article 200, suitably confined to the UK Budget problem, than to jeopardise either the 5 year duration of the settlement or our position on the maintenance of the 1% ceiling.

/THE 1%

THE 1% CEILING AFTER ENLARGEMENT

16. The Belgian President of the Council of Foreign Ministers is believed to have it in mind to propose some form of commitment to the renewed progress of the Community as an element in the final agreement on the Mandate. This will be attractive to a number of member states, especially Italy. Even France is committed to relance. Increasingly, the Community is considering the implications of the accession of Spain and Portugal. The date of their accession may be delayed beyond 1984 as at present planned, but it is likely to occur during the period of application of the solution of the Budget problem. (Even a 4 year solution would impose a charge on the 1986 Community budget, for example). It is generally assumed that both Spain and Portugal, because they are both so far below average GDP per head, should be net beneficiaries from the Budget at least to some extent - so that their accession will tend to erode and not to increase the leeway within the 1% ceiling. For that reason, it is quite possible that either the Belgian Presidency or the Commission, or both, will propose a commitment by the member states to consider the future of the own resources system in the context of the further enlargement of the Community.

17. It is possible that some member states at least will insist on a review of the own resources system as a condition of their agreement to the use of Article 200 to finance our refunds on a temporary basis. Even if the Germans maintained their resolve not to raise it, UK Ministers might need to consider at some point whether we could go along with some form of obligation to examine the future of the 1% ceiling, perhaps in the context of enlargement.

18. If we did agree to a review in the course of this year's negotiations, that would not commit us to accepting any change to the 1% ceiling when the review took place. But the negotiations on the future of the ceiling would provide us with a new opportunity to secure changes in the Community's financial arrangements. Possibilities that could be discussed are that a binding ceiling should be imposed on the rate of growth of agricultural expenditure corresponding to the informal political agreement incorporated in the draft Mandate conclusions; the replacement of the Value Added Tax element in own resources by some form of progressive tax; the addition of a tax on imported oil designed to bring about a significant adjustment in the UK's unadjusted net contribution; and a commitment to the principle that

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resources should flow from the rich to the poor member states and not vice versa.

DEGRESSIVITY

19. Tindemans has indicated that he will make a new attempt to secure agreement to a guideline on degressivity at the Foreign Ministers'meeting on 23 March. We do not yet know what he has in mind but he is well aware that the UK will accept no form of words that commits us to an arbitrary reduction in our refunds even if our unadjusted net contribution increases. The Foreign Secretary is seeking to persuade Genscher thatthe Commission's objective indicators plus a revised financial mechanism will automatically provide quite enough degressivity to meet German requirements in the sense that (i) our net contribution after refunds will increase, other things being equal, as the size of the budget increases and (ii) the refunds will be reduced as our other receipts increase from a Budget of any given size.

THE ALLEGED OVERPAYMENT TO THE UK

20. At an earlier stage in the negotiations it was suggested that the Budget solution for 1982 and later years should take account of some or all of the 900 million ecu by which the UK's net contribution after adjustment was fortuitously reduced below the figures of 609 and 730 mentioned in the 30 May decision. Less has been heard of this suggestion recently; but we cannot be sure that it will not revive.

THE TIMING OF PAYMENTS

21. The 30 May Agreement was based on an arbitrary lump sum for refunds, derived from Commission estimates of the UK's unadjusted net contribution. The current proposal is that the adjustment should be based on actual figures established on an ex post basis. A reasonable presumption about timing, which broadly follows what happens now, might be that refunds in respect of the 1982 budget, for example, would be paid by the end of March 1983 (so that we could bring them to account in our financial year 1982-83) as a charge to the 1983 Community budget and on the basis of provisional figures for the actual effect of the 1982 budget on the UK. It would then be necessary to have a final adjustment in the middle of 1984 when complete accounts for 1982 were available, in order to bring the refunds paid exactly into line with the application of the agreed method to the actual 1982 figures.

/SUMMARY

SUMMARY

(1) The Commission's 'objective indicator' scheme would only reduce our net contribution to something of the order of 150 million ecu a year if a very high rate of compensation under it were combined with an improved form of financial mechanism.

(2) Although we were able to insert a reference to the possible need for a financial mechanism into the draft budget guidelines, the other member states and the Commission are not yet committed to either its continuation or its improvement to meet our requirements.

(3) Informal contacts suggest that some member states may be thinking in terms of a refund amounting to two-thirds of our unadjusted net contribution as established after the out-turn figures for each year's budget are known. To hold our net contribution down to a figure of around 150 million ecu a year, we should need a refund of some 95% of our unadjusted net contribution. In money terms, the gap between two-thirds and 95% is about 600 million ecu in respect of 1982; and would be likely to increase over a 5 year period.

(4) It is highly unlikely that the Community will be able to finance refunds on the scale we require within the own resources system as at present defined for the whole of the 5 year period; indeed, there is little prospect that there will be enough money in the 1983 budget to finance even the first year's refunds.

(5) It may therefore be in our interest to go along with an agreement to revive financial contributions under Article 200 of the Treaty.

(6) We may come under pressure to agree, as part of the eventual conclusion of the Mandate negotiations, to review the future of the 1% ceiling in the context of the accession of Portugal and Spain.

(7) Even if we agreed to such a review, we should not, of course, be committed to increasing the ceiling. The review, when it took place, would give us an opportunity to fight for new changes in the Community's financial arrangements. Among the possibilities are a binding ceiling on the growth of agricultural expenditure; a progressive tax to replace the VAT tranche of own resources; a levy on oil imports; and a commitment that resources should flow from the more to the less prosperous member states and not vice versa.

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(8) Tindemans is believed to intend to make a new attempt to agree a formula on degressivity at the next Foreign Ministers' meeting on 23 March.

(9) Little has been heard recently of an earlier suggestion that the '900 million ecu over-payment' to the UK be taken into account in the new settlement; but it may revive.

Cabinet Office
26 February 1982