Recess Box

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MAP 8/8

PRIME MINISTER

FUTURE COMMUNITY STRATEGY

In his letter to Mr Wright of 16 July, Mr Alexander said you would like to have a progress report for the summer recess on the restructuring of the Community budget. I attach a paper which has been prepared by a group from Treasury, Foreign and Commonwealth Office, and Ministry of Agriculture, Fisheries and Food under Cabinet Office chairmanship. As you will see, it tries to set the scene and concentrates on the shorter term issues which will arise in connection with next year's agricultural price fixing and the approach of the 1 per cent VAT ceiling. It identifies some of the issues we shall have to face, but suggests that it would be premature to try to fix our line until the further work on longer term remedies have been completed. As regards the legal position, I hope to let you have a note shortly on the powers and obligations of national governments if and when Community financial resources run out. This will be relevant to the discussion you are intending to have with the Financial Secretary (Mr Alexander's letter to Mr Wiggins of 21 July refers).

2. I am sending copies of this minute and the progress report to the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and the Minister of Agriculture, Fisheries and Food.

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(ROBERT ARMSTRONG)

1 August 1980

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THE COMMUNITY BUDGET: THE APPROACH TO THE 1% CEILING

INTERIM REPORT BY OFFICIALS

INTRODUCTION

1. This interim report describes the outlook for the Community Budget, own resources and the economies of the member states in 1981 and 1982, and their implications for the budget restructuring review agreed at the 29/30 May Foreign Affairs Council; sets out the key stages in the Community's negotiating timetable; and considers how we and the other member states might react to the situation that expenditures are tending to exceed the resources available under the 1 per cent VAT ceiling introduced by the 1970 Own Resources Decision. While the report draws a number of provisional conclusions, it should be stressed that our strategy can only finally be settled when the studies now in hand on our long-term objectives have been completed. It will be important to ensure that the options which we press for the short-term are compatible with our longer-term objectives.

COMMUNITY BUDGETARY AND ECONOMIC DEVELOPMENTS IN 1981 AND 1982

1981 Community Budget

2. The 1981 Preliminary Draft Budget (PDB) prepared by the Commission provides for total expenditure of 20,051 MEUA (about £12,200M), an increase of 28% over 1980. Total revenue from levies, duties and other revenue is estimated at 8913 MEUA (about £5,400M), leaving 11,138 MEUA (about £6,800M) to be financed by VAT contributions for the nine existing member states and a financial contribution from Greece. The latter is estimated at 180 MEUA (about £110M) and thus leaves 10,958 MEUA (about £6,700M) to be financed by VAT which represents a rate of 0.9520% of the harmonised base. The product of a 1% rate of VAT own resources for the nine existing member states is estimated at 11,510 MEUA (about £7,000M) which implies that there would be about 550 MEUA (about £335M) headroom within the 1% ceiling.

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3. Within this total, agricultural spending in the FEOGA Guarantee Section is estimated at 12.9 billion EUA, an increase of about 12% from the revised 1980 provision of 11.6 billion EUA. This is less than the initial estimate used in the Public Expenditure Survey (PES) based on past trends, namely 14.7 billion EUA. The main difference is that the Commission forecast a standstill on spending in the milk sector, relying chiefly on the Council's commitment to introduce a super levy on milk if production continues to increase. It is likely that other member states, notably Germany, will try to cut other items in the Budget because of the imminence of the 1% ceiling. We must ensure that they do not in the process reduce the provision for the UK's budget refund, which is one of the explanations for the high rate of increase in the 1981 draft Budget. It represents 7.7% of the total Budget. Without our refund, the increase over 1980 would be only about 20% and not 28%.

4. Given the limited headroom, any proposals from the Parliament for additional expenditure could result in the 1% ceiling becoming a constraint on the size of the 1981 Budget. But on balance it is unlikely that proposals which would take the Community over the 1% ceiling will be made in the negotiations on the 1981 Budget or that, if they were made, a majority of the Council would support them. This does not, however, exclude the possibility that the Community might come up against the 1% ceiling during 1981 through a miscalculation of the expenditure implications of its agreed Budget.

The growth of own resources in 1981 and 1982

5. The yield of own resources within the 1% ceiling will reflect the recession in Community economies in this period: the Community VAT base is likely to grow by only 10% a year in cash terms, the yield from import duties by about 7% a year, and agricultural levies by about 5% a year. Taking these trends together, we expect own resources within the 1% ceiling to grow by about 8-9% a year.

6. Assuming that the yield of own resources in 1982 were 22,200 MEUA (ie the Treasury PES forecast), the headroom or shortfall would depend almost entirely on what assumption is made about the rate of growth of CAP expenditure. For there to be any headroom at all in 1982, its rate of growth would have to be approximately halved, whereas if past trends continued there would be a shortfall of possibly some 4,500 MEUA.

/Growth

Growth and domestic public expenditure in the Community

7. The Treasury do not expect Community GDP to grow by more than 1½-2% in real terms a year in 1980-82, compared with the 1973-79 average of 2½-3%. Unemployment will rise, and the Commission estimates that real earnings per head in the Community will grow on average by only ½-1% in the years 1980 and 1981, compared with an average annual increase of about 3% between 1973 and 1979. The Commission further expects that the average annual growth of government expenditure in member states will slow to about 12½% nominal between 1979 and 1981, compared to an average annual rate of some 15% between 1973 and 1979. The rate of growth of Community expenditure has also tended to slow down, but it has still been growing faster than national expenditure. This is mainly due to the growth in the cost of the CAP (although there has also been some substitution of domestic by Community expenditure as a result of the development of the Social and Regional Funds). Thus, if the member states were to exercise the same restraint on the Community Budget as on national public expenditure, this would create major difficulties for the farming community, since it will involve a sharp reduction in the rate of growth of total public expenditure (Community plus national) on agriculture.

Implications for agricultural policy

8. The general slowing-down in the economies of the member states is likely to affect their attitudes to CAP expenditure. The recent rate of growth of 23% in Guarantee Section expenditure posed few problems for our partners so long as their economies were growing reasonably fast and a major and increasing share of the cost was borne by the UK. But with the recession biting, total own resources growing at only 8-9%, and the redistribution of the budgetary burden following the 30 May agreement, this high rate of growth may not be tolerated in the future. The recession could also be expected to inhibit governments from transferring more of the cost of the CAP from the Budget to consumers.

9. At the same time a sharp fall in the rate of growth of CAP expenditure would cause problems for the farming communities and for governments that have traditionally been concerned to keep up farm incomes. Even the rate of growth in the late 1970s failed to prevent the increase in real income per head in farming falling behind the increase in income per head of the

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Community economies as a whole. Moreover, any further movement off the land into cities by marginal farmers will be unwelcome, since it will add to the problems of urban unemployment. Governments are likely to face this dilemma in an especially acute form when it comes to the 1981 CAP price fixing.

THE TIMING OF COMMUNITY DECISIONS

10. We now have an indication of how the present Commission propose to put in hand the mandate under the 30 May agreement to produce proposals by June 1981 on the development of Community policies to achieve restructuring. The present Commission does not intend to leave all the work to its successor, although it is clear that the making of proposals will be left to the new Commission under Mr Thorn. A group of Commissioners has been set up and will have its first meeting on 4 September. The whole Commission will then have a brainstorming section on 11/12 October. Given the widely differing interests and views of member states, what the Commission does will be of considerable importance; we shall attempt to influence the Commission's work through our normal informal contacts.

11. Normally, the Commission would make its agricultural price proposals before the end of the year, but with the change in Commission this may be left until the beginning of 1981. However, the present Commission may make some suggestions in the Autumn designed to show how CAP economies can be made. The French will be anxious to give farmers price increases before their elections in May 1981. The 1 per cent ceiling could therefore emerge as a substantive and critical issue in this context. Chancellor Schmidt's and President Giscard's resolve to remain within the 1% ceiling will be tested against the pressures exerted by their domestic agricultural lobbies, who will be affected by the factors mentioned in paragraph 9 above. Even if efforts are made to accommodate price increases with the 1% ceiling for 1981, the agricultural price fixing will seriously affect the preparation of the draft 1982 Community Budget. This will be under consideration at about the time that the Commission proposals are due under the 30 May restructuring mandate. This sequence of events suggests that the intense negotiating activity over the 1981 CAP price-fixing may raise, and that over 1982 Community Budget very probably will raise, some of the issues which are due to emerge from the budget restructuring review.

ACTION TO STAY BENEATH THE 1% CEILING

12. The following paragraphs do not go into depth about ways to restructure the Community Budget in the longer term so as to keep expenditure beneath the

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1% VAT ceiling, but concentrates on short-term methods. The following types of action are considered:-

(i) measures to raise revenue;

(ii) measures to postpone expenditure;

(iii) measures to reduce CAP expenditure;

(iv) measures to reduce non-CAP expenditure.

(i) Short-term Expedients to Raise Revenue

13. Increases in customs duties and levies. Article 28 of the Treaty provides for the possibility of a temporary increase in customs duties. But in most cases the compensation for third countries required under the GATT rules would offset any revenue benefit. The few exceptions would yield only a small increase in revenue, so this route is unlikely to be pursued. The same is broadly true of increase in agricultural levies (other than those which would follow from any decision to raise agricultural prices).

14. Advances. Article 10.2 of the Own Resources Regulation 2891/77 authorises the Commission to invite member states to advance the payment of own resources, other than VAT, by one month to meet a revenue deficiency but not an expenditure over-run. At present levels of payment, this would bring forward by one month some 700 MEUA of revenue. Although the process could be repeated, so that payments of customs duties and agricultural levies were always running one month ahead of schedule, the benefit would be once-for-all. We shall need to examine the Commission's estimates to see whether they have deliberately over-stated the likely yield of own resources in 1981 so as to be able to claim advances as a way of financing a higher rate of expenditure in that year.

15. Borrowing. Under Article 12 of Regulation 2891/77, the Commission have what is in effect an overdraft facility: if their cash needs to meet expenditure approved in the Budget exceed the amounts in their accounts with member states, they may draw more than their current balance in proportion to each member state's average contribution share. The provision was included in the Regulation to cater for a short-term revenue shortfall and we do not believe that it could be used to enable the Commission to borrow to finance excessive expenditure.

16. More generally, the Commission have no powers to borrow from the market to balance the Budget, nor the Community to create own resources other than under the Article 201 procedures, which require ratification in each of the member states.

/Postponement

(ii) Postponement of Expenditure

17. The Community has obligations, which could not be postponed, to pay the staff of the institutions. It also has contractual obligations, which could probably not be deferred, on things such as rent and insurances. On other administrative expenditure, the Commission could delay entering into new commitments and, to some extent, slow down its rate of payments, at least temporarily.

18. However, these are small items compared with agricultural expenditure under the FEOGA Guarantee Section. Short-term savings eg by cutting the rates of export restitutions are within the Commission's competence through the Management Committee procedures. But this would tend to drive more goods into intervention and add to the budgetary costs of disposal in the following year (this is considered in more detail in paragraphs 22 and 23 below). There are legally binding commitments under the Community's structural funds (the Regional Development Fund, Social Fund, CAP Guidance Section and funds for aid to developing countries). In these areas appropriations in the Budget of a particular year normally go to finance expenditure late in the year, or are carried forward to finance expenditure in the following year. If the Commission knew that they were likely to run short of funds, they could defer virtually all the payments to which they were committed in these fields, amounting in the 1980 Budget to some 1,100 MEUA (approximately £670 million) and transfer this sum to FEOGA. Because the commitment to payment at some future date would remain, the transfer is likely to be criticised as inappropriate. Because it would involve a transfer from non-obligatory to obligatory expenditure the agreement of the European Parliament would be essential. The Commission cannot therefore rely on such a solution to prevent the exhaustion of money for FEOGA.

19. Such transfers would significantly increase the UK's unadjusted net contribution in the year in which they took place because they would move expenditure from schemes from which we benefit substantially to the CAP. However, in subsequent years, they would reduce our net contribution as the deferred payments were made. Whether or not this would be in the UK's interest would depend on:-

(i) the Community's willingness to implement the 30 May agreement in full and to compensate the UK through its special refund for its increased net contribution;

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(ii) the availability of funds in later years to make good the deferred payments; and

(iii) any impact that the reduction in the UK's unadjusted contributions in future years might have on the outcome of the review of the Community's policies and budgetary arrangements.

(iii) Short-term Action to Reduce CAP Expenditure

20. The following measures could all be used to meet a short-term crisis, though most also have important long-term implications and need accordingly to be assessed with those implications in mind. Some of them (eg increases in co-responsibility levies, the planned introduction of national financing) would require a decision of the Council of Ministers, others (ie those described in paragraphs 22 and 23) could be taken by the Commission. If measures of the first kind are sought, the ability to block them in the Council would give us leverage. Commission action would require prior discussion in a Management Committee composed of representatives of the member states. But it is not possible to block action proposed by the Commission in Management Committee unless a qualified majority of member states is opposed to it; and even then the Commission may report the matter to the Council and proceed unless the Council takes a different decision within one month.

21. The main possibilities for achieving a sizeable short-term effect on the budgetary cost of the CAP are:-

(a) further co-responsibility levies - which the Germans in particular favour - would not be acceptable to us if accompanied by price increases as in the past or if they discriminated against the UK more than the present co-responsibility levy on milk. In considering any proposals to raise more revenue from this source we would need to be satisfied that not only the Budgetary implications but also the resource implications were acceptable. These will be examined in a later paper. This leaves

(b) action by the Commission to influence the timing and level of expenditure;

(c) national financing.

22. Action by the Commission to Effect CAP Economies. Most CAP expenditure is incurred in the day-to-day market management for the main northern products and significant savings could accordingly be sought in the same area. But the Commission are constrained by the need to avoid a cutback in one item which simply leads to increased expenditure in a different form. This applies most

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obviously to subsidies for surplus disposal, whether by export to third countries or internally. If these are reduced beyond a certain point, goods will be driven into intervention and, although the expense (other than for financing and storage) will initially fall upon the member states, the stocks will eventually have to be disposed of at the expense of the Community.

23. If cuts in subsidies were not to lead to a build-up of intervention stocks, the cuts would need to be accompanied by measures to make intervention less attractive, which in turn implies a weakening in support for producers. This would be feasible, though it would be strongly opposed by several member states. One way would be to delay payment for sales into intervention, along lines recently introduced by the Commission for the milk sector. The effect would be to reduce the financing costs falling on FEOGA and, more important, to discourage offers. It would be possible to go further and pay for purchases only when the produce was actually sold out of intervention again. This would automatically become a greater deterrent if stocks increased and the element of uncertainty would also discourage traders. Other ways in which the Commission could discourage intervention would be to insist on higher quality standards; to restrict the form in which produce could be offered; to reduce the number of points where delivery would be accepted; and to reduce Community finance for storage to member states.

24. National Financing. National financing could come about because the Commission had run out of money. If national funds were to be used in these circumstances, it would amount to the *de facto* introduction of a form of national financing. Whether or not this would be legal relates to the question which Chancellor Schmidt raised about whether persons in member states who have claims on the CAP could enforce them against national Governments if Community funds had run out. The Commission believe it would not be within Community law to meet claims out of national funds. A separate note on this issue, incorporating the considered advice of the legal advisers to the Departments concerned, will be submitted later. But there is no doubt that individual member states would come under compelling pressures from persons who had claims outstanding, to meet these. This would put national Finance Ministries in an extremely awkward position because they would have no internal budgetary provision for making such payments. This would create a situation in which the Council would at least try to agree on a positive decision rather than allow the haphazard introduction of some form of national financing in each member state. The most obvious approach would be for the Community to reimburse member states for CAP expenditure at some rate less than the present 100 per cent so that

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national funds would automatically bear a proportion of the total cost.

25. Partial national financing would be likely to be to our advantage as compared with the same volume of expenditure being funded wholly through the budget, though the benefit might be subject to reduction because of the risk-sharing formula under the Budget settlement. However, national financing of part of the cost where it fell would create an incentive for the net exporting countries to export their surpluses to other member states, and this might be disadvantageous to the UK, and more particularly, to Germany. Other forms of national financing are also under consideration.

(iv) Expenditure Reductions Outside the CAP

26. It is likely that some other member states would want the economies to fall on other Communities' expenditures rather than on the CAP. This would not suit us. Our first priority would be to safeguard our refund under the 30 May agreement. Subject to that, we should also want to resist cutbacks in Regional and Social Fund expenditure, since they could prejudice our future receipts from Community policies and would not square with our long-term policy of reducing the proportion of the Community Budget spent on agriculture.

CONCLUSIONS

27. The provisional conclusions emerging from this interim report are that:-

(i) It is likely that the 1981 Community Budget can be adopted within the 1% ceiling although the possibility of reaching it during 1981 because of an over-run on expenditure cannot be ruled out. The ceiling will however exert an influence on the 1981-82 agricultural price-fixing, and very probably be a constraint in the preparation of the Community Budget for 1982;

(ii) The period of negotiation will begin in the autumn as member states attempt to influence the Commission in the execution of their mandate on restructuring. It will intensify from the spring of 1981 onwards as the 1981-82 CAP price-fixing discussions come to a head, and when the Commission produce their proposals for the 1982 Community Budget and for restructuring; all three subjects could become linked. In this period we may be faced with decisions whether to accept possibly unwelcome expedients in order to defer the onset of the ceiling or whether to reject them, the sooner to exploit the leverage which the ceiling offers;

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(iii) The slower rate of economic growth in the Community will limit the growth in Own Resources over the next few years. The scope for raising extra revenue or postponing Community expenditure is probably not great enough to allow the 1982 Budget to be adopted within the 1 per cent ceiling unless major reductions in the growth of Community financed CAP expenditure are achieved.

(iv) From the UK's point of view it is important that any short-term action to cut the cost of the CAP is consistent with our longer-term objectives for CAP prices. Of the possible measures, the introduction of an element of national financing and action to cut subsidies and make intervention less attractive, would suit us best.

(v) In considering possible cuts in expenditure in the 1981 and 1982 Budgets, we should give first priority to cuts in agricultural expenditure. Only if it were necessary to protect our Budget refund, would we accept cuts in the Regional and Social Funds. We would not accept a cut in our Budget refund.

These conclusions must remain provisional until our longer-term objectives have been established by Ministers on the basis of studies yet to be completed.

Cabinet Office
31 July 1980