

PO.-CH/NL/0363 PART B



Part B

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Begins : ~~2/10/87~~ . 8/9/87.  
Ends : ~~30/11/87~~ . 19/10/87.



PO -CH /NL/0363



PART B

Chancellor's (Lawson) Papers:

**FUTURE FINANCING OF THE  
EUROPEAN COMMUNITY**

DD's : 25 Years

*Philomen*

29/11/95.

PO -CH /NL/0363

PART B



[illegible]



FROM: A J C EDWARDS  
DATE: 8 September 1987

PAYMASTER GENERAL

cc : PS/Chancellor  
Sir P Middleton  
Sir G Littler  
Mr Lavelle  
Mr Crabbie  
Mr Mortimer  
Mr Donnelly  
Mr Cropper

*Ch/ Content with the  
terms of the draft PMG  
minute to the PM? (You may also  
like to see Mr Donnelly's briefing  
minute of 7/9, attached below).*

*8/9*

*I have bypassed a  
draft of a new  
p1 - a new  
substantive  
on p2.*

**VISIT OF VICE PRESIDENT CHRISTOPHERSEN :  
DRAFT MINUTE TO PRIME MINISTER**

Your Private Secretary's letter of 31 July to No 10 promised a further note for the Prime Minister about the problem of the 1988 Community Budget after the visit of Mr Tygesen and before the Prime Minister's meeting with Christophersen.

2. In the event, the order of events has been reversed, with Christophersen's visit preceding that of Mr Tygesen. You may think it right, nevertheless, to offer the Prime Minister further advice as promised.

3. I attach a draft minute accordingly, which I trust will be self-explanatory.

4. Also attached (not to all) are the earlier exchanges with No 10 and the draft advice from the FCO Private Office for the Prime Minister's meeting with Christophersen. We understand that Sir Geoffrey Howe has approved the latter subject to some drafting changes.

AJCE

A J C EDWARDS



DRAFT

FROM: PAYMASTER GENERAL  
DATE: September 1987

PRIME MINISTER

## 1988 COMMUNITY BUDGET :

YOUR MEETING WITH VICE PRESIDENT CHRISTOPHERSEN, 10 SEPTEMBER

Although your discussion with Vice President Christophersen will doubtless be primarily concerned with future financing, Christophersen may well take the opportunity to mention the 1988 Community Budget, on which the Budget Council is due to resume discussion on 17 September. I promised you a further note on this before your meeting with Christophersen.

2. As you will recall, the Commission have proposed a Budget requiring a VAT rate of 1.7 per cent for next year, but the Danish Presidency did not succeed in July in obtaining a qualified majority for a similar Budget. The Council legal services confirmed our view that the Council could not legally establish a draft Budget in excess of the 1.4 per cent ceiling unless there had been unanimous agreement in the Council that the ceiling should be raised. Even so, only the Germans and, possibly, the Dutch supported our insistence that the draft Budget must respect the 1.4 per cent ceiling.

3. I suggested in my minute to you of 27 July, paragraph 7, that the best way ahead for the Council would be to establish a draft Budget within the 1.4 per cent ceiling and to accompany this with a declaration to the effect that the Council would act to amend the Budget after the Copenhagen European Council if that Council decided to increase the Community's revenues. You expressed concern subsequently through Charles Powell's letter of 28 July that this would create a clear expectation that the Budget would be increased. My Private Secretary's



letter of 31 July accepted this while pointing out that in practice nothing would be given away since it is certain that a qualified majority of member states would insist on increasing the 1988 budget figures if there should be agreement to raise the own resources ceiling: as explained in the letter, expenditure in a 1.4 per cent Budget would be far below Budget discipline levels, largely because of the exceptionally large figure for the UK's abatement next year.

4. If Christophersen does raise this matter, I suggest that, consistently with the advice in the FCO Private Secretary's letter, your line should be:

(i) we cannot to agree to prejudge the question of raising the own resources ceiling this side of the Copenhagen European Council. There is in any case no legal basis for doing so in the absence of unanimous agreement to raise the ceiling;

(ii) we would however be prepared to accompany a 1.4 per cent draft Budget with a Council declaration to the effect that the Council will review the position in the light of any decisions taken at Copenhagen.

The reason why I think it important that our position should include the second proposition as well as the first is that, if we were to stick with the first alone, others would regard that as needlessly obstructive and might well be tempted to respond by attacking the large provision for the UK's abatement.

5. The Danish president of the Budget Council, Mr Tygesen, is calling to see me on Friday. I will, if I may, seek your agreement to the UK's line at the 17 September Budget Council in the light of that discussion.

6. I am copying this minute to Geoffrey Howe and to Sir Robert Armstrong.



RESTRICTED

Pnp

FROM: A J C EDWARDS  
DATE: 14 September 1987

PAYMASTER GENERAL

cc : PS/Chancellor  
Sir P Middleton  
Sir G Littler  
Mr Lavelle  
Mr Bonney  
Mr Crabbie  
Mr Mortimer  
Mr Donnelly  
Mr Cropper

Ch/

Content for PMG

To write in these terms? Given  
Mr Powell's assurances, below,  
it seems worthwhile.

1988 COMMUNITY BUDGET:

DRAFT MINUTE TO THE PRIME MINISTER

The Budget Council President, Mr Tygesen, asked you on Friday whether, if the Council could agree a draft Budget within the 1.4 per cent VAT ceiling, the UK would be prepared to go along with a Council Declaration to the effect that the Council would reconsider the Budget in the event of extra revenues becoming available. You undertook to have a firm position on this by the time of Thursday's Council, while warning Mr Tygesen that we would not be able to prejudge the outcome of the Copenhagen European Council in any way.

2. Given Mr Tygesen's request and what you said in your earlier minute, I think that you will need to go back once more to the Prime Minister on this issue in spite of her discouraging response to your earlier minute (Charles Powell's letter of 10 September).

3. I have taken the precaution of checking the position with Charles Powell. In reply to my questions, he said that:

- (i) the Prime Minister would not, he thought, be irritated by one further minute on this matter, suitably drafted;



- (ii) he did not think that she wished to rule out going along with any form of Council Declaration;
- (iii) he thought she would find a form of words along the lines of paragraph 8 of the accompanying draft minute (which I read over to him) more acceptable; and
- (iv) the background to the Prime Minister's concern was her strong feeling that the 1988 Budget would in practice set the mould for the whole period 1988-92.

4. In the light of this I have prepared the further draft minute attached. This notes that your line on other aspects is covered by the earlier exchanges of minutes.

AJCE

A J C EDWARDS



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DRAFT

## 1988 COMMUNITY BUDGET:

EC BUDGET COUNCIL, 17 SEPTEMBER

The President of the Budget Council, Mr Tygesen, called on me at the end of last week as well as Mr Christophersen.

2. In contrast with his position in July, Mr Tygesen seemed now to accept that the Council's draft Budget for 1988 cannot exceed the 1.4 per cent VAT ceiling. He is not optimistic that the Council will be able to agree on how to scale down the individual Budget lines so as to respect this ceiling. He asked me, however, whether, if agreement could be reached on a 1.4 per cent draft Budget, we would be willing to go along with an accompanying declaration to the effect that the Council would reconsider the Budget in the event of extra resources becoming available.

3. I promised Mr Tygesen that I would have a firm position on the question of an accompanying declaration by the time of the Council. In the meantime I warned him that there could be no question of our agreeing to a declaration which would prejudice any decisions which the Copenhagen European Council might or might not take.

X 4. I understand that the Germans had earlier told Mr Tygesen that the draft Budget could not exceed 1.4 per cent but that they would not expect to have any difficulty in agreeing to an accompanying declaration.

5. The UK line for the Council is, I believe, fully covered by our earlier exchanges of minutes, beginning with mine of 21 July. The only question outstanding is whether there is any form of Council declaration which I could accept on the UK's behalf to accompany a draft Budget within the 1.4 per cent ceiling.



6. I do of course fully accept your point that we must not prejudge or preempt in any way the question whether the Copenhagen European Council will agree on additional resources. We should not even, I believe, be prepared to prejudge whether any decisions relevant to 1988 will be taken at Copenhagen. These considerations are all the more important when one bears in mind the strong possibility that any decisions on 1988 will in effect set the pattern for the period 1988-92.

7. I do take also your point that there will be no need for us to volunteer anything about a Council declaration.

8. If however, somewhat against expectations, the Council can reach agreement on a 1.4 per cent draft Budget and we are asked to join with other member states in a non-prejudicial declaration to accompany it, I think we would cause considerable irritation to no good purpose if we refused outright. I also fear that other member states might be tempted to respond by attacking the large figure for our abatement. I have noted well your concern about the kind of formulation sketched in my minute of 9 September, whereby the Council would stand ready to review the situation in the light of any decisions taken at Copenhagen. I wonder whether we might however be ready if pressed to go along with something more neutral, perhaps along the lines that the Council will be ready to meet again if necessary after the Copenhagen European Council (or: if the Copenhagen European Council should take decisions affecting 1988).

9. If the Council cannot agree on a Declaration, the Presidency might decide to make a Declaration on its own authority about its intention to summon a Budget Council after Copenhagen.

10. I am copying this minute to Geoffrey Howe and John MacGregor and to Sir Robert Armstrong.



CONFIDENTIAL

FROM: R G LAVELLE  
DATE: 18 September 1987

CHANCELLOR

cc Paymaster General )  
Sir G Littler ) w/out  
Mr Edwards ) attach-  
Mr Mortimer ) ments  
Mr Bonney )

## FUTURE FINANCING OF THE COMMUNITY

OD(E) is scheduled on 1 October to have a first post-holiday review of the negotiating prospect in the Community's future financing exercise. There seems advantage in maintaining the pattern that the Treasury provides the central paper taken at the discussion: which, for convenience, has so far taken the form of a cover note by you to a fuller detailed paper by your officials.

2. Since our run over the main agricultural issues at the end of July, the main development has been a flurry of further papers by the Commission, a summary of which you may have looked through in your briefing for the Nyborg meeting. In brief, these contributions represented an advance in terms of the Commission's commitment to stabilisers and were as bad as ever on more or less everything else. In general, amongst our Community partners, there is no sense of any drawing back from the relatively open view most displayed in June to the prospect of additional resources: the reverse may be true with, for example, the French elections coming closer.

3. Against this background, Mr Edwards and others in the EC group have been preparing a series of notes on individual aspects of the negotiation. We judged it useful to bring those issues with major financial implications together in the attached single paper which we are in the process of discussing with other departments. This is still in the nature of work in progress, and Mr Edwards has annotated some of the areas undergoing revision, but it may be convenient for you to see it at this stage. Subject to your views, something of this sort might back the paper you put to OD(E).

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4. The object of the note by officials is to get a better feeling for the main elements in the coming negotiation, their relationship to each other, and their possible financial implications. This sort of analysis seems essential in order to move towards a judgment of the orientation we should have in each area. Although we need a scoresheet to inform this process, we do not suggest that OD(E) should be concerning itself at this stage with more than a feel for the orders of magnitude.

5. You will have your own views on the message emerging from this preliminary analysis and we will report further on departmental reactions. Some of the points that seem to me to stand out are, however, as follows:

(i) the 1988 problem dominates the prospect. In addition to the perennial issue of agricultural expenditure, there is the special factor of an exceptionally large UK abatement plus the problem of substantial sums for own resources refunds and 1984 IGA repayments postponed from 1987 into 1988;

(ii) the eventual settlement looks like being loaded in agriculture's favour. This underlines the paradox in the whole of this negotiation that we are expected to pay for reforms which logically would reduce the case for new resources eventually. Some device is necessary to build in a correction to the excessive share of agriculture over time. This is an awkward point as you noted in July;

✓ (iii) we have to take a rigorous line on non-obligatory expenditure. This flies in the face of general expectations. But there is no evident middle way between adherence to the maximum rate, finding such prizes as possible within it for poorer countries, and throwing the whole of budget discipline overboard. In political terms, all the technical improvements in budget management which have been painfully scraped together would rightly be regarded as meaningless if we went



the Commission's way. The position is not quite as black as it looks in that there are some declining expenditures (the refunds to Spain and Portugal) coming along to act as a wedge for the future. If we adopted a GNP ceiling this would also represent a significant concession. And, of course, DNO has risen exceptionally fast in real terms over the past three years;

(iv) the proposed structure of own resources reform could offer some minor benefits to us. Tactically we need to nurture this one inconspicuously;

(v) the abatement remains as ever a crucial element in the outcome.

6. We have prepared a separate paper, with which I do not think you need to be troubled in detail, covering the linked questions of the exceptional circumstances clause, the Commission's bid for reserves, etc. We will need to weave our analysis of these issues into the main paper. But the essential point is, as we see it, that we will have virtually to outlaw the exceptional circumstances concept and make clear that a guideline limit means precisely that. The latter sentiment is one which would pave the way to putting forward in due course the safety valve. There have been no developments as yet to reduce our belief that a device of this sort may be an essential underpinning of the agricultural arrangements.

7. Two other general reflections I had were:

(i) there will be siren voices favouring some safety margin of unused resources within the ceiling. The analysis in the officials' paper, not least on non-obligatory expenditure, suggests that we will be bidding for higher standards of performance than have been achieved in the past. But if on that argument one built in a hefty safety margin to provide extra headroom for emergencies, experience demonstrates that this would simply be used up;



(ii) an open-handed approach will not buy us a better bargain. Nothing in the analysis so far suggests that we would get a better bargain on stabilisers or budget management if we were evidently prepared to pay over the odds.

8. We will be reflecting further on the issues which you might wish to bring out in a covering paper which, as noted earlier, might best be directed to broad orientations than anything more precise. I hope you will be prepared to look at a draft at some point during your time in Washington so that it can be circulated for the meeting taking place very soon after your return.

If you  
are  
content,  
Sir TB  
can bring  
out a draft.  
JF

*R*

R G LAVELLE



RESTRICTED

FROM: J E MORTIMER

DATE: 22 SEPTEMBER 1987

CHANCELLOR OF THE EXCHEQUER

cc: Paymaster General  
Sir G Littler  
Mr Lavelle  
Mr Edwards  
Mr Mercer  
Mr Bonney  
Mr Evans  
Mr Donnelly

FUTURE FINANCING OF THE COMMUNITY: GNP CONTRIBUTIONS AND DIFF TAX

In his minute to Mr Lavelle of 21 September, Mr Taylor said that you would like a note on the pros and cons of moving from VAT-based to GNP-based contributions.

2. The main argument for making a change of this nature is that, all other things being equal, we would benefit financially because our share of GNP contributions is less than our VAT share.

3. The size of this benefit is uncertain. However, on the basis of some fairly conservative estimates of our own, assuming a budget in 1992 of 49210 mecu (at 1987 prices, the assumption in the Commission's forecasts), the reduction in that year in our gross contribution before correction could be around 550 mecu. France would also benefit substantially (by about 450 mecu), while the Netherlands, Greece, Ireland and Portugal would benefit on a more modest scale. Italy would lose out on a large scale (though the amount of this loss is particularly uncertain). Spain and Denmark would also suffer a disadvantage.

4. In practice, there would be little chance of combining GNP contributions with the Fontainebleau abatement system in exactly its present form. Both the Commission and other member states would argue that the results would be too generous to us. In the circumstances, our aim would be to convince other member states that only the minimum



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changes to the Fontainebleau abatement system should be made to bring it into line with the new structure of own resources. This would point to the introduction of a corrective mechanism giving us 66 per cent of our GNP expenditure gap rather than 66 per cent of our VAT expenditure gap as under the Fontainebleau system (see the attachment for a mathematical definition of the alternative mechanisms). A corrective mechanism on these lines would largely erase the benefit, in terms of the reduction in our gross contribution, resulting from the introduction of GNP contributions. But it would not do so entirely. We would still end up slightly better off (by a little under 100 mecu) than with the continuation of the present financing arrangements (including the Fontainebleau abatement system) but with an increase in the VAT ceiling.

5. The changes in 1992 in gross contributions before and after abatement of other member states assuming the introduction of GNP contributions and an abatement system modified on the lines described above would be as follows:

mecu, 1987 prices

	Change in gross contribution before correction	Change in contribution to UK correction	Change in net contribution after correction
Germany	8	-106	-98
France	-442	-184	-626
Italy	929	-41	888
Netherlands	-43	-38	-81
Belgium	105	-13	92
Denmark	46	-11	35
Luxembourg	-21	-3	-24
Greece	-70	-14	-84
Spain	165	-32	133
Ireland	-64	-10	-74
Portugal	-66	-12	-78
UK	-546	+466	-80



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These figures still assume a budget of 49210 mecu. With a smaller budget, the gains and losses would be reduced, but not by much.

6. It is clear from the table that the changes in the contributions made by other member states to the UK's correction would not greatly affect the extent to which they themselves gained or lost from the changes in the structure of own resources. Italy would still lose out on a large scale, and Spain and Denmark on a more modest scale. France could benefit by some 600-650 mecu, while Germany, the Netherlands, Greece, Ireland and Portugal would benefit by something under 100 mecu a year.

7. Apart from the financial advantage to us, other arguments in favour of GNP contributions are:

- they would in effect be a Community income tax. This would arguably be more Communautaire than the existing VAT own resources;
- GNP contributions would be far simpler than the complicated structure envisaged by the Commission.

8. Arguments against GNP contributions include:

- such contributions would not be a real tax but an artificial statistical construct (this argument applies to VAT own resources as well but to a lesser extent);
- GNP statistics are less firm than tax data. They are subject to greater periodic revisions (for example, Italian GNP was recently revised up 15 per cent after 5 years), and differences in sources and methods mean that GNP information is not always entirely comparable as between different member states.

9. Initial soundings of other member states suggest that their attitude to the introduction of GNP contributions would largely depend on whether they would benefit or lose financially from the change. Thus France would be in favour, and possibly Germany, while Italy and Denmark would be against.



10. The opposition of Italy and Denmark means that in practice it is unlikely that agreement will be reached on a wholesale move to GNP contributions. However, one advantage of keeping open the option of advocating an own resources structure on these lines is that we might thereby bracket the attempts by the Italians in particular to block or water-down the Commission's diff tax proposal.

#### The diff tax

11. The Commission have proposed that the ceiling on VAT contributions should be reduced to 1 per cent, and that there should be a new tax - the "diff tax" - to be levied on the difference in each member state between GNP and the VAT base.

12. As with the introduction of GNP contributions, the diff tax would, all other things being equal, be to our financial advantage. Indeed, if the budget were of such a size that the rate of diff tax called up just equalled the rate of VAT (1 per cent), the effect on our gross contributions before abatement would be exactly the same as if we had GNP contributions.

13. We have examined the effects of the diff tax in some detail in the attached note, which was discussed at an official level Cabinet Committee meeting last week. The note also considers how the diff tax might be combined with a new corrective mechanism. It concludes that a combination of the diff tax and a corrective mechanism giving us 66 per cent of our weighted average VAT/diff tax expenditure gap (again see the attachment for a mathematical definition) would leave us slightly better off than with the continuation of the present financing arrangements and Fontainebleau mechanism. We would be able to argue that the new abatement mechanism incorporated the minimum changes required to bring the Fontainebleau mechanism into line with the new own resources structure. The new mechanism would also have the merit that the absolute size of our abatement would be reduced (compared with what our Fontainebleau abatement would be).

14. The winners and losers from the introduction of the diff tax are broadly the same as for the introduction of GNP contributions (though



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the scale of the gains and losses would be different and would depend more on the size of the budget). If the diff tax were to be introduced, we should have to overcome stiff opposition from the Italians and Danes in particular.

*J.E.M.*

J E MORTIMER



ALTERNATIVE CORRECTIVE MECHANISMS

1. Fontainebleau abatement system

$$C = .66(V\%-R\%)A$$

2. 66% of our GNP/expenditure gap

$$C = .66(GNP\%-R\%)A$$

3. 66% of the weighted average of our VAT/diff tax expenditure gap

$$C = .66((V+D)\%-R\%)A$$

Symbols

C	- amount of correction
V%	- UK share of VAT (before correction)
(V+D)%	- UK share of total VAT and diff tax payments (before correction)
R%	- UK share of allocated receipts
A	- allocated budget
GNP%	- UK share of Community GNP



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AA

Puy

CHANCELLOR

FROM : R G LAVELLE

23 September 1987

cc PS/Chancellor  
 Paymaster General  
 Sir G Littler  
 Mr Edwards  
 Mr Mortimer  
 Mr Bonney

*dh  
OK? (I need to  
my back to London  
on Monday morning)*  
 AA

*Sorry about  
green highlights  
- now all yellow and!*

FUTURE FINANCING OF THE COMMUNITY

As, I hope, a relatively minor distraction from your business in Washington, I attach the draft of a paper which you might like to circulate to OD(E) covering the overview by officials which you read last weekend. We have tried to pick out a manageable number of key issues on which it would be most helpful for Ministers to focus. The paper does not reproduce the argumentation in the longer paper. Some of the political arguments, eg the unacceptability of throwing over the maximum rate, may also be best hammered home orally. We will provide suitable briefing.

2. Mr Edwards is revising the long paper in the ways indicated in his marginalia on the earlier version you saw. He has in mind to add a brief resume of the expectations of other member states and a reminder of the costs to us of different outcomes on the lines of the table included in the material given to OD(E) last time. To round out the agricultural analysis, we need also we think to add a summary account of the nexus of problems to do with the exceptional circumstances clause/reserves proposal/legal issues touched on in your July meeting with us.

3. In general, departments have for the moment largely bought the analysis in the long paper. But there are a number of points on which UKREP and others are potentially wobbly and we have had this in mind in selecting the points for your cover note. On agriculture, Hannay is still not totally convinced about the arguments for coping with the hump of expenditure without financing some outside the guideline. He and others are also extremely wary about the safety valve idea which is regarded



as unnegotiable. On DNO, people are prepared to sign up on a tough line but I fancy that many believe that in the last analysis, we will have to find some device for buying off at least Spain and Portugal even if this represents a barnacle on top of the maximum rate. Finally, there is an FCO disposition to regard a GNP numeraire, already conceded by the eleven, as something on which it is unnecessary to maintain the pretence of a reserve. I would expect some of these concerns to surface at OD(E).

4. Circulation of papers is proposed for not later than Monday next, 28 September. It would therefore be very helpful if Mr Allan could let us know over the telephone of any points you have on the cover paper.



R G LAVELLE



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CHANCELLOR

FROM : R G LAVELLE

23 September 1987

cc PS/Chancellor  
Paymaster General  
Sir G Littler  
Mr Edwards  
Mr Mortimer  
Mr Bonney

FUTURE FINANCING OF THE COMMUNITY

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LAVELLE  
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as unnegotiable. On DNO, people are prepared to sign up on a tough line but I fancy that many believe that in the last analysis, we will have to find some device for buying off at least Spain and Portugal even if this represents a barnacle on top of the maximum rate. Finally, there is an FCO disposition to regard a GNP numeraire, already conceded by the eleven, as something on which it is unnecessary to maintain the pretence of a reserve. I would expect some of these concerns to surface at OD(E).

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R G L'AVELLE



CONFIDENTIAL

CHANCELLOR

FROM: A J C EDWARDS  
DATE: 30 September 1987

cc Paymaster General  
Sir P Middleton  
Sir G Littler  
Mr Lavelle  
Mr Bonney  
Mr Mercer  
Mr Mortimer  
Mr Donnelly (o/r)  
Mr C Evans  
Mr Tyrie

OD(E), 1 OCTOBER at 2.15pm:  
EC FUTURE FINANCING  
OD(E)(87)17 (YOUR PAPER) AND 20 (SIR G HOWE'S PAPER)

The main purpose of this OD(E) meeting is to consider the UK's strategy on future financing between now and Copenhagen. The Prime Minister has called a meeting for 3.30pm. So OD(E) can only last an hour and a quarter at the outside. We understand that Sir Geoffrey Howe is likely to take future financing first, and devote almost an hour to it.

2. From two points of view, the shortage of time is a less serious problem than might appear. First, other departments seem for the time being to have come round to our way of thinking on most issues: we do not foresee any major disagreements. Second, the absence of the Prime Minister means that OD(E) is hardly the appropriate forum for reaching final views on UK strategy.

### Objectives

3. We suggest that your objectives should be:

(i) to secure agreement to the thrust of your own paper and the supporting Treasury paper;

(ii) to support the thrust of Sir Geoffrey Howe's paper; and

(iii) to ensure that your own paper and the Treasury note are included with any subsequent report to the Prime Minister.



The background to objective (c) is that we do not want to see a repetition of the mistakes made in the run-up to the June European Council. Although OD(E) discussed the future financing issues then, and considered the Treasury papers, we believe that the Prime Minister did not see our papers. This made her task at the end of June needlessly difficult.

#### Changes to Treasury paper

4. Since the version which you saw, we have shortened some parts of the paper as you suggested. In the interests of making it reasonably comprehensive, however, we have added short sections on -

(i) what the Commission's financing proposals would imply for the UK's net contribution, and the likely attitude of other Member States (paragraphs 2-3);

(ii) a preliminary assessment of the prospects for a legally binding agricultural guideline, based on some rather pessimistic advice from the departmental lawyers (paragraph 23) and some discussion of "exceptional circumstances" (paragraphs 23-7);

(iii) the problem of the hump of demands on the Community's resources in 1988 and possible ways of dealing with it (paragraphs 57-60); and

(iv) a reworking of the figures on the implications for the level of own resources of the expenditure scenario discussed in the paper: we now think that an own resources ceiling equivalent to around 1.7 per cent VAT as currently defined would be needed to cover expenditure next year in the absence of major agricultural 'savings' such as postponing stock disposals or depreciation provisions or introducing an oils and fats tax: the figure is swollen by the exceptionally large UK abatement figure next year.



Notes for introducing the discussion

5. What this negotiation is about is what terms can be extracted for what increase in the ceiling.

6. If the ceiling is to be raised, the agriculture expenditure guideline will have, realistically, to be raised as well. There will likewise be pressures for large additions to non-obligatory expenditure.

7. This is not a welcome prospect, either in substance or in presentation.

8. Our general aim should be to go for the lowest ceiling which can realistically cover the needs of 1988, including our own abatement, and to keep the ceiling at that level thereafter.

9. Even this will add to the UK's already formidable budgetary burdens. It will be hard to present at home. We shall therefore need to obtain in return the most concrete and bankable improvements we can on:

(i) control of agricultural expenditure (stabilisers which really work, a guideline which is an absolute constraint and a solution to the ever-worsening stocks problem);

(ii) continuation of the maximum rate discipline on non-obligatory expenditure;

(iii) improvements in budget management and financial procedures;

(iv) some improvements, even if small, in the UK's overall financial deal, in particular through changes to the own resources/abatement nexus.

10. To maximise the chances of a satisfactory outcome, we must continue to take a hard line right up to Copenhagen.

11. If in the final analysis an increase is contemplated which goes beyond the realistic minimum needed to cover 1988 requirements, we shall then want to look for more substantial improvements for the UK in the own resources structure/abatement nexus.



**Sir G Howe's paper**

12. This paper seems to us rather unnecessary. We think, however, that you can go along with it. We would, in particular, endorse the proposition (which you decided, presumably for tactical reasons, not to include in your own paper) that the UK should not contemplate paying over the odds in the hope of getting better quids pro quo.

13. The increase in own resources proposed by the Commission is 45 per cent, or substantially more if abatement-exclusive, not 40 per cent.

**Controversial points**

14. Here, finally, are some notes on possible areas of concern or controversy:

**(i) Agricultural expenditure**

Officials and legal advisers are continuing to examine the difficult question of legally-binding limits. Sir D Hannay or others may well argue that the safety-valve (national financing of agricultural guarantee expenditure in excess of the guideline) is unnegotiable. We suggest that you should not endorse this proposition but simply note that there is no need to decide at this stage whether to deploy this idea and, if so, how and when. On inclusion or non-inclusion of stock disposals/depreciation within the guideline, it is premature to take a firm and final view, though our own instinct is for inclusion (see Treasury paper, paragraphs 14-16).

**(ii) Non-obligatory expenditure**

The key thing will be to transform over-ambitious objectives for non-obligatory expenditure as a whole into a limited redistribution of Regional Fund spending in favour of Spain and Portugal. We can agree with Sir Geoffrey Howe that officials should study this further. Other departments will probably say that the assumption that non-obligatory expenditure will continue to respect the budget discipline maximum



rate limitation is unrealistic. That may or may not be so. What is clear, however, is that if the UK continues to insist (as clearly we must) on reinforcement of budget discipline, we cannot simultaneously go along (least of all at this stage) with a major relaxation such as agreeing to exceed the maximum rate. Other departments may also argue that the UK will obtain a larger share of the structural funds than we have assumed. The answer is that we sincerely hope they are right.

**(iii) The 1988 "hump" and intermediate own resources ceilings**

The FCO and UKREP want to stop just short of ruling out intermediate own resources ceilings between 1988 and 1992. Sir D Hannay argues that, if the final settlement should provide for a new own resources ceiling which exceeds requirements in 1988, it would be better to phase the subsequent increase than have it all at once. If the hypothesis is granted, the argument has some force. In practice, however, we think that the game we are in will be to choose a minimalist ceiling figure for covering the needs of 1988 (with adjustments to various programmes along the lines set out in paragraphs 57-60 of the Treasury paper) and to keep the ceiling at the same level thereafter. If budget discipline works, a profile of rising own resources ceilings will anyway be unnecessary and indeed undesirable.

**(iv) Level of new own resources ceiling**

It is too soon to be talking with others about the level of the new ceiling. Our own scenario arithmetic suggests that the best realistic outcome would be a 1.1 per cent GNP ceiling (abatement exclusive) or a 1.2 per cent GNP ceiling (abatement inclusive), the former being preferable to the latter. In 1988, this would be equivalent to a VAT ceiling of around 1.7 per cent. But this figure is swollen by the abnormally high UK abatement figure in next year's



budget. The problem about going for own resources ceilings lower than these levels is that they would not permit a realistic agricultural guideline. The only way in which expenditure could be compressed in this way would be by postponing indefinitely any action on the serious stock disposals problem and by introduction of an oils and fats tax.

The FCO were earlier showing some inclination to concede at an early stage that own resources should grow in line with Community GNP. This would surely be a serious error. Any such concessions should be kept for the final stages.

(v) **UK abatement**

The FCO paper speaks of the possibility of further Commission proposals before Copenhagen. If this does happen, we should clearly remain firm on retaining the Fontainbleau system and changing it only so as to improve the UK's position. This is not, of course, to rule out some technical modifications to the system to reflect introduction of the diff tax, if that is agreed.

(vi) **Prospects for agreement at Copenhagen**

Chirac and Kohl, as well as the Prime Minister, have been expressing private scepticism as to the possibilities for reaching agreement at Copenhagen. The list of issues to be decided is indeed long and formidable. We have no overriding interest for or against agreement at Copenhagen but should continue to support the objective of agreement there.

AJCE

A J C EDWARDS





CONFIDENTIAL

PRIME MINISTER

CH/EXCHEQUER	
REC.	05OCT1987
ACTION	MR GARELL
	CST FST PMG EST
	SIR P MIDDLETON
	SIR G. LITTLE
	MR A. J. EDWARDS
	MR C. EVANS
	MR P. R. H. ALLEN
	RS C+E

## A SINGLE EUROPEAN MARKET - OUR OBJECTIVES

My minute of 24 July suggested a hard-nosed look at our negotiating objectives as well as early action to encourage British companies to face up to the challenge of completing the single market.

2 When we considered our strategy in OD(E) on 1 October there was strong agreement that we must plan positively for a genuine single market in goods and services. There are a substantial number of areas in which progress on the right terms should bring us major benefits. These include the five priority areas singled out by the Brussels European Council for decisions by the end of 1988. Financial services generally, transport and telecommunications are equally important.

3 For all of these, as well as other areas where we are likely to have problems of principle with the Community's approach, we agreed to work up sharper negotiating strategies in the next couple of months. We should not hesitate to take a tough line where the Commission's approach causes us difficulties (for example tax approximation, plant and animal health, drugs and immigration issues and company law), while seeking practical progress where possible to reduce barriers to trade.

DW5BZ0





CONFIDENTIAL

4 But the overriding conclusion at OD(E) was that such difficulties should not be allowed to obscure the importance for British business of moving decisively towards a unified market of 320 million people. This means pressing ahead with work on our priorities and - a point to which I attach particular importance - identifying initiatives which can bring us positive results.

5 Work on our overall strategy has underlined the central importance of ensuring that British companies face up to the challenge rapidly and develop their own strategies for making the most of the opportunities. I intend therefore to take early steps to raise the public profile to develop a sustained interest and involvement in the business community. The initial focus will be on the one day national conference which I have proposed for next March at Lancaster House or the QEII Centre. I expect this to involve a number of leading business speakers and perhaps the Commission. I also want to give the conference substance by organising a number of groups of businessmen to look at the key issues. The conference will attract major publicity and I hope that you will feel able to make the opening speech.

6 I will now take immediate steps to set in motion the process of discussion and consultation. In particular I will be writing within the next week to senior business people and organisations to invite them to join in a dialogue on the main issues in preparation for the conference. I intend to take the opportunity of my speech at the conference next week to launch this publicly.

DW5BZO





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7 I am copying this minute to Geoffrey Howe, to members of OD(E), to Douglas Hurd, Nicholas Ridley, Kenneth Baker, Paul Channon, John Moore and to Sir Robert Armstrong.

A handwritten signature, likely of Douglas Hurd, in dark ink.

D Y

05 October 1987

DEPARTMENT OF TRADE & INDUSTRY

DW5BZO



CHANCELLOR OF THE EXCHEQUER

FROM : J E MORTIMER

5 October 1987

cc Chief Secretary  
Mr Lavelle  
Mr Edwards  
Mr Addison

NET PAYMENTS TO COMMUNITY INSTITUTIONS

The latest projection of our net payments to Community institutions is as follows:

1.4 per cent projectionOverall position

	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>£million</u> <u>1990-91</u>
Current projection	1260	800	1700	1220
PES projection	900	490	1510	1220
Changes since PES projection	+360	+310	+190	-

2. The projection will be revised in the next day or two, but will probably not end up very much different. With an increase in the own resources ceiling, the projection would be worse.

3. The reasons for the drop in our net payments in 1988-89 are:

- i. we are expecting a huge abatement in 1988 of 2.5 becu (£1.8 billion). This includes not only a large abatement in respect of 1987 (2.3 becu) but a 244 mecu correction in respect of 1986;
- ii. the 1988 "budget exchange rate" (the rate of exchange used for certain budget transactions) is favourable (£1 = 1.34 ecu, as opposed to the current exchange rate of £1 = 1.44 ecu). This means that our VAT liability in the 1988 budget in ecu is comparatively low;
- iii. we expect to receive a large VAT adjustment in 1988 (a correction in respect of an overpayment in 1987).



4. The reasons for the increase in our net payments in 1988/89 are:


i. our relatively low VAT share in 1988 (because of ii. and iii. above) increases our VAT expenditure gap and so reduces our abatement entitlement in 1989 (to around 1.8 becu);

ii. the saving in our VAT payments in 1988 due to the favourable budget exchange rate (ii. above) means we will probably have to pay a VAT adjustment in 1989.

5. The projection of our net payments in 1990/91 (£1220 million) represents a more normal figure.

6. We know that GE would like to smooth the profile of our net payments a little, and we shall be discussing the possibilities with them tomorrow.

7. The reasons for the overall worsening in our net payments are set out in the attached note.

  
J E MORTIMER



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Comparison with PES projection

9. The Autumn Statement projection shows a marked deterioration compared with the PES projection completed last May. The reasons for this are:

- (i) the supplementary budget agreed in July worsened our net payments position in 1987/88. It provided for a higher level of total spending, as well as the postponement of this year's IGA repayment and 400 mecus' worth of own resources refunds;
- (ii) it also provided for a switch from advances to reimbursement of agricultural expenditure, which meant that in 1987/88 we shall lose about 2 months of agricultural receipts (a loss of around £200 million);
- (iii) payments of customs duties and agricultural levies in sterling terms have been considerably higher this year than previously anticipated, leading us to revise up our assumed share of traditional own resources in all years. This effect has been exacerbated by the recent strength of sterling;
- (iv) this year's VAT adjustment was larger than expected, partly because of the decision to accept that VAT should be levied on water rates;
- (v) the strength of sterling has also led us to revise up our assumed share of Community VAT contributions for 1989 onwards;
- (vi) MAFF have revised down from 8 per cent to 7 per cent our assumed share of agricultural receipts from 1988 onwards. (This is a very disappointing outlook: as recently as 1984, our share of guarantee receipts was 11½ per cent.)





*1 agree that  
we can't say we  
is Norway maybe  
keep it  
no more.*

CH/EXCHEQUER <sup>6/10</sup>	
REC.	06 OCT 1987
ACTION	PMG
COPIES TO	

FCS/87/208

CHANCELLOR OF THE EXCHEQUER

6/10/87

Further enlargement of the European Community?

1. As you know, possible further EC enlargement is again a live issue. The Turkish application is being processed by the Commission; a Moroccan application is being politely turned aside; Malta and Norway are showing interest; Cyprus could follow suit. We need to assess where the UK interest lies, and what our attitude should be.

2. I believe that our general line should be sceptical, for any enlargement will make the Community still more unwieldy. But that consideration need not be overriding in particular cases where the admission of the applicant country would significantly benefit UK interests within the Community. We need a case-by-case approach; and I accordingly attach a paper summarising potential UK costs and benefits in the cases now envisaged. It touches briefly on the Moroccan, Maltese and Cypriot questions, concluding that all are academic; deals at some length with possible Norwegian aspirations; but concentrates on the Turkish application, as the most immediate and much the most potentially significant case. It concludes that Norway's EC membership would be in our interest, while Turkey's would not; that the Norwegians would be welcomed by most Community member-states, while the Turkish

/application





application evokes generally hostile reactions, and that our main task should be to ensure that the response to the Turks, though negative, does not take the form of an outright rebuff, which could have damaging consequences in Ankara and hence for the Alliance. It accordingly suggests that we should emphasise - as the Prime Minister did when she saw Ozal in Berlin - the importance of ensuring that the EC-Turkey Association develops in ways which allow the Turks to feel that it confers substantive advantages to them: this seems to me the only sensible face-saving half-way house.

3. I should welcome confirmation that you are in general agreement with the approach in the paper.

4. I am sending copies of this minute to OD(E) colleagues, to the Defence Secretary, and to Sir Robert Armstrong.

A handwritten signature in black ink, appearing to be 'G. Howe'.

(GEOFFREY HOWE)

Foreign and Commonwealth Office  
6 October 1987



## FURTHER ENLARGEMENT OF THE EUROPEAN COMMUNITY?

### Summary

1. An analysis of the UK cost/benefit of possible further EC enlargement; arguing that Norway's membership would be in the UK interest (paras 3-6); that the questions of Maltese, Moroccan or Cypriot membership are, for different reasons, unlikely to be given serious consideration in the Community (paras 7-11); that Turkey's membership would be counter to UK economic interests (paras 12-13), would transform the Community in ways which might be against our political interests (paras 14-20), and will be opposed by most present EC members; and that a compromise, short of accession, will be required (paras 21 - 22). Policy deductions: a case for discreet UK encouragement for a Norwegian re-application for EC membership, and - in due course - for the full development of the EC/Turkey Association Agreement (paras 23 - 25).

### Introduction

2. Demands for further EC enlargement are growing. For Switzerland, Austria and Sweden, Community membership remains a distant prospect; but Norway is likely to re-apply in the mid/late 1990s; the new Nationalist Party Government in Malta has already indicated a wish for eventual membership; Morocco has formally registered its interest; Cyprus is toying with the idea; and a Turkish application is being processed in Brussels. From the EC's point of view, expansion has some attractions, particularly if it enlarged the area of democratic stability in Europe. But at what cost? This paper attempts a UK cost-benefit analysis, considering the economic and political impact of Norwegian, Maltese, Moroccan, Cypriot or Turkish accession, but concentrating on the Turkish application, as the most pressing issue.

### Norway

3. Of these five cases, a Norwegian application would be the most warmly received, would cause fewest problems in negotiation, and would probably result in early accession. Norway is readily



assimilable, with a population of 4.1 million and GDP per capita of almost \$14,000, (cf the EC average of \$8,000). Domestic political and constitutional considerations make an application very unlikely until after Norway's 1993 election, but feasible thereafter, and highly probable by the late 1990s.

4. The terms of Norwegian membership have already been negotiated once. The main stumbling blocks in 1972 were fisheries and oil; these are likely to be less problematic now, particularly in view of the new Common Fisheries Policy (CFP) negotiated by the UK. Under the 1979 EC/Norway Fisheries Agreement the Community is allowed to fish in the Norwegian Economic Zone (and vice versa) subject to agreed Total Allowable Catches, and quotas, and this agreement should easily be absorbed into the CFP. The prospect of free access to EC markets and the growing strength of the fish farming (as opposed to traditional fishing) lobby may also serve to reduce domestic opposition to Norwegian membership. Agriculture could cause Norway transitional problems if in the meantime her support were to remain 30% above CAP levels, but the Nordics are already under pressure in GATT negotiations. And Norway is conscious of the need to adapt to developments in the EC internal market in order to maintain exports to the EC (now 65% of total Norwegian exports, equivalent to 17.6% of her GDP). Thus for the UK Norwegian accession would bring few economic disbenefits, other than perhaps marginally (3 QM votes) increasing resistance to full CAP reform. The economic advantages to the UK of a further widening of the EC market, and the strengthening of the Community's Northern tier through the accession of a country making little call on structural funds and likely to abide by the terms of the EC Treaties (and her own accession terms) and be a substantial net contributor to the Community budget, are clearly much stronger. Our economic interest lies in having Norway in.

5. The political arguments go the same way. Though Norway could be expected to share many Danish attitudes, eg on environment and nuclear energy, which would be difficult for the UK, her Parliamentary democracy or NATO membership are not in question, and her attitudes on national sovereignty issues would be similar to ours. Norway could be expected to play a full and constructive



part in Political Co-operation - indeed her present exclusion from it is a major cause of her renewed interest in EC membership.

6. In short, Norwegian EC membership would be in the UK interest. The arguments in respect of Malta, Morocco and Cyprus are very different, but equally straight-forward.

#### Malta

7. The Maltese economy is so small (population 360,000 - similar to Luxembourg, - per capita GDP \$3,300, 41.5% of EC average) that absorption into the EC would present no particular difficulties. On the worst assumptions (ie high resource transfers per head), direct costs would be very small: agriculture and fisheries contribute less than 5% of Malta's GDP. But the objections to Maltese membership arise not from economic considerations but from the recognition of the existing members that the Maltese would make the conduct of Community business extremely difficult. Maltese democracy and administration are idiosyncratic; Malta is active in the Non-Aligned Movement and seems determined to maintain a treaty of friendship with Libya; and membership of the EC would be unlikely to diminish Malta's taste for blackmailing her Western friends. It would not be in the UK interest to encourage the disruption to Community business and cohesion which would result from admitting Malta; other member states - even Italy - share this view, and, since the Maltese will have no sponsor, an application would generate little serious debate.

8. Fortunately, a sensible alternative to Maltese membership already exists. The EC-Malta Association Agreement of 1970, envisages progress to an eventual customs union (similar to that just negotiated with Cyprus). The Maltese can - and should - be encouraged to aim for this if they are serious in wanting a closer relationship with the EC. The Maltese may argue that this is not a satisfactory alternative to membership; but we must be careful to avoid implying any commitment to eventual membership.



Morocco

9. The economic arguments against Moroccan membership are overwhelming. Her population of 22 million is growing at a rate of 2.4% a year. But her GDP is only \$12 billion, of which industry accounts for only about 20%; and GDP per capita only some \$600 - less than one-third that of Portugal. Morocco is heavily indebted.

10. Fortunately her application is effectively ruled out of court by geography: Article 237 of the EEC Treaty states that "Any European state may apply", and Morocco is not European. The Community's current response to Morocco therefore is negative. But in order to avoid delivering an outright rebuff, the Community will be offering to consider ways of beefing up the existing Cooperation Agreement to constitute a closer association. Customs Union, and perhaps closer political consultation, may be worth exploring. The Moroccan application is a political signal of interest in increased alignment with Europe: we should ensure that the Community gives an appropriate response. But EC membership is not on.

Cyprus

11. Though the Cypriots currently claim that they do not envisage an application, it remains a possibility we cannot discard. With a population of 660,000, GNP per capita of \$3,800 (47% of EC average) and progress towards Customs Union with the EC already in train, assimilation of Cyprus would probably not be too difficult. But politically, the Community could not respond favourably to a Cypriot application unless also saying "Yes" to Turkey; and Customs Union and close association remains the appropriate course.

Turkey

12. The question of possible Turkish accession is much the most complex. Comparisons with Norway pinpoint the problems. Both are NATO members. But whereas Norway, as a small (4 million), rich (per cap GDP \$14,000) unquestionably European, democratic country would be easy to absorb, with few costs to the UK, Turkey is large (50m),



poor (per cap GDP \$1,000 - 14% of the current EC average), largely Asian (98% Muslim) in culture, and with little democratic tradition and still fragile respect for human rights. Moreover, the economic disparity between the existing Community and Turkey is unlikely to narrow naturally in the foreseeable future. Turkey's economy has made significant progress under the current administration, but still operates on a very flimsy base. Furthermore, although her economic growth is likely to continue to exceed the EC average, her very rapid population growth - well over 2%p.a. - is certain to do so, so that by 2000 her population will reach 70 million, but her per capita income, if outside the EC, will remain well below that of the poorest member states (and probably still some 15% of the EC average). The high birth rate and relative poverty would also entail large influxes of migrant workers into other Community countries in the event of Turkish accession, a consideration which the Commission themselves see as a crucial reason for excluding Turkey. Turkey furthermore has a high proportion of its labour force in agriculture, is a net exporter of agricultural produce, has large regional imbalances, an industry as yet not ready to compete in a free market, and high inflation and foreign debt.

13. Economically, Turkish accession would clearly be against the UK interest. It would massively strengthen pressures for intra-EC North-South resource transfers, via agricultural support and through the structural funds, increasing burdens on the UK and other net contributors. Had Turkey been a member of the Community in 1986 net transfers from Northern to Southern Member States would have increased from \$5 billion to \$7.5 billion : this probably under-estimates the real extra cost to the North for Turkish claims would have led to a reduction of \$1 billion in net receipts by other Southern Member States, whose clamour for compensation might have led to a still larger overall increase. The gap between Northern and Southern Member States in GDP per capita in 1986 would have grown from \$4482 to \$5840. Turkish accession would also drive a coach and horses through the concept of the internal market, for the Turks' ability to respect Treaty provisions in full is very doubtful: they would in practice be much more likely to emulate the cavalier attitude of the Greeks.



14. A political case for supporting Turkey's application is nonetheless sometimes made, eg by Americans, in terms of the merits of consolidating the South-Eastern flank of NATO, and Turkey's European and pro-Western orientation. In fact the likelihood that Turkey, if rejected by the Community, would in practice abandon the substantial benefits of Alliance membership and turn towards the Soviet Union or the Middle East is small. But Turkish prestige is engaged, and a rebuff would certainly risk triggering the forces of nationalism and Islamic conservatism which are already stirring. The Turks might become more difficult allies, potentially aggressive towards Greece and sulkily self-regarding.

15. However, one also has to consider the political effects on Western Europe and hence the Alliance of the changes to the Community which would result from Turkey's admission. For, while Norwegian accession would change the Community hardly at all, and only in ways beneficial to the UK, Turkish accession would change it rather radically, to our political as well as economic disadvantage.

#### How would the Turks change the Community?

16. The foundations of the Community are a body of Community law (the Treaties and rules made under them) directly and equally applicable in all member states; and a Community budget to which all member states contribute. Turkish accession would obviously put considerable strain on common budgetary arrangements, but it would also be likely to accelerate the erosion in practice of the principle of a market regulated by common laws. At present the cost of (mainly Greek) non-compliance is bearable, Greece being a small economy. In 1985 Greece was served 69 formal notices of infringement (out of an EC total of 503), a total only (narrowly) exceeded by France and Italy, and her record has been getting steadily worse. However, Greece's population is one-fifth of Turkey's; she has a total GDP of only about \$35 billion, compared to Turkey's \$56 billion; while her GDP per capita is over three times that of Turkey. For the most populous EC country - which Turkey would be by the time of any possible accession - to emulate Greece would be much more damaging. Yet Turkey could not in practice afford to comply without seeing her infant industries swamped. She



would be likely - like the Greeks - to pay lip-service to the law, and demand heavy financial compensation - again like the Greeks: even if such compensation were provided, she would probably not practise free movement of goods, services, and capital - just as the Germans and others would resist free movement of Turks. And the Turkish example would greatly encourage further back-sliding by other Mediterranean member states.

17. The result, *de jure* or *de facto*, would be a two-tier Community. Some argue that, by admitting the Greeks, we have already started down this path, but that is as yet unproven: the inclusion of Turkey could well tip the balance decisively. Moreover Turkey's size and significance would make the damage to our interests resulting from the inevitable creation (and its inevitable inclusion in) a second tier, of those with more rights than responsibilities, far greater than if such a tier were limited to Greece and Portugal. While there already are many examples of Community legislation containing provision for differential application, the *de facto* route to a two tier Community would introduce increased uncertainty and complexity into EC law; in particular cases the outcome might be open to challenge as contrary to the principles of the Treaty of Rome; and the fiction of a unified corpus of law would be even more blatant. The *de jure* route would mean Northern tier countries, no longer able to tolerate accelerating contempt for central elements of the Treaty of Rome, concluding that the obligations in question, especially as amended in the Single European Act, reached too deep into the Community's economic and legal fabric to be capable of two permanently different levels of interpretation, and that a separate framework was necessary for those activities which were originally envisaged as within the sphere of the Community, but in which some members had now shown themselves unable or unwilling genuinely to participate. The willingness of the FRG, as the EC's principal contributor, to follow the *de facto* route, sustaining present EC financial arrangements, while turning a blind eye to increasing Turkish and other breaches of EC rules, must be doubtful. Yet the *de jure* route would entail a major political upheaval, not least because there is no provision in the Treaty of Rome for expulsions, and those wishing to form an inner core would therefore have to abrogate the existing Treaties. So the *de jure* route looks



politically still more unattractive than the de facto one.

Should we mind a two-tier Community?

18. For the UK, the immediate economic effects of the emergence of a two-tier Community would not be particularly serious: 80% of our exports to the present EC go to the countries likely to remain in the upper tier. But the vision of a single large internal market, the achievement of which is strongly in the UK's economic interest, would have faded, whichever route were followed. The de jure route would be economically less damaging to us than the de facto route, for formalising the two tiers would provide a legal and sustainable way of limiting resource transfers from the first to the second tier via the EC Budget; whereas the de facto route would leave the Northern tier vulnerable, as at present, to demands for budgetary compensation from the South for market-opening measures, even though such measures would be applied by the Southern tier even less than at present.

19. As the Prime Minister's paper on "Europe: The Future", presented to the June 1984 European Council suggested, some (variable geometry) forms of two-tier community are obviously in our political interest: we might, for example, welcome the emergence of a European Defence identity, provided that the Alliance was thereby strengthened, and we would lose no sleep over Irish self-exclusion. But the political effects of the emergence of the particular form of two-tier Community which would be likely to result from Turkish accession would do serious damage, and particularly in Bonn (leaving aside the turbulence of the transitional period if, for economic reasons, the de jure route were chosen). For this would not be a question of a group of like-minded member states deciding to act together on a project (eg Airbus) not covered by Community competence or one on which (eg ERM) all partners do not yet agree - such forms of two-tier activity cause no greater qualms in Bonn than in London - but rather recognition, de facto or de jure, that despite massive FRG financial support some member states were making it impossible for the Community any longer to follow the path laid down in the Treaties. The long-term effect on FRG policies is not easy to predict; and it may be over-alarmist



to suggest that the price for securing Turkey's current Western orientation by the EC membership route might be a change in the FRG's orientation. But there can be no doubt that the arrival of Turkey would fundamentally change the Community, and that this would change FRG attitudes to it, in ways which could well be unwelcome to the UK, and damaging to the Alliance.

#### UK attitude in EC discussion of the Turkish application

20. It follows that Turkey's accession would not, in the foreseeable future or perhaps ever, be in the UK's interest, economically or politically. A positive line over the present application must consequently be ruled out.

21. The Commission and most member states are likely to reach a similar conclusion. Turkey's application has already aroused violent Greek objections (for bilateral and Cyprus reasons), strong German opposition (on migrant worker grounds), and general Benelux/Danish doubts (mainly on human rights grounds). The Germans, and others, are concerned that Turkey, with social and political traditions far removed from those even of present Southern Member States, has only a small educated minority which understands or sympathises with European social mores. They will argue that, despite substantial progress towards democratic norms since 1980, Turkey has never met the requirement (Copenhagen Declaration) of "respect for and maintenance of representative democracy and human rights", and that its prospects of doing so within a short period without serious risk of further public disorder are slim. Underlying the political arguments will be the German perception of the major extra costs to them, and damage to Community coherence, which would result from Turkish accession.

22. In these circumstances it will be important for the UK to point out that the Turkish reaction to an outright rejection could be hardly less damaging, particularly given the inevitable Greek gloating. We should argue that the right response to the Turks will therefore be a conciliatory "No - or at least not yet" and should draw attention to the EC/Turkey Association Agreement as the appropriate framework for developing a closer relationship. Some



further progress under the Agreement is probably the best alternative way, less damaging to overall Western European cohesion than Turkey's accession, of cementing her Alliance orientation. In practice it will not be easy to find areas of real benefit to Turkey on which the Community could agree to proceed under the Association agreement. Customs Union is one of the Agreement's aims; but the Turks do not see it as advantageous. Wholly free movement of labour will be blocked by the Germans; and full implementation of the aid provisions vetoed by the Greeks, (and if it involved activation of the dormant 4th Financial Protocol, would place a severe strain on our own aid budget). Closer political consultation should however be feasible. And commitment to some real development of the association is essential, and would have to be negotiated and decided as part of the Community's response to the Turkish application. The Turks would not be impressed by empty words on association, and the only chance of securing Greek agreement to deeds would be through linkage to a negative response on accession.

23. Our tactics should therefore be:-

- (a) for the present, to allow the Germans, Benelux, Danes and Greeks to make most of the running on the accession issue, but avoiding any UK statements which might raise false Turkish hopes;
- (b) at the appropriate moment, to join the likely consensus that the Turks be told that the difficulties facing both themselves and the EC, identified in the Commission Opinion, prevent the Community from opening substantive negotiation for the time being; but
- (c) simultaneously to suggest that the Community should propose the fuller development of the EC/Turkey Association Agreement and further improvements in political consultation, if necessary presented as a step towards, but in reality probably an alternative to, eventual accession.

This course would safeguard British commercial interests, whereas



being seen in Ankara to be responsible for a rebuff would certainly be commercially disadvantageous. The appropriate time for course (b) and (c) is not yet, for the Commission Opinion on the Turkish application will not emerge before 1989, and it would be premature now to peddle a compromise which the Turks are certainly not yet in a mood to accept.

24. To reduce the risk of invidious Turkish comparisons, and a perceived rebuff, it will be important that the processing of a Norwegian application should not start until a compromise on the Turkish application has been struck. But the probable timing of any Norwegian application (para 3 above) is such that this is unlikely to cause problems in practice. We need not therefore be deterred from discreet encouragement of the Norwegians, in the medium term.

### Conclusions

25. (a) Norway's membership of the EC would strengthen the Community and be in our economic and political interests; a re-application is unlikely before 1993, but would evoke little opposition and should in due course be discreetly encouraged;
- (b) the Moroccan application, and possible bids from Malta or Cyprus, raise problems of diplomatic handling, but no issues of substance, for none of these countries will be seen as a credible candidate;
- (c) Turkish membership of the EC would run counter to our economic interests; evokes major opposition; and would affect the Community in ways damaging to our political interests - the wrong sort of two-tier structure would emerge, de jure or de facto;
- (d) but Turkey should not, given her NATO Southern Flank role, be rebuffed: we should in due course work for the compromise of a carefully structured further development of the Association Agreement, together with improved political consultation arrangements.




CONFIDENTIAL

FROM: J E MORTIMER

DATE: 7 OCTOBER 1987

- ADCE Note at end*
1. MR EDWARDS
  2. CHIEF SECRETARY

cc: Chancellor   
 Paymaster General  
 Sir P Middleton  
 Sir G Littler  
 Mr F E R Butler  
 Mr Anson  
 Mr Lavelle  
 Mr Turnbull  
 Mr Gieve  
 Mr Bonney  
 Mr Mercer  
 Mr Donnelly  
 Mr Evans  
 Mr Addison

*Is there not a  
 plan for this a  
 smooth sir v. m.*

AUTUMN STATEMENT PROJECTION OF OUR NET PAYMENTS TO COMMUNITY INSTITUTIONS

We would be grateful to know whether you are content that the figures for our net payments to Community institutions contained in line 4 of the table below should be included in the Autumn Statement:

	£m			
	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>
1. PEWP projection (completed Oct 86) and PES baseline	870	440	1060	(1087)
2. Initial PES projection (completed May 87)	900	490	1510	1220
3. Latest projection (unsmoothed)	1260	860	1720	1240
4. Latest projection (smoothed)	1400	790	1580	1320
5. Increase over baseline (4-1)	+530	+350	+520	+233



Main assumptions

2. Given the firm insistence of the Prime Minister (and the Government as a whole) that nothing should be said or done which prejudices our negotiating position in the future financing negotiations by implying that we could accept any increase in own resources, our recommendation is that the Autumn Statement figures should assume the continuation of the 1.4 per cent VAT ceiling, although the possibility of an increase in the ceiling will need to be taken into account when setting the reserve. The projection summarised in paragraph 1 accordingly assumes there will be no increase in the own resources ceiling, nor any other form of supplementary financing at any stage during the forecast period.

3. Other assumptions are:

- (i) a budget at the 1.4 per cent VAT ceiling will be agreed before next March;
- (ii) to ease the Community's financing difficulties in 1988, there will be no IGA repayments, nor payment of the own resources refunds postponed from this year;
- (iii) we shall receive a VAT abatement in 1988 of 2.5 becu (£1800 million), and that, in 1989 and later years, our abatements will be determined exactly according to the Fontainebleau abatement mechanism.

The own resources ceiling

4. In practice, it is likely that some increase in the own resources ceiling will be agreed at some stage in the next nine months or so. If, for example, the VAT ceiling were increased to 1.6 per cent, the extra expenditure (compared with the 1.4 per cent projection) might be as follows:

	£m			
	1987-88	1988-89	1989-90	1990-91
Extra expenditure if VAT ceiling increased to 1.6%	+80	+280	+160	+140



With a larger increase in the own resources ceiling, the additions to expenditure would be correspondingly greater.

Reasons for the deterioration in the projection

5. The projected level of our net payments to the Community is considerably higher than the forecast contained in the last PEWP. The main reasons for this are:

- (i) a very sharp fall in our assumed share of agricultural receipts. The PEWP projection assumed our share of FEOGA receipts in future years would be 8½ per cent (a fall of nearly 3 percentage points since the peak in 1984). On the advice of MAFF and IAE division, however, we now assume a share of 6½ per cent from 1988 onwards. The problem is that, while Community agricultural expenditure as a whole has been spiralling upwards, our own receipts in some areas (eg milk, beef, sheep-meat and sugar) have been declining, while in other areas (eg oil-seeds), the increase in our receipts is slower than in other member states. Reasons for our disappointing performance and the gloomy outlook include high negative MCAs (which at the current level, minus 16 per cent, depress receipts by around £400 million a year), the deferred reimbursement of losses on butter stock disposals (which is likely to cost us £200 million in 1988), and the enlargement of the Community which is resulting in a rapid build-up of expenditure in Spain and Portugal;
- (ii) an increase in our share of Community contributions. Higher than expected receipts of customs duties and agricultural levies this year have led us to revise up our share of Community "traditional" own resources in 1987 and all forward years. The recent strengthening of sterling against the ecu has also led us to revise up our projected share of Community VAT contributions;
- (iii) the supplementary budget agreed in July worsened our net payments position in 1987/88. It provided for a higher level of total spending, as well as the



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postponement of this year's IGA repayment and 400 mecu's worth of own resources refunds. It also provided for a switch from advances to reimbursement of agricultural expenditure with the result that, in 1987/88, we shall lose about 2 months' worth of agricultural receipts (a loss of around £200 million).

Reasons for the uneven profile of the projection

6. The profile of the projection is very uneven. The relatively low net payments figure in 1988/89 arises because:

- (i) we are expecting a huge abatement (2.5 becu) to be made in 1988. Not only are we expecting a large abatement in respect of 1987 (2.3 becu), but also a correction to our abatement in respect of 1986 (244 mecu);
- (ii) because of the favourable budget exchange rate, our VAT liability in the 1988 Community budget is relatively low.

7. The relatively high net payments figure in 1989/90 arises mainly because the saving in our VAT contribution in 1988 ((ii) above) results in a smaller abatement in 1989.

8. Because GE were concerned about this uneven profile, we have smoothed our initial projection considerably. The unsmoothed projection was:

	£m			
	1987-88	1988-89	1989-90	1990-91
Unsmoothed 1.4 per cent projection	1260	860	1720	1240
Smoothed 1.4 per cent projection	1400	790	1580	1320
Smoothing adjustment	+140	-70	-140	+80



The smoothing was done by assuming that a £140 million payment of traditional own resources would be advanced from next April to next March (and hence from 1988/89 into 1987/88), and by reducing or eliminating the VAT adjustments the Community are likely to pay us in 1988, and we are likely to pay them in 1989.

### Sensitivity of the figures

9. Both the deterioration in the figures compared with those in the last PEWP and the uneven profile of the projection are likely to attract unwelcome comment. You may therefore wonder whether it would be worth shading down the estimate of our net payments in 1987/88 and/or 1989/90.

10. Our inclination would be not to do so. As far as 1987/88 is concerned, we understand from GE division that a relatively high net payments figure would not be unwelcome given that public expenditure as a whole is running below the planned level. You will also want to bear in mind that the outturn for our net payments this year could be worse than we have projected if a budget at the 1.4 per cent ceiling is not agreed by next March. In that event, the Community would have to go on to an emergency financing regime ("provisional twelfths") and we would not benefit from the large abatement which should be included in the 1988 budget proper. (We would not suggest increasing the £1400 million estimated outturn for 1987-88 either: it would not be easy to do so without reducing our net payments in 1988-89, and that would exacerbate the step up to 1989-90.)

11. As for 1989/90, we cannot of course rule out that things may be better in some respects than we have suggested (eg because our share of agricultural receipts might not fall quite as far as anticipated). On the other hand, we have already massaged down the net payments figure quite considerably (by about £140 million), and we do not think that the projection taken as a whole is pessimistic. Indeed, our current best estimate of what will actually happen is that our net payments to the Community



will be higher than suggested in paragraph 1 because agreement is likely at some stage to an increase in the own resources ceiling. The effect of any further shading down of the 1989-90 figure would therefore be to increase what is already a large potential claim on the reserve.

12. The consequence of not making any further changes is that the profile of our net payments to the Community would remain uneven. We do not believe that this of itself should present a problem. An uneven profile is virtually certain to happen, and can be justified easily, and will be anticipated by the relevant outside experts. Indeed, the last PEWP contained an uneven profile, and a full explanation was provided in the White Paper text.

13. We would therefore be grateful to know whether you are content for the projection contained in paragraph 1 to be included in the Autumn Statement. GEP have been consulted and are content.

*Am*

J E MORTIMER

These latest projections indicate a formidable worsening in our financial imbalance with the Community, from an underlying annual rate of net contribution of around £½ billion implicit in the last public expenditure White Paper to around £1½ billion. The figures make no allowance, of course, for the expected increase in the own resources ceiling.

2. The problem is, in a nutshell, that everything has deteriorated simultaneously. The dramatic decline in our share of receipts from agricultural guarantee expenditure, partly associated with our heavily negative MCAs, has coincided with a significant resurgence of levies and duties and increases in our share of VAT contributions reflecting the stronger sterling exchange rate.

3. It is possible that some of our underlying assumptions may be on the pessimistic side; but others are probably, if anything, optimistic. I agree with Mr Mortimer that there is little scope for reducing the figures or for further smoothing of the year to year "hog-cycle" fluctuations, which result from curiosities in the UK abatement system and the procedure for paying and correcting VAT contributions.

4. The only good thing about these figures is that they may help in some degree to reinforce the UK's case in the December European Council at Copenhagen.

*AJCE*

A J C EDWARDS



FROM: I C R BYATT  
DATE: 7 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

c Paymaster General  
Sir P Middleton  
Sir T Burns  
Mr F E R Butler  
Sir G Littler  
Mr Cassell  
Mr Lavelle  
Mr Monck  
Mr A Edwards  
Mr H P Evans  
Mrs Lomax  
Mr Odling-Smee

Mr Peretz  
Mr Scholar  
Mr Spackman  
Mr Turnbull  
Mr Crabbie  
Mr Culpin  
Mr S J Davies  
Mr S Matthews  
Mr Mortimer  
Mr M Parkinson  
Mr Tyrie  
Mr Bostock (UKREP)

*Note @ And. M.*

COMMISSION OF THE EC: ANNUAL ECONOMIC REPORT

We have now received a draft of the Annual Report. The first chapter, which acts as a summary, and the UK country chapter, are attached.

2. The main report is not very helpful, but the UK country chapter is broadly satisfactory. There is generally a different emphasis between what is said in the main report and the country chapters, which seem reasonably acceptable to the other member states as well as to ourselves.

3. The main report says much less than in previous years about the need for a medium term approach, continued anti-inflationary policy and improvements in the supply side, including wage restraint. It emphasises demand expansion by means of fiscal policy. This was in the report last year and the Commission have already been pressing it this year, in particular in the discussion of the second quarterly review at the July Ecofin.

4. Earlier in the year the Commission were arguing for fiscal expansion in Germany. This time, as in July - partly to avoid singling out Germany - they have argued the case for concerted fiscal expansion in Denmark, France, Germany, Luxemburg and the UK. But they have also indicated that there would be problems in fiscal expansion in the case of Denmark, France and the UK. So the Germans are isolated, but without anyone saying so.



5. It seems to me reasonable to be concerned about the German economy and the need to switch activity from the export to the domestic sector. The Germans themselves are concerned about the low level of investment but are reluctant to see further monetary expansion.

6. The main report was discussed last week in the Economic Policy Committee, where it was not received badly. As in the July Ecofin, there was a division of views on the policy analysis. The French made it clear that fiscal policy relaxation was not for them. The Germans thought the report too pessimistic and did not accept the need for further expansion, but were otherwise reasonably relaxed, perhaps because they were not singled out. The other supply siders, such as the Dutch, were not singled out as part of the fiscal expansion and so needed to say little. We were the most hostile, stressing the need to continue to set economic policy in a medium term framework, to continue with anti-inflationary policy and not to relax on the ~~supply~~ <sup>side</sup> side. We argued that the call for concerted fiscal expansion ignored important constraints and neglected the harmful effect that this policy could have. But we were, we said, content with the fairly balanced discussion of monetary policy. We handed over a set of amendments which, if adopted, should deal with our major worries.

7. At the end of the meeting, the Commission agreed that they would amend the document to make it clear that the medium term approach, non-accommodating policies and the supply side were as important as ever. They also agreed to set the call for fiscal expansion within the context of the conclusions of the July Ecofin, namely, that if there were a major slow-down, there would be a need to consider the policy mix. There would be no call for concerted expansion in the short term.

8. I am more optimistic about their assurances on the first of these points than on the second. I think we shall find amendments which talk about the importance of supply side and non-accommodating policies. But I fear we may still find the main report rather more "demand expansionary" than we would wish.



[illegible]



9. The UK chapter contains the Commission's short term forecast for the UK. Output growth in both 1987 and 1988 is higher than in the FSBR forecast, and also than the average of outside forecasts. But both inflation and the current account deficit are higher in 1988 than in 1987.

10. On policy, the UK chapter says that the growth of credit needs to be kept under review, that an extended period of exchange rate stability is desirable, and that an easing of the fiscal stance would be the appropriate response to an undershoot of money GDP. It calls for more supply side measures, including the promotion of labour mobility and training, the rehabilitation of inner cities, the use of part of the fiscal adjustment to reduce employers' NICs, public sector wage restraint and tax reform.

11. The Commission staff will submit a revised version to the Commission itself. The Commission plan to adopt the report on 14 October and, in accordance with normal practice, will then release it to the press. We will aim, as last time, to get the summary and conclusions in London as quickly as possible in order to deal with press questions.

12. What the Commission publish will, of course, be their report, which then goes to Ecofin. But it will be possible to make amendments before the report is adopted by the Council. Adoption is planned for the December Ecofin and will be preceded by a meeting of the Co-ordination Group. With the continued division of views on fiscal expansion, our aim should, I think, be to go no further than the approach adopted in July.

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 report w. calls for  
 corrects these expansion.  
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CHANCELLOR OF THE EXCHEQUER

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c Paymaster General  
Sir P Middleton  
Sir T Burns  
Sir G Littler  
Mr Monck  
Mr Odling-Smee  
Mr Scholar  
Mr R I G Allen  
Mr Segal  
Mr Parkinson

COMMISSION OF THE EC: ANNUAL ECONOMIC REPORT

We have just received the summary and economic policy conclusions of the annual report which was adopted by the Commission today.

2. I have not looked at it in detail because I thought you would want to see it quickly as there may be something in the press tomorrow. I expect press stories will come out on Friday, but I cannot be sure.

*New  
attribution,  
b/hw*

3. Unfortunately, page 9 has failed to come through the fax. Unless there are any problems on that, the report seems to me much more satisfactory than what we saw before. The concerted expansion point on the last page is in itself harmless.

4. The interventions in the EPC seem to have been useful.

*I & J*  
I C R BYATT  
14 OCTOBER 1987



## EXCHANGE CONTROLS IF NECESSARY:

(B) AN ERGA OMNES DECLARATION OF INTENT BY MEMBER STATES WITH REGARD TO EXTENDING LIBERALISATION TO TRANSACTIONS WITH THIRD COUNTRIES.

IN ALL THIS, THE COMMISSION WOULD EXPECT TO BE GIVEN COMPETENCE TO JUSTIFY AT, SAY, OECD LEVEL ANY SUBSEQUENT REINTRODUCTION OF RESTRICTIONS BY A MEMBER STATE AND ALSO TO ACTUALLY RECOMMEND THAT PROTECTIONIST MEASURES BE TAKEN IN THE CASE OF EXTERNAL SHOCKS, BOTH WITHIN THE COMMUNITY AND VIS A VIS THIRD COUNTRIES.

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FRAME ECONOMIC

LIBERALISATION OF CAPITAL MOVEMENTS

1. DISCUSSION OF THIS SUBJECT AT YESTERDAY'S MEETING OF EEC COMMISSIONERS IN STRASBOURG APPARENTLY REVEALED LITTLE MORE THAN THE INFORMATION ALREADY ISSUED IN THEIR OFFICIAL PRESS RELEASE REPORTED TODAY.

2. PRESIDENT DELORS MAINLY WISHED TO UPDATE HIS FELLOW COMMISSIONERS ON DEVELOPMENTS, AND ACCORDING TO MINGASSON (DEPUTY DIRECTOR GENERAL DG II) WHO WAS PRESENT, THE WAY IS NOW CLEAR FOR THE PROPOSALS TO BE ADOPTED BY THE COMMISSION ON 28 OCTOBER. PROVISION HOWEVER WILL BE MADE FOR AMENDMENTS BY THE MONETARY COMMITTEE WHEN IT MEETS ON 30 OCTOBER. THE FINAL TEXT SHOULD BE AVAILABLE SHORTLY THEREAFTER IE IN THE FIRST WEEK OF NOVEMBER, READY FOR PRESENTATION TO THE 16 NOVEMBER ECOFIN.

3. PRIVATELY WE HAVE BEEN TOLD THAT THE PROPOSALS WILL BE THREEFOLD:-

- (I) A NEW DIRECTIVE WITH A SIX MONTH MAXIMUM SAFEGUARD CLAUSE AND TRANSITIONAL ARRANGEMENTS (FOR PORTUGAL AND SPAIN AND PROBABLY ALSO GREECE AND IRELAND) SWEEPING UP TRANSACTIONS STILL REMAINING TO BE LIBERALISED IE THOSE OF A SHORT TERM NATURE.
- (II) A COMBINING OF THE PRESENT MEDIUM TERM FACILITIES (THE SUPPORT MECHANISM AND COMMUNITY LOANS BUT NOT THE NICS WHICH WILL REMAIN UNTOUCHED) PLUS THE INTRODUCTION OF A SHORTER TERM STANDBY FACILITY (ONE YEAR RENEWABLE FOR A FURTHER YEAR) FOR MEMBER STATES WITH TRANSITIONAL TYPE DEROGATIONS IMPLEMENTING THE DIRECTIVE MORE QUICKLY THAN PLANNED. THIS WOULD BE THUS A SYMMETRICAL COUNTERPART TO THE MEDIUM TERM SUPPORT CURRENTLY GRANTED TO COUNTRIES REINTRODUCING EXCHANGE CONTROLS. THE FINANCING OF THE ABOVE FACILITIES WOULD BE BY COMMUNITY BORROWING IN THE CAPITAL MARKETS AND, AS A BACKSTOP, FROM MEMBER STATE CONTRIBUTIONS.
- (III) FINALLY THERE WOULD BE :
  - (A) AN OBLIGATION FOR MEMBER STATES TO HAVE IN PLACE 'INSTRUMENTS OF REGULATION' TO ENABLE REINTRODUCTION OF

*IX*



PS/PAYMASTER GENERAL

FROM: C B EVANS

DATE: 15 OCTOBER 1987

cc: (without copy of  
COM(87)420)  
Mr Edwards  
Mr Mortimer  
Mr Mercer  
Mr Donnelly  
Miss Wright  
Miss Wheldon(TS)

**EXPLANATORY MEMORANDUM ON EUROPEAN COMMUNITY DOCUMENT COM(87)420**

1. I attach a draft Explanatory Memorandum on COM(87)420, which contains the Commission's proposal for a new Decision on the Communities' own resources. The proposal puts into the form of draft Community legislation certain of the Commission's ideas on the future financing of the Community which were set out in its document COM(87)101, issued earlier this year. A copy of the Commission's proposal is also attached.
2. COM(87)420 is one of a number of recent Commission proposals on future financing on which EMs need to be deposited in Parliament. One was submitted to you yesterday on the Community's Financial Regulation, and others are being handled by FCO, MAFF and DTI. Cabinet Office have asked for the EMs to be deposited by Friday 16 October, in time for the Scrutiny Committee to consider them at its meeting on 21 October.
3. The attached EM has been discussed with other Departments concerned, although we do still need to confirm finally with our legal advisers tomorrow morning that the references to Parliamentary approval and the impact on UK law (para 8iii-iv) are accurate.
4. In view of the Scrutiny Committee's timetable, and with apologies for the short notice, I should be most grateful for the Paymaster General's approval (subject to final checking of the legal point mentioned above) and signature of the attached draft EM as soon as possible.

*Chris Evans*

C B EVANS



**EXPLANATORY MEMORANDUM ON EUROPEAN COMMUNITY LEGISLATION:  
COMMISSION PROPOSAL FOR A NEW OWN RESOURCES DECISION**

Submitted by HM Treasury

October 1987

**SUBJECT MATTER**

This document sent by the Commission to the Council contains a proposal for a new Council Decision on the Communities' own resources system. The document consists of a draft Decision and an Explanatory Memorandum.

2. The proposal develops aspects of the Commission's ideas on the future financing of the Community which were set out in its "Report to the Council and Parliament on the Financing of the Community Budget" (COM(87)101) (deposited in Parliament on 27 March 1987).

3. The principal changes which this proposal would make to the present system of own resources are as follows:

- (a) customs duties on imports of coal and steel would be payable to the Community;
- (b) VAT contributions payable to the Community would be fixed at 1 per cent of the Community's harmonised VAT base, but this could be modified subsequently by unanimous agreement of the Council without the need for subsequent adoption through national constitutional procedures;
- (c) a new own resource based on the difference between member states' GNP and their VAT base would be introduced alongside VAT; the rate applied would be decided each year in the budget;



- (d) the Own Resources Decision would refer explicitly to the possibility (already provided for in the EC Treaties) of further Community levies being introduced by unanimous agreement of the Council and subject to adoption through national constitutional procedures;
- (e) the ceiling on own resources would apply in future to all own resources and would be set at 1.4 per cent of Community GNP;
- (f) within that overall ceiling, annual sub-ceilings would be set on own resources progressing from 1.2 per cent of Community GNP in 1988 to 1.3 per cent in 1992;
- (g) the 10 per cent refund of customs duties and levies (intended to cover member states' collection costs) would be abolished.

4. The Commission's Explanatory Memorandum recalls the arguments in COM(87)101 in favour of its proposed changes. In particular, it argues that these will:

- link member states' contributions more closely to their relative prosperity, through introduction of the new own resource related to GNP; and
- provide greater buoyancy in the overall level of own resources.

5. The Commission notes that its proposal in COM(87)101 that VAT contributions should in future be based on actual VAT revenue, rather than on the 'harmonised' VAT base as at present, has been dropped for practical reasons.

6. The current Own Resources Decision provides among other things for the "Fontainebleau" abatement mechanism which helps to compensate for the UK's excessive net contribution to the Community budget. In COM(87)101 the Commission proposed that that mechanism should be replaced by a new system. The new draft Decision makes no provision for any correction mechanism (other than transitional provision for the abatement in 1988 and for



corrections of abatements in earlier years), although the Commission states that the draft is without prejudice to future discussions on this issue.

## **MINISTERIAL RESPONSIBILITY**

7. Treasury ministers are responsible for Community budgetary matters, including the question of own resources. The Foreign Secretary has overall responsibility for policy in the review of Community financing.

## **LEGAL AND PROCEDURAL ISSUES**

### **8. (i) Treaty basis**

The proposed Decision would be based on Article 201 of the Treaty establishing the European Economic Community and Article 173 of the Treaty establishing the European Atomic Energy Community.

### **(ii) Cooperation procedure**

The cooperation procedure introduced by the Single European Act does not apply to this proposal.

### **(iii) Voting procedure**

The proposal would require unanimous agreement by the Council and adoption by member states in accordance with their respective constitutional requirements. In the UK, it would need to be approved by Parliament.

### **(iv) Impact on United Kingdom law**

If a new Own Resources Decision were adopted, it would be given the same status under the European Communities Act 1972 as the existing decision, which has Treaty status. It would accordingly be directly applicable in United Kingdom law. The current Own



Resources Decision was published as Cmnd 9549, and relaid before Parliament as Cm 88.

## POLICY IMPLICATIONS

9. The proposal would have significant implications both for the amount of revenue available for financing the Community's budget and for the level of the United Kingdom's contributions to it. These are discussed below in the section on financial implications. As the Prime Minister informed Parliament on 1 July 1987, (OR vol 118 col 493), she made clear at the European Council in June 1987 that there must be agreement on effective and binding mechanisms to control Community expenditure before the question of the future level of own resources could be addressed.

## FINANCIAL IMPLICATIONS

10. The proposed increase in the own resources ceiling to 1.4 per cent of Community GNP, with annual sub-ceilings, would increase by some 45 per cent in real terms the level of own resources available to the Community. The Commission's intention, as spelt out in COM(87)101, is that the budget for payment appropriations should increase from some 36.9 becu (£25.9 billion\*) in 1987 to 52.7 becu (£36.9 billion) at 1987 prices by 1992. The maximum budget that could be financed within the proposed 1.3 per cent sub-ceiling in 1992 would be 52.9 becu (£37 billion).

X OM 11. The Commission estimates in Com(87)101 that if the proposed new structure of own resources had been used in 1987, the UK's total gross contribution before abatement would have been 6354 million ECU (£4443m), compared to 6660 million ECU (£4657m) under the current system, a saving for the UK of 306 million ECU (£214m).

12. The full financial implications for the United Kingdom of the proposed changes to the structure of own resources need to be seen in the context of the other proposals in COM(87)101, discussed in the earlier Explanatory Memorandum.

\* Sterling figures calculated at fl=1.43 ecu



**TIMETABLE**

13. The Council is considering the present proposal along with other proposals arising from COM(87)101, in preparation for negotiations at the Copenhagen European Council in December on the Community's future financing. The opinions of the European Parliament and the Economic and Social Committee have been sought but not yet delivered.

**PETER BROOKE**  
**PAYMASTER GENERAL**  
**HM TREASURY**



CONFIDENTIAL

FROM: C J A CHIVERS  
DATE: 15 October 1987

PAYMASTER GENERAL

cc PS/Chancellor  
PS/Chief Secretary  
Sir Peter Middleton  
Mr Kemp  
Mr A J C Edwards  
Mr Luce  
Mr Gilhooly  
Mr Mortimer  
Mr Jordan  
Mr Bostock (UKREP)

## EUROPEAN COMMUNITIES' STAFF PAY : THE CRISIS LEVY

Mr Jordan and I had discussions with our German and Dutch colleagues yesterday about the line our respective Governments should take when the subject of the crisis levy comes up at the Foreign Affairs Council next Monday. It now appears that it will be a proper agenda item and that a decision will be sought.

2. There is a great deal of common ground between the UK, the Germans and the Dutch. We all agree:

- i. that salaries in the Community are too high in relation to national civil services;
- ii. that we would be entirely within our rights to insist that the levy stayed at the level of 12.7% until 1991;
- iii. that although such a decision would be subject to legal challenge it would not be self-evidently unlawful: there are arguments each way;



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- iv. the Dahrendorf report has done nothing to clarify the issues, and indeed the weakness of its argumentation if anything strengthens our conviction that we have good grounds for sticking to 12.7%;
- v. there are no objective grounds for worrying about the prospect of industrial action in the Community;
- vi. we cannot go along with Dahrendorf's proposal that we give the staff a commitment to parallelism after 1991.

3. Nevertheless the Germans are in some difficulty. The Interior Ministry and the Treasury, backed by resolutions of the German Parliament, believe that we should stand firm at 12.7%. The Foreign Ministry however is becoming increasingly concerned to have the matter resolved before the Republic takes over the Presidency in January, and Genscher has the support of his Economics and Agricultural colleagues in this. The Federal Cabinet discussed the subject yesterday but found it difficult to reach a definite conclusion. There will be a further meeting of State Secretaries this evening. Their officials had put to them two options:

- i. to make no move at all; or
- ii. to propose that there should be a fresh negotiation involving the Presidency, the Commission, Professor Dahrendorf and the three no-saying countries to try to reach a compromise, which might involve:
  - a lesser reduction of the Levy than that proposed by Dahrendorf,
  - its consolidation into staff salaries, and
  - agreement to reform the method of pay determination based on "parallelism" in 1991.



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4. We and the Dutch had serious doubts about the latter idea. Unless the Commission can be persuaded to propose it any compromise would require unanimity in the Council, which is very unlikely to be achieved. And each of the three points presents a problem:

- i. it is hard to see why the Commission should agree to a Levy higher than 7.62%;
- ii. consolidation into salaries would require a change in the method of determining staff pay, which would be out of order at present unless the Council were to adopt it by unanimity;
- iii. the Commission could not accept, on behalf of their staff, any questioning of the principle of parallelism: the most we could aim for would be some questioning of the way in which the method was applied.

5. At COREPER this morning the Greeks surprised everyone by declaring that they would support the maintenance of the 12.7% levy. Their voting strength is too small to make a difference, but their decision (and the re-affirmation of the UK and Dutch positions) may help to influence the German State Secretaries tonight.

6. We do not believe that there is any compromise acceptable to the Commission short of the Dahrendorf recommendations. We agree with the Dutch that the danger of being prepared to discuss any compromise is that, whatever we might protest, we would effectively have sacrificed our legal position. If the Germans weaken and we are out-voted it will be damaging, but not as damaging as if we had compromised along the way. It is important that we should be seen to maintain our position that the Levy is not only legally justified but justified on objective criteria, viz that Community salaries are too high.



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7. We need to maintain this stand not just in relation to the Community but because of the example it sets in other international organisations - and indeed back home, where the relaxation of the Levy could well be reflected in unhelpful headlines about uncovenanted benefits for highly paid officials. If you agree, we shall ask the Foreign Office to brief their Minister (Mrs Chalker) to speak to her German and Dutch colleagues in the margins of the Council and explain that this is and will remain the UK position.

8. If we are certain to be out-voted the question will arise whether we should abstain or vote against. Mrs Chalker would no doubt prefer - having made her position clear - to do the former. I would be inclined to leave that to her to decide in conjunction with the other reluctant countries. I do not believe that it would make any significant difference, and it may have some slight diplomatic advantage.

Conclusion

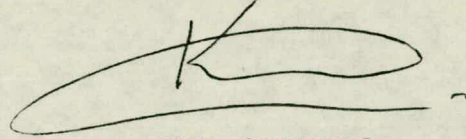
To sum up, we recommend:

1. the UK should maintain its opposition to any reduction in the 12.7% levy and to the giving of any assurance to the staff about the continuation of parallelism after 1991;
2. our representatives should say that we see no advantage in trying for a compromise on the lines suggested by the Germans;
3. Mrs Chalker should be invited to do her best to persuade Mrs Adam-Schwaetzer to hold the line;
- X | 4. but if the no-sayers are about to be out-voted Mrs Chalker should have discretion to abstain rather than vote against a reduction to 7.62%;



**CONFIDENTIAL**

5. She should however oppose any resolution regarding parallelism after 1991 on the grounds that it is out of order in the present context; and should vote against it if necessary.

A handwritten signature in black ink, consisting of a stylized 'K' followed by a horizontal line and a small flourish.

KIT CHIVERS



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EUROPEAN COUNCIL : COPENHAGEN

X 1. AT AN EC AMBASSADORS' LUNCH THIS WEEK ELLEMANN-JENSEN WAS ASKED WHETHER A FOREIGN MINISTERS' MEETING WOULD BE CONVENED BEFORE THE EUROPEAN COUNCIL IN DECEMBER AND WHETHER OTHERS - EG FINANCE MINISTERS - WOULD TAKE PART. HE SAID THAT HIS OBJECTIVE WAS TO KEEP FINANCE MINISTERS OUT OF THE WHOLE BUDGETARY AND FINANCIAL CONTROL DEBATE. AS FOR CONVENING A MEETING OF FOREIGN MINISTERS, IF HE DID SO ALL WORK WOULD STOP IN ROUTINE FORA. HE WANTED TO SEE PROGRESS IN REGULAR MEETINGS AND NOT RELY ON A SPECIAL CONCLAVE.

2. ELLEMANN-JENSEN ALSO SAID THAT THE EUROPEAN COUNCIL WOULD HAVE TO CONTINUE UNTIL SUCCESS WAS ACHIEVED. THE PRESIDENCY WERE NOT TALKING ABOUT STOPPING CLOCKS: THEY WOULD JUST INSIST ON AGREEMENT AND GO ON UNTIL 7 DECEMBER IF NECESSARY.

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Ch. OD(E) Paper: future financing

You will see that the minutes are vague about what should go to the PM (they refer to "appropriate supporting material"). Mr Lavelle feels she should see the full note by officials: FCO are resisting this. Mr L. thinks that, if you agree, you might usefully have a word with Sir G Howe about this at the Conference. (The paper would include updated figures, which would be a further advantage).

That is  
scandalous. If this @  
I posted 5/10 Sir A H  
to my, & you  
concerned.

up, the Rev  
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CONFIDENTIAL

FROM: A J C EDWARDS  
DATE: 16 October 1987

CHANCELLOR

cc: Chief Secretary  
Paymaster General  
Sir P Middleton  
Mr F E R Butler  
Sir G Littler o/r  
Mr Bonney  
Mr Gieve  
Mr Mercer  
Mr Mortimer  
Mr Donnelly  
Mr Evans  
Mr Tyrie

### FUTURE FINANCING NEGOTIATIONS: OVERVIEW AND SCORESHEET

You and Sir G Howe have both agreed that a revised and updated version of the Treasury paper which OD(E) considered on 1 October should go forward to the Prime Minister as background to her meeting on 28 October about the future financing negotiation. Sir G Howe has indeed promised this in his minute of 12 October to the Prime Minister reporting on the OD(E) meeting.

2. I have now revised the paper accordingly, with enormous help from Mr Mortimer, Mr Bonney, Mr Evans and Mr Donnelly, and in consultation with Mr Lavelle (Cabinet Office), Mr Kerr (FCO), Mr Hadley (MAFF) and Miss Wheldon (T Sol). The revised version is attached.

3. Our objective in the revisions and updatings has been to produce a comprehensive guide to all the main issues in the future financing negotiations. The Prime Minister has made clear on previous occasions that she likes to have full papers of this kind on this subject. She has also indicated in discussion with Mr Christophersen that she intends before Copenhagen to have mastered the whole dossier down to the finest detail.

EDWARDS  
to  
CJ/EX  
16/10



4. The new version is, I fear, longer than the previous one. But it deals with some important issues which were touched only lightly or not at all in the previous version and about which we think the Prime Minister needs to be informed. These are:

- (i) the serious deterioration in the UK's net contribution implied by our latest projections for the autumn statement (paragraphs 2-4): we have rebased and revised virtually all the figures in the paper;
- (ii) the Commission's proposals and their estimated effects on the UK and other member states (paragraph 6-9);
- (iii) a recapitulation of the broad objectives of the UK and other member states in this negotiation and the nature of the likely deal (paragraphs 10-16);
- (iv) the nature of the deal on agriculture (paragraph 17), the possibilities for a legally binding guideline limit (paragraphs 35-7), our requirements on stabilisers (paragraphs 39-41) and in-year budgetary control (paragraphs 42-43) and a more extended discussion of the exceptional circumstances/safety-valve range of issues (paragraphs 44-55);
- (v) a short discussion about the impossibility of a legally binding guideline for non-obligatory expenditure (paragraph 63);
- (vi) a short discussion of the proposal for bringing the European Development Fund within the Community Budget (paragraphs 75-78);
- (vii) a fuller discussion of why and how the Fontainebleau mechanism will probably need to be adjusted if there is agreement on the Commission's diff tax proposal (paragraphs 111-113); and



(viii) a new section at the end about the problem of the 1988 budget and pressures for an IGA, which are certain to be major issues at Copenhagen.

X 5. If you are content with the paper, I suggest that it should now go to No 10 under cover of a short Private Secretary letter which simply flags some points which will be new to the Prime Minister or which particularly need consideration at this stage. Sir G Howe's minute implied that he himself would be sending the paper forward. It would however be unusual for an FCO Minister to submit a Treasury paper, and I think we can assume that this was no more than an aberration on the part of the Cabinet Office official (not Mr Lavelle) who drafted the minute for Sir G Howe.

Shall I  
check  
with  
Mr Lavelle?

6. We are still checking facts and figures. I hope we may have discretion to make any necessary changes on Monday. If there are changes of real significance, we will of course seek your agreement.

yes  
yes

AJCE  
A J C EDWARDS



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## DRAFT LETTER FROM:

## The Chancellor's Private Secretary to:

The Private Secretary to the Prime Minister  
Charles Powell, Esq  
10 Downing Street

## EC FUTURE FINANCING NEGOTIATIONS:

## OVERVIEW AND SCORESHEET

1. In preparation for the Prime Minister's meeting on 28 October, I attach the compendium paper which the Foreign and Commonwealth Secretary foreshadowed in his minute of 12 October. Treasury officials have prepared the paper with help from officials in other departments, in particular the Cabinet Office, FCO, MAFF and Treasury Solicitor.
2. The Chancellor believes that the Prime Minister will wish particularly to note the following points in the paper:
  - (a) the serious deterioration in our net contribution implied by the latest projections due to be published in the Autumn Statement (paragraphs 2-4);
  - (b) the important questions about the nature of the deal on agriculture (paragraph 17), including the legal form of the guideline limit (paragraphs 35-37) and the idea of a safety-valve (paragraphs 47-54), on which Ministers ~~will~~ need to take a view within the next two or three weeks; *may*
  - (c) the form of budget discipline on non-obligatory expenditure (paragraph 63);
  - (d) the magnitudes involved in the own resources ceiling, including the problem of the hump of demands on resources in 1988 (paragraphs 90-94);
  - (e) the possible benefits to the UK from the Commission's



proposed diff tax and the link between this and the Fontainebleau abatement system (paragraphs 111-113); and

- (f) the likely pressures at Copenhagen for agreement on a budget for 1988 and an IGA (paragraphs 119-125).

3. I am copying this letter to the Private Secretaries to the Foreign and Commonwealth Secretary, the Minister of Agriculture and Sir Robert Armstrong.



EC FUTURE FINANCING REVIEW:OVERVIEW AND SCORESHEETCONTENTS

	<u>Paragraph</u>
Introduction	1
Net contributions and receipts since Fontainebleau	2
Commission proposals	6
UK Objectives	10
Other member states' objectives	14
Agricultural expenditure guideline: rebasings and stock depreciation	17
Agricultural expenditure guideline: growth over time	30
Making the guideline stick	32
Other obligatory expenditure	57
Non-obligatory expenditure	61
European Development Fund	75
Expenditure totals	79
Inter-institutional agreement and intermediate own resources ceilings	82
Budget management and the Financial Regulation	87
Own resources ceiling	89
Own resources structure	100
UK abatement	109
Decisions on 1988 Budget	120

TABLES

1a	UK net contribution and VAT/expenditure gap, 1980 to 1991
1b	Net contributions and receipts of member states, 1985 and 1986
1c	UK net contribution, 1987-92, on various scenarios
1d	Effects of Commission proposals on member states, 1992
2	Agricultural Guarantee expenditure, 1987-92
3	Prospects for non-obligatory expenditure and the structural funds
4	Community Budget 1987-92: a possible scoresheet
5	Ready reckoner: implications for UK net contribution of various changes
6	GNP and VAT ceilings conversion table
7a	Effect of Commission's proposal for adding the diff tax, 1992
7b	Effect of substituting GNP contributions for VAT, 1992
7c	Variants on diff tax and GNP contributions instituted by Commission
7d	VAT, GNP and diff tax shares, 1992
7e	ECSC customs duties, 1987
8	Commission's alternative correction mechanism and Fontainebleau compared



EC FUTURE FINANCING REVIEW:OVERVIEW AND SCORESHEET

## Note by HM Treasury

1. This note reviews ~~briefly~~ all the issues with major financial implications which are likely to feature in the future financing negotiations. Its primary concern is with identifying broad magnitudes and UK interests rather than tactics.

Net contributions and receipts since Fontainebleau

2. The UK's underlying financial imbalance with the Community has deteriorated sharply since the Fontainebleau agreement was negotiated and over the past year in particular.

3. So far as our net contribution is concerned, next month's Autumn Statement will show an underlying rate of net payments to Community institutions after abatement of some £1¼ billion a year, with large annual fluctuations reflecting the operation of the abatement system and the procedure for paying and correcting VAT contributions. The £1¼ billion figure compares with an underlying annual rate of £¾ billion in the last public expenditure white paper. The problem is, in a nutshell, that all the main elements which make up our net contribution have deteriorated simultaneously. A steep decline (to an underlying rate of about 6½ per cent) in our share of agricultural guarantee expenditure, partly associated with our heavily negative MCAs, has coincided with a significant resurgence of levies and duties (UK share about 20 per cent) and increases in our VAT contributions share (currently around 20 per cent as well), the former reflecting increased UK imports and the latter reflecting the stronger sterling exchange rate.

4. The VAT/expenditure gap, which the Community decided at Fontainebleau should be used to measure the UK's net budgetary burden, has increased



even more than the net contribution (see Table 1a). It has more than doubled since Fontainebleau.

5. Elsewhere in the Community, Germany's net contribution has likewise continued to grow inexorably, while France's relatively small net contribution has shown no clear trend (see Table 1b). The chief gainers have been Ireland and Greece, followed now by Spain and Portugal. The Community's two most prosperous member states, Luxembourg and Denmark, have likewise done extremely well, as has Belgium.

### Commission Proposals

6. The Commission have proposed that the own resources ceiling should be raised by 45 per cent in real terms by 1992 (substantially more if the UK abatement were financed outside the ceiling) from 1.4 per cent of the Community's harmonised VAT base to 1.4 per cent of Community GNP, equivalent to a 2.1 per cent VAT rate as at present defined (see Table 6). Their proposals envisage that the own resources ceiling should in future be expressed as a percentage of Community GNP and grow in line with it. They envisage real increases of some 15-20 per cent in agricultural guarantee expenditure and a doubling in real terms of both the structural funds and other non-obligatory expenditure by 1992.

7. The Commission's other main proposals are that a new own resource based on the difference between GNP and the VAT base, the so-called "diff tax", should be introduced alongside VAT at 1 per cent and that the Fontainebleau abatement system should be replaced by a new corrective mechanism which would refund us 50 per cent of the difference between our actual and GNP shares of agricultural guarantee expenditure.

8. We estimate that the Commission's proposals, if accepted in their entirety, could by 1992 increase the UK's underlying net contribution, now around  $1\frac{1}{4}$  to  $1\frac{1}{2}$  becu a year after abatement, by a further  $1\frac{1}{4}$  becu. On our calculations, which differ markedly from those of the Commission, the proposed new UK correction mechanism



would leave the UK some 800 to 900 mecu a year worse off even after allowing for the benefits from introducing a fourth own resource, or diff tax, alongside VAT, the remainder of the deterioration being due to the increased size and changed distribution of the budget (see Table 1c).

9. The other main losers from the Commission's proposals would be Germany (perhaps  $2\frac{1}{4}$  becu a year) and France (perhaps  $\frac{1}{2}$  becu a year). Greece, Ireland and Spain would gain massively, and also the Netherlands to some extent. Portugal would doubtless do well, too. The other member states would retain their substantial existing levels of net receipts. Table 1d brings together our estimates of the likely effects on other member states.

### UK Objectives

10. We assume that the latest deterioration in the UK's underlying financial imbalance with the Community will reinforce Ministers' broad objectives of -

- (i) limiting any increase in the own resources ceiling, and in agricultural and other expenditure, to the minimum amounts realistically needed for the next <sup>five</sup>~~four~~ years;
- (ii) introducing effective and binding discipline on agricultural and other expenditure designed in particular to ensure that any future ceiling can be maintained and respected; and
- (iii) retaining the Fontainebleau abatement system, preferably with improved procedures and with changes in the structure of own resources which would lighten in some degree the UK's budgetary burdens.

11. So far as the first objective is concerned, it seems unlikely as of now that we could obtain a better deal by being prepared to pay over the odds on own resources.



12. As regards the second objective, a deal involving an increase in the own resources ceiling will have in practice to be accompanied by an increase in the guideline limit on agricultural spending, and possibly in non-obligatory expenditure as well. It will not be easy to present this domestically. The broad nature of the deal will have therefore to be to trade a limited increase in the own resources ceiling and expenditure for a much (and visibly) strengthened assurance that any future ceiling will be respected through effective and binding budgetary discipline.

13. The third objective, of maintaining and if possible improving the UK's position with regard to the abatement and the distribution of own resources contributions, will doubtless continue to be an absolute prerequisite for the UK. The Commission and other member states are the demandeurs in this negotiation, not the UK, and the existing abatement system cannot be changed without our agreement. The UK's negotiating position on this point is therefore strong.

#### Other member states' objectives

14. As the figures in paragraph 9 illustrate, considerable financial issues are at stake in this negotiation for other member states as well as the UK. For Germany, the potential increase in budgetary burdens is even greater than for the UK. For France, too, the amounts at stake are significant. It does not follow, however, that French and German interests will coincide with those of the UK. German thinking will continue to be dominated by a desire to protect and increase the Community's agricultural expenditure. France too will perceive a strong national interest in making adequate provision for agriculture. Both France and Germany are likely to join with other member states in wanting the UK to shoulder an even larger burden as a means of reducing their own burdens.

15. The only area where France, Germany and the UK have a close identity of interest is non-obligatory expenditure. The French and Germans will be anxious to trim back the Commission's ambitions for doubling this expenditure in real terms, as will other more



prosperous northern member states. Even here, however, they will probably be ready to concede more than the UK would consider appropriate.

The priority objective of the southern member states and Ireland will be to maximise the increase in non-obligatory expenditure, from most of which they are large net recipients.

16. UKREP have advised that other member states generally would regard an outcome in which the Fontainebleau abatement system was maintained and agricultural stabilisers agreed as being favourable to the UK.

#### Agricultural expenditure guideline : rebasing and stock depreciation

17. If there is to be an increase in own resources at the end of the negotiation, some increase in the agricultural guideline limit will clearly be unavoidable. We assume that the broad nature of the deal on agriculture will be that the UK, with support on particular issues from other member states, will be willing to trade -

- (a) a tough but realistic increase in the guideline limit, possibly accompanied by
- (b) some provision for income aids if necessary, preferably nationally financed,

in return for satisfaction on -

- (c) the legal form of the guideline limit,
- (d) stabiliser mechanisms,
- (e) budgetary control mechanisms,
- (f) 'exceptional circumstances' and
- (g) a proper system for stocks management and depreciation,



so that the guideline limit may in future be respected. The annex to this paper attempts to summarise more fully what the UK would need to achieve on agriculture at Copenhagen in order to justify agreement to raise the own resources ceiling. The paragraphs which follow discuss the individual elements in turn.

18. Last year's guideline limit, based on average expenditure in 1984 and 1985 uprated in line with the growth of the own resources base, was 21.2 becu. Actual expenditure was 22.1 becu. The guideline limit for 1987 was 23.0 becu. Ignoring the deliberate deferment of two months' expenditure into 1988, the outturn is likely to be around 27 becu. The Commission claim that the major factors responsible for these overruns have been external to the CAP - the depreciation of the US dollar against the ecu, the decline in world prices of many agricultural products and the consequences of realignments within the EMS.

19. The Commission have proposed that for the future the guideline limit should be based on the "real needs" of 1987 multiplied by a factor based on the Community's GNP growth. The Commission's February proposals in Com(87)101 included a figure of 25.8 becu as the new base. This assumed that the Commission's price fixing proposals would be accepted in full. In the event, the Council's decisions fell far short of the Commission's proposals, mainly but not exclusively because the oils and fats tax was not agreed, and the Commission have indicated that the "real needs" figure for 1987 should be raised to 27.5 becu less 600 mecu of expenditure postponed from 1986, giving a net figure of 26.9 becu. But the Commission have not yet proposed that this figure should be used as the revised base for the guideline.

20. The revised "real needs" figure of 26.9 becu itself raises two problems. First, there will doubtless be arguments that this figure, too, inadequately represents the real needs of 1987. Moreover in discussion on the 1988 Preliminary Draft Budget (which includes provision of 27 becu for agriculture consistently with the new guideline proposal) the Commission has indicated that their unconstrained forecast of expenditure in 1988 is no less



than 30.2 becu on the assumption that the oils and fats tax is not adopted. This is nearly 2 becu above the figure of 28.4 becu in cash terms obtained by adding a GNP growth factor to their revised assessment of real needs in 1987.

21. If an oils and fats tax were introduced, expenditure could probably be brought within the re-based guideline limit proposed by the Commission. Some member states will doubtless seize the opportunity, therefore, to argue that this clinches the case for the oils and fats tax. Without it, they will argue, a much higher guideline limit will be unavoidable. Our answer should be, presumably, that the oilseeds regime should be reformed in accordance with our own and the Commission's proposals, viz:

- i. remove the price-reduction cut-off if production exceeds the specified maximum guaranteed quantities; and *preferably*
- ii. substitute a flat-rate payment per tonne of oil (or per hectare of production land) for the existing deficiency payments linked to world prices.

We can argue that, with the introduction of these changes to the oilseeds regime and other necessary changes and stabilisation mechanisms throughout the other regimes (notably cereals, milk, wine and olive oil), the proposed guideline limit should be adequate.

22. Second, there is the problem of stock depreciation and disposal: how should the UK respond to the Commission's proposal for a new system for depreciation of stocks, and should disposals of existing stocks be financed inside or outside the guideline limit?

23. The Commission have not yet spelled out their proposal in any detail. In principle, however, the idea of depreciating stocks in future in line with their market value in the year of purchase is worthy of strong support. The existing lack of systematic depreciation is clearly unsatisfactory and tends to result in large overhangs of expenditure. Making the change is likely, however, to be expensive in the short term. The new system will



involve paying member states for the loss in value of new stocks on entry into intervention and then in line with their declining value rather than postponing these payments until the time of disposal. This will inevitably involve a temporary increase in expenditure. The costs of disposing of existing, undepreciated stocks (where the Commission envisage substantial destocking) will have to be combined over a transitional period with depreciation of the new stocks, and the savings associated with this depreciation will take a little time to build up.

24. The size of the temporary increase in expenditure will depend crucially on how the new system is phased in. The two obvious possibilities, both illustrated in Table 2, are:

- i. a "big-bang" introduction with effect from 1988 (or possibly 1989), and
- ii. a phased introduction, designed to spread the extra costs fairly evenly over (say) the five years 1988-92. Phasing could be applied either to the new depreciation policy or to the costs of running down existing stocks or to both.

25. The preliminary calculations reflected in Table 2 suggest that the net cost of the new depreciation system, in the sense of the amount of expenditure brought forward to earlier years, will be of the order of 2 becu net at current stock levels (more if stocks rise). On the "big-bang" approach the extra expenditure would be likely to be some 1.8 becu in 1988, falling to some 0.3 becu in 1989, zero in 1990 and small gains thereafter. Alternatively, introduction of the new system, and hence the costs profile, could be postponed for a year. The cost of disposing of existing stocks would show a similar profile: some 3.1 becu in 1988 and 0.6 becu in 1989, followed by small sums thereafter (see Table 2 again).

26. As these figures imply, a "big-bang" introduction of systematic stock depreciation in 1988 would produce a hump of expenditure in 1988 and a smaller hump in 1989 (though the whole timetable



could be postponed by one year). The excess over "normal" levels would reflect partly the heavy initial costs of the new system and partly the accelerated programme for disposal of old stocks assumed by the Commission (though how realistic this programme is may be open to question). The Commission have said that all stock disposal and depreciation costs should be contained within the guideline, and their latest <sup>e</sup>forecast of 30.2 becu for guarantee expenditure in 1988 includes 3.5 becu for depreciation and losses on disposal (comparable with the 4.9 becu big-bang figure for 1988 in table 2). As noted above, however, this figure lies some 2 becu above their proposed guideline figure for 1988. If savings on the lines indicated in paragraph 9 above cannot be achieved, there will be a hump of expenditure of some 3.5 becu in 1988, and the question will arise how best to deal with it.

27. There is no obviously satisfactory way. There would clearly be some attractions from the UK's point of view in financing the hump outside the guideline limit and setting a lower guideline limit as a result. If the guideline is set high enough to include the hump, it will in effect be <sup>t</sup>racheted forward, with a GNP growth rate attached to it, into all future years or to 1992 at least. If however the hump is treated as outside the guideline limit, the dilemma then arises whether it should be financed from within the new own resources ceiling or outside the ceiling as an IGA. The former approach would be likely to involve setting the new own resources ceiling at a level higher than Ministers would wish to see. The latter approach, an IGA, would be an extremely unwelcome complication, though presentationally it could be related to a crash disposals programme. Further anxieties are (a) the possible difficulty of ensuring that the guideline limit actually is set lower than otherwise as a result of taking out the hump and (b) the dangerous precedent which hiving off one of the components of agricultural market support expenditure outside the guideline limit would set.

28. Alternatively, the costs of the new depreciation system or the destocking programme or both could be phased ~~in~~ over the period 1988-1992 so that the expenditure would be spread over five years



rather than concentrated on one. The hump problem would be greatly reduced, and the Commission's principle of containing all market support expenditure within the guideline could then be respected. It may be that this approach, which would avoid the precedent problem and the dilemma of a higher own resources ceiling versus an IGA, would be preferable. Table 2 illustrates a possible pattern, based on smoothing out the costs of disposing of existing stocks.

29. We shall need further information on the Commission's ideas and further study of their implications before reaching firm and final views on the best way ahead. As of now, however, there would seem a presumption in favour of:

- (A) arguing initially for a 1987 base for the guideline limit below 25.8 or 26.9 becu so as to maximise the chances of ending up with the Commission's figure;
- (B) pressing for genuine savings along the lines of paragraph 21 above to bring down the 1988 figures to a level consistent with (and indeed below) the 1987 base of 25.8 or 26.9 becu (ie below 27.3 or 28.4 becu at 1988 prices);
- (C) supporting in principle a formal change to a new system for annual depreciation of stocks, subject to studying the detailed proposals, including the timing, and the financial implications;
- (D) subject to further information and analysis, including all stock disposal and depreciation expenditure, as recommended by the Commission, within a guideline limit consistent with (or below) the 25.8 or 26.9 becu 1987 base;
- (E) if there is no prospect of agreement on this, we should aim to hold down the guideline figure by spreading over the period 1988-92 the costs of running the new stock depreciation system in tandem with disposals of existing



stocks (or conceivably by financing off-guideline the cost of disposal of the old stocks).

#### Agricultural expenditure guideline : growth over time

30. If the UK were to concede that the own resources base should grow in line with GNP, as the other eleven member states agreed at the June European Council, the GNP growth rate would on past precedent and on the Commission's proposals apply to the agricultural guideline limit from year to year as well. It will doubtless be difficult to resist this change. The change would however mean that agricultural expenditure would be permitted to grow perhaps  $1\frac{1}{2}$  times as fast in real terms as under the existing formula (which has not, of course been observed in practice). The extra resources for agriculture would over time become extremely substantial (3.7 becu by 1992 compared with a guideline which increases in line with inflation and 1.6 becu compared with the present own resources basis). Alternative approaches which the UK might consider canvassing include the following:

- (a) the guideline should grow in line with prices, thus remaining constant in real terms (implying 3.7 becu less expenditure, at 1987 prices, by 1992 on the Commission's figures); or
- (b) it should grow by (say) one-half of the rate of growth of Community GNP rather than by the full amount (this would probably entail a real rate of growth close to zero and hence expenditure savings similar to (a) above). We canvassed a similar fraction in 1983-84 before the Fontainebleau agreement but did not finally press the point.

There are good "Communautaire" arguments for keeping the rate of growth of agricultural spending below the rate of growth of own resources. We should be prepared to deploy such arguments for the time being at least. If a GNP growth rate should eventually be conceded, it should be unnecessary to make any extra provision



for Spain and Portugal as they become fully integrated into the CAP. This would however need to be part of any agreement.

31. Our main conclusion is that:

- (F) the UK should not commit itself at this stage to a GNP growth factor for the guideline limit (any more than for the own resources limit) but should argue for a rate of growth in the limit substantially below that of Community GNP.

### Making the guideline stick

32. The Commission have correctly recognised the importance of making the guideline effective. To this end they have proposed that:

- i. their own price fixing proposals should be "within" the guideline limit;
- ii. the main principles of agricultural budget discipline should be enshrined in a European Council decision, with stablisers, trigger mechanisms and changes to a reimbursement system being enshrined in regulations;
- iii. stabilisers should be introduced throughout the CAP regimes, together with trigger mechanisms and expenditure monitoring procedures on a regime by regime basis: there should be time limits for Council decisions to activate stabilisers and increased Commission powers to take interim measures pending these decisions;
- iv. a "monetary reserve" should be established to deal with adverse currency movements;
- v. there should remain nevertheless an ultimate provision for exceeding the guideline limit in exceptional circumstances if all else fails;



- vi. excesses over the guideline not covered by the reserve would in principle be clawed back over the following two years. But the Council would be able to override this clawing back.

33. The UK will wish strongly to support many of these proposals (despite resistance from other member states), especially those at (i), (ii) and (iii) above. The proposal at (iv) above for a monetary reserve to deal with currency fluctuations is less compelling and less well thought through. Others will criticise it, and there will be no need for the UK to take the lead.

34. There are however four main areas where the Commission's proposals will need to be strengthened if they are to meet the minimum conditions which UK Ministers have laid down.

35. The first relates to the legal status of the guideline limit and related measures. Officials have examined with the departmental legal advisers whether and how the guideline limit could be made legally watertight in the sense that it could not be exceeded (or at least not without the UK's agreement). There are four main Options:

- (i) Treaty amendment. The only really satisfactory way to make the guideline limit watertight would be through substantive amendment of the Treaty. This is probably not, however, a realistic option.
- (ii) Article 235 Regulation. Failing Treaty amendment, the guideline might be enshrined in a Regulation based on a Treaty Article which stipulates unanimity voting. The legal advisers believe that the least unpromising Treaty Article for this purpose would be Article 235, which empowers the Community to agree by unanimity to do things not provided for in the Treaty in furtherance of the Treaty objectives. But they warn that the Community's lawyers would be almost certain to resist this on the grounds that the guideline limit is essentially



an agricultural measure, for which the proper legal base is Article 43 (a qualified majority Article). They add that, in any event, an Article 235 guideline would be vulnerable in practice because of its doubtful base.

- (iii) Article 43 ~~WA~~ Decision or Regulation. This would be feasible. The problem is that such a Decision or Regulation could be overridden or repealed by qualified majority. It would however be legally binding until so overridden or repealed and would be universally recognised as having formed part of the European Council's overall political deal on future financing. If in addition the related implementing provisions for stabilisers and cost overrun measures were enshrined in Regulations under Article 43, with matching provisions in the Financial Regulation, the package as a whole could be expected to enhance the status of the guideline limit and to increase in some degree the procedural obstacles to exceeding the budgetary provision for particular regimes.
- (iv) A Council conclusion. This would likewise raise no legal problems but, like the existing budget discipline text, would not be legally binding or enforceable and would therefore fall well short of the requirements which UK Ministers have laid down.

36. In the light of the above, the UK's best approach may be to argue for Option (ii) but be prepared to settle in the end for something along the lines of Option (iii). If the European Council had solemnly agreed on this aspect of the wider own resources package, *it would at least be a considerable obstacle in the way of* the Agriculture Council ~~could not lightly overturn it.~~ *settling for excessive price increases.*

37. An outcome on the lines of Option (iii) would preferably be buttressed by a Commission undertaking that they would not in any circumstances propose decisions which would involve excesses over the guideline limit: the Council could then exceed the limit



only by unanimity. In the all too likely event that the Commission were not willing to comment <sup>it themselves</sup> in this way, we could press them to undertake ~~or (failing that)~~ that they would propose exceeding the guideline limit, if at all, only by direct amendment of the guideline limit regulation and not indirectly through changes to other regulations.

38. A further important consideration is that the new Regulations for the guideline limit and for production and ~~f~~ financial stabilisers will need to be so drafted as to ensure that the legitimate expectations of farmers and traders are reduced so that the Community or national intervention agencies will not be vulnerable to being attacked before the Court of Justice for failing to meet such expectations.

39. The second area where some strengthening of the Commission's proposals is needed is stabilisers. Negotiations on the Commission's proposals for individual commodities are being conducted in the Agriculture Council, where the UK is as usual in a small minority in supporting the general thrust of the Commission's position. The Commission's detailed proposals and draft legal texts, while generally responding positively to the UK's earlier suggestions, are defective in a number of respects. In particular:

- (i) the formal proposals are for framework mechanisms only, with at best some indication of what the Commission intend to propose next year on crucially important details such as the size of maximum guaranteed quantities and the trigger mechanisms for stabilisers;
- (ii) the mechanisms envisage some additional powers for the Commission but these are not always clearly defined and the intention seems to be that the detail would be settled by the Council in next year's Price Fixing;
- (iii) the proposals include reviews of the sheepmeat and sugar regimes and milk quota arrangements which go much wider than stabilisers and will complicate the task of securing decisions on stabilisers in isolation from the rest;



- (iv) there are no proposals at all for some products (olive oil, cotton and rice).

40. The Presidency seem to think that it would be too difficult to reach specific decisions on stabilisers before Copenhagen, and will probably try to settle instead for an agreement in principle with all the details to be resolved in next year's Price Fixing. From the UK's point of view, such an approach would be inadequate. It would not provide the basis for an overall deal. The results finally negotiated in the Agricultural Council would almost certainly be unsatisfactory. For the moment, therefore, we should continue to insist that stabilisers should cover all products; that quantified stabilisers and trigger mechanisms should be agreed before Copenhagen; and that stabilisers should for the most part be based on the maximum guaranteed quantity (MGQ) principle with production in excess of the MGQ triggering automatic in-year price reductions.

41. There is in practice no chance of reaching detailed agreements on all commodities by December. We should perhaps be prepared therefore to settle for fully quantified and articulated agreements for the major commodities (cereals, oilseeds, olive oil, wine and milk) provided that this is accompanied by a clear statement of principles for the rest (<sup>with</sup> ~~and~~ preliminary <sup>quantification</sup> ~~contribution~~ wherever possible) and a deadline whereby quantified stabilisers must be agreed before the new Own Resources Decision can be agreed. This would give us a 'second lock' in negotiating terms.

42. The third area where the Commission's proposals need to be strengthened is effective in-year budgetary control. In their paper on budget discipline COM(87)430 the Commission proposed that action on stabilisers should be triggered not only by the level of production as discussed in paragraph ~~37-38~~<sup>40</sup> above but also by the level of expenditure on individual commodities. This is essential if the new budget discipline procedures are going to be effective. For expenditure overruns can be and have frequently been caused by factors other than the level of production such as falls in world or internal market prices. These factors rather



than overall production were chiefly responsible for the overspending in 1986, 1987 and, prospectively, in 1988. The Commission have not yet tabled detailed proposals to implement this aspect of COM(87)430, although there has been some (mostly negative) discussion of their proposals to amend the Financial Regulation to permit closer monitoring of expenditure on individual commodities.

43. We shall need to press hard for further detailed proposals in this area, for discussion in COREPER, the Foreign Affairs Council and possibly the ECOFIN Council rather than the Agriculture Council. As a minimum we shall need to secure that the new Budget Discipline Decision gives the Commission a clear responsibility to monitor expenditure on individual commodities (ie by individual chapters of the budget) and to take remedial action if expenditure on any one chapter exceeds an objectively determined profile. We should recognise that the Commission will need additional powers to carry out this responsibility effectively. We should argue that either they should be given general powers to adjust prices, aid rates and intervention arrangements within certain limits or else the Council should bind itself to increase the Commission's powers on a product by product basis before the end of 1987 while accepting that the Commission should in the meantime have the power to take interim action pending the Council's decisions. Officials will need to discuss how best to take these issues forward with the Commission.

44. The last, crucial area where the Commission's proposals fall short of what is required is the proposal than an "exceptional circumstances" loophole should remain. Most other member states will be determined to retain some flexibility which would permit the guideline limit to be exceeded in certain circumstances. They will doubtless argue, with some cogency, that agricultural support cannot by its very nature be a cash-limited programme.

45. In considering this problem we have to assume that the pressures on agricultural spending, already severe, are likely to become more so over the years ahead as production continues to rise, both inside the Community and outside, without any corresponding



rise in consumption. Offsetting the resulting pressures on expenditure through price restraint, stabiliser mechanisms and other measures will inevitably be extremely difficult, especially given the strong views of the Germans, the French and others. We have therefore to expect the Council to come under the strongest pressures to make use of any residual exceptional circumstances loophole which remained and to exceed the guideline limit, possibly by substantial amounts. This in turn would have serious consequences for maintenance of the own resources ceiling and for the UK's net contribution, even after abatement.

46. Against this background the UK's line should be that any rebased guideline must be an absolute constraint on expenditure; the limit must be a limit. Our internal doubts as to the legal possibility of a totally watertight limit do not affect this. In addition, this limit should be supported by effective stabiliser mechanisms in each regime, which would be related to levels of production, and by effective procedures for ensuring that the budgetary provision for individual regimes is not exceeded because of other factors, for example as a result of falls in world prices. In discussing possible ways of circumscribing exceptional circumstances, we should make clear that this is without prejudice to our fundamental view on the need for an absolute limit. We could acknowledge that member states might have discretion to provide nationally financed income aids if the effects on particular groups of farmers were exceptionally severe.

47. An approach on these lines will have the advantage of keeping open the possibility of arguing at a later stage, if Ministers so decide, for a "safety-valve" arrangement whereby the agricultural expenditure guideline would be an absolute limit on the amount of expenditure from the Community budget on agricultural market support, with any unavoidable excess over the limit falling on national exchequers.

48. A safety-valve provision on these lines would form part of the Decision or Regulation which provides for the guideline limit itself. In substance, it would resemble a proposal put forward



by M Delors earlier this year, admittedly as a temporary expedient, whereby the Commission would reduce payments of FEOGA advances below the traditional 100 per cent level in the event that the Community ran out of money.

49. The basic idea of the safety-valve would be that the Commission and the Council would commit themselves to taking the necessary steps to ensure that the guideline limit is respected. In the event that expenditure cannot be so contained, however, the Commission would ensure that the Community budget does not finance any spending in excess of the limit by reimbursing to intervention agencies in member states, not the full amount of their expenditure, but only the amount permitted by the guideline limit. Each member state would receive over the year in question a proportion of its market support expenditure given by  $\frac{x}{x+y}$ , where  $x$  is the guideline limit and  $y$  the excess of expenditure over the guideline limit.

50. The advantage of a safety-valve on these lines would be that, in the all-too-likely event that continuing pressures on agricultural expenditure result in the guideline limit being exceeded or evaded, the UK would contribute only to its own share of the excesses and not that of other member states as well. In other words, excesses of agricultural expenditure would not be allowed to increase further our net budgetary contribution. It is possible that, if agreement is reached on a new structure of own resources with consequential changes in the Fontainebleau abatement system, the marginal net cost to the UK, after abatement, from extra agricultural spending might be slightly less than at present. The central assumption has to be, however, that under any new arrangements likely to be agreed the UK's net contribution will continue to rise significantly at the margin as a result of agricultural expenditure excesses.

51. From two points of view, a safety-valve would be a second-best device. First, a binding and absolute limit on total expenditure would undoubtedly be preferable to a device which would simply improve in some degree the distribution of the financing burdens. The chances of reaching agreement on an absolute limit (even one



which is less than watertight from a legal point of view) cannot however be considered bright, even if the impact were softened by means of national income aids. Second, any proposal which would enable the Council to require member states by qualified majority to increase their own national expenditure on Community policies must give some cause for concern. Some member states might see this as a precedent for evading the Community's own resources ceiling. On the other hand, the safety-valve would in practice be used only where the alternatives would be worse from the UK's point of view. Specifically, it would be used only in cases where, in the alternative, the extra spending would have been channelled through the Community budget and we would therefore have been obliged to contribute to expenditure in the rest of the Community as well as in the UK. If excesses over the guideline limit and activation of the safety-valve were subject to unanimity voting, these anxieties would disappear.

52. As regards negotiability, all member states which are net recipients from FEOGA guarantee expenditure (a category which in practice includes all member states except Germany and the UK) would be likely vehemently to oppose a safety-valve system. The safety-valve would not however hit farmers and traders in the same way as an absolute limit with no possibility of excesses. The Germans have already mentioned the possibility of something along safety-valve lines at official-level discussions in Brussels alongside their ideas for a wider extension of production quotas; as always, however, they could not be relied upon to provide continuing and robust support for such a device. <sup>Although there must be</sup> ~~The FCO have~~ severe doubts <sup>the negotiability of</sup> as to whether a safety-valve, ~~would be negotiable and see it rather~~ <sup>proposing one</sup> ~~as an 'in terroran' proposal which~~ could nevertheless have tactical value.

53. Opponents of the safety-valve could argue with some force that it was ultra vires the Treaty for member states to be required to pay particular sums nationally in discharge of Community responsibilities.



We would have to counter-argue that there are precedents for the Community reaching agreement on policies whose implementation necessitates national expenditure. The legal objections could in principle be met by providing that the Community budget would reimburse subsequently any amounts left to national financing under the safety-valve. To meet the UK's requirements, however, any subsequent reimbursements would themselves have to be accommodated within the guideline constraint in the following year (or following two years), while ranking behind expenditure of the year in question, and it would be important that the Community's liability to re-imburse should lapse after two years. This could in principle be achieved through the operation of a clawback mechanism akin to that proposed by the Commission. A ~~non-reimbursable~~ safety-valve on these <sup>lines,</sup> ~~limits,~~ introduced on the basis of a firm political commitment by the European Council in spite of the legal anxieties, would be attractive for the UK though doubtless very difficult in negotiating terms.

54. Ministers will need to decide in the next two or three weeks whether to press for a safety-valve on the lines described above and if so how and when.

55. If neither an absolute limit on guarantee expenditure (with some discretion for nationally financial <sup>ed</sup> ~~aid~~ income-aids) nor a safety-valve were obtainable, a possible alternative might be to limit the exceptional circumstances loophole to a provision whereby the guideline would be increased or reduced, as appropriate, in the event of large currency movements (for example, a movement of more than 10 per cent in the dollar/ecu rate compared with the average rate of the previous year which had led to a change of more than 10 per cent in world prices). A degree of flexibility in the guideline might, just conceivably, enable member states to accept a slightly lower starting figure than otherwise. The trouble with any approach along these lines, however, is that exchange rates and world prices can and do fluctuate by substantial amounts from year to year, and it would be difficult to obtain agreement on a sufficiently high minimum movement threshold. There would consequently be a clear risk that such a provision would make a nonsense of the guideline limit discipline. A further serious problem in admitting extra Community spending in response to any kind of exceptional circumstance is that if, as is all



too likely, the budget were up against the own resources ceiling, there would be no resources available to finance excesses over the guideline limit save by means of supplementary financing through an inter-governmental agreement (IGA).

56. Our main conclusions on making agricultural budget discipline stick are:

- (G) in the light of the legal advice, we should be prepared in the last analysis to have the guideline limit enshrined in a legally binding Council Decision based on Article 43 rather than Article 235, even though this would be formally subject to amendment or repeal by qualified majority, with the related implementing provisions for stabilisers and cost overrun measures being likewise enshrined in Regulations under Article 43 and matching provisions in the Financial Regulation. We should seek the firmest possible assurances from the Commission that they would not bring forward proposals which would involve exceeding the guideline limit;
- (H) we should insist on strengthening the instruments needed to make the guideline limit effective, notably stabilisers and (no less important) in-year monitoring and control of expenditure by the Commission, and to that end we should be prepared to increase the Commission's powers to take interim measures in individual regimes. We should stipulate that all these aspects, including quantified stabilisers for the five regimes where overspending is most serious, must be specified in sufficient detail in any overall settlement;
- (I) we should continue meanwhile to insist that any rebased guideline must be a binding and absolute constraint on expenditure. The ideas under discussion for limiting the exceptional circumstances loophole to changes in the dollar/ecu rate above a threshold level do not at present seem very promising. When discussing such ideas, we should always make clear that this is without prejudice



to our fundamental position on making the guideline an absolute constraint. Taking this line now will keep open the option of arguing next month, if Ministers so decide, that the choice has to lie between an absolute spending limit (with some discretion for nationally financial<sup>ed</sup> income aids) and a safety-valve along the lines discussed above.

#### Other obligatory expenditure

57. Other obligatory expenditure includes the 10 per cent own resources refunds, the 1984 IGA repayments and transitional period restitutions to Spain and Portugal. We may expect to come under continuing pressure to abolish own resources refunds and to waive the IGA repayments so as to free more resources for Community policies.

58. The proposal to abolish own resources refunds is one which Belgium and the Netherlands will doubtless resist strongly. They benefit greatly from these refunds because of their high levels of imports caused by the Rotterdam/Antwerp entrepot trade. Germany may also resist. Our own share of these refunds is slightly above our VAT and significantly above our diff tax shares. We would stand to lose some 65 mecu per year on our uncorrected net contribution if they were abolished (see table 5). We should therefore support Belgium and the Netherlands in opposing abolition. If a concession in this area seemed tactically necessary at the end of the negotiation, we should insist on obtaining something more valuable in return.

59. Waiving the 1984 IGA repayments would of itself barely affect the UK's net contribution, though it would release more resources for spending within any given own resources ceiling and the UK's share of such marginal spending would probably be low. Waiver or delay would ease the problem, discussed below, of the 'hump' of expenditure in 1988. Our line for now should be to resist waiver on the grounds that it is better not to unpick agreements already made. We could doubtless however be flexible on this issue at a later stage, though it will be necessary to attend



carefully to the legal and Parliamentary propriety implications.

60. Our conclusion is:

(J) The UK should resist the Commission's proposals to abolish the 10 per cent own resources refunds. We could however be flexible at a later stage about waiving or delaying the 1984 IGA repayments, while attending carefully to the Parliamentary propriety implications.

### Non-obligatory expenditure

61. As with agricultural expenditure, so with non-obligatory expenditure, it will be difficult to avoid some increase if there is to be an increase in the own resources limit. The Commission have proposed that structural fund commitment appropriations should double in real terms between 1987 and 1992 and that other non-obligatory expenditure programmes, taken together, should more than double in real terms. In contrast with this, the 1984 budget discipline conclusions (not respected in the 1986 budget) provide for the growth of non-obligatory expenditure to be contained within the maximum rate of increase laid down in the Treaty. This implies a real growth rate of the order of 10-15% over the period 1987-92: the Commission projections assume 10.5 per cent, but we think a figure of around 15 per cent more likely. Be that as it may, the gap between the Commission's proposals and budget discipline as previously interpreted is enormous: the Commission want non-obligatory expenditure to grow about nine times as fast as their projection of the maximum rate.

62. We assume that Ministers will wish not to be deterred by the enormous increases proposed by the Commission and to avoid, if possible, conducting the discussion in these terms. We assume that they will wish to argue strongly instead for a reaffirmation of the 1984 budget discipline conclusions on non-obligatory expenditure, which provide that the "maximum rate" of increase laid down in the Treaty must be respected, preferably strengthened by the improvements which we ourselves have suggested (see paragraphs 87-88 below).



63. It would be tempting to go further than this and argue for a legally binding limitation whereby the growth of non-obligatory expenditure could not <sup>in any circumstances</sup> exceed the calculated maximum rate of increase laid down in the Treaty. The problem with this, however, is that Article 203(9) of the Treaty explicitly provides for the possibility of exceeding the calculated maximum rate of increase by agreement between the Council and the Parliament. Since legal instruments in the Community must be based on <sup>and consistent with</sup> the Treaty, and must not <sup>impose or</sup> infringe rights provided <sup>by</sup> within the Treaty, it would not be possible to incorporate in a legal instrument the tighter maximum rate limitation provided for in the 1984 budget discipline agreement. The only option is a political <sup>a</sup> Agreement <sup>by the Council</sup> along the lines of the 1984 <sup>budget discipline</sup> Agreement itself, limiting the rate of increase in non-obligatory expenditure to the calculated maximum rate for the year. Since the European Parliament has the power under the Treaty to insist on a full maximum rate of increase, there is no scope for a more restrictive limitation even in the form of a political agreement.

64. We have however to recognise that the pressures for a rate of growth in non-obligatory expenditure far above the "maximum rate" will be immensely strong. First, the Southern member states and Ireland, who benefit enormously from the structural funds, are certain to argue that large increases will be an essential element in the future financing deal. The Commission will argue in a similar vein. The Northern member states other than the UK are anxious to increase the own resources ceiling to cover perceived agricultural requirements. The signs are that they will be prepared to make significant concessions on non-obligatory expenditure in order to clinch the deal and (they will say) prevent a blocking minority of Southern member states on internal market issues.

65. Second, there is likely to be a general perception that increases in permitted agricultural expenditure, through rebasing and possibly a GNP growth factor, will have to be accompanied by comparable increases in non-obligatory expenditure. Although we can defend continued observance of budget discipline on the grounds that the Community has already increased the structural funds by about



one-third in real terms over the period since 1984, it will be argued that the proportion of the budget which is devoted to agriculture cannot be allowed to rise. A slightly more credible deal, from this point of view, would be one under which the growth over time of the agricultural guideline limit was held below the growth of own resources and non-obligatory expenditure.

66. In arguing for a continuation of budget discipline for non-obligatory expenditure, we shall need to bear in mind the commitment of the other eleven member states at the June European Council to a 'final objective for the structural funds by 1992'. Any form of commitment which applies to the funds as a whole would be certain to be incompatible with budget discipline. Hence we shall need, in collaboration with France, Germany and the Netherlands, to try to transform this objective for the structural funds as a whole into a target for Regional Development Fund grants to the four least prosperous member states or (better still) to Spain and Portugal alone. An alternative possibility would be to have a special programme for Spain and Portugal similar to the integrated Mediterranean programmes (IMPs) <sup>for</sup> of Italy and Greece. But we need to beware of ending up paying twice over, with an increase in the structural funds (possibly exceeding the maximum rate) and an IMPs-style programme. We need also to bear in mind that, in the light of the June European Council conclusions of the Eleven, some commitment specifically related to the structural funds will probably be unavoidable. We should argue, further, for preserving a balance between the Regional Development Fund and the Social Fund (where our share of receipts is higher), even if this means some restraint on the Regional Development Funds receipts of the more prosperous countries.

67. In tables 3 and 4, we have set out some figures to illustrate what might be involved in holding the growth of non-obligatory expenditure to our own estimate of the "maximum rate" of increase over the next five years. The Commission, as noted above, have projected a slower growth of the maximum rate.

68. In contrast with the Commission's demands for real increases



of over 100 per cent in the non-structural funds and 88 per cent in structural fund payment appropriations (corresponding to doubling in commitment appropriations), our figures envisage real growth of around 15 per cent over the period to 1992 in non-obligatory expenditure other than the structural funds, comprising:

- (a) a 60 per cent real increase in R&D expenditure in accordance with the framework programme,
- (b) growth from 0 to 250 mecu in 1992 in "new policies", mainly the environment, where the Commission have proposed expenditure of no less than 2.1 becu in 1992,
- (c) an increase in the Community's overseas aid programme from 1989 onwards in line with the growth of Community GNP: the reduction from 1987 to 1988 reflects the much lower levels of world food prices taken into account in the Commission's 1988 Preliminary Draft Budget;
- (d) other programmes to be held constant in real terms.

The Commission and other member states would, of course, regard these figures as extremely austere.

69. These assumptions on non-obligatory expenditure other than the structural funds would leave scope, within our projection of the 'maximum rate', for real growth of some 17 per cent (more realistically, between 15 and 20 per cent) in the structural funds as a whole over the period to 1992. This would fall far short of the Commission's objective for doubling structural fund commitment appropriations over the period but would permit the following, not unattractive elements:

- (a) a 116 per cent real increase by 1992 in the ERDF receipts of Spain and Portugal, with the rest of the structural funds taken together (ie ERDF grants to other countries and Social Fund and FEOGA Guidance grants) remaining constant in real terms; or



- (b) an 82 per cent real increase by 1992 in the ERDF receipts of the four least prosperous countries, with the rest remaining constant in aggregate as in (a) above; or
- (c) a 50 per cent real increase by 1992 in the ERDF receipts of Spain and Portugal, with a 12 per cent real increase spread across the rest of the ERDF and the other structural funds; or
- (d) a 50 per cent real increase by 1992 in the ERDF receipts of the four least prosperous countries, with a 9 per cent real increase spread across the rest of the ERDF and the other structural funds.

The variants which would channel funds to Spain and Portugal are perhaps more attractive than those which would channel extra funds to Greece and Ireland as well. There is quite a widespread perception among other member states that Greece and Ireland are already doing quite well enough out of the Community.

70. In the light of the above analysis, the UK might argue initially at least for an increase of 50 per cent in real terms in the ERDF receipts of Spain and Portugal (see option (c) above) within a context of continuing budget discipline based on the maximum rate provisions of the Treaty. Since "concentration" of the structural funds on less prosperous member states is expensive in terms of our net contribution (see table 3), we should try hard to ensure that concentration is confined to the ERDF and should argue even here for less concentration initially than may have to be accepted eventually.

71. We shall wish to make common cause as far as possible on these matters with France, Germany and the Netherlands. The latest indications are that, initially at least, there may be some scope for this. We are likely to find, however, that these other member states will soon decide to adopt a position more accommodating to Southern member states in order to hasten a decision on increased



own resources. If so, the UK will presumably wish to continue arguing even so that strengthening budget discipline means what it says.

72. One possible resting place which the French in particular may have in mind is that the growth of non-obligatory expenditure should be ~~lines~~<sup>limited</sup> to one and a half times the maximum rate rather than the maximum rate. As illustrated in Table 3, this would be a major departure from existing budget discipline and a major concession in terms of the implied real growth of non-obligatory expenditure. The extra half maximum rate, in contrast with the initial one maximum rate, would consist entirely of real growth. It would be a bad outcome from the UK's point of view. A more promising approach, if something above the maximum rate had to be conceded, might be to envisage a small programme of supplementary measures for Spain and Portugal along the limit discussed above, preferably classified as obligatory expenditure.

73. The approach for which the net recipient member states will probably press will be to set a specific target for the increase in the structural funds by 1992, as envisaged in the June European Council conclusions of the Eleven, and to reflect this target, along with agricultural expenditure and other non-obligatory expenditure, in intermediate own resources ceilings. This would be likely to be a very expensive option. Any figure which was agreed for the growth of the structural funds over this period would inevitably be a high one which would be incompatible with the maximum rate of increase in non-obligatory expenditure and budget discipline as previously interpreted. There is also a serious objection of principle to specifying a rate of increase over time for a slab of expenditure as large as the structural funds. One cannot say in advance, with any confidence, what rate of growth in such a large slab of expenditure will be affordable within the own resources ceiling. If the ceiling is to be held over time, the growth of expenditure must continue to be a function of the growth of own resources (or something similar such as the maximum rate) and not fixed independently of it. For all these reasons, we assume that Ministers will wish to continue to oppose a specified



rate of increase for the structural funds as a whole.

74. Our conclusions on non-obligatory expenditure are:

- (K) we assume that Ministers will wish to argue strongly, despite the ambitious proposals of the Commission, for re-affirmation of the maximum rate discipline <sup>on non-obligatory expenditure</sup> in the 1984 budget discipline conclusions, with the improvements discussed in paragraphs 87 - 88 below, ~~on non-obligatory expenditure~~ while recognising that the maximum rate limitation cannot be <sup>enshrined</sup> ~~achieved~~ in a legally binding instrument; ~~on non-obligatory expenditure~~
- (L) consistently with this, the aim should be to transform the proposed 1992 financial target for the structural funds into a less damaging form of target such as an increase of perhaps 50 per cent in the real take of Spain and Portugal from the Regional Development Fund;
- (M) to contain damage to the UK's net contribution, we should seem to confine "concentration" of the funds to the Regional Development Fund and to preserve the existing balance between the Regional Development and Social Funds, even if this implies some reduction in real terms in the ERDF receipts of Northern member states.

#### European Development Fund

75. A further expenditure issue which could feature in the final stages of the negotiation is the Commission's proposal to bring the next European Development Fund (EDF VII) within the Community budget although it is perhaps more likely that the decision will be taken in the context of negotiating the next Lome Convention (Lome IV). The EDFs provide concessional aid finance, <sup>with</sup> expenditure currently running at around 1 becu a year, but rising to 1.5 becu by 1995, to developing countries <sup>y</sup> ~~signatories~~ of of the Lome Convention and to certain dependencies of member states. Member states finance the EDFs directly, outside the Community budget, in accordance



with negotiated shares. The UK's share of EDF VI is 16.58 per cent. ODA's annual expenditure is expected to rise from £104 million in 1987-88 to £136 million in 1989-90. Although an agreement was reached with the European Parliament in 1982 under which EDF expenditure would be classified as obligatory if brought within the Community budget, it is most unlikely that this could be sustained except for the 60 per cent of each EDF committed to national programmes.

76. The UK has in the past opposed budgetisation of the EDF on the grounds that:

- (a) the pressures to increase the EDF would be strengthened by the Parliament and the ending of national contributions;  
*and*
- (b) our financing share would increase.

77. If the Council accepts the Commission's proposal for a "diff" tax, including the EDF within the Community budget would reduce the UK's marginal financing share from 16.58 per cent to perhaps 13½ per cent or 14 per cent. On the other hand our ability to control the overall level of the EDF and our contribution to it would be greatly diminished or lost. If the Community does not accept the diff tax, ~~On the other hand~~ the UK's financing share if EDF VII<sup>13</sup> is financed from the budget would rise from 16.6 per cent to around 18 per cent.

78. In the light of the above, our conclusion is that:

- (N) the UK should continue to oppose the proposal for bringing the EDF within the Community budget.

#### Expenditure totals

79. When we bring together the restrictive sets of figures for agricultural spending, other obligatory spending and non-obligatory spending discussed above, the resulting totals are as shown in the "scoresheet" table (Table 4).



80. A particular problem with the scoresheet figures as they stand is the imbalance, as many member states and the Commission would perceive it, between the relaxation of budget discipline on agricultural spending (through the guideline rebasing and the GNP growth factor) and the maintenance of the existing discipline on non-obligatory expenditure. The Southern member states and the Commission, in particular, will agree that agriculture cannot be allowed to consume a larger share of the budget in this way. As noted earlier, our own preferred solution would be to reduce the growth factor for the agricultural guideline to something below the growth of the own resources base. A more likely argument, however, is that balance should be restored by allowing non-obligatory expenditure to grow faster than the maximum rate - for example by one and a half times the maximum rate or by a stated amount or percentage each year. As table 3 illustrates, growth at a rate of one and a half times the maximum rate each year would be a costly concession, adding a further 1½ to 2 becu to non-obligatory expenditure by 1992.

81. A second problem illustrated by the scoresheet is the risk that the system will be overdetermined through potentially conflicting decisions. There is no way of knowing accurately in advance what own resources ceiling would be needed to accommodate particular combinations of agricultural expenditure guideline ~~formulae~~ and maximum rate formulae together with other obligatory expenditure needs, especially if the UK abatement is to be financed within the ceiling. We shall need to do what we can to guard against the dangers of overdetermining the system.

#### Inter-institutional agreement and intermediate own resources ceilings

82. As the earlier discussion on non-obligatory expenditure illustrates, the Commission's ambitions for this expenditure exceed the likely maximum rate of increase as laid down in the Treaty by a factor of between five and ten. To get round this potentially serious obstacle, the Commission have put forward the two proposals of (a) an inter-institutional agreement at the beginning of the budgetary process each year and (b) the following intermediate own resources



ceilings:

1988	1.20 %
1989	1.22 %
1990	1.24 %
1991	1.27 %
1992	1.30 %

83. Taking these in reverse order, there should be no need for intermediate own resources ceilings if there is agreement on budget discipline along the lines sketched above. With budget discipline, the growth of both agricultural guarantee expenditure and non-obligatory expenditure should be similar to the growth of the own resources base. Rising ceilings would only encourage the Council and the Parliament to exceed budget discipline levels. The only circumstance in which intermediate ceilings could have a useful role would be if the final agreement provided for an own resources ceiling well above the perceived needs of 1988. This in turn would imply a more relaxed form of budget discipline and in particular a rate of growth in non-obligatory expenditure faster than the maximum rate. Even in this hypothetical situation, however, the UK's preference would doubtless be for financing any such faster increases in non-obligatory expenditure by means of a slower rate of growth in the agricultural guideline limit than in the own resources base.

84. The proposed inter-institutional agreement is a second element in the Commission's attempt to bypass the maximum rate discipline. It is illusory to suppose that the Council and the Parliament could reach agreement before the budget process begins and there has been discussion on individual budget lines. The procedure suggested by the Commission would serve only to increase the pressures on the Council to concede excesses over budget discipline limits.

85. None of this is to suggest that we should oppose the search for a budget discipline common to all three institutions. We can continue to support this in principle and renew our own proposal for a Trilogue at the beginning of the budgetary process at which



the three Presidents would discuss the Commission's multi-annual forecasts and the prospects for the coming budgetary round. This would be unlikely in practice to contribute greatly to the budgetary process but would have the great merit of not being harmful.

*A pretty  
ironic  
conclusion in  
the bulk  
of the  
Commission's  
proposals!*  
25

86. Our conclusions can be summarised as follows:

- (O) the UK should express deep scepticism about the proposal for intermediate own resources ceilings: these would make sense only in the context of agreement on a new own resources ceiling which significantly exceeded the perceived needs of 1988 and of relaxed budget discipline arrangements which would not be consistent with the consensus on the need for more effective and binding budgetary discipline;
- (P) we should renew our own proposal for a Trilogue at the beginning of the budgetary process in place of the proposed inter-institutional agreement.

#### Budget management and the financial regulation

87. The UK should continue to press for progress in this area. This is desirable not only in its own right but also because it could help considerably with presentation of the final outcome of the negotiation. Our main aims should be:

- (a) to tighten up the Commission's latest proposals on carry-forwards of expenditure and cancellation of commitments along the lines which we ourselves have suggested;
- (b) to press for reinstatement of the Commission's earlier idea of a ceiling on commitment as well as payment appropriations;
- (c) to secure the limitations on negative reserves (ie unspecified expenditure reductions) and "actions ponctuelles" (ie expenditure which has no proper legal base) which we have put forward but the Commission have ignored; and



- (d) to secure the improvements which we have proposed in Council procedures, including the use of pro rata reductions to produce consistent decisions compatible with the maximum rate.

Recent experience, including the "<sup>cost</sup>out of the past" problem and the proposals for a "balancing factor" or negative reserve in the 1988 budget, have undermined the importance of (b) and (c) above.

88. Our conclusion is:

- (Q) we should continue to press for budget management improvements as set out in the preceding paragraph.

#### Own resources ceiling

89. Given the incompatibility between intermediate own resources ceilings and budget discipline as hitherto interpreted, we assume that the UK's aim, if any increase in the own resources ceiling should be contemplated, will be to set a tough but realistic figure for 1988 and keep the ceiling at the same level until 1992 or beyond. Three major issues for consideration are:

- (a) the problem of the 'hump' of demands on own resources in 1988;
- (b) should the UK's abatement be financed inside or outside the ceiling?
- (c) what are the pros and cons of a ceiling which grows in line with GNP?

90. The 'hump' of prospective demands on resources in 1988 (item (a) above) arises from three factors:

- i. the exceptionally large figure for the UK abatement in 1988 (about 1 billion ecu, in expenditure terms,



above the trend level), resulting from exchange rate movements and corrections to our 1986 abatement;

ii. the Council's decision to postpone 400 mecu of own resources refunds and 250 mecu of 1984 IGA repayments from 1987 into 1988; and

iii. the large provision of some 3.5 becu which the Commission have proposed for agricultural stock depreciation and disposals in 1988.

91. As discussed below, the best solution to the problem of the high UK abatement figure would be to finance the UK abatement outside the own resources ceiling.

92. The hump of expenditure on own resources refunds and 1984 IGA repayments could in principle, as shown in table 4, be smoothed out by providing for a permanent delay of six months in future in payment of own resources refunds and spreading the three remaining IGA repayment instalments over 1989-91. The totals shown in table 4 assume that these changes would be made.

93. The high level of 1988 expenditure proposed by the Commission for stock depreciation and disposals could likewise be reduced, as discussed earlier in the paper, by phasing introduction of the new system over five years or spreading the costs of disposal of existing stocks or by some combination of the two.

94. The main point which emerges from the figures in table 4 is that a 1.1 per cent GNP ceiling (abatement-exclusive) or a 1.2 per cent GNP ceiling (abatement-inclusive), equivalent to a VAT ceiling as presently defined of about 1.7 per cent, would be likely to suffice to cover expenditure in 1988 and thereafter along the (fairly restrictive) lines discussed earlier in this paper - an agricultural guideline based on 1987 needs strictly interpreted and then growing in line with GNP, together with continued observance of the maximum rate discipline on non-obligatory expenditure, any higher increase in non-obligatory expenditure (eg for Spain



and Portugal) being counterbalanced by corresponding reductions in agricultural expenditure. The position for 1988, as illustrated in the table, would be on the tight side but could be eased by phasing in of the new stock depreciation system or spreading the costs of disposals of old stocks (see preceding paragraph). The position in later years is eased by the falling amounts of transitional refunds for Spain and Portugal.

95. On the second issue of whether the UK abatement should be financed inside or outside the ceiling, the UK's interest continues to lie in financing it outside the ceiling. In terms of the arithmetic discussed above, a 1.1 per cent abatement-exclusive GNP ceiling would be more restrictive than, and hence preferable to, a 1.2 per cent abatement-inclusive ceiling. There are, moreover, two additional considerations which argue for financing the abatement outside the ceiling.

96. First, inclusion of the abatement within the ceiling makes it more vulnerable to attack since it then competes, inside the ceiling, with cherished expenditure programmes. When the budget is up against the ceiling (a common occurrence in the Community), member states looking for savings frequently suggest that the abatement should be reduced. We have largely succeeded in fighting off such attacks so far. It would however be much preferable if they could not be made in the first place.

97. Second, the abatement tends to fluctuate widely from year to year, thus producing corresponding fluctuations in the amounts available for expenditure. This tends to undermine discipline and makes it more difficult to respect own resources ceilings.

98. On the third issue of the rate of growth of the own resources ceiling, agreement that the ceiling should grow in line with Community GNP would be a major concession compared with the status quo, possibly implying an extra  $2\frac{1}{2}$  becu of resources by 1992. It would be difficult, moreover, to avoid a matching concession on the agricultural guideline limit, whereby that too would grow in line with Community GNP, permitting an extra  $1\frac{1}{2}$ -2 becu of agricultural



expenditure by 1992. The other member states have already agreed, at the June European Council, on a GNP growth rate for the own resources ceiling, and it will be hard to overturn this. In view of the significance of the concession, however, the UK will probably be well advised to continue to reserve its position.

99. Our conclusions are:

- (R) the UK's aim should be to set a tough but realistic own resources ceiling for 1988 and keep it at the same level until 1992 or beyond;
- (S) if we are to succeed in this, some ways will have to be found of smoothing away the 'hump' of demands on resources in 1988: the best techniques would be to finance the UK abatement outside the ceiling, to rephase payments of own resources refunds and 1984 IGA repayments, and to phase disposal of existing stocks or introduction of the proposed new stock depreciation scheme;
- (T) a ceiling of 1.1 per cent GNP (abatement-exclusive) or, less desirably, 1.2 per cent GNP (abatement-inclusive), equivalent to about 1.7 per cent VAT as currently defined, should suffice to finance the development of expenditure along the lines discussed in this paper: a lower ceiling would probably necessitate postponing indefinitely the introduction of satisfactory arrangements for depreciation of stocks;
- (U) from the UK's point of view there continues to be a strong case for financing the abatement outside the own resources ceiling, although the French and others would continue to oppose this;
- (V) growth of the own resources ceiling in line with GNP, already agreed by eleven member states, would provide a major element of buoyancy in the own resources system: the UK should continue to reserve its position on this



for the foreseeable future (while recognising that it is likely to form part of the final deal).

#### Own resources structure

100. Since our share of Community GNP is likely to be about 2 per cent or more below our share of the harmonised VAT base, the Commission's proposal for a fourth own resource, the "diff tax", based on the difference between a member state's VAT base and GNP, would significantly improve the UK's net contribution before abatement (perhaps by some 750 mecu in 1992 on the Commission's expenditure assumptions). We have in practice to assume, however, (see further below), that the Fontainebleau abatement formula would be modified so as to correspond to the new structure of own resources and that our abatement would be based on the difference between our expenditure share and our weighted VAT/diff tax share rather than our VAT share as now. Such a modification would remove most of the benefit but not eliminate it altogether: on the Commission's projections of expenditure, our net contribution after abatement in 1992 could benefit by something of the order of 130 mecu; with lower levels of expenditure, the benefit would be less. (See table 7a.)

101. In view of the sharp deterioration in our underlying net imbalance (our VAT/expenditure deficit having doubled since Fontainebleau), and the serious consequences which this has had for our rate of net contribution even after abatement, Ministers will doubtless wish to obtain whatever improvement they can in the UK's net position. Any gains associated with a change in the structure of own resources would be less naked and obvious than (for example) an increase in the abatement percentage, highly desirable as that would be, and may therefore be more negotiable (especially if others want small concessions from us in other areas). A further consideration is that any reform which lessens the extent to which we have to rely on the abatement to moderate our budgetary burden is in principle desirable.

102. For all these reasons, the UK should argue in favour of the diff tax. We are likely to be supported by eight other member



states (at least), and there is a very real chance of getting the new tax introduced.

103. We can also argue, as occasion arises, that the reform suggested by the Commission should be taken one step further and that a GNP or national income own resource should be substituted for the existing VAT own resources. We see little prospect of securing agreement to GNP contributions. There are however two tactical reasons why the UK can usefully present the case for this. First, we calculate that a GNP own resource in place of VAT would benefit the UK over the next few years, even after allowing for changing the abatement formula to reflect our GNP/expenditure gap, rather more than the Commission's composite system (by some 150 mecu in 1992 on the Commission's expenditure projections as against some 130 mecu). Table 7b sets out our estimates. Second, we understand that the Italians have been bringing strong pressure on the Commission to reduce the role of the fourth resource by providing for a rate of VAT above 1 per cent. It would be useful to counteract such pressure by corresponding pressure in the opposite direction.

104. The effects over time of such changes in the structure of own resources are necessarily highly uncertain: they depend critically on how relative shares of VAT, GNP and the diff tax develop (see Table 7d). It seems clear however that Italy would be a heavy loser from the introduction of either GNP contributions or the diff tax, and that Germany, Belgium, Denmark and possibly Spain would lose as well. Italy probably pays substantially too little own resources at present because of the black economy problem and arguably does not therefore deserve much sympathy. Neither do Belgium and Denmark, both of whom are heavy net recipients from the budget. Any Spanish problem could perhaps be solved by including Spain among the member states which benefit substantially from increased ERDF money. France would benefit much more considerably from the change (Table 7<sup>a</sup><sub>5</sub>) and might therefore complain less about French contributions to the UK's abatement.

105. The Commission have made one further suggestion on the structure



of own resources, viz that customs duties on products covered by the European Coal and Steel Community (ECSC), which member states now collect and retain, should in future become part of the Community's <sup>y's</sup> own resources like other customs duties and be paid into the Community budget. The Council has rejected a similar proposal on several occasions in the past.

106. The sums of money involved are relatively small: around 180 mecu for the Community as a whole, of which the UK's share is 20 mecu. The amounts for each member state, and their shares in the Community total, are set out in Table 7e together with a column showing for comparison, the Commission's estimates of member states' shares in the proposed diff tax. Since the UK's share of the duties is relatively low, we would stand to gain a small amount, some 3-5 mecu a year, from budgetisation provided that the duties substituted for an equivalent amount of diff tax contributions rather than simply increasing the overall level of own resources.

107. The UK has not supported this proposal on previous occasions and has reserved its position on the current occasion. The difference now is that, under the Commission's proposal for a comprehensive GNP percentage ceiling on own resources, incorporating the ECSC Customs duties within own resources would not add to the total resources available to the Community. In view of this and of the slightly beneficial financial effects on the UK, we think that the UK should now be prepared to support this change.

108. Our conclusion on the structure of own resources is:

- (W) we should support the Commission's case for reforming the own resources system so as to reflect GNP as well as VAT shares (the 'diff' tax) and should indeed suggest that VAT own resources should be replaced by a new own resource based on Community GNP, in effect a Community income tax, if this appears to offer tactical advantage. (We should also be prepared to support the proposal to connect <sup>vert</sup> ECSC customs duties into own resources.)



## UK abatement

109. Ministers' existing line on the UK abatement is that the UK's underlying imbalance has deteriorated sharply since pre-Fontainebleau and is likely to deteriorate further if the budget is expanded, so that any changes in the Fontainebleau system will need to be changes for the better from the UK's point of view.

110. This line has served well. The UK should, we suggest, continue to argue strongly for maintenance of the Fontainebleau system. The comprehensive coverage of the system exposes us to much less risk than the agricultural expenditure correction formula suggested by the Commission. There are however certain complications which will arise in the event that the Community agrees to the Commission's diff tax proposals.

111. If the diff tax proposal should be agreed and the Fontainebleau abatement formula continued to apply to the difference between our actual and VAT shares of allocated Community expenditure, the UK would retain the whole benefit of the introduction of the diff tax, which could be of the order of 550 to 900 mecu a year by 1992, depending on the budget size. This marked improvement in the UK's position would be quite defensible on two grounds:

- (i) the UK would still have a large net contribution after abatement, and one which would rise further if the own resources ceiling is raised, while other "prosperous" member states such as Belgium, Denmark, the Netherlands, Luxembourg and Italy would still be net recipients on a substantial scale; and
- (ii) this benefit to the UK would make up in some degree for the concession which we made at Fontainebleau when we agreed that our abatement should be based on the VAT/expenditure gap rather than our net contribution (so that we receive no abatement in respect of our high share of levies and duties).



Other member states, however, would be very unlikely to be willing to make such a generous concession, as they would see it, to the UK. They would point out that combining the diff tax with an abatement based on the VAT/expenditure gap would mean that additions to Community expenditure would tend, perversely, to reduce the UK's net contribution after abatement, even if our share of receipts from the extra expenditure was small, because our abatement would be calculated as if we had contributed to the extra expenditure in accordance with our (high) VAT share rather than our (lower) diff tax share. The Commission would probably oppose such a change, too, on the grounds that a VAT/expenditure gap made no sense in a VAT/diff tax world.

112. Against this background, a combination of the diff tax with the Fontainebleau formula exactly as now will almost certainly not be negotiable. The obvious solution will be to base our Fontainebleau abatement, not on the difference between our actual and VAT shares of expenditure, but on the difference between our actual share of expenditure and our share of VAT and the diff tax taken together. This relatively simple and intuitive change would greatly reduce our net benefit from introduction of the diff tax. But we would retain a useful residual net benefit of perhaps 130 mecu a year (1992 figure): see Table 7a.

113. Other member states may well argue that, given the benefits to the UK of the diff tax, we should be prepared to accept a lower abatement percentage. We imagine that, in view of the massive deterioration in the UK's underlying position since Fontainebleau (Table 1a) and our exceptionally unfavourable net financial position vis a vis most other member states (Table 1b), Ministers will wish firmly to reject such a suggestion.

114. The UK may also come under pressure to switch over to an agricultural expenditure correction system along the lines advocated by the Commission. Other member states' main reason for wishing to change the system will be their continuing desire to reduce and phase out the UK's compensation. The Commission and the Northern member states tend also to argue that it is a nonsense to have



all the arguments we do about using the structural funds as instruments of cohesion and redistribution in the Community and then compensate the UK for our net contribution (if any) to these funds.

115. If we do encounter such arguments, we should continue to deploy the case for preserving the Fontainebleau system, preferably with some improvements. We should also continue to insist that, on our calculations, the Commission's alternative proposal would leave us some 800-900 mecu a year worse off than the Fontainebleau system and that broad equivalence between the two systems would require a compensation rate under the Commission's system of around 85 per cent (depending on what is assumed about the size and structure of the budget, and the UK share of receipts). If this line should result in our being offered the alternative of a Commission-type system with a compensation rate close to 85 per cent, we could consider that at the time. But on the Commission's highly dubious figures, which other member states will use, an ~~80~~<sup>85</sup> per cent compensation rate would be far more generous to the UK than continuation of Fontainebleau. The contingency is unlikely, therefore, to arise.

116. In the final agreement it will again be crucially important to ensure that the UK abatement system remains an integral part of the own resources system and remains in place unless and until there is unanimous agreement to change it. We might also at that time wish to consider some statement, perhaps a joint statement with France and Germany, along the lines that, in the event of any future proposal to expand the Community's activities, we would not be able to countenance any further increase in our net contribution.

117. We should also look out for any opportunities to improve the modalities for implementing our abatement and in particular the provisions for correcting it when the Commission's initial estimate is wrong.

118. Our main conclusions are:

(X) the UK should stick with its existing line on the Fontainebleau



abatement and the inadequacy of the Commission's counter-proposal. If the diff tax is agreed, we shall probably have to accept that the abatement formula be related to our share of the total of VAT and the diff tax rather than our share of VAT alone. If the Commission or other member states came forward with a vastly improved version of the Commission's proposal, incorporating a compensation rate of 85 per cent or thereabouts, we could consider it; but this is very unlikely to happen;

- (Y) we should also ensure that the final agreement maintains the UK abatement as an integral part of the own resources system and provides for it to remain in place unless and until there is unanimous agreement to change it.

#### Decisions on 1988 Budget

119. Whether or not there is agreement at Copenhagen on the Community's future financing, there is virtually certain to be discussion on how the 1988 budget difficulties are to be resolved.

120. If there is no agreement on additional resources, the Commission and a majority of member states will almost certainly demand that extra money be made available on an interim basis to allow a 1988 budget to be adopted at a level in excess of the current 1.4 per cent VAT ceiling. We assume that Ministers will wish firmly to oppose any attempt to prejudge or anticipate the final outcome of the future financing negotiations in this way, especially bearing in mind that an interim concession on these lines would take the pressure off other member states to agree on effective and binding budgetary discipline. Our argument would be that the Council must settle the future financing package before any supplementary finance can be agreed.

121. If on the other hand there is agreement on additional resources from 1988, we assume that Ministers would wish to be flexible about the modalities of implementation during 1988. Our understanding is that, in many member states, IGAs can be ratified more quickly



than changes in the own resources ceiling. If there seems little prospect of final ratification by all member states of a new own resources decision in time for it to enter into effect during 1988, we assume that Ministers would be willing to accept an inter-Government agreement (IGA) for 1988 on condition that:

- (i) the extra resources would not exceed those which would have been available under the agreed new own resources system;
- (ii) the UK's abatement entitlement would not be affected; and
- (iii) the extra resources would not be made available until after Parliamentary ratification of the IGA where that is required.

122. Decisions would be needed on the amount and financing shares of any IGA. Officials have still to discuss these issues in detail. Our preliminary view, however, is that the aim should be to replicate as closely as possible what would have happened if the agreed new own resources system had been able to take effect immediately. A neat way of achieving this, assuming that agreement had been reached on the Commission's proposed diff tax, would be to provide for (a) a 1 per cent rate of VAT and (b) an IGA in an amount not to exceed the remaining resources available under the agreed new ceiling, financed by member states in accordance with shares in the diff tax. On this approach, the IGA would be the diff tax in all but name.

123. We calculate that the UK would be some 40 mecu better off in 1988 with an arrangement on these lines than with an IGA financing, as on previous occasions, according to VAT shares. Member states such as Italy, who would contribute more than with a VAT-shares IGA, would doubtless argue strongly for VAT-shares financing. But the effect of the formula in the previous paragraph would be to implement, ahead of ratification, precisely the agreement which had ~~been~~ ex hypothesis <sup>ed,</sup> been reach<sup>ed</sup> on future own resources.



So the objectors would have a weak case to argue.

124. The vehicle for seeking Parliamentary approval of an IGA would likewise need to be decided nearer the time. In principle, however, as with the 1985 IGA, we would seek to include it in the legislation required for the new own resources decision.

125. Our conclusion is:

- (Z) whether or not there is agreement on new own resources at Copenhagen, there is likely to be pressure for an IGA to tide the Community over 1988. If there is no agreement at Copenhagen, we should not be prepared to prejudge the outcome of the negotiations in this way. If there is agreement, we think that it would be reasonable for the UK to accept that, subject to the important conditions set out in paragraph 121, there should be an inter-Governmental agreement (IGA) on a basis which would replicate as closely as possible what would have happened if the new agreement on own resources had taken effect immediately.

TREASURY CHAMBERS

16 OCTOBER 1987



**AGRICULTURE: OBJECTIVES FOR COPENHAGEN**

<u>Issue</u>	<u>Opening Position</u>	<u>Fallback</u>	<u>Negotiability</u>
1. <u>Legal Form of Financial Guideline</u>	Binding legal instrument (preferably under Article 235 of Treaty (i.e. subject to unanimous agreement)	Council Decision under Article 43 (ie subject to Qualified Majority)	Fallback should be achievable (but legal base of Commission proposal unclear)
2. <u>Procedure</u> (Commission commitment on respecting Guideline)	<p>(i) Budget Discipline Decision should provide that Commission will not at any stage propose Price Fixing or other decisions exceeding Guideline (ie Council requires unanimity to decide to exceed Guideline)</p> <p>(ii) ECOFIN to approve any excess over Guideline</p>	<p>(i) Commission statement in minutes to this effect</p> <p>(ii) Joint Council to approve excess over Guideline</p>	<p>(i) Fallback may be achievable (Commission commitment on not amending original proposals will be difficult)</p> <p>(ii) ECOFIN preferable but not sticking point.</p>
3. <u>Financial Guideline definition</u>	<p>(i) fixed base less than 25.8 becu</p> <p>(ii) growth in line with prices <u>or</u> x% of growth in OR Base</p>	<p>(i) fixed base no more than 26.9 becu (1987 real needs)</p> <p>(ii) <u>less than</u> OR Base growth</p>	<p>(i) principle achievable; number negotiable;</p> <p>(ii) difficult to get beyond fallback.</p>
4. <u>Stock disposals and Depreciation</u>	<p>(i) Regulation to provide systematic depreciation on purchase to disposal value</p> <p>(ii) all disposal costs within guideline <u>or</u> old stocks outside guideline with lower guideline</p>	<p>(i) phased introduction</p> <p>(ii) consider spread ing disposal costs of old stocks forward</p>	<p>(i) Difficult to get anything more systematic than Commission proposals.</p> <p>(ii) Need to ensure that disposal costs paid off by 1992.</p>



5. Stabilisers

(i) Council to agree to detailed stabilisers for all commodities and the powers the Commission would require to operate them

(i) heads of agree-  
ment including  
mechanisms for  
major commodities  
(cereals, oilseeds,  
olive oil, milk,  
wine) and general  
principles for rest  
to be translated  
into firm numbers  
before Own Resources  
Decision is agreed.

(i) statement of  
principle achievable  
Difficult to secure  
details but important  
to have firm arrange-  
ments for doing so.

(ii) Council to increase Commission powers to act when expenditure on any commodity over profile (see 6(i))

(ii) agree on substance;  
detailed decisions  
by December 1987  
and/or Commission  
powers to act in  
anticipation of  
Council decisions.

(ii) very difficult  
but essential if new  
Guideline to be  
effective constraint.

6. Budgetary  
Control

(i) Obligation on Commission to monitor expenditure by chapter and take remedial action using powers in 5 (ii)

(i) no fallback

(i) Monitoring achievable  
Remedial action  
difficult but  
essential if budget  
discipline is to work.

(ii) definitive switch to reimbursement of FEOGA expenditure

(ii) any reimburse-  
ment system, how  
ever described,  
which makes 6(i)  
practicable.

(ii) fallback should  
be achievable.

7. Exceptional  
Circumstances

no exceptional circumstances:  
ie Guideline is absolute constraint on  
expenditure

either

(i) safety valve  
(providing for  
national fin-  
ancing of any  
excess, possibly  
subject to sub-  
sequent reim-  
bursement.)

Ministers will need to  
decide whether to float  
safety valve. If they  
do not, second fallback  
is the best we are  
likely to achieve. In



(or)

(ii) Limiting exceptional practice difficult  
circumstances to changes to persuade others  
in ecu world prices of to drop general  
more than 10%. Any excess exceptional  
subject to clawback over circumstances loop  
next two years. hole or to enforce  
clawback.



## UK'S NET CONTRIBUTION AND VAT EXPENDITURE GAP 1980-91

mecu, current prices

	Net contribution before correction	Net contribution after correction	VAT expenditure gap before correction	VAT expenditure gap after correction
1980	1512	337	1012	-163
81	1419	9	1069	-341
82	2036	985	1793	742
83	1790	1040	1518	768
84	1938	938	1379	379
85	2914	1033	2850	969
86	2996	1155	2790	949

## Treasury figures (assuming 1.4% VAT ceiling)

87	3753	1314	3695	1256
88	3102	1276	2767	941
89	4234	1453	4214	1433
90	4258	1515	4156	1413
91	4516	1589	4435	1508

## Commission figures

87	3117	908	3347	1138
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Note: refunds and abatements are credited to the year in respect of which they arise. For 1985 and 1986 we have included the latest estimates of the abatements due rather than the figures in the 1986 and 1987 budgets.

Some of the figures received in confidence from the Commission.



Table 1b

## NET BALANCES OF THE MEMBER STATES

## 1. UNADJUSTED FIGURES (before UK and German compensation)

	1980	1981	1982	1983	1984	1985	1986 (mecu)
Belgium	+233	+276	+253	+233	+343	+643	+711
Denmark	+327	+279	+253	+319	+497	+342	+471
Germany	-1526	-1684	-2086	-2439	-2957	-3107	-3129
Greece	-	+173	+685	+1015	+988	+1332	+1428
France	+431	+576	-19	+68	-367	+423	+139
Ireland	+650	+582	+732	+757	+926	+1257	+1269
Italy	+737	+788	+1616	+1161	+1691	+1269	+728
Luxembourg	+206	+239	+256	+263	+282	+297	+380
Netherlands	+454	+190	+304	+411	+536	+447	+398
United Kingdom	-1512	-1419	-2036	-1790	-1938	-2914	-2996
Portugal	-	-	-	-	-	-	+269
Spain	-	-	-	-	-	-	+331

## 2. ADJUSTED FIGURES (after UK and German compensation)

	1980	1981	1982	1983	1984	1985	1986
Belgium	+174	+206	+196	+191	+294	+566	+633
Denmark	+294	+242	+262	+295	+468	+291	+416
Germany	-1957	-2185	-2317	-2574	-3201	-3501	-3540
Greece	-	+161	+660	+996	+965	+1279	+1403
France	+81	+139	-397	-206	-705	-118	-405
Ireland	+639	+568	+717	+747	+913	+1235	+1247
Italy	+527	+549	+1391	+977	+1468	+899	+355
Luxembourg	+203	+235	+253	+261	+278	+291	+374
Netherlands	+376	+94	+218	+351	+462	+326	+275
United Kingdom	-337	-9	-985	-1040	-938	-1033	-1155
Portugal	-	-	-	-	-	-22	+247
Spain	-	-	-	-	-	-223	+145

Note: figures for 1985 assume a UK correction of 1881 mecu; those for 1986 assume a correction of 1841 mecu. The 1985 net contribution figures for Spain and Portugal represent their contributions to the UK's 1985 abatement.

Source: Commission document received in strict confidence.



# UK NET CONTRIBUTION AFTER ABATEMENT, 1987-92, ON VARIOUS SCENARIOS

Table 2

Scenarios	Mecu 1987 prices					
	1987	1988	1989	1990	1991	1992
1. 1.4% VAT ceiling and Fontainebleau abatement as now (Autumn Statement forecast)	1242	1166	1269	1278	1294	1326
2. Commission expenditure proposals (modified for 26.6 becu EAGGF Guarantee in 1987) with:						
(a) diff tax and Commission correction mechanism increase on (1))	2068 (+826)	2243 (+1077)	2367 (+1098)	2450 (+1172)	2446 (+1152)	2528 (+1202)
(b) diff tax and modified Fontainebleau abatement (weighted VAT/diff tax; 66%) (increase on (1))	1315 (+73)	1378 (+212)	1458 (+189)	1524 (+246)	1534 (+240)	1588 (+262)
(c) no diff tax and Fontainebleau abatement continued unchanged (increase on (1))	1341 (+99)	1417 (+249)	1512 (+243)	1590 (+312)	1615 (+321)	1695 (+369)
3. 1.1% GNP ceiling (not covering UK abatement) (ie expenditure as in table 4); fourth resource and modified Fontainebleau abatement (weighted VAT/diff tax; 66%) (increase on (1))	1304 (+62)	1399 (+233)	1418 (+149)	1458 (+180)	1374 (+100)	1452 (+126)

## Notes

- Line 1 shows our estimates, at constant 1987 prices - based on the latest Autumn Statement forecast - for the UK's net contribution, on the assumption that the 1.4 per cent VAT ceiling and Fontainebleau abatement system remains unchanged throughout the period. The continuing increase over the period reflects the likelihood that, with the integration of Spain and Portugal into the Community and the continuing pressures for 'cohesion' policies, the UK's share of spending programmes will tend to decline.
- Lines 2(a) to (c) and line 3 show how much we estimate the net contribution figures would rise on various assumptions about the outcome of the future financing negotiations.
- The abatement is read back to the year in respect of which it arises.
- The figures show only the UK's net contribution to the allocated budget. Our net contribution to the unallocated budget would fall by a small amount if the diff tax were introduced.



## EFFECTS OF COMMISSION PROPOSALS ON MEMBER STATES 1992

Net balances (a) in 1986, and (b) in 1992 assuming implementation of COM(87)101

Mecu 1987 prices

	Be	Dk	Ge	Gr	Sp	Fr	Ir	It	L	Ne	P	UK
(a) 1986	660	430	-3660	1450	150	-420	1290	370	390	280	260	-1200
(b) 1992 with COM(87)101 proposals	820	450	-5890	2800	1180	-890	2210	330	520	590	380	-2500
Difference	+160	+20	-2230	+1350	+1030	-470	+920	-40	+130	+310	+120	-1300

Notes

Row (a): 1986 net balances from Commission document received in confidence; figures inflated to 1987 prices

Row (b): derived by taking contribution figures from table 38 of COM(87)101 statistical annex. Receipts shares in 1992 assumed to be as in 1986, but shares in the structural funds adjusted as follows: B -1 percentage point, Dk -1, Ge -4, Gr +4, Sp +7, F -5, Ir +3, It +2, N -1, P +2, UK -6; and other receipts shares adjusted to take account of projected fall in other UK receipts.

Both rows show net balances after correction of the UK's budgetary imbalance, which is read back to the year in respect of which it arises.



## FORECASTS OF FEOGA GUARANTEE

		becu 1987 prices				
		1987	1988	1989	1990	1991 1992
A: Financial Guideline						
1.	Current basis, 1984-85 base, growth in Own Resources (current definition)	23.0	22.8	23.9	24.3	24.8 25.1
2.	Commission proposal (Com 101) ("1987 real needs" x GNP growth)	25.8	26.4	27.1	27.8	28.5 29.2
3.	Revised "1987 real needs" x GNP growth	26.9	27.6	28.3	29.1	29.9 30.7
B: Possible unconstrained base forecast (Commission's forecast outturn for 1988. Assumed annual growth rate of 5% based on outturn 1980-87)						
	Potential gap -	26.9	29.3*	30.8	32.4	34.0 35.7
		.0	1.7	2.5	3.3	4.1 5.0
C: Savings from existing and prospective policy changes						
1.	1986 milk/beef decisions excluding butter disposals	-	-	-1.2	-2.4	-2.4 -2.4
2.	1987 Socio-structures regulation	-	-	-.2	-.2	-.3 -.4
3.	Pre-pensions proposal	-	-	.0	-.1	-.2 -.2
4.	Stabilisers proposal					
	(a) cereals MGQ of 155 tonnes					
	i. price cut@ 65m per 1%		-.8	-1.1	-1.2	-1.2 -1.3
	ii. increase in Co-resp levy		-.8	-1.2	-1.3	-1.3 -1.4
	(b) oilseeds removal of floor to price cut under MGQ system		-.3	-.3	-.4	-.4 -.4
	(c) protein seeds MGQ system		-.1	-.1	-.1	-.1 -.1
	(d) abolition of GDBF - wine		-.1	-.3	-.3	-.3 -.3
	(e) other commodities		-.2	-.2	-.2	-.2 -.2
	Subtotal stabilisers		-2.3	-3.2	-3.4	-3.6 -3.7
	TOTAL SAVINGS		-2.3	-4.6	-6.1	-6.5 -6.7
D: Disposal and depreciation of stocks						
I "Big Bang"						
	(a) depreciation of new stocks	1.8	.3	.0	-.1	-.1
	(b) 1987 and 1988 butter disposals	.0	1.0	.9	.9	.8
	(c) disposal of other old stocks	3.1	.6	.2	.1	.1
	Total	4.9	1.9	1.1	.9	.8
II Phased approach						
	(a) depreciation of new stocks	1.8	.3	.0	-.1	-.1
	(b) 1987 and 1988 butter disposals	.0	1.0	.9	.9	.8
	(c) disposal of other old stocks	.9	.9	.9	.9	.9
	Total	2.7	2.2	1.8	1.7	1.6

Notes;

\* ie. 30.2 becu deflated to 1987 prices.



## PROSPECTS FOR NON-OBLIGATORY EXPENDITURE AND THE STRUCTURAL FUNDS

	Payment appropriations. becu. Constant 1987 prices							
	1987	1988	1989	1990	1991	1992	Increase(%) 1987-92	UK net contribution to structural funds, 1992 (before abatement)
<b>A. Commission projections</b>								
(a) R&D (7.7 becu)	0.8	0.9	1.4	1.5	1.6	1.7	119.6	
(b) Aid (incl. 7th EDF)	1.1	0.8	0.9	0.9	1.2	1.7	51.0	
(c) New policies	0	0.2	0.6	1.0	1.5	2.1	00	
(d) Other (excl. structural funds* (max rate)	1.7	1.7	1.7	1.7	1.7	1.8	10.5	
(e) Structural funds*	[6.2]	[6.5]	[8.2]	[9.2]	[10.4]	[11.6]	88.4	0.45**
less obligatory EAGGF guidance (max rate)	[0.6]	[0.6]	[0.6]	[0.7]	[0.7]	[0.7]	16.4	
gives	5.6	5.9	7.6	8.5	9.8	10.9	96.1	
(f) Total	9.1	9.5	12.2	13.6	15.8	18.2	100.6	
<b>B. Illustrative alternative (within max rate)</b>								
(a) R&D (5.6 becu)	0.8	0.9	1.0	1.1	1.2	1.2	60.9	
(b) Aid (excl. 7th EDF)	1.1	0.8	0.9	0.9	0.9	0.9	-16.1	
(c) New policies	0	0.1	0.1	0.2	0.2	0.3	00	
(d) Other (excl. structural funds*) (constant)	1.6	1.6	1.6	1.6	1.6	1.6	0	
(e) Structural funds*	[6.2]	[6.7]	[6.8]	[6.9]	[7.1]	[7.2]	16.7	0.28**
less obligatory EAGGF guidance (max rate)	[0.6]	[0.6]	[0.6]	[0.7]	[0.7]	[0.7]	16.4	
gives	5.6	6.1	6.1	6.2	6.4	6.5	16.7	
(f) Total	9.1	9.5	9.7	10.0	10.3	10.5	16.3	
<b>C. Memorandum items</b>								
1. Expenditure permitted by maximum rate								
(a) Commission assumptions	9.1	9.5	9.6	9.8	9.9	10.0	10.6	
(b) Treasury assumptions	9.1	9.5	9.7	10.0	10.3	10.5	16.3	
2. Expenditure permitted by maximum rate x 1.5								
(a) Commission assumptions	9.1	9.8	10.2	10.5	10.9	11.3	25.0	
(b) Treasury assumptions	9.1	9.8	10.4	10.9	11.5	12.2	34.3	

\* includes fisheries (about 220 mecu in 1987).

\*\* Assuming Commission's financing proposals. Treasury estimates not necessarily accepted by other departments



## COMMUNITY BUDGET 1987-92 : A POSSIBLE SCORESHEET

becu. Constant 1987 prices							
	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>Increase (% 1987-1992)</u>
1. Agricultural guarantee expenditure (1987 needs plus GNP growth factor), of which	26.6	27.3	27.9	28.7	29.4	30.1	13.28
(a) sugar levies, food aid, ACP refunds	2.2	2.2	2.2	2.2	2.2	2.2	3.53
(b) other	24.4	25.1	25.8	26.5	27.2	27.9	14.14
2. Other obligatory expenditure, of which:	3.3	3.5	3.7	3.4	3.0	2.7	-18.21
(a) own resources refunds adjustment gives	[0.7] - 0.7	[1.8] [-0.8] 1.0	[1.33] - 1.2	[1.3] - 1.3	[1.3] - 1.3	[1.3] - 1.3	83.76
(b) Spain/Portugal "	1.4	1.1	0.9	0.6	0.1	-	-
(c) IGA repayments adjustment gives	- - -	[0.5] [-0.5] -	[0.3] - 0.3	- [+0.3] 0.3	- [+0.3] 0.3	- -	-
(d) EAGGF guidance (two-thirds)	0.6	0.6	0.6	0.7	0.7	0.7	16.41
(e) Other (max rate)	0.6	0.7	0.7	0.7	0.7	0.8	16.25
3. Non-obligatory expenditure (max rate), of which:	9.1	9.5	9.7	10.0	10.3	10.5	16.26
(a) ERDF receipts of SP&P	0.8	0.9	0.9	1.0	1.1	1.2	50.00
(b) Other structural Funds (and Fisheries)(excl.2(d))	4.8	5.3	5.2	5.2	5.3	5.3	11.11
(c) R&D	0.8	0.9	1.0	1.1	1.2	1.2	60.85
(d) Aid (excl-EDF)	1.1	0.8	0.9	0.9	0.9	0.9	-16.05
(e) New Policies	0	0.1	0.1	0.2	0.2	0.3	-
(f) Other	1.6	1.6	1.6	1.6	1.6	1.6	0
4. Total expenditure (1 + 2 + 3)	39.0	40.2	41.4	42.1	42.7	43.4	11.29
5. Implied VAT rate )uniform rate, )not covering	1.48	1.52	1.53	1.52	1.51	1.50	
6. 4 as % of GNP base )UK abatement	1.09	1.10	1.10	1.09	1.08	1.07	
7. UK abatement (Fontainebleau system applied to VAT & diff tax) - expenditure effect.	2.3	3.6	2.7	2.8	2.8	2.8	
8. Total (1 + 2 + 3 + 7)	41.3	43.8	44.1	44.8	45.4	46.2	11.69
9. Implied VAT rate, )highest rate, )covering	1.61	1.71	1.67	1.66	1.65	1.63	
10. 8 as % of GNP base )UK abatement	1.16	1.20	1.17	1.16	1.15	1.13	

Notes 1. Some columns may not sum exactly, due to rounding.  
2. See accompanying paper for explanation of assumptions.



TABLE 5

**READY RECKONER: IMPLICATIONS FOR UK NET CONTRIBUTION  
OF VARIOUS CHANGES**

Mecu at 1987 prices		
<u>Increase in UK net contribution</u>		
	Before abatement	After abatement
1. Increase of 1 becu in agricultural guideline (effect in 1992)	74	27
2. Agricultural guideline to grow in line with GNP, not present OR base (effect in 1992)	190	70
3. Waive own resources refunds (1992)	65	20
4. ECSC duties as own resources (1992)	-5	-11
5. EDF within budget (1992)	102	83
6. Increase in ERDF receipts of 4 least prosperous member states (real terms) by 1992:		
-25%	39	13
-33%	53	19
-50%	79	28
7. Diff tax plus 1% VAT instead of VAT alone (1992)		
-1.1% GNP ceiling	-552	-76
-1.2% GNP ceiling	-740	-121
-1.3% GNP ceiling	-927	-169
8. GNP own resource instead of VAT (1992)		
-1.1% GNP ceiling	-762	-106
-1.2% GNP ceiling	-856	-141
-1.3% GNP ceiling	-949	-174

**Notes**

1. Calculations in sections 1-7 assume VAT plus diff tax financing and an abatement mechanism giving us 66 per cent of our weighted average VAT/diff tax expenditure gap. Section 4 also assumes that ECSC duties substitute for an equivalent amount of diff tax, and that the size of the allocated budget in 1992 is as projected by the Commission. Section 8 assumes a corrective mechanism giving us 66 per cent of our GNP expenditure gap.
2. In line 5, no account is taken of the ending of national financial contributions to the EDF. If our diff tax share were below our share of national financial contributions (16.58 per cent for EDF 6), the budgetisation of the EDF could lead to a small financial saving.



1987 prices

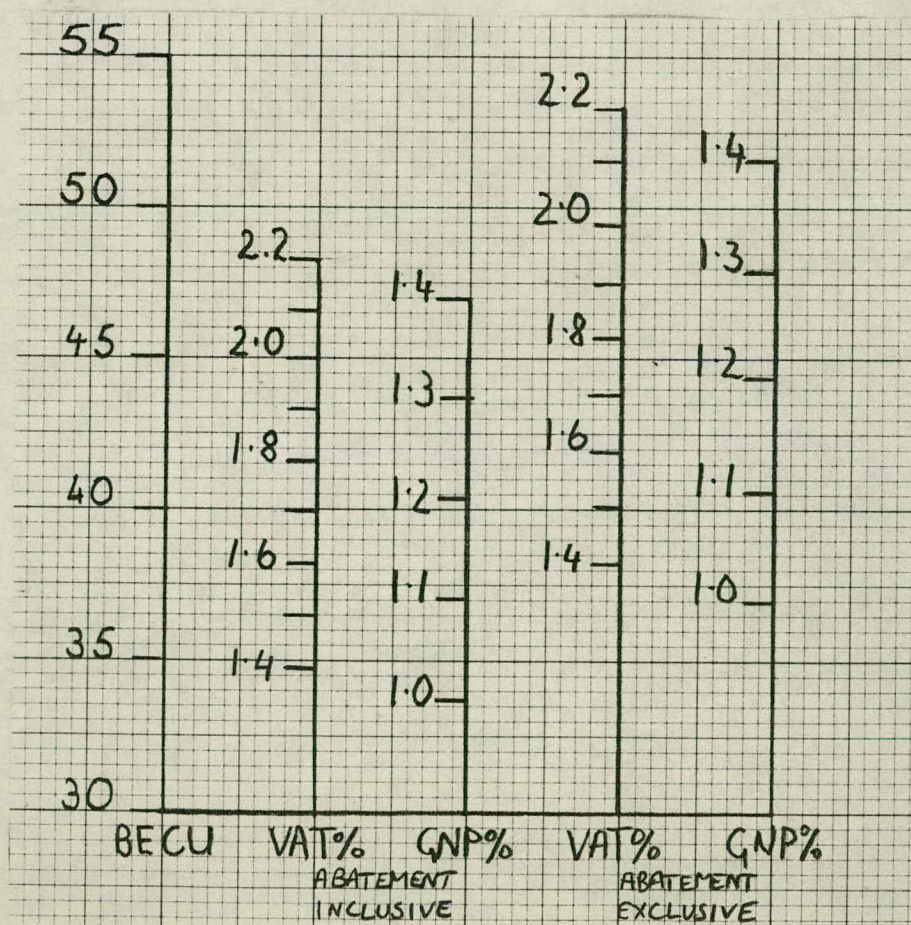
## VAT/GNP CEILING CONVERSION TABLE

Abatement inclusive				Abatement exclusive			
VAT%	Available revenue (becu)	GNP%	Available revenue (becu)	VAT%	Available revenue (becu)	GNP%	Available revenue (becu)
1.4	34.8	1.0	33.7	1.4	38.2	1.0	36.9
1.5	36.5	1.05	35.4	1.5	40.1	1.05	38.8
1.6	38.2	1.10	37.0	1.6	41.9	1.1	40.6
1.7	39.9	1.15	38.7	1.7	43.8	1.15	42.4
1.8	41.6	1.20	40.4	1.8	45.7	1.2	44.3
1.9	43.3	1.25	42.0	1.9	47.5	1.25	46.1
2.0	45.0	1.30	43.7	2.0	49.4	1.3	47.9
2.1	46.6	1.35	45.4	2.1	51.4	1.35	49.8
2.2	48.3	1.4	47.0	2.2	53.3	1.4	51.6

**Notes:** - abatement inclusive figures assume Fontainebleau abatement of 3400 mecu (expenditure equivalent) at 1.4 per cent VAT and that the abatement uses up 170 mecu of resources for each additional 0.1 per cent VAT, and 330 mecu for each 0.1 per cent of GNP

- figures are based on Commission estimates of EC12 GNP and VAT in 1988. The assumed abatement for the UK, however, is less than the actual figure in the 1988 PDB

- EC12 GNP, 3663 becu; 1 per cent VAT, EC12, 18.57 becu; traditional OR, 11.9 becu; other revenue, 0.3 becu.





EFFECT OF COMMISSION'S PROPOSAL FOR ADDING THE DIFF TAX  
ALONGSIDE 1 PER CENT VAT, 1992

mecu, 1987 prices

	Change in gross contribution before correction	
	Commission estimate	UK estimate
Belgium	126	104
Denmark	72	48
Germany	255	95
Greece	-56	-58
Spain	202	166
France	-273	-323
Ireland	-56	-54
Italy	1020	877
Luxembourg	-18	-18
Netherlands	-2	-21
Portugal	-53	-56
UK	-1217	-757

Note: If the Fontainebleau abatement system were modified to give us 66 per cent of our weighted average VAT/diff tax expenditure gap, the change in the UK's net contribution after correction would be about 130 mecu.



**EFFECT OF REPLACING VAT CONTRIBUTIONS  
BY GNP CONTRIBUTIONS, 1992**

mecu, 1987 prices

	Change in gross contribution before correction	
	Commission estimate	UK estimate
Belgium	139	120
Denmark	78	53
Germany	278	105
Greece	-62	-64
Spain	224	192
France	-299	-376
Ireland	-62	-64
Italy	1126	1011
Luxembourg	-20	-19
Netherlands	-2	-26
Portugal	-59	-60
UK	-1342	-865

Note: If the Fontainebleau abatement system were modified to give us 66 per cent of our GNP expenditure gap, the change in the UK's net contribution after correction would be about 150 mecu.



## COMMISSION ESTIMATES OF EFFECTS OF ALTERNATIVE FINANCING REGIMES

TABLE 7c

## DIFFERENCE FROM FONTAINEBLEAU FINANCING IN MECU

		D	F	I	NL	B	DK	L	GR	IRL	E	P	UK	E-12
Variant 1 - COM 101	1988	157	- 240	590	- 16	53	39	- 12	- 41	- 30	106	- 28	- 576	
	1992	255	- 273	1020	- 2	126	72	- 18	- 56	- 56	202	- 53	- 1217	
Variant 2 - COM 101 but with 1.4% VAT	1988	54	- 66	114	- 3	11	16	- 3	- 7	- 6	14	- 4	- 121	
	1992	146	- 152	525	- 1	66	43	- 10	- 28	- 29	100	- 26	- 632	
Variant 3 - 0.5% GNP Variable VAT	1988	157	- 240	591	- 16	53	39	- 12	- 41	- 30	106	- 28	- 578	
	1992	166	- 175	616	- 1	77	48	- 11	- 33	- 34	119	- 31	- 740	
Variant 4 - GNP contributions	1988	220	- 348	887	- 25	79	53	- 17	- 62	- 45	163	- 43	- 861	
	1992	278	- 299	1126	- 2	139	78	- 20	- 62	- 62	224	- 59	- 1342	
Variant 5 - 1% VAT plus GNP key	1988	93	- 132	295	- 8	27	25	- 6	- 20	- 15	49	- 13	- 294	
	1992	142	- 149	509	- 1	64	42	- 9	- 27	- 28	97	- 25	- 613	
Variant 6 - 1% VAT plus GNP per head at PPP	1988	379	- 79	272	- 4	17	31	6	- 73	- 42	- 155	- 54	- 298	
	1992	672	- 49	467	8	46	54	13	- 122	- 77	- 289	- 102	- 620	
Variant 7 - 1% VAT plus GNP per head (at market prices)	1988	864	- 131	425	- 21	50	106	- 3	- 96	- 52	- 236	- 76	- 831	
	1992	1580	- 108	771	- 41	127	188	- 2	- 161	- 97	- 442	- 144	- 1671	

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13.08.97 12:45



VAT, GNP AND DIFF TAX SHARES, 1992

	VAT %	GNP %	Diff tax %
Belgium	2.9	3.3	3.6
Denmark	2.1	2.2	2.4
Germany	25.9	26.2	26.5
Greece	1.2	1.0	0.9
Spain	6.3	6.8	7.3
France	21.0	20.0	19.1
Ireland	.8	0.6	0.4
Italy	15.4	18.1	20.7
Luxembourg	0.3	0.2	0.2
Netherlands	4.9	4.8	4.7
Portugal	1.0	0.8	0.7
UK	18.3	16.0	13.7
	[18.4]	[15.0]	[11.5]

**Note:** the shares for the UK are Treasury projections. The figures in square brackets are the Commission's estimates for the UK. The figures for other member states are the latest Commission estimates adjusted to take account of the Treasury projections for the UK.

	80	81	82	83	84	85	86	87
Gap between UK VAT and diff tax shares (percentage points)	-.2	-4.4	2.4	2.5	5.1*	6.7*	5.7*	4.2

\* In these years, the UK VAT take (and hence VAT share) was inflated because of the abolition of postponed accounting for VAT on imports and the Keith reforms (which have shortened VAT payment lags).



TABLE 7(e)

## ECSC CUSTOMS DUTIES, AND COMMISSION ESTIMATES OF DIFF TAX SHARES - 1987

	ECSC Customs duties		Diff tax
	mecu	% of EC12	% of EC 12
Belgium and Luxembourg	7	3.9	3.9
Denmark	15	8.3	2.6
Germany	74	41.1	27.7
Greece	3	1.7	1.0
Spain	4	2.2	6.6
France	14	7.8	21.1
Ireland	1	0.6	0.5
Italy	29	16.1	17.6
Netherlands	9	5.0	5.4
Portugal	4	2.2	0.7
UK	20	11.1	12.9
EC12	180	100	100

- Sources: i) ECSC customs duties from Commission's COM(87)101, p.27  
 ii) Commission estimates of diff tax shares from SEC(87)461/2, table 8 (the UK estimate for the UK share in 1987 is some 13½%).



*Mr Edwards,  
We spoke. Here is  
the revised table.*

*[Table still  
being revised.]*

TABLE 8

*Commission's 15/10*

**RATE OF COMPENSATION REQUIRED WITH NEW CORRECTIVE MECHANISM  
PLUS DIFF TAX FOR US TO BE AS WELL OFF AS  
WITH FONTAINEBLEAU**

*[Perhaps omit]*

Commission's proposed mechanism based on our GNP agriculture gap (%)	Modified Fontainebleau system based on our weighted average VAT/diff tax expenditure gap (%)
--	---

Assumption about budget size,  
structure and UK receipts

1. Assuming Commission expenditure, receipts and revenue projection as set out in COM(87)101	55	53
2. Assuming Commission expenditure projection, Autumn Statement receipts and revenue projection	79	62
3. Assuming a smaller budget (1.1% of Community GNP), Autumn Statement receipts and revenue projection	84	64
4. As for 2, but assuming 70% of the allocated budget (rather than 62%) is spent on agriculture	67	56
5. As for 2, but assuming UK receipts share from agriculture of 7.3% and 6.3%	70	55

Note: the table shows, on different assumptions about the size and structure of the budget, what rate of compensation would be required in 1992 with the diff tax plus a corrective mechanism based on our:

- (i) GNP agriculture gap  
(ii) weighted average VAT/diff tax expenditure gap

*the difference between  
our actual & GNP share  
of agricultural exp*

to leave us as well off as we would be with the continuation of the present financing arrangements but an increase in the VAT ceiling.

*a correspondence*

*equal above the 3*



CONFIDENTIAL

FROM: A J C EDWARDS  
DATE: 19 October 1987

CHANCELLOR

*Ch/Content with this  
revised draft letter?**OK 19/10**OK*EDWARDS  
to  
CH/EX  
19/10FUTURE FINANCING NEGOTIATIONS: OVERVIEW AND SCORESHEET  
POSTSCRIPT

Mr Lavelle told me over the weekend that he has it in mind to suggest that Sir G Howe should circulate for the Prime Minister's meeting on 28 October a short annotated agenda which would refer to the relevant sections of the Treasury's overview paper. He hoped that any covering note we provided would not get in the way of this.

2. Having looked again, in the light of this, at the draft Private Secretary letter which we submitted on Friday, I think it might be helpful to recast paragraph 2 a little so as to remove any impression that it was intended to serve as an annotated agenda.

3. With apologies for troubling you further, I attach a revised draft letter accordingly.

AJCE

(A J C EDWARDS)



CONFIDENTIAL

*Be type letter for 26.10.71*

## DRAFT LETTER FROM:

The Chancellor's Private Secretary to:

The Private Secretary to the Prime Minister  
Charles Powell, Esq  
10 Downing Street

## EC FUTURE FINANCING NEGOTIATIONS:

## OVERVIEW AND SCORESHEET

1. In preparation for the Prime Minister's meeting on 28 October, I attach the compendium paper which the Foreign and Commonwealth Secretary foreshadowed in his minute of 12 October. Treasury officials have prepared the paper with help from officials in other departments, in particular the Cabinet Office, FCO, MAFF and Treasury Solicitor.

2. The Chancellor has asked me to point out that the paper has been substantially revised since the earlier version discussed at OD(E). Our objective has been to provide a comprehensive guide to all the main future financing issues.

3. Although the revisions extend to all parts of the paper, there are four pieces of new material which the Prime Minister may wish particularly to note:

- (i) the latest projections for the UK's net budget contribution, due to be published in the Autumn Statement, which indicate a serious deterioration in our underlying budgetary imbalance with the Community (paragraphs 2-4);
- (ii) the discussion on the legal form of budget discipline for agriculture (paragraphs 35-7), including the safety-valve (paragraphs 47-54), and for non-obligatory expenditure (paragraph 63);



- (iii) the fuller discussion of link between the proposed diff tax and the UK abatement (paragraphs 111-113); and
- (iv) the discussion of the likely pressures at Copenhagen for agreement on a budget for 1988 and an IGA (paragraphs 119-125).

4. I am copying this letter to the Private Secretaries to the Foreign and Commonwealth Secretary, the Minister of Agriculture and Sir Robert Armstrong.