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Ref. A04065

Prime Minister

MR ALEXANDER

The other document is clearer on the two approaches, although some of the phrases are somewhat "distributedly" mixed.

① Agree proper report at Flag B? Yes
② Agree 'non-paper' for transmission to Mr Hiss? Yes

Community Budget Restructuring: Progress Report
The Foreign and Commonwealth Secretary has minuted the Prime Minister enclosing a report by officials on the present state of discussions. He suggests that the paper should be circulated to OD for information. The Prime Minister herself will have the opportunity shortly to consider the line she should take on this subject when she visits Mr van Agt on 6 February. She may therefore wish to indicate that she is content for the report to be circulated to OD. Our latest intelligence is that M Thorn has in mind to make an oral progress report to the European Council in March, but it will probably be only at the June European Council, when the Commission has made its formal proposals and after the French elections, that substantive discussion can begin. We understand informally that the Commission may look at some form of national financing of the CAP as an alternative to an overall budget corrective mechanism.

2. The report by officials suggests that we should now explore some ideas for corrective mechanisms with the Germans and the Commission. So far as the Germans are concerned, the Prime Minister will recall that Chancellor Schmidt made it clear that he has by no means dropped the idea of limits on net contributions and benefits and, at the last meeting which Mr Franklin had with the Chancellor's representative, Dr Hiss, it was agreed that Mr Franklin would produce a "non-paper" on the subject as the basis for their next meeting in early February. I attach the draft of such a paper which, if the Prime Minister approves, Mr Franklin would send to Dr Hiss - who in return has promised a paper on reform of the CAP. It looks as though this channel may be the best way to explore German thinking, since neither the German Foreign Ministry nor the Ministry of Finance has shown much response to tentative approaches from our side.

ROBERT ARMSTRONG
(approved by Sir R. Armstrong and signed on his behalf)

23 January 1981

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COMMUNITY BUDGET RESTRUCTURING

1. Reform of the Common Agricultural Policy and a consequent reduction in the proportion of the Community Budget devoted to agriculture are necessary in their own right if the European Community is to develop and prosper. They will also contribute to improving the 'structure' of the Community Budget. But they are unlikely to go far enough or fast enough to result in a tolerable budget position for all Member States.

2. The development of non-agricultural Community spending policies will also help to improve the general 'structure' of the budget and could help towards making the budget position of individual countries more tolerable; but the massive increase in non-agricultural expenditure which would be required to remove the imbalance resulting from the present pattern of budget expenditure is ruled out by the limit on "own resources" which the United Kingdom and the Federal German Government as well as the French Government wish to maintain.

3. The further enlargement of the Community to include Spain and Portugal will, on present policies, lead to significantly increased financial commitments and will make the budget position of certain Member States even less tolerable. Given the firm commitment of all Member States to such an enlargement, this element too needs to be taken into consideration in the current review of the Community's policies and of its budgetary arrangements.

4. The unacceptable nature of the budgetary burden on the United Kingdom was recognised in the agreement of 30 May and led to the undertaking to find a permanent solution and the mandate to the Commission. The mandate rightly refers to the need to avoid an unacceptable situation for "any Member State". The Community needs to find a lasting solution which is fair to all members and ensure that no member state is asked to bear an unfair burden after enlargement. We assume that that was the thinking behind the statements of Chancellor Schmidt, confirmed at the last meeting with Mrs Thatcher, that the solution should include some limit on net contributions and, as a consequence, on net benefits also.

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5. If it were agreed to pursue such an approach, two questions arise

(i) what should be the rationale on which such an approach should be based?

(ii) how could it be given practical expression?

6. The Community decided in 1970 on a system of 'own resources' which finances a series of separate expenditure policies, decisions on which have been taken without giving any conscious attention, at least until recently, to their overall distributional consequences. The outcome was that one of the less prosperous Member States (United Kingdom) was asked to bear an unacceptable burden while some of the more prosperous Member States (Denmark, Benelux) have been large net beneficiaries. The restructuring exercise creates an opportunity to ensure that in future, the overall distributive effect of the budget would be a matter of conscious Community policy - as it is at the national level - instead of being the chance outcome of the method of financing and of the combination of individual policies as at present. The nature of the redistributive policy would be a matter for discussion; but an equitable policy would necessarily take account of the need to foster greater economic convergence within the Community.

7. If it were accepted that the Community should have, even in a modest way, a redistributive fiscal policy, this could be implemented by ensuring that existing sectoral policies conformed to that objective or, if for good reasons these policies cannot be changed or changed quickly enough to bring about that effect, their budgetary outcome should be adjusted so as to do so. The two are not mutually exclusive.

8. As to the question in paragraph 5(ii), there are doubtless numerous ways to give such a rationale practical expression. For instance, one approach might be to draw up a hypothetical "objective" distribution of net contributions and net benefits among Member States arrived at on the basis of relative prosperity and size; agree that the Community should aim to develop its expenditure policies over time to achieve that distribution; and in the meantime apply a system of temporary financial adjustments which would progressively fill the gap between the actual net budget contribution or benefit for each Member State and the objective distribution.

Work-
work.



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9. Another approach would be to distinguish between those items of Community expenditure like the Regional and Social Funds and CAP structural expenditure which are intended to promote convergence) and those like CAP guarantee expenditure and administrative costs which have large, but often perverse, transfer effects between Member States that are not part of the object of the policy itself. This could be reflected in a "dual budget", the "structural" part of the budget reflecting a deliberate decision as to the size of budgetary transfers to be made by the more prosperous Member States to the less prosperous in order to help convergence, and the "central" part of the budget being made distributionally neutral between Member States through a clearing account which would iron out net benefits and contributions without changing the policies. Alternatively, without actually dividing the budget into two, the desired pattern of redistribution could be achieved by means of direct transfers.

expenditure

Would this limit the FRG net-contribution sufficiently?

10. Any such approach would need to be

- (i) compatible with the own resource system, the principles of the CAP and with the maintenance of the 1 per cent VAT ceiling;
- (ii) capable of preventing an "unacceptable budgetary situation" for any Member State;
- (iii) complementary to other efforts eg to reduce the cost of the CAP;
- (iv) capable of controlling the cost of enlargement to the existing Member States.

Cabinet Office,
London,

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