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CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

# FUTURE COMMUNITY STRATEGY: RESTRUCTURING THE COMMUNITY BUDGET

Note by the Secretary of the Cabinet

1. The attached Report by Officials is circulated for discussion at the Committee's next meeting. It was prepared by the Official Steering Committee on European Questions and has been considered by a group of Permanent Secretaries under my chairmanship.

2. The main purpose of the Report, whose conclusions are summarised in paragraphs 64 to 72, is to get an initial steer from the Committee on our broad objectives for the longer term restructuring review to which the Community is pledged as a result of the 30 May settlement, and on the various means that might be pursued to attain those objectives, as a basis for exploratory contacts with our partners and the Commission. It concentrates on the medium term but recognises that immediate issues, notably next year's agriculture price fixing and the imminent exhaustion of the Community's financial resources will be highly relevant. Both of these create potential bargaining levers which will be very important in securing our restructuring objectives. How they might best be handled tactically will be the subject of further papers.

<u>United Kingdom objectives</u> (paragraphs 12 and 13)

3. Our broad objectives in this review are clear -

i. to achieve a lasting solution which will bring our budget contribution permanently to a level certainly no higher and if possible lower than that resulting from the 30 May settlement, and will avoid our contribution being a recurring source of friction within the Community;

ii. to reduce the resource cost of the Common Agriculture Policy (CAP).



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It is difficult to formulate our objectives with more precision at this stage, until the progress of discussions with our partners gives us some idea of what it may be practicable to achieve.

Means to the objectives

4. The Report discusses various means by which the objectives might be achieved -

i. changing the pattern of Community expenditure, reducing the proportionate cost of the CAP (paragraphs 22-37 and 68) and increasing the amount of non-agricultural expenditure (paragraphs 38, 39 and 69);

ii. changing the pattern of Community own resources (paragraphs 41-56 and 70);

iii. the introduction of corrective systems which do not change policies but adjust their budgetary effects (paragraphs 57-62 and 71).

These are not necessarily alternatives: it seems likely that the eventual solution will be a package of measures reflecting some kind of balance of the conflicting interests of member countries. We shall need to be ready in discussions with our partners to consider all the options available, with a sharp eye open for our objectives and interests and a careful eye also upon the aims and interests of our partners as they emerge.

5. On reducing the cost of the CAP, there are broadly two possible approaches: price restraint, particularly on products in surplus, and quantitative limitation. We have argued forcefully for price restraint, or even freeze, on products in surplus, and we should continue to do so in the restructuring discussions. Our ability to block price increases is an important bargaining lever for us, whose effectiveness we must preserve; and keeping down the rate at which prices increase will certainly be one of the means of keeping the cost of the CAP within bounds. But our pursuit of this line will need to be tempered

a. by the thought that, now that there is no scope for compensating our own farmers for restraint in CAP prices by means of green pound devaluations, British farmers (whose net income has already fallen seriously in real terms) will be as reluctant as Continental farmers to envisage total freezes on prices; and





b. by the disadvantages that would ensue for our general negotiating position if this were allowed to become too early in the game, a major issue on which we might find ourselves in a minority of one and in some sort of confrontation with the rest of the Community.

Quantitative limitations on production could be a means of helping to keep down the cost of the CAP without relying on price restraint alone, and we should certainly be willing to discuss them; but they do have serious drawbacks.

6. As regards non-agricultural expenditure, the line taken by the French and Germans in the recent Budget Council shows how difficult it will be to retain even its present share of the total in the face of pressure from rising CAP costs and the constraint of the 1 per cent ceiling. But it will be an important object of policy for us to increase the proportion of the budget that is available for non-agricultural expenditure from which we can benefit, and we should explore the more promising areas identified in paragraph 38 of the Report.

7. As to changing the pattern of own resources, making the VAT contributions progressive (ie relating them in some way to relative national wealth) would suit us, but is likely to be negotiable only in the context of agreement to raise the 1 per cent ceiling. An oil import levy could also be arranged to suit us, so long as the United Kingdom remained a substantial oil producer, although the gain on our net contribution would depend on how high a share of the receipts we could get. But unless compensating offsets could be found it would add to industrial costs, particularly in energy-intensive industries.

8. As to corrective systems, (paragraphs 57-62 and 71) a direct budget adjustment mechanism could be an attractive answer to our problem, either on its own and bearing the whole weight or as a supplement to changes in the pattern of Community expenditure. But it would probably be sensible for us not to lead with this sort of suggestion: it should be possible to arrange for it to emerge in the course of discussion, following upon the ideas floated by President Giscard and Chancellor Schmidt in the discussions leading up to the 30 May agreement.

Negotiating style and tactics

9. The Report and subsequent official discussions of it suggest that -

a. We must preserve the effectiveness of the strong bargaining levers we enjoy in the 1981 price-fixing and our insistence on the 1 per cent VAT ceiling (though we may want eventually to move on that in the context of an otherwise satisfactory settlement).

b. We should encourage and participate fully in a wide-ranging discussion, and we should not at this stage regard any option as not available for consideration. The mutually acceptable solutions will emerge more easily if we have been seen to be reasonably open-minded, and keen to find solutions which make sense for the Community as a whole, as well as meeting our own requirements.

c. We should try to avoid getting into an 8 to 1 confrontation, preferably at all and certainly for as long as possible.

d. We should take advantage of the improvement in our relations with the French to explore with them, as well as with the Germans, where our interests are shared and where they conflict. There are signs of modification in the thinking both of the French and of the Germans, and we shall have interests in common with both of them - particularly in our refusal to contemplate breaching the 1 per cent VAT ceiling and in some quarters in reducing the cost of the CAP. But there will also be important differences: they are likely to be interested in dealing with the problems of products in surplus by means of price rises offset by co-responsibility levies biased against the larger and more efficient producers - a system which we are bound to resist.

10. Finally, if Ministers endorse the general approach of the paper, they will wish to consider the next steps. The importance the Government attach to this exercise has already been stated publicly eg, in the Lord Privy Seal's statement to the House following the 30 May settlement. It would be premature for us to announce precise proposals now: what is needed is a







period of private bilateral discussion with our partners. The forthcoming Anglo-German Summit will provide an important opportunity to influence German thinking at the top level, and we hope to have preparatory contacts with them beforehand. We also need to begin talking at official level to other member states and the Commission to explore and influence thinking at an early stage. Although the Commission are not due to report until next June there are signs that the Dutch who hold the Presidency during the first half of next year will try to accelerate the timetable.

Signed ROBERT ARMSTRONG

Cabinet Office
3 October 1980

CONFIDENTIAL

# FUTURE COMMUNITY STRATEGY: RESTRUCTURING THE COMMUNITY BUDGET

Report by Officials

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CONFIDENTIAL

# FUTURE COMMUNITY STRATEGY: RESTRUCTURING THE COMMUNITY BUDGET

~~Draft~~ Report by Officials

## I. INTRODUCTION

1. The agreement concluded at the 29/30 May Foreign Affairs Council, besides providing for specific reductions in the UK's net contribution to the Community Budget for 1980 and 1981, included the following paragraph. "For 1982, the Community is pledged to resolve the problem by means of structural changes. (Commission mandate to be fulfilled by the end of June 1981. The examination should concern the development of Community policies, without calling into question the common financial responsibility for these policies which are financed from the Community's own resources, or the basic principles of the common agricultural policy. Taking account of the situations and interests of all member states, this examination will aim to prevent the recurrence of unacceptable situations for any of them.)"

2. This report examines the background against which the restructuring negotiations will take place (Section II); discusses what the UK's aims might be (Section III); describes the approach to the 1 per cent VAT ceiling and the broad choices it presents (Section IV); considers the various routes by which restructuring could be achieved (Sections V-VII) examines the feasibility of a Community-wide system of direct budget adjustments (Section VIII) and suggests conclusions for consideration by Ministers (Section IX). While it identifies a number of major negotiating situations which will arise in the Community over the next 18 months, it does not attempt to deal with the tactical handling of them, which will be the subject of separate papers.

## II. THE NEGOTIATING SCENARIO

3. The relevant landmarks are -

a. the German Federal election, October 1980

b. the Anglo-German Summit, mid-November 1980

c. the Anglo-Italian Summit, 24-25 November 1980

d. possible Commission proposals for economies in the Common Agricultural Policy (CAP), November/December 1980



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e. Commission proposals for and decisions on 1981/82 CAP price fixing, spring 1981

f. the French Presidential elections in April/May 1981

g. Commission proposals for restructuring - by June 1981

h. establishment of 1982 Budget - July or September 1981

i. the 1 per cent VAT ceiling might be reached say during the second half of 1981

j. decisions needed before December 1981 on the budget arrangements for the UK for 1982

k. CAP price-fixing, spring 1982.

4. It seems probable that the negotiations will fall into three main phases as follows, but a crisis arising on the 1981 CAP price-fixing or on the establishment of the 1982 Budget could change the timetable -

i. A preparatory and exploratory phase lasting until the Commission proposals appear in final form by the agreed deadline of end June 1981. All member states including the UK will want to use this period to do their own basic homework, to influence the Commission's thinking and to explore each other's positions.

ii. A preliminary negotiating phase, probably still centred primarily on bilateral contacts, lasting to about October 1981 or perhaps longer. This may be the period in which the Community reaches the VAT ceiling.

iii. The decisive negotiating phase, mainly in the Council, but almost certainly involving the European Council as well, which may last beyond the end of 1981.







Phase i. is likely to coincide with first the Luxembourg and then the Dutch Presidency; phases ii. and iii. with the UK Presidency (June-December 1981), followed in 1982 by the Belgian and Danish Presidencies.

5. Other areas of Community business could impinge on the restructuring negotiations. Our partners are currently looking for progress on fisheries, but provided agreement is reached by the end of the year there is no reason why fisheries should get caught up in the restructuring exercise. It is conceivable that we will come under pressure, particularly from the Germans, on North Sea oil as the price for meeting our aims on restructuring, although this did not happen in the 30 May settlement. It is also conceivable that a link could emerge between our joining the EMS exchange rate mechanism and restructuring.

6. Apart from these possibilities, the French, and perhaps others, may seek to use restructuring to delay progress in the enlargement negotiations. But even those with the interests of the acceding countries most at heart will not be prepared to let the applicants in on the restructuring negotiations or to give absolute priority to enlargement. The prospect of enlargement may serve to put pressure on our partners to complete restructuring before Spain and Portugal add to the Community's problems. The accession negotiations will thus complicate the work of restructuring but should not seriously delay it.

7. Though formally separate, the 1981 agricultural price-fixing will play an important tactical role in relation to the restructuring exercise. The coincidence of the price-fixing with the French Presidential election might offer opportunities for us or for other member states to exert bargaining leverage in one direction or another. We shall need to reconcile our approach to the price-fixing with the Government's broader economic policies and our longer term interest in reforming the CAP as part of the restructuring review. Following the price-fixing, the establishment of the 1982 Community Budget could prove impossible to achieve without policy changes, particularly in the CAP, which would become bound up with the restructuring negotiations. The negotiations on the 1982 CAP price-fixing could influence the later stages of the restructuring exercise.

The Objectives of other Member States

8. In principle we may expect our partners' approach to restructuring to be founded on the gains or losses they might get from it. So long as inflation continues to be the main economic problem facing the Community all member states will be influenced by the need for domestic financial retrenchment. The following table, which shows the existing position of each member state in relation to both budgetary and non-budgetary transfers will be the starting point.

TABLE 1: ESTIMATED RESOURCE TRANSFERS

million EUA

| | Budgetary Commission forecast 1981 | | Budgetary Post settlement** | Non-Budgetary Transfers (based on '79 figures) |
|---|---|---|---|---|
| | | as % GDP | | |
| UK | -2200* | -0.6 | -730 | -720 |
| Germany | -1400 | -0.2 | -1970 | -380 |
| France | - | - | -447 | +520 |
| Italy | 800 | 0.3 | 571 | -1390 |
| Netherlands | 600 | 0.5 | 506 | +840 |
| Belgium | 600 | 0.9 | 526 | -250 |
| Denmark | 600 | 1.1 | 559 | +680 |
| Ireland | 700 | 5.0 | 687 | +500 |
| Luxembourg | 300 | n.a | 299 | (included with Belgium) |
| Greece | likely to gain | | | gain |
| EC(10) | | | | |
| Spain | likely to gain | | | ?gain |
| Portugal | gain | | | ?lose |
| EC12 | | | | |

* Before adjustment

** After UK refunds in respect of 1981, though in practice most of these refunds will be made in 1982.





9. Although it is too soon to be sure what our partners' specific objectives will be, there are grounds to suppose that they may be on the following lines. The Germans may be concerned to reduce their net contribution, if necessary through the imposition of a ceiling on net receipts; and to retain the 1 per cent VAT ceiling. They seem willing to contemplate changes in the CAP. It remains to be seen, however, whether they are mainly concerned with limiting their share of its cost eg by developing co-responsibility levies, or whether they are ready to accept more fundamental changes. The attitude of the FDP/SPD coalition is, and may remain, somewhat ambivalent; a CDU administration would be no less sensitive to farming interests. The French will probably want to get back to broad balance and may also be attracted by mechanisms designed to limit the receipts or payments attributable to any single member state. President Giscard is at present firmly committed to preserving the 1 per cent ceiling, though he may be under strong pressure to give way if French farm incomes can only be maintained by raising the ceiling. The French seem more willing than in the past to consider changes in the CAP. But they may be concerned to reduce its cost in ways that do not damage their interest (but could conflict with ours) rather than with more fundamental changes. The Danes will also want to preserve the CAP but they may be in conflict with the French on modalities since the French make most of their CAP gains through intra-Community trade while the Danes depend more on subsidies paid from the Community budget. The Benelux countries may be as much concerned to restore the Community's momentum as to advance their own financial interests, though they will probably resist any budget override mechanism that puts a limit on their present receipts. Ireland, as another major CAP beneficiary, is likely to resist any substantial changes in its present methods of operation. The smaller Community countries in general may not regard the 1 per cent ceiling as sacrosanct. Italy, having shown Presidential restraint during the negotiation of our budget solution, will look for compensation for the resource burden she bears under the CAP as a net importer of temperate foodstuffs. Together with Greece, she is more likely to look for heavier spending on Mediterranean agriculture and the structural funds than to work for greater economy.

10. In sum, with the possible exception of the Germans and the French, most member states are likely to regard the 1 per cent ceiling as a means rather than an end; all acknowledge that some changes in the CAP will be necessary but will fiercely resist any attempt to dismantle it; none will willingly give up the net advantages they gain from the



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unrestructured budget, although they will have at the back of their minds the cost to them of an extension of the 30 May settlement. The Commission is likely to see in the restructuring review an opportunity to expand the Community's role through additional structural expenditure and to secure approval for a proposal to increase own resources; the European Parliament will probably support this approach and may also seek to exploit the situation to enlarge its own powers.

11. While our partners will defend vigorously their separate interests along the lines above, they will also have in mind the development and interests of the Community as a whole. And they will look for evidence that we are also thinking about the Community's interests and not simply concerned with our own national gains and losses. The majority will certainly see finding a generally acceptable solution to the UK's budget problem as one of the Community's interests. It will be important for us to show flexibility on the means by which our overall objective is achieved, and to present our case (especially important in the initial stages) in the most communautaire terms possible. In particular we must be extremely careful to avoid presenting views which others will consider to be damaging to the longer term development of the Community. Our task in the first two phases of the negotiation will be to create both a bargaining situation in which we have the necessary levers to achieve an acceptable solution in the final stages, and a political situation in which our partners can make the necessary concessions to us in a way acceptable to their own public opinion.

## III. UNITED KINGDOM OBJECTIVES

12. It is clear that, of all the member states, we have the greatest interest in a successful restructuring exercise. But, for the first time, there is now a great deal of dissatisfaction with the Community Budget arrangements; and this provides us with an opportunity to present the exercise as being of genuine Community interest and not one dictated by the peculiar circumstances of the UK. The other member states have virtually accepted the proposition that the UK can never again be called upon to make a disproportionately large net contribution and, as a result of the 30 May settlement, our net contribution to that part of the Community Budget which is allocated in the Commission calculations to individual member states will be held in 1980 and 1981 to around 600-800 million EUA. For the purpose of illustrating the effect of different options discussed in this paper, we have assumed that we should aim for a slight improvement in nominal terms (ie a substantial improvement in real cost to the UK) and





used figures in the range 500-600. It would be imprudent to assume that we will be able to negotiate a better deal than that for 1982 and the immediately following period. But, given that we are and will remain one of the poor member states and pay for the general benefits of Community membership by resource transfers as well as through the Budget, we should aim to make further improvements in our net budgetary position over time. In principle, there is no reason why we should be a net contributor at all; in relative terms we might seek to pay not only less than the Germans but also less than the French. It will be a matter for later decision how far we can press for this result in the forthcoming negotiations.

13. When considering changes in the budgetary arrangements, we should not lose sight of the additional resource cost to the UK arising from the CAP. In considering changes in the Policy we should be aiming to reduce those costs as well; and certainly to avoid budgetary savings which simply make the resource cost worse.

14. There are three kinds of structural change in the Community's budgetary arrangements which could in principle contribute to these objectives-

a. reducing expenditure on the CAP;
b. expanding non-agricultural expenditure of benefit to the UK;
c. changing the pattern of own resources.

Each of these in turn is examined in sections V-VII. All are linked in one way or another with policy on the approach to the 1 per cent ceiling which is considered in the next section. Section VIII looks to a different method of preventing the recurrence of unacceptable situations; the direct adjustment of budgetary transfers.

## IV: THE APPROACH TO THE 1 PER CENT VAT CEILING

15. It is clear from the Commission's estimates that Community expenditure in 1981 will come very close to the limit of the Community's available resources. The draft Budget is still under discussion but we believe it unlikely that proposals which would take the Community over the 1 per cent ceiling will be made by the Parliament or that, if they were, a majority of the Council would support them. It cannot be excluded however that the Community might run out of money during the course of 1981 if its expenditure exceeds the Budget estimates. What the Community might or could do in these circumstances has been discussed in other papers.

16. Given the recession in Community economies, we do not expect the Community VAT base to grow during the next two years by more than about 10 per cent a year in cash terms, import duties by about 7 per cent a year, and agricultural levies by some 5 per cent a year. Taking these trends together, own resources will grow by only about 8-9 per cent a year. If this is the case, the rate of growth of CAP expenditure will have to be roughly halved to stay within the 1 per cent limit. If the trends in agricultural spending apparent until 1980 continued, there could be a shortfall of some 4,500 million EUA in 1982. The adoption of the 1982 Budget within the 1 per cent ceiling will only be possible if there are major reductions in the growth of Community financed CAP expenditure.

17. On the current timetable which must be viewed as uncertain, Spain and Portugal will join the Community in January 1984. The prospect is that both countries will make a net gain from the Community Budget. Their accession will therefore make the 1 per cent ceiling more difficult to hold if it is still in place at the time.

18. It may be helpful to pick out four broad options which face the Community given these financial constraints:

i. To stay within the ceiling, adapting existing policies by one means or another to this end.

ii. Only to agree to a limited increase in the ceiling if changes in Community policies eg the CAP have also been agreed.





iii. To agree to some modest increase in the ceiling eg to meet the needs of enlargement.

iv. To provide for a further substantial increase in own resources as a means to operate a genuinely redistributive budget within the Community.

19. Option (i) has so far been espoused by the Germans and French as well as the UK. It would place a limit on the likely increase in our net contribution and would protect our position provided that the limit was not circumvented by other measures, such as increased co-responsibility levies. It might also force the Community into a degree of national financing of the CAP. But it would place a severe restraint on the development of other Community policies favourable to us, especially if the costs of enlargement had to be accommodated within the ceiling, and might even put at risk arrangements to preserve our net budget position. There would clearly be less reason for us to insist on the retention of the 1 per cent ceiling if we were able to negotiate a budget override system that kept our net contribution at satisfactory levels.

20. If option (ii) were to be attractive to us, we would have to insist on adequate conditions which might cover CAP reforms, a limit on the proportion of the Community budget to be absorbed by agriculture or a different own resources system. Option (iii) would probably be seen by the smaller member states as the most likely scenario. It has no attractions for us.

21. Option (iv) would be in line with the recommendations in the 1977 MacDougall Report, which highlighted the contrast between the major redistributive functions of national budgets and the extremely small redistributive impact of the Community's finances. The Report suggested that spending through the Community Budget would have to be raised from about 0.7 per cent of Community GDP (in 1977) to about 2.2 per cent if it were to have any useful redistributive effect. Although some of the smaller member states and Italy may in principle favour a high spending Community as a means of securing greater economic integration, they are unlikely to press so radical a proposal in any serious way in the present economic climate.

## V. REDUCING THE COST OF THE COMMON AGRICULTURAL POLICY

22. The case for a reduction in the CAP surpluses stands in its own right as a major objective for the United Kingdom and now for most other member states, although there is also a widespread desire to preserve the basic fabric of the CAP. In the budget context, unless the growth in spending on agriculture (in recent years an average annual rate of 23 per cent) can be checked or the Community's responsibility for it diminished, there is no prospect of a substantial re-orientation of the Community's spending priorities within a total budget of an acceptable size. Table 2 shows that over half of Guarantee Section expenditure goes on milk and cereals. The mediterranean products (olive oil, fruit and vegetables, wine and tobacco) currently show the largest increase in cost.

23. The main objectives for the UK in any reform of the CAP are to -

a. reduce chronic surpluses of CAP products;

b. ensure that the CAP does not exacerbate the problem of containing inflation;

c. reduce the net budgetary cost to the UK of the CAP Guarantee Section of the budget;

d. minimise the resource costs resulting from the difference between CAP and world food prices and the fact that the UK is a net food importer;

e. preserve a healthy domestic agricultural industry;

f. resist proposals which would descriminate against the UK;

g. have regard to the interests of New Zealand and the Commonwealth sugar exporters, and reduce the disruptive effects of subsidised Community exports on world markets.

24. So long as the UK's high inflation rate was reflected in a depreciation of the pound against other Community currencies, it was possible to take a strong line on increases in the CAP common prices while compensating our own farmers for the increases in their production costs through devaluation of the green pound. But while the pound maintains





its current value against the ECU, there is no scope for further green rate devaluation and any increases in UK support prices will be confined to increases in common support prices. For this reason, it will be more difficult next year than in the past to reconcile the interests of British agriculture with our other aims.

25. We have never sought to question the objectives of the CAP as set out in Article 39 of the Treaty. The French (and other member states) would block any attempt to question directly these objectives or what they regard as the "basic principles" of common prices, Community preference and common financing. The most fruitful approach is, therefore, likely to be to focus discussion on the cost of the individual regimes (including the expected increases resulting from enlargement) and consider commodity by commodity how the operation of the policy and the mechanisms might be modified.

### METHODS

#### Price Restraint

26. Price restraint is at present the main plank of our approach to CAP reform. Ministers have seen this as the best way of deterring excessive production and encouraging consumption and also of cutting the budgetary costs of the CAP and the cost of our food imports. We have had some success in that over the last three years average support prices in the Community as a whole have fallen in real terms by about 2 per cent per year. However the growth in the production of surplus commodities and in the cost of the CAP has not so far been checked. Officials have therefore examined the case for a more radical long term approach to pricing. This would establish the principle that prices should be set at levels which, taking one year with another, would balance supply and demand in the Community markets. The role of price support would then be confined to the smoothing out of seasonal fluctuations, in the interests of both producers and consumers. "Demand" would be defined as Community consumption, the stocks appropriate as a hedge against fluctuations, unsubsidised exports and food aid.

27. To balance the Community markets for the main commodities would require substantial cuts in current support levels. The precise size of such cuts is difficult to determine but it could be as much as 30 per cent for milk, the most intractable problem. It has never proved possible to reduce prices in nominal terms. The most, therefore, that we can realistically hope to achieve is a freeze in the nominal level of common prices for



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CAP products in surplus. Such a freeze would leave real prices to be eroded by inflation. This policy would initially fall hardest on countries with high inflation rates. Some of their producers - the small farmers with fewer production alternatives - would suffer a severe loss of income. This imbalance would in time be corrected if exchange rates adjusted to reflect inflation differentials, giving scope for green currency devaluations, but it is improbable that member states would be content to rely entirely on this effect.

28. Officials are studying the feasibility of a direct income aid for those whose livelihood would be put at risk by the move to lower prices. To avoid conflict with the objective of balancing the market, this aid would not be directly related to output, or to input costs. Since the UK has the lowest proportion of small farmers among the member states, we should from the budgetary point of view want the cost of the aid to be defrayed largely be national governments. But it would probably be necessary to have a Community contribution also, in order to ensure Community supervision and control and to avoid the unfair competition which could arise from excessive national subsidies.

29. On this approach, the following gains would in time be realised -

i. a substantial fall in the budgetary cost of the CAP and a further improvement in our net position as a result of the partial switch from Community to national financing;

ii. a fall in retail food prices and the unit cost of our food imports;

iii. third country producers would face less heavily subsidised Community exports.

However, apart from the practical difficulties of devising a workable income aid, it is open to the following objections -

a. a policy of price restraint would be ill received in agricultural circles in the current situation of falling real farm incomes;

b. this policy might not in any event produce substantial savings within the timescale of the restructuring exercise;





c. it is uncertain how much price restraint the income aid would buy;

d. it would be difficult to devise the aid in such a way that marginal farmers were not kept artificially in business and the desired cut in production was achieved;

e. the income aid would involve increased bureaucracy.

Quantitative Limitations on Support

30. Another approach would be to place the emphasis on restricting production, through techniques like standard quantities, production quotas and taxes on increments to production. The practicability and the method of restriction will vary according to the structure of production and marketing of each commodity. The Community already has a quota scheme for sugar. The Commission are due to make new proposals to reduce the quota. There is a limited quota arrangement on processed fruit and vegetables which we should like to see extended. There is interest in France in a standard quantity system for cereals, based on that which operated for wheat in France before the CAP, whereby support was given only for a pre-determined level of production. The Council of Ministers has agreed in principle to introduce a supplementary levy on milk at the next price fixing if Community production has increased (as it has) in the current year. If the Commission come forward with the same proposal as last year, this would be a penal tax on production above a certain level. It seems possible that milk production may not in any case increase materially in the UK in the next few years so that a tax on the increment to production could bring us a budgetary benefit. But the concentrated structure of milk production and processing in the UK would make it easier to collect the levy here than in some other countries and we would need to ensure that there were adequate arrangements to control evasion. It might be more difficult to develop effective quota or standard quantity arrangements for other commodities.

31. Officials are studying in detail the feasibility of introducing new quantitative limitations into the CAP. In principle they could -

i. reduce the budgetary cost of the CAP by acting directly on surplus production;

ii. be geared with price policy to produce a desired level of farming income;

iii. reduce the quantity of Community food going into subsidised export.

The main objections of principle to this approach are -

a. it would not reduce the prices to consumers or the food trade cost of the CAP. Indeed Community partners might argue that the imposition of a quota made price discipline less necessary;

b. it would ossify the pattern of production and discourage innovation - but less so if the quotas were saleable;

c. it would increase bureaucracy.

Other Methods of CAP Reform

32. We differ in our assessment of the relative merits of these two different methods of reform. But we are agreed -

a. that we should resist increases in the co-responsibility levy for milk compensated by price increases since this effectively raises extra revenue by taxes on consumers. We would not take the same view of co-responsibility levies applied eg to wine;

b. existing Community schemes for paying producers to get out of production or to set aside land, or to convert to a commodity not in surplus are not cost effective. The approach would only be of interest to us if better schemes can be devised;

c. taxes on competitive products and inputs (eg vegetable oils and soya) cause major problems with third country suppliers and are not in general in our interest;

d. independently of the restructuring negotiations, it must be our aim to secure some changes in the arrangements for mediterranean products before Spain and Portugal join the Community. But if our arguments are to cut any ice with the mediterranean countries, we will have to show that we are ready to accept equally unpalatable changes on Northern products.





Changes in the Financing Arrangements and Procedures of the CAP

33. Three kinds of change are considered below -

a. a cash ceiling on the budgetary cost of the CAP;

b. national financing of part of that cost;

c. synchronisation of the timetables for the CAP and the Community Budget.

34. The exhaustion of existing Own Resources could itself in certain circumstances constrain the cost of the CAP. A specific ceiling for CAP expenditure could also be adopted as a policy measure. The German Government has recently stated that CAP expenditure should increase less fast than the increase in own resources. This would provide some scope for a reduction in agriculture's share of the total budget. In principle a cash ceiling could also be in the UK interest but, given the open-ended nature of agricultural support, it would depend on what agreement the Community was able to reach on responsibility for expenditure once the ceiling was exceeded. The Germans will probably want to get round the problem through co-responsibility levies. This would not be in our interest if the cost were to be passed on to consumers. Others, if they were willing to entertain the principle of a cash ceiling, might want to make savings on ad hoc policies (including some from which we benefit) not integral to the basic functioning of the CAP. Our interest is that the responsibility should be transferred from the Community to national governments - ie to use the ceiling as a lead-in to national financing - but open advocacy of such a policy in the early stages of negotiation might make its ultimate achievement more difficult.

35. National financing could come about either by default - if CAP funds ran out during the year due to a failure to take adequate short-term measures to keep within the budgetary provision - or by decision of the Council, for example at the price-fixing, because this was the only way to reconcile the desired level of farm support with the headroom in the budget. It would be a measure of last resort which a number of member states would be most reluctant to accept, especially as the principle of common financing is enshrined in the Commission's restructuring mandate. The simplest decision would be for each member state's expenditure within its frontiers on agricultural price guarantees to be reimbursed at less than the present rate of 100 per cent. Figures showing the effect of national financing in this form and at a rate of 20 per cent, assuming no change in the patterns of trade, are as follows.



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TABLE 3: EFFECT OF NATIONAL FINANCING IN EACH MEMBER STATE

Million EUA

20% National Financing of all Guarantee Expenditure

| | Net budget receipt/contribution | | Difference |
|---|---|---|---|
| | with 100% budget financing | with 20% national financing | |
| Belgium/ Luxembourg | +136.2 | +83.0 | -53.2 |
| Denmark | +377.1 | +303.4 | -73.7 |
| Germany | -252.3 | -162.4 | +89.9 |
| France | +271.4 | +309.0 | +37.6 |
| Ireland | +293.2 | +232.5 | -60.7 |
| Italy | +309.5 | +247.2 | -62.3 |
| Netherlands | +589.9 | +421.9 | -168.0 |
| United Kingdom | -1725.3 | -1435.4 | +289.9 |

Other keys and rates for the apportionment of expenditure between the Community and member states can be envisaged. Expenditure might for example be re-distributed between the Community and member states in proportion to self-sufficiency in the commodities concerned (favourable to us), to shares in Community agricultural output, or, less helpfully from our point of view, to shares in Community GDP. Broadly speaking, the change would benefit those member states like the UK who make a net contribution to the CAP, at the expense of those who make a net budgetary gain. It might also be a catalyst for reform by bringing home the cost of surpluses to the countries which produce them. National financing would, however, create an incentive for net exporting countries to ensure that their surpluses were dealt with in a country other than their own. Such manoeuvres might bring our benefit down to somewhat below the figures in Table 3 since our market, after that of Germany, is probably the most vulnerable to them.

36. Commissioner Tugendhat has also suggested that the price-fixing negotiations should be advanced to coincide with the budget process in the second half of each year. Simultaneous work on the budget and the price-fixing might concentrate the minds of the Commission, the Council of Ministers and the European Parliament on the need for





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consistency in their budget and agricultural policies. On the other hand, the running in tandem of these two complex sets of negotiations might prove unwieldy and an attempt to fit the price-fixing into the necessarily more rigid timetable of the Budget negotiations could be turned against us. Earlier price decisions would in some cases be helpful to farmers but there might be dangers in fixing the prices for crops further in advance of the marketing years to which they apply. Nevertheless this ancillary suggestion deserves consideration.

37. Section V Conclusions The restructuring negotiations give our Community partners and ourselves an opportunity to put forward suggestions for the reform of the CAP and for changes in its financing arrangements and procedures. We shall need to assess the ideas which will be canvassed not only in terms of their budgetary effect but also in terms of their effects on the consumer, on the cost of our food imports and on the interests of our own agriculture and food industries (paragraph 23). Ministers will wish to consider whether the main emphasis should be put on price policy, possibly linked with direct income aids, as against quantitative limitations on support where practicable. We should take a strong line on the rapidly growing cost of Mediterranean products (paragraph 32d.), both in the restructuring and the enlargement negotiations, without exposing ourselves to the charge of prescribing stronger medicine for others than we are willing to take ourselves. The introduction of an element of national financing of CAP price support would be in our interest (paragraph 35). This could be brought about simply through a cash shortage or by the Community financing only a part of any income aids. It would be better for us to pursue the objective of national financing by indirect means. We should be ready to consider suggestions for the imposition of a cash limits on the CAP (paragraph 34) or for the synchronisation of the price-fixing and budget timetables (paragraph 36).







VI. INCREASED COMMUNITY EXPENDITURE OUTSIDE THE AGRICULTURAL FIELD

38. Since our share in CAP expenditure has only been about 5-9 per cent, whereas we secure a net benefit from structural expenditure (the social and regional funds, research and development, energy etc), one way of reducing the UK's net contribution to the budget, if the 30 May arrangements had lapsed, would be to expand non-agricultural programmes, which currently account for only 8-9 per cent of the Community budget. To do so would help to give the UK a greater long-term economic interest in Community policies, though by the same token it would bring more Community involvement in some of our domestic policies. However, it would require 12-13 times the present levels of non-agricultural expenditure and a very ambitious target for our share of any new expenditure (25 per cent return against a marginal contribution of 16.5 per cent in a Community of Twelve) to bring the UK's unadjusted net contribution down to 500 million EUA by 1982; and a doubling of the size of the total budget. It is therefore not realistic to consider that this approach could do more than partially meet our needs. Nevertheless there are possibilities where proposals for expansion of non-agricultural expenditure might be of some net benefit to us. We may be expected by our partners to look at any such proposals and others. Not to do so might be tactically damaging to us, particularly in the earlier stages of the negotiations. Amongst the areas which have been identified as possibilities are -

Regional Fund.

Although at present the UK benefits to the extent of 7 per cent net, we could become a net contributor with the accession of Spain and Portugal. But there are a number of ways in which we might continue to be a net beneficiary, for example through a special window in the Fund, or even a new fund, confined to the less prosperous member states.

Social fund.

Again, enlargement will, on the Fund's present terms, make us a net contributor; and since most possible new areas of Fund intervention would also benefit schemes in other member states which are often on more generous terms than those here, it is hard to see this providing more than modest scope for expanding non-agricultural expenditure in a way which would give us a net return.

Urban/Industrial Decay.

Provided that it was based on criteria favourable to the UK, we could argue for a one third share of a fund designed to help areas of urban and industrial decay.

Transport Infrastructure.

Again, the UK could be a net beneficiary from a fund specifically financing transport infrastructure within peripheral member states and/or member states with lower than average GDP per head aimed at linking such states to the Community's "heartland".

Energy.

The UK would be a net beneficiary of a scheme to encourage investment in the production of coal and possibly other energy sources, (but see also paragraph 41 below).

Fisheries.

The UK could be a small net beneficiary from Community aid for restructuring and fishery protection costs, at least before the accession of Spain and Portugal.

39. Areas which have been ruled out as unlikely to offer potentially significant net benefits to the UK are research and development, the environment, and the financing of unemployment benefits (where any net gain to the UK would depend largely on the UK having, over a number of years, an unemployment level consistently higher than the Community average, which historically has not been the case). It is certain that expansion of non-agricultural expenditure cannot alone solve our budgetary problem; and, in some areas, might raise problems for the control of public expenditure. But if Ministers agree that we should be ready to consider proposals which could be of substantial net benefit as a contribution to our budget problem, then officials would examine in more detail the more promising areas in which significant net benefit might accrue, ie the existing regional and social funds, urban/industrial decay, transport infrastructure, energy and fisheries.





## VII. CHANGES IN THE OWN RESOURCES SYSTEM

40. Table 4 in the Annex shows the contributions which member states are forecast to make in 1980 and compares them with their national income. The system results in the United Kingdom contributing a share of Community revenue larger than its share of GDP. The reason for this lies chiefly in our relatively large payments of duties and levies on imports from third countries, though our VAT contribution is also slightly above our GDP share. To the extent that current trends toward lower protection continue, VAT will, because of its natural buoyancy, form a large part of the Community's revenue (even without an increase in the VAT ceiling) and the problem of our excessive gross contribution will be reduced. For the time being the excess is very largely reimbursed through the Financial Mechanism, but our Community partners regard it as a temporary measure and may resist its extension. This section therefore discusses structural changes in the Own Resources system which would reduce our gross contributions if the Financial Mechanism were not extended. We do not think it realistic to tamper with the system of duties and levies. Two more feasible changes are considered.

Progressive Element in VAT

41. At present member states all pay the same proportion of VAT contributions (up to the maximum of 1 per cent) on a harmonised base. If progressivity were introduced, the share of its VAT base which each member state would be required to pay over to the Community would be adjusted to take account of the relative wealth of that member state; a country with an above average per capita income would expect to have a VAT share which exceeded its GDP share and vice versa. In a discussion document published in November 1978 the Commission hinted that "a progressive system of financing the Community Budget might be introduced". The reaction from the richer member states was predictably hostile and the idea has made no progress since.

42. The United Kingdom's interest in the introduction of progressivity depends essentially on two factors; the degree of gearing towards ability to pay introduced and the extent to which our GDP per head is below the Community average. Table 4 shows the GDP per head of each existing member state as a proportion of the Community average both at market exchange rates and at purchasing power parities (PPPs) which take account of the purchasing power of national income in terms of the full range of goods and services and are not affected by exchange rate fluctuations.

43. Table 5 shows the changes in the gross contributions of member states which would result from multiplying the existing VAT shares by GDP per head as a percentage of the Community average. This represents a high degree of progressivity. The figures should thus be regarded as more or less the maximum savings in gross contribution which we could expect from progressivity on an additional VAT tranche of 0.25 per cent or within the existing 1 per cent tranche; in round terms 125 and 500 million EUA respectively. For the existing VAT tranche it is reasonable to regard the improvement in our net position as the same as the saving on gross contribution; for an additional tranche, the effect on the net position would depend on the use to which the extra revenue was put. Forecasts of the United Kingdom's relative GDP per head within the Community in future years are highly speculative, the more so after enlargement; the actual percentage of the Community average could be considerably higher or lower than the 85 per cent used in Table 5. Our best view at present is that we are likely to remain below average GDP, but perhaps not sufficiently far below for a mildly progressive tax to give any significant help after enlargement.

44. The introduction of progressivity into VAT would require an amendment to the Own Resources decision ie ratification by all member states. We would have potential allies in Italy, Ireland and Greece and enlargement could bring support from Spain and Portugal. The richer member states on the other hand would oppose progressivity as for them an expensive way of preventing the recurrence of unacceptable situations. It is not therefore realistic to suppose that the concept would be negotiable except in the context of an increase in the 1 per cent ceiling; and even then the member states adversely affected would resist extending it to the existing VAT tranche. It might however bring us tactical advantage to advocate progressivity within the 1 per cent ceiling as an alternative to the Financial Mechanism. The saving in gross contribution to us of introducing progressivity only into an additional VAT tranche would be relatively small.

An Oil Levy

45. There has been some talk in Community circles of a Community tax on oil to reduce dependence on imported supplies and encourage energy conservation and the exploitation of indigenous energy sources. The question is whether we should promote a tax introduced on these grounds as a significant contribution to a permanent solution of the UK's budgetary problem. This will depend on -

i. the net budgetary benefit that the scheme would offer; and,

ii. the implications that it would have for other UK policies eg energy and fiscal policy.





46. The two forms of impost most frequently canvassed are a tax on oil consumption and an import levy. A Community oil consumption tax would not serve the UK budgetary interest since our share of Community oil consumption is slightly above our share of Community GDP. An import levy could however bring us net budgetary benefit since our share of Community oil imports is only 9 per cent. The levy would take the form of a customs duty on imports and as such would automatically accrue to the Community as Own Resources without the need to amend the Own Resources decision. To satisfy the GATT rules, there would also need to be a tax on domestic production. The UK could ensure that the revenue from such a tax accrued to national exchequers and not the Community since it would have a veto over the amendment to the Own Resources decision which would be needed to add a production tax to Community revenues. Both levy and production tax could be rebated on exports to third countries.

47. A Community oil levy would reduce the proportion of the Community budget met by the UK but the extent to which it would improve our net position would depend even more on the use to which the proceeds were put. If the levy was simply used to finance a continued expansion of the CAP or to defray the cost of growth in the Community budget as now constituted, there would be little or no improvement in our net position despite a UK share of levy contributions as low as 9 per cent. In these circumstances the levy would merely prevent the UK's net contribution from deteriorating as rapidly as it would have done if an expansion of the Community budget were financed by an increase in VAT payments. Even this advantage would last only as long as the UK remained a substantial oil producer.

48. A levy would only reduce the UK's net contribution significantly if we managed to secure a share of the receipts very much higher than our share of present Community expenditure. If, as the Commission suggested earlier this year, the proceeds of the levy were spent on Community support for energy investment, the UK might be able to justify a high share by reference to its share of Community indigenous energy production (40%), although our partners would probably argue that the proceeds should benefit the energy deficient.

49. Both the budgetary impact and, to some extent, the wider implications of an oil levy depend on the size of scheme envisaged. To illustrate this point, two objectives may be considered:

i. to aim to maintain the United Kingdom net contribution at its post 30 May level (taken as 600 million EUA p.a.). This would need a combination of a high ($ 3.7 a barrel) levy with the United Kingdom receiving 25 per cent of the proceeds, or a lower levy ($ 1.9 a barrel) and a higher United Kingdom share of 40 per cent.

ii. to provide only part of the solution to our Budget problem through an oil levy. For example, a levy of $ 1.6 a barrel and a receipts share of 25 per cent would yield to the United Kingdom about 700 million EUA net in 1981. This would be broadly equivalent to and could substitute for the yield from the financial mechanism, which brings our gross contribution to the Commity budget broadly into line with our GDP share.

(Note: the effect of these and other combinations of rate and United Kingdom receipts share are set out in Table 6).

50. The effect of a levy in encouraging energy conservation and the expansion of indigenous non-oil energy production would depend on the rate adopted. Any resulting decrease in the demand for imports would reduce the Community's dependence on OPEC producers and might induce the latter to cut their prices, especially if the other major oil consumers (notably the USA and Japan) introduced parallel levies. However the extent to which the Community succeeded in this objective would depend not only on the behaviour of other major oil consumers but also of the OPEC producers. Their reaction is likely to be hostile. They might well retaliate by raising prices and cutting production on the grounds that such self-inflicted imposts showed that member states could absorb OPEC price increases. But OPEC's reaction might be less strong if it could be shown that the Community levy was part of a wider energy strategy and not simply a device to soak them. The increase in Community oil prices could be expected to lead to some increase in the price of substitutes (notably gas, and to a lesser extent coal).

51. The increases in fuel prices arising from an additional tax in the energy sector would raise industrial costs. This might present an acute domestic political problem. The impact on competiveness would depend on the rate of levy, on the oil prices of non-Community competitors and on the effect on the exchange rate. A high rate of levy would, in the absence of special reliefs, have a much more severe effect on the energy-intensive industries (eg petrochemicals, ceramics, steel, paper and glass making) than on the bulk of manufacturing industry. Any substantial long-term effect would probably be confined to the energy-intensive sectors.





52. The introduction of a levy and production tax on oil would have legal consequences and might weaken our ability to maintain the requirement that oil and gas produced from the UK Continental Shelf (UKCS) should be landed in the UK. For the time being we have satisfied the Commission that the landing requirement is compatible with Community law, but the Law Officers have identified two defences we could use if the case were reopened -

i. that the landing requirement is needed to guarantee the UK's security of supply;

ii. that the relvant Treaty article does not apply to Continental Shelf oil (the "limbo" argument).

Of these two, the first is the more important and would not be affected by the introduction of an import levy. The second rests essentially on the contention that the UKCS is not subject to treaty provisions because it is neither "within the UK" nor "a third country". This would be undermined by an import levy if it involved the adoption of common rules of origin.

53. Production of oil from the UKCS is already subject to royalty, Petroluem Revenue Tax and Corporation Tax. There is also an excise duty on most hydrocarbon oil used in this country. The addition of a production tax would complicate this domestic fiscal regime. Further work is needed in this area, including how far the production tax should be distinguished from the existing domestic tax regime. Some additional staff would be required to administer the two imposts. The number would depend on the details of the scheme which might well have to be quite complicated in order to achieve the most satisfactory arrangements for the UK.

54. An oil levy would offer the UK non-budgetary benefits, resulting from the sale of North Sea oil to consumers elsewhere in the Community at prices above world market levels. These gains might amount to 195 million EUA for every $ per barrel of levy on the present pattern of North Sea oil exports, or as much as 290 million EUA if all our exports were switched to the Community. They would help to offset the non-budgetary losses which the UK suffers under the CAP.

55. A levy as high as $3 a barrel would raise Community revenue by almost 50 per cent. It is unlikely that Community partners heavily dependent on imported oil (including Italy and Ireland which are poorer than ourselves) would agree to so high a levy. Equally, it is unlikely that the Community would agree to a UK share of receipts as high as 40 per cent, whatever the arguments that we could muster in support. Even 25 per cent would be difficult to negotiate. There might in any case be public expenditure and competence difficulties for us in absorbing within the UK the large increase in Community expenditure that it would entail. This means that it is not realistic to believe that an oil levy could by itself meet the whole of our requirements. A more modest scheme of a $2 a barrel levy and a 25 per cent UK share would do less to encourage energy conservation, would still create problems for the North Sea fiscal regime and would undermine the "limbo" argument as a defence of the landing requirement for North Sea oil. But on the other hand it would be less likely to provoke a damaging OPEC reaction, would have less impact on the competitiveness of Community industry and would nevertheless be of substantial budgetary and non-budgetary benefit.

56. Section VII Conclusions The two main possibilities for changes in the own resources system of benefit to the UK are an oil import levy and progressive VAT. They are not mutually exclusive. The former is financially the more attractive; our estimated contribution share of 9 per cent is much lower than we could hope to achieve through progressive VAT, and we would have a good case for seeing that a good proportion of the proceeds came to the UK. Advocacy of an oil levy would imply that we were willing to see a substantial increase in the Community's revenues but it could be achieved without raising the 1 per cent VAT ceiling. A progressive VAT would not require any significant new administrative arrangements whereas the oil levy would require complicated rules and additional calls on administrative resources. A progressive VAT would involve no implicit or actual extension of Community competence or control; but it might give us little benefit after the accession of Spain and Portugal. Even so, there could be some tactical advantage in suggesting a sufficient degree of progressivity as a partial substitute for the financial mechanism.







## VIII. DIRECT BUDGET ADJUSTMENT MECHANISMS: A COMMUNITY-WIDE SYSTEM

57. The 30 May agreement has shifted a significant share of the cost of financing the Community Budget onto Germany and France. One reaction from President Giscard, taken up by Chancellor Schmidt, was to float the idea of a wider budgetary mechanism, applying to net beneficiaries as well as to net contributors. This section examines the possible implications for the UK of the ideas thrown out by Giscard and Schmidt and considers what version of a wider direct Budget adjustment mechanism, were it to be negotiated, would suit us best.

58. The objective of a direct budget adjustment mechanism would be to limit the size of unjustifiable net budgetary flows between member states resulting from the operation of Community policies. It may therefore be thought of as a generalised version of what the Community agreed to do for the UK on 30 May. A direct adjustment mechanism would not require any expansion in the scope of the Community Budget and, depending on the success in cutting the costs of the CAP, might be compatible with the continued preservation of the 1 per cent ceiling. Ministers may therefore find it an attractive approach. For the purpose of designing a scheme, two questions arise -

i. should the mechanism limit the size of all such transfers, or only those in a 'perverse' direction?

ii. what criteria should determine the amount of the correction?

An arrangement which limited the scale of all transfers would probably be of benefit to Germany - because it would take into account not only whether the direction of payment is perverse, but also whether transfers are disproportionate. Germany would remain a net contributor under such a mechanism, but not to the extent that it is under the 30 May agreement. On the other hand, Ireland might not remain such a large net recipient, which could have serious implications for the Irish economy given that Irish net benefits under the budget amount to 5 per cent of Irish GDP. To a lesser extent, the same consideration applies to Italy. Such a system would also systematically introduce a form of juste retour, which would no doubt arouse doctrinal opposition. It may therefore be more realistic to think in terms of a mechanism limited only to those transfers which are in a perverse direction ie from a less prosperous country which was also a net contributor





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or to a relatively rich country which was a net beneficiary. This would limit the UK's net contribution (as long as we qualified as 'less prosperous') but not those of Germany or France; and it would reduce the net gains enjoyed by Denmark, or the Benelux countries, but not Ireland or Greece. Compared to the 30 May agreement, Germany and France would still benefit, since Denmark, Belgium and Luxembourg would be making a larger contribution towards the UK solution.

59. A direct budget adjustment mechanism based mainly on criteria related to differences in size - GDP or population - would limit the net receipts of excess beneficiaries quite sharply. The 30 May agreement is likely to be equivalent to a limit on our net contribution of around 0.2 per cent of our GDP in 1981. A general ceiling on net transfers as low as this would practically eliminate the budgetary gains enjoyed by Denmark and Belgium (and a fortiori Ireland, if all transfers rather than simply 'perverse' ones were included): 0.2 per cent of GDP is likely to be only about 100 million EUA for Denmark in 1981, and about 200m EUA for Belgium. Using GDP per head as the criterion instead is unlikely to go far enough to surmount this difficulty. The alternative of flat-rate cash limits on net transfers would not have much communautaire appeal since it would eliminate a great deal of interest in the financial effects of Community policies.

60. There are a large number of possible variants. We are not satisfied that we have yet hit on a version which would both suit us and stand a reasonable chance of being negotiable. But, in order to illustrate the possibilities, two schemes are described below. Scheme A provides a scale of limits for both net contributions and net benefits. Scheme B limits perverse transfers only.

61. Scheme A (Table 7) is one under which cash limits would apply to all net transfers. Cash limits would be different for net contributions and net benefits: and would vary between countries according to their GDP per head. These limits are worked out as follows. A flat rate limit, for purposes of illustration 500 million EUA, is set on the permissible net transfers for a country with average GDP per head. A more prosperous country has a higher ceiling on its net contribution, and a lower ceiling on its net benefits; a less prosperous country has a lower ceiling on its net contribution and a higher limit on its net benefit. These limits are used to determine the first round of adjustment but since this redistribution does not sum to zero, it must be financed. The table illustrates the effect of all member states contributing to the residual according to the VAT key. The final two columns of the table compare the financial implications of a general scheme and one confined to the UK.





62. The basic idea behind Scheme B (Table 8) is that perverse transfers should be scaled down by three-quarters. The net result of this scaling down is to increase the financing needs of the Community by 75 million EUA, which is assumed to be financed according to the VAT key. A characteristic of this scheme is that each member state would retain a financial interest in Community policies, since there would be no absolute maxima or minima for budget contributions or receipts. It would benefit only the UK (or the UK and Portugal in an enlarged Community).

63. In many ways a direct budget adjustment mechanism would be an attractive as a means of securing a just and durable solution to our budget problem. It would not require an expansion of the Community's activities, it would be administratively simple and it might be possible in this type of arrangement to avoid the problems for our domestic policies created by Article 235 supplementary expenditure under the 30 May agreement.

IX. CONCLUSIONS

64. For no member state is the outcome of the restructuring exercise of greater importance than for the UK. If our net contribution problem is permanently resolved it will remove the grievance about our disproportionate share in the Community budget and shift the balance of argument at home about the benefits of our membership. If the exercise is not successful, we shall not have found a permanent solution to our Budget problem and shall be obliged periodically to argue for continuation of special measures in favour of the UK.

65. But it is an exercise which is also of importance for the future of the Community as a whole, and it will be important for us to show that we are as concerned as anyone about its future development. Our task in the early stages will be to create not only a bargaining situation in which we have the necessary levers to achieve an acceptable solution in the final stage, but also a political climate in which our partners can ultimately make the necessary concessions to us in a way acceptable to their own public opinion.

66. Although the mandate to restructure the budget arose immediately out of the UK problem, the Community is well aware that it faces a financial crisis from the imminent exhaustion of existing own resources. The prospect of enlargement makes the problem even more acute. This situation can be exploited to contain the level of our net contribution and to find a lasting way to prevent the "unacceptable budgetary situation" from recurring. The fact that decisions will be taken on the 1 per cent ceiling and budget restructuring at the same time is helpful to us and our tactics in relation to the 1 per cent ceiling as the negotiations proceed will plainly be crucial (Section IV).

67. We should not seek to define too precisely at this stage the means by which our aims could be achieved. Provided we eliminate those which would clearly be damaging to our interests, or are likely to be totally ineffective, we should be ready to look constructively at various possibilities. Equally, we should not shrink from putting forward solutions merely because they are unpalatable to other member states. If they do not like our preferred solutions, the onus will be on them to propose others that we can accept.





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68. There is no single solution which would achieve the totality of our aims and which we can advocate from the outset. Cutting the cost of the CAP and reducing surpluses is clearly an essential part of our policy, but other member states are likely to be more concerned to find ways round the CAP financing problem than with more fundamental reforms. It will therefore be difficult to achieve genuine savings in a short time. The discussion in Section V suggests that different remedies will be appropriate to different commodities. Further work is in hand. But Ministers may wish to give guidance as to how much emphasis should be put on price restraint, possibly linked with direct income aids, as against quantitative restrictions and standard quantity devices. National financing of the CAP is likely to be in our interest, but not as an alternative to more radical reform, and we need to be cautious about advocating it ourselves.

69. It is clear that within the 1 per cent ceiling the scope for reducing our net contribution through increasing non-agricultural expenditure is limited and depends largely on success in cutting CAP costs, but for the reasons given in Section VI, it is desirable that we should show a readiness to explore certain existing or potential policies in this field.

70. On the own resources side, making the VAT contribution progressive could be of benefit to us and there could be tactical advantage in our advocating it (paragraphs 41 to 44). A special energy scheme involving on oil import levy coupled with expenditure concentrated in the UK could produce a very substantial improvement in our net budget position but it is clear from the discussion in Section VII that it raises much wider issues which need more detailed consideration. Whatever views Ministers eventually take on these ideas, we do not think it would be tactically wise for us to float them at this stage.

71. A direct budget adjustment mechanism (see Section VIII), which unlike the 30 May special solution for the UK applied to the entire Community, would have many attractions for us. It would be the only single measure which could produce a solution to our Budget problem, although not to that of the CAP. But of all those discussed in this report, it is the one most likely to arouse opposition within the Community. We should therefore try to get it included in the restructuring discussions without getting ourselves identified as its advocate.





72. We are only at the beginning of what will be a long and difficult negotiation and we should try to fix final positions now. Nevertheless paragraphs 12 and 13 of Section III suggest what our general objectives should be and Ministers may wish to endorse them. They will also wish to consider these conclusions and give guidance on any of the particular points which these raise. Subject to that, we think it desirable that officials should now have exploratory talks with the Commission and our Community partners (all of whom are already giving thought to this exercise and in the case of the French and Germans doubtless already in touch with each other) to give an indication of our thinking, without commitment, and to seek to influence the way in which their maids are moving.

Cabinet Office

3 October 1980

# FUTURE COMMUNITY STRATEGY: RESTRUCTURING THE COMMUNITY BUDGET

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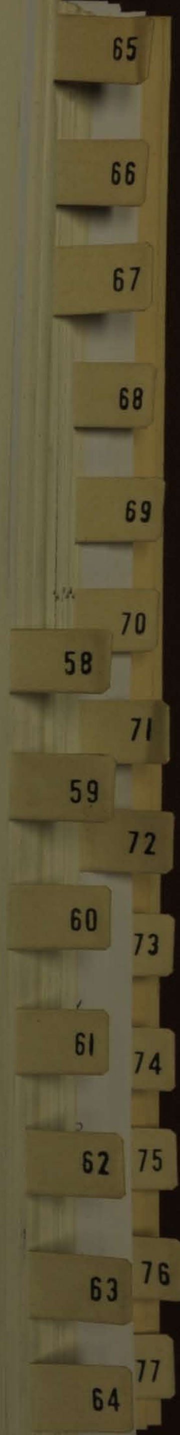

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TABLE 2 : CAP (GUARANTEE SECTION) EXPENDITURE [1]

Million EUA

| | EXPORT REFUNDS | | | SUBSIDISED SALES | | | INTERVENTION | | | OTHER (essentially production aids) | | | TOTAL | | | PERCENTAGE INCREASE IN EXPENDITURE | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1979 | 1980 | 1981 | 1979 | 1980 | 1981 | 1979 | 1980 | 1981 | 1979 | 1980 | 1981 | 1979 | 1980 | 1981 | 1980/1979 | 1981/1980 | 1981/1979 |
| Cereals and rice | 1226 | 1137 | 1724 | - | - | - | 121 | 213 | 330 | 260 | 305 | 313 | 1607 15.4% [2] | 1665 14.4% [2] | 2367 18.4% [2] | + 3.6% | + 4[illegible].2% | + 47.3% |
| Milk and milk products | 2088 | 2715 | 2611 | 1863 | 1940 | 1707 | 487 | 155 | 106 | 89 | 167 | 163 | 4527 43.4% | 4976 43.1% | 4587 35.6% | + 9.9% | - 7.3% | + 1.3% |
| Olive oil | ... | 2 | 2 | - | - | - | 22 | 15 | 27 | 366 | 450 | 552 | 388 3.7% | 467 4.0% | 581 4.5% | +20.4% | +24.4% | +49.7% |
| Sugar | 685 | 426 | 668 | 5 | 7 | 5 | - | 2 | 3 | 250 [3] | 292 [3] | 337 [3] | 940 9.0% | 727 6.3% | 1013 7.9% | -22.7% | +39.3% | + 7.8% |
| Beef and veal | 270 | 460 | 495 | 254 | 321 | 333 | 163 | 193 | 199 | 61 | 204 | 209 | 748 7.2% | 1178 10.2% | 1236 9.6% | +57.5% | + 4.9% | +65.2% |
| Fruit and vegetables - Fresh | 28 | 45 | 60 | - | - | - | 86 | 110 | 127 | 38 | 45 | 57 | 152 1.5% | 200 1.7% | 244 1.9% | +31.6% | +22.0% | +60.5% |
| - Processed | 6 | 10 | 10 | - | - | - | - | - | - | 285 | 449 | 491 | 291 2.8% | 459 4.0% | 501 3.9% | +57.7% | + 9.2% | +72.2% |
| Wine | 5 | 14 | 15 | - | - | - | 24 | 91 | 92 | 33 | 245 | 258 | 62 0.6% | 350 3.0% | 365 2.8% | +564.5% | + 4.3% | +588.7% |
| Tobacco | 4 | 4 | 5 | - | - | - | 12 | 31 | 41 | 209 | 246 | 294 | 225 2.2% | 282 2.4% | 340 2.6% | +25.3% | +20.6% | +51.1% |
| Other [4] | 420 | 459 | 511 | - | - | - | 30 | 17 | 172 | 342 | 504 | 648 | 792 7.6% | 980 8.5% | 1331 10.3% | +23.7% | +35.8% | +68.1% |
| TOTAL | 4,732 | 5,273 | 6,101 | 2,122 | 2,268 | 2,045 | 945 | 827 | 1097 | 1,933 | 2,907 | 3,322 | 9,732 | 11,274 | 12,565 | +15.8% | +11.5% | +29.1% |
| Percentage | 45.3% | 45.7% | 47.4% | 20.3% | 19.6% | 15.9% | 9.1% | 7.2% | 8.5% | 18.5% | 25.1% | 25.8% | 93.2% | 97.6% | 97.6% | | | |
| MCAs + ACAs | | | | | | | | | | | | | 708 | 277 | 307 | -60.9% | +10.8% | -56.6% |
| Percentage | | | | | | | | | | | | | 6.8% | 2.4% | 2.4% | | | |
| GRAND TOTAL | | | | | | | | | | | | | 10,440 | 11,551 | 12,872 | +10.6% | +11.4% | +23.3% |

1. 1979 figures are out-turn figures from the 1979 FEOGA annual report. Figures for 1980 are those in the 1980 Budget and for 1981 those in the draft 1981 Budget.

2. Percentage of total Guarantee expenditure

3. Includes expenditure on storage of 240 meua (1979) 282 meua (1980) and 326 meua (1981)

4. Principally expenditure on oils and fats (excluding olive oil), sheepmeat, pigmeat, eggs and non-Annex II products.

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## TABLE 4: GROSS CONTRIBUTIONS TO THE COMMUNITY BUDGET, 1980 AND NATIONAL INCOME

| GROSS CONTRIBUTIONS, 1980 | | UK | GERMANY | FRANCE | ITALY | NETHERLANDS | BELGIUM | DENMARK | IRELAND | LUXEMBOURG |
|---|---|---|---|---|---|---|---|---|---|---|
| total: | million EUA | 2908 | 4110 | 2614 | 1641 | 1197 | 851 | 327 | 124 | 16 |
| | as % EC(9) | 21.1 | 29.8 | 19.0 | 11.9 | 8.7 | 6.2 | 2.4 | 0.9 | 0.1 |
| per head: | million EUA | 52 | 71 | 51 | 30 | 90 | 91 | 67 | 40 | 49 |
| | as % EC(9) | 98 | 127 | 92 | 54 | 161 | 163 | 121 | 71 | 88 |
| as % EC(9): | levies | 19.8 | 19.5 | 12.8 | 20.6 | 14.7 | 10.4 | 1.6 | 0.4 | 0.0 |
| | duties | 26.0 | 30.2 | 14.6 | 9.7 | 9.5 | 6.5 | 2.4 | 1.1 | 0.1 |
| | VAT | 17.4 | 32.8 | 24.7 | 10.9 | 6.1 | 4.5 | 2.6 | 0.9 | 0.2 |
| **NATIONAL INCOME** | | | | | | | | | | |
| GNP as % EEC(9): | 1979 | 16.3 | 31.8 | 23.8 | 13.6 | 6.3 | 4.9 | 2.7 | 0.6 | 0.2 |
| forecast | 1980 | 17.0 | 31.1 | 24.1 | 13.7 | 6.1 | 4.7 | 2.5 | 0.7 | 0.2 |
| GNP per head as % EEC(9): | 1979 | | | | | | | | | |
| at market exchange rates | | 78 | 135 | 115 | 61 | 118 | 124 | 138 | 50 | 122 |
| at purchasing power parities | | 92 | 119 | 114 | 72 | 108 | 109 | 119 | 63 | 110 |

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TABLE 4: GROSS CONTRIBUTIONS TO THE COMMUNITY BUDGET, 1980 AND NATIONAL INCOME

| GROSS CONTRIBUTIONS, 1980 | UK | GERMANY | FRANCE | ITALY | NETHERLANDS | BELGIUM | DENMARK | IRELAND | LUXEMBOURG | E9 |
|---|---|---|---|---|---|---|---|---|---|---|
| Total: million EUA | 3320 | 4731 | 3057 | 1893 | 1346 | 982 | 382 | 139 | 16 | 15868 |
| as % EC(9) | 21.0 | 29.8 | 19.2 | 11.9 | 8.5 | 6.2 | 2.4 | 0.9 | 0.1 | 100 |
| per head: EUA | 57 | 77 | 57 | 33 | 96 | 100 | 75 | 42 | 49 | |
| as % EC(9) levies | 23.0 | 18.0 | 12.0 | 19.0 | 14.0 | 14.0 | 0.4 | 0.2 | 0.0 | 100 |
| duties | 25.8 | 30.0 | 14.5 | 9.7 | 9.4 | 5.4 | 3.0 | 1.1 | 0.1 | 100 |
| VAT | 17.4 | 32.8 | 24.7 | 11.2 | 6.2 | 4.5 | 2.5 | 0.9 | 0.2 | 100 |
| NATIONAL INCOME | | | | | | | | | | |
| GDP as % EEC(9): 1979 | 16.3 | 31.8 | 23.8 | 13.6 | 6.3 | 4.9 | 2.7 | 0.6 | 0.2 | |
| forecast 1980 | 17.9 | 30.7 | 23.6 | 13.9 | 5.9 | 4.6 | 2.5 | 0.7 | 0.2 | |
| GDP per head as % EEC(9): 1979 | | | | | | | | | | |
| at market exchange rates | 78 | 135 | 115 | 61 | 118 | 124 | 138 | 50 | 122 | |
| at purchasing power parities | 92 | 119 | 114 | 72 | 108 | 109 | 119 | 63 | 110 | |

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TABLE 5: PROGRESSIVE VAT SUMMARY (million EUA)

| | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|
| | COMMUNITY OF 10 | | | | COMMUNITY OF 12 | |
| | | | Savings (+) or increases (-) in gross contributions compared with existing VAT Key | | Savings (+) or increases (-) in gross contributions compared with basic VAT Key | |
| | Existing Key | Progressive* VAT Key | On marginal 3300 | On 1% VAT tranche (of 13200) | On marginal 3630 | On 1% VAT tranche (of 14520) |
| UK | .182 | .1446 | +123 | +494 | +102 | + 407 |
| Germany | .309 | . 384 | -248 | -990 | -294 | -1176 |
| France | .242 | . 260 | - 59 | -238 | - 98 | - 392 |
| Italy | .124 | . 073 | +168 | +673 | +156 | + 624 |
| NL | .051 | . 055 | - 13 | - 53 | - 22 | - 87 |
| Belgium | . 04 | . 044 | - 13 | - 53 | - 18 | - 73 |
| Denmark | .022 | . 028 | - 20 | - 79 | - 29 | - 116 |
| Ireland | .007 | .0037 | + 10 | + 40 | + 9 | + 36 |
| Luxembourg | .001 | .0009 | - | - 2 | 0 | - 1 |
| Greece | .017 | .0072 | + 32 | +129 | + 33 | + 131 |
| Spain | | | | | +123 | + 494 |
| Portugal | | | | | + 25 | + 102 |

*This key was obtained by multiplying the VAT share by GDP per head (at market exchange rates) as a percent of the Community average (UK= 85% in a Community of 10 ) For a Community of 12 the two right hand columns are based on an existing VAT share for the UK of 16½% and a progressive VAT key of 13.7% obtained by assuming a UK GDP per head 94% of the Community average.

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TABLE 6

NET BUDGETARY AND NON-BUDGETARY RESOURCE BENEFITS TO THE UK FROM COMMUNITY EXPENDITURE FINANCED BY AN OIL IMPORT LEVY ⁄

million EUA at present prices and exchange rates

| | Total Community Revenue | Net Budgetary Benefits for UK | | | | | | Non-Budgetary Resource Gains ∅ |
|---|---|---|---|---|---|---|---|---|
| | | UK Share of RESULTANT Expenditure | | | | | | |
| | | 40% | 25% | 16½% | 10% | 8% | 5% | |
| Rate of levy* | | | | | | | | |
| $1.5 per barrel | 4030 | 1250 | 645 | 300 | 40 | - 40 | - 160 | 430 |
| 2.0 | 5370 | 1665 | 860 | 400 | 55 | - 55 | - 215 | 580 |
| 2.5 | 6710 | 2080 | 1075 | 500 | 65 | - 65 | - 265 | 725 |
| 3.0 | 8050 | 2495 | 1290 | 600 | 80 | - 80 | - 320 | 870 |
| | | $ per barrel | | | | | | |
| Rate of levy needed to produce a net budgetary benefit of: 2200 meua | | 2.7 | 5.1 | 11.0 | 82.5 | - | - | n.a |
| 1600 meua | | 1.9 | 3.7 | 8.0 | 60.0 | - | - | n.a |
| 700 meua | | 0.9 | 1.6 | 3.5 | 26.2 | - | - | n.a |

Notes: ⁄ These estimates make no allowance for possible reductions in oil imports as a consequence of the levy. Such adjustments could probably be small in the short run.

∅ The division between budgetary and non-budgetary benefits is on present UK import patterns. If we imported less, budgetary benefits would rise but exports would fall and so the reduction in non-budgetary resource benefits would be pro rata.

* $1 a barrel is a 3 per cent increase.

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(million EUA)

| | VAT key (1) | Unadjusted net transfers (2) | 1st round effect of "scaled" limits (3) | Financing according to VAT Key (4) | Total adjustment (5) | Adjusted net transfers (6) | Effect of financing transfer to UK alone* (7) | Difference (5) - (7) |
|---|---|---|---|---|---|---|---|---|
| United Kingdom | 17.5 | -2200 | 1775 | -337 | +1440 | - 760 | +1440 | -- |
| Germany | 32.5 | -1400 | 735 | -625 | + 110 | -1290 | - 568 | +678 |
| France | 25.0 | -- | -- | -481 | - 481 | - 481 | - 436 | - 45 |
| Italy | 11.0 | 800 | - 6 | -212 | - 218 | + 582 | - 192 | - 26 |
| Netherlands | 6.0 | 600 | -165 | -115 | - 280 | + 320 | - 105 | -175 |
| Belgium | 4.5 | 600 | -180 | - 87 | - 267 | + 333 | - 79 | -188 |
| Denmark | 2.5 | 600 | -235 | - 48 | - 283 | + 317 | - 43 | -240 |
| Ireland | 0.8 | 700 | -- | - 15 | - 15 | + 685 | - 14 | - 1 |
| Luxembourg | 0.2 | 300 | -- | - 4 | - 4 | + 296 | - 3 | - 1 |

* adjustments produced by special scheme which would leave UK exactly as well off in net terms as under general adjustments

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TABLE 8: SCHEME B: PERVERSE NET TRANSFERS REDUCED BY ¾

| (million EUA) | Unadjusted Net | Adjustment to Perverse Transfers | VAT | Adjusted Net | Difference from financing transfer to UK alone |
|---|---|---|---|---|---|
| Germany | -1400 | nil | -24 | -1424 | + 611 |
| Denmark | + 600 | - 450 | - 2 | + 148 | - 406 |
| Belgium | + 600 | - 450 | - 3 | + 147 | - 371 |
| Luxembourg | + 300 | - 225 | nil | + 75 | - 223 |
| Netherlands | + 600 | - 450 | - 5 | + 145 | - 350 |
| France | nil | nil | -19 | - 19 | + 478 |
| UK | -2200 | +1650 | -13 | - 563 | nil |
| Italy | + 800 | nil | - 8 | + 792 | + 247 |
| Ireland | + 700 | nil | - 1 | + 699 | + 14 |
| Sum | nil | + 75 | 75 | nil | nil |

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