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10 DOWNING STREET

From the Principal Private Secretary

cc B. Ingham. / Italy
cc Master
Europe Pol
Budget P's
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CAP P's 5
29 May 1980

Dear Paul,

EUROPEAN COMMUNITY: VISIT OF SIGNOR COLOMBO

The Prime Minister gave a dinner last night for Signor Emilio Colombo, the Italian Foreign Minister. The Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and Mr. Franklin were also present. Signor Colombo was accompanied by Signor Cagiati, the Italian Ambassador in London, and Signor Ruggiero.

The Prime Minister said that the problem of the British contribution to the Community budget had got bigger rather than smaller since the meeting of the European Council in Luxembourg. She hoped that progress towards its solution would be made at the meeting of the Foreign Affairs Council the following day. If the issue was still substantially unresolved by the time the European Council met on 12/13 June, there would be a crisis of unprecedented proportions at Venice. She wondered whether the other member states were genuinely seeking a solution or not.

Signor Colombo said that he hoped very much that the question would not have to be referred again to the European Council. He agreed that the situation had got worse not better since Luxembourg, but he believed nonetheless that all the members of the Community wanted a solution. The fact was, however, that every country had its own problems, and to all of them their difficulties had seemed more complicated after their return to their capitals from Luxembourg. Chancellor Schmidt, for example, had had serious trouble with his Finance Minister, Herr Matthofer, and there was something of a Cabinet crisis on this issue in Bonn. Similarly, President Giscard had been attacked on his return to Paris by supporters of M. Chirac. If progress on the problem of the British budget contribution was to be made, account had to be taken of everybody's difficulties, including the UK's, and of each member country's approach to the matter.

The Prime Minister commented that some of the other heads of government had dramatised their problems. In fact their difficulties were small in relation to the UK's. Even if a settlement had been agreed in Luxembourg on the basis of a British contribution of 538 meua for 1980, the UK would still have been the second biggest net contributor by far.

/Signor Colombo said

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Signor Colombo said that he believed that support was growing for the idea that there should be a fundamental review of the Community's financial arrangement, while a "truce" was called in the short term. Under this approach a precise mandate, with a firm timetable, would be given to the Commission to study the restructuring of the Community's finances. This might include a provision that when agricultural surpluses accumulated beyond defined limits, they would be financed only partially by the Community budget and for the rest by national funds.

The Foreign and Commonwealth Secretary said that the problem needed a more fundamental attack than that. The Chancellor of the Exchequer commented that what Signor Colombo had described was only one element of a mid-term solution which did not, in any case, remove the urgent need to deal with the immediate problem of the UK contribution.

Signor Colombo said that when he had referred to a "truce" for the period prior to a comprehensive reshaping of the Community's financial arrangements, he had in mind a provisional solution which dealt with the problem over the next two years. At Luxembourg there had been a proposal on the table for 1980: this had envisaged a UK net contribution of 538 meua for that year, and this meant that a burden of 1240 meua would have been transferred to the Eight. But because of Chancellor Schmidt's domestic difficulties since Luxembourg, this proposal no longer existed. His soundings over the last few weeks had shown, however, that it might be possible to bring forward another proposal for 1980 which entailed transferring a smaller burden to the other member countries. As regards 1981, Mrs. Thatcher had proposed at Luxembourg that the British net contribution should increase in proportion to the growth of the budget as whole. Another approach might be to distribute the increase in the UK's contribution by fixed proportions round the member countries: for example, if the UK's net contribution went up by 100 meua in 1981 X% might be paid by the UK and Y% by the other countries. We virtually had a firm figure for 1980, even though some small change would be needed to accommodate Chancellor Schmidt's difficulties, and it should be possible to get an agreed figure for 1981 without too much difficulty. 1982, however, was much more of a problem. It was very difficult to see what the UK's contribution in that year would be. If the fundamental review of the whole system which he had earlier suggested was completed in the next two years, the problem would disappear. But we could not be sure that the system would have been fundamentally reformed by 1982. If it had not been restructured and we were still using the existing system, it remained very difficult to forecast what the figures would be for that year. All this pointed to the need to build on what was done for the first and second years to "open a window" for the third year which would allow the Community to deal with the situation if the system had not been reformed in the meantime. An approach on these lines might offer the way ahead, but he had to admit that it was not at present accepted by either the French or the Germans. He had already mentioned the Germans' difficulties over the figure for the first year. The French, on the other hand, saw problems about the second year: they felt that they were being asked to decide now what the UK's net contribution should be but without any guarantee on agricultural prices for 1981. What was

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needed - though he had no formulation to offer yet - was an arrangement which balanced the certainty of the budget solution for the second year with some measure of security for the French on farm prices.

The Foreign and Commonwealth Secretary said that Signor Colombo appeared to be suggesting a trade-off in the second year between the budget solution and agricultural prices. But this would only compound the follies of the CAP of the last 10 years and would make the problem of reforming the Community's finances even more difficult than it was now. The Chancellor of the Exchequer added that everybody had been agreed in 1972 on the need for radical reform of the CAP. But this had not been achieved eight years later and nobody knew when it would be. In the meantime the UK was paying an unfair share of the cost of the unreformed policies. Britain needed a solution that dealt with the problem until a fundamental reform took effect. An acceptable approach would be to agree upon the UK's net contribution in terms of a proportion of its unadjusted contribution to the budget for 1980 and then to apply this principle to all subsequent years until such time as there was a permanent solution resulting from the kind of fundamental review which Signor Colombo had been advocating.

The Prime Minister said that just as Chancellor Schmidt now thought that he had been too generous with his offer at Luxembourg, so she believed that she had been too forthcoming in agreeing on a figure of 538 meua for 1980. A net contribution of this size would still make the UK the second largest contributor by a long way, despite the fact that our income per head was well below the average of the Community as a whole. Nonetheless, she had agreed to this figure in Luxembourg and she stood by it now.

Signor Colombo said that it was essential to oblige the institutions of the Community to find solutions to the problems facing the member countries: otherwise empirical solutions would have to be adopted and these were likely to be damaging in one way or another. This was why it was important to fix a timetable for financial reform. If a radical solution was not found, there was no doubt that the Eight would have to make larger contributions to the budget in order to reduce the burden on the UK. He had no doubt that all nine member countries wanted a fundamental solution. Signor Ruggiero added that the truce which Signor Colombo had mentioned earlier would apply to the short term. It would be a compromise which sought to alleviate the problem of the budget but not to solve it. Part of the truce would have to be higher agricultural prices. An approach of this kind was in keeping with the natural logic and habit of the Community. Did the UK accept the idea of a truce?

The Prime Minister said that she had no difficulty in agreeing to the concept, but everything depended on the terms of the truce.

Signor Ruggiero said that the terms of the truce had to be negotiated. Once that was done, the UK would have all the weapons in its hands to negotiate the peace - the permanent reform of the Community's financial arrangements. Surely the UK did not want to try to negotiate the peace while still fighting. This was the case for the truce, which

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ould embody firm arrangements for the first two years and a window on the third year. Replying to a question by Lord Carrington, he said that he could not at present put a figure on the fixed ceiling for the UK contribution in the first year. Signor Colombo interjected, however, that it would have to be "a little more" than 538 meua.

The Foreign and Commonwealth Secretary said that 538 meua for 1980 and indexed thereafter was as far as we could go. We had after all argued for broad balance at Dublin and then in the New Year had told Signor Cossiga that we were prepared to go up to a net contribution of 400 meua. We had moved a very long way and could go no further. The Prime Minister added that we had been trying to find a solution to the UK's problem for over a year. What hope was there that the Community could tackle successfully the much bigger issue of fundamental reform of its finances in as little as two years?

Signor Colombo said that if a formula for the British contribution was agreed for the first and second years, it was inconceivable that it would not be used for the third year if there had been no reform in the meantime. The history of the Community showed that once something of this kind was established, it was very difficult not to carry on with it.

The Chancellor of the Exchequer said that the conditions of the truce must endure until the peace treaty had been negotiated, and we had no idea how long this would be. The Prime Minister said that she was not convinced by what Signor Colombo had said about the third year. It was likely that at the end of the second year, the Community would come up against the 1% VAT ceiling, and this was likely to lead the other heads of government to say that the UK could have a solution for the third year, provided the 1% VAT ceiling was breached. But the moment we went above the ceiling, we were abandoning any prospect of reforming the CAP. We must have a solution for the third year which prevented this happening.

Signor Colombo said that one way of dealing with the Prime Minister's concern would be for the mandate to the Commission to say that in studying how the Community's finances might be reformed, they should exclude the possibility of going above the 1% VAT ceiling. Signor Cagiati added that the Prime Minister's point about the 1% VAT ceiling could be reversed: the UK could argue that unless the Community accommodated them on the budget, they would not agree to go above the 1% VAT ceiling.

The Chancellor of the Exchequer said that Signor Colombo's suggestion about the Commission's mandate was part of the peace treaty. We had to have a truce that lasted three years. If it was agreed that the formula for the first year worked in the second year as well, why should it not govern the third year rather than some much vaguer arrangement? The Foreign and Commonwealth Secretary said that public opinion in the UK was such that we had to have a settlement that was cast iron for three years: the British Government could not sell anything less at home. He believed that our partners were reluctant to agree to a firm arrangement for the third year because the budget figures for 1982 were so big and so speculative that they did not want to accept the risk-sharing which a reduction in the UK's net contribution required. Mr. Franklin added that the UK did not believe

/that a radical reform

that a radical reform could be agreed and implemented in two years. But if we were wrong, the new system could be introduced in time to take care of the third year. What was needed now therefore was an arrangement for the third year on the same lines as that for the first and second years but on a contingency basis.

Signor Ruggiero said that if the UK stuck out for arrangements which applied uniformly to all three years, the Eight would argue that the base line should be less favourable to the UK than what had been proposed in Luxembourg for the first year. They would say that what Britain gained on duration they should lose on the amount. If he were in the UK's place, he would prefer to create in the first and second years a better precedent for the third year. Signor Cagiati said that if the agreement extended explicitly to the third year, this would reduce the pressure on the Community to go for fundamental reform. What was required was a solution that formally covered the first two years but in practice extended to the third, fourth, fifth years and so on. It might be possible to say in the mandate for the Commission that the problem had to be solved in two years but if it was not, the interim solution would continue: this would avoid mentioning the third year. Signor Colombo said that he had suggested his approach because everybody was uncertain about the third year: in looking ahead to 1982 we were entering the unknown, though it was worth bearing in mind the corrective mechanism would still exist in that year.

The Prime Minister said that she could not accept an arrangement which left the third year unclear. She could not contemplate having a wrangle year after year. It would be better to have one big row early on and reach a lasting solution. She would be prepared to accept a formula which provided that, in the absence of a permanent solution being introduced in the third year, the UK net contribution for that year would be no bigger as a proportion of the Community budget than it had been in the second year. The Chancellor of the Exchequer said that we should not forget that of the first two years five months had already gone. For the purpose of the UK's domestic financial plans he would have to take account in less than 12 months' time of what our net contribution in 1982 would be. This meant that if 1982 was left undecided now, we should have to reopen the budget issue again in less than a year. If the formula being suggested for years one and two was a device which shared equitably the risks and burdens, how could it be unreasonable to apply it to the third year when we were all faced with uncertainty?

Signor Colombo said that he was making a big effort to see that everybody understood everyone else's problem. He was trying to ensure that there were no victors and no vanquished. But he also had to consider what would happen if there was no agreement on the budget. It would mean that there would be no agricultural price increases on 1 June: on the other hand, national aids would lead to the break-up of the Community. It would mean also that there was no budget for 1980; nor could the 1981 budget be drafted. Failure to reach internal agreement would seriously reduce the ability of the Community to act cohesively on the international scene. He was therefore trying to find a solution acceptable to everybody and he believed that what he had in mind was a step forward from Luxembourg.

/The Prime Minister

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The Prime Minister said that if the French introduced national aids, it would be the end of the CAP. If the French acted in this way, it would be very difficult for the British Government to stand idly by and do nothing. National aids would produce yet bigger surpluses, but the UK were not prepared to finance them. She hoped that there would be a serious negotiation in the Foreign Affairs Council the following day and that substantial progress towards a solution would be made. But if that did not happen, she was ready for the European Council to resume their discussion of the problem at Venice.

I am sending copies of this letter to Martin Hall (Treasury), Garth Waters (Ministry of Agriculture) and David Wright (Cabinet Office).

Yours ever,

Alvi Whitmore.

Paul Lever, Esq.,
Foreign and Commonwealth Office.

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