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Prime Minister
You will want to look at these papers over the next few days. I have arranged a meeting for mid-June. CDP 27/5

Treasury Chambers, Parliament Street, SW1P 3AG
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PRIME MINISTER

COMMUNITY BUDGET STRATEGY

The events of the past few weeks have removed any doubt that we shall face major and continuing problems over the Community budget right through to the Election. We need to take stock of the position and consider how best to chart our way through the reefs.

The problem is, in a nutshell, that budget discipline has failed to hold back the tide of Community expenditure. It is all but certain that from around the end of this year the Commission, the Parliament and most other Member States will be demanding an increase in the 1.4 per cent VAT ceiling, to take effect from January 1988.

The pressures for extra spending have arisen both on agriculture and on non-obligatory expenditure. On agriculture, the recent price-fixing package had, in its own terms, much to commend it. We have graduated over the past few years to price-fixing and intervention decisions which, superficially at least, are noticeably restrained. We are suffering, however, from the legacy of excessive settlements in earlier years, and the pressures on intervention spending have been intensified by an increasing excess supply of food in world markets, the exceptional devaluation of the dollar (which has further reduced world prices in ecu terms) and the recent EMS currency realignment which, together with the 1984 Agreement on MCAs and the green ecu, have given a further upward twist to expenditure.

In non-obligatory expenditure, the pressures arise from a combination of: enlargement; the vested interests of the Parliament, the Commission and the Southern Member States in increasing these categories of expenditure; the "maximum rate" provisions of the Treaty, whose practical effect is to ensure a substantial minimum rate of increase in this expenditure, year by year; and the piling up of past commitments in the structural funds now falling due for payment which the Commission and other Member States are unwilling to offset by reducing the level of the new commitments undertaken.

In the light of these pressures, we face the prospect of large overruns, this year and next, of the budget discipline limits both on agriculture and on non-obligatory expenditure. On agriculture, the overrun can perhaps be justified by reference to the "exceptional circumstance" of the large devaluation of the dollar. For non-obligatory expenditure, there is no such excuse. The extra provision which the Commission have proposed, and which the Council and Parliament are likely broadly to endorse in spite of our objections, will take the level of expenditure well above the amounts unilaterally added by the Parliament last December, whatever the outcome of the European Court case on the 1986 Budget may be.

Looking ahead, perhaps the most troublesome feature of all is that, on the Commission's latest proposals, the 1.4 per cent ceiling will only barely be respected this year and next at the cost of pushing substantial amounts of expenditure forward into later years.

The position is not totally black. The discussions I have had with colleagues in recent weeks suggest that, at least among the Northern Member States, there is some determination to maintain the 1.4 per cent ceiling, without supplementary financing through inter-governmental agreements, this year and next. The ceiling will, I think, continue to be seen as a binding constraint for the time being, even if the budget discipline arrangements are giving us precious little leverage.

The consequence of this, however, is that all in the Community who want to increase spending on agriculture, the structural funds or new policies will press hard for raising the ceiling with effect from January 1988. The Commission have now made clear that they will submit their "ex novo" review of the Fontainebleau system before the end of this year, and there can be little doubt that they will propose, inter alia, a further increase, to 1.6 per cent, with effect from 1 January 1988. Member States will certainly want to discuss the matter early in 1987, and a considerable negotiation is likely to be set in train in February, after the German election.

It is arguable that our negotiating position with regard to maintaining the 1.4 per cent ceiling will at least be stronger than last time. Whereas last time we ran the risk of receiving no abatement or refund if we did not agree to raise the ceiling, the Fontainebleau abatement system will continue in being this time unless or until we agree to change it, though tampering with our abatement by the Parliament in particular could not be excluded.

On the merits, I see no reason to raise the 1.4 per cent ceiling. On the contrary, maintaining it will be the best - and probably, indeed, the only - way to force economies in Community spending including, I would hope, some shift to national support in place of CAP spending. It would seem to me in any event politically impossible to agree to raise the ceiling before the Election.

This points in my view to the conclusion that we should camp on the 1.4 per cent ceiling for as long as practicable. It is doubful whether anything we could secure in return would be seen as justifying agreement to raise it. We shall, however, come under great pressure in the Community in the course of next year to agree to raise the ceiling. We may find ourselves in a minority of one.

We need in any case to consider how best to take matters forward and to think through the options. The attached paper by Treasury

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officials sets out some of the considerations bearing on the handling of budgetary issues over the next few months and on the 1.4 per cent ceiling. I agree with the conclusions at paragraph 42.

You may feel that it would be useful to arrange for early discussion of these problems.

I am copying this minute to Geoffrey Howe, Michael Jopling and Sir Robert Armstrong.

N.L.

21 May 1986

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COMMUNITY BUDGET STRATEGY

Annexes

Treasury Chambers
20 May 1986

COMMUNITY BUDGET STRATEGY

The UK faces more than usually intractable problems over the Community Budget, both during our Presidency and beyond. This paper and the annex discuss what the Government's broad strategy and tactics should be on the 1986 and 1987 Budgets and, more provisionally, on the 1.4 per cent VAT ceiling.

General Objectives

2. In spite of the negotiating successes of recent years, the UK remains a large net contributor to the Community Budget. Thus:

- our net payments to European Community institutions (excluding overseas aid) are expected to average some £850 million a year over the 3 financial years 1985-1986 to 1987-88;

- the annual cost to our balance of payments, after allowing for trading losses on net imports of agricultural products from the rest of the Community, is probably of the order of £1 billion a year;

- the total impact of the Community Budget on UK public expenditure, as measured by our gross contributions after abatement less savings from the non-additionality policy, is probably approaching £2½ billion a year.

This paper starts from the premise that containment and, much preferably, reduction of the net contribution, the balance of payments burden and the public expenditure burden of the Community Budget will remain key objectives of UK policy.

3. In addition to those general objectives, it is useful to distinguish some of the more important intermediate objectives for the UK, as follows:

i. maintaining the 1.4 per cent VAT ceiling during 1986 and 1987 and for as long as possible thereafter;

ii. within the 1.4 per cent ceiling, restraining both agricultura and non-obligatory expenditure in as close accordance as possible with the budget discipline agreement;

iii. changing CAP regimes so as to reduce surpluses and economic and budgetary costs;

iv. obtaining the full amounts of abatement due to us under the Fontainebleau Agreement.

4. A separate, but important, objective in the second half of this year will be to make a success of the demanding Presidency functions in relation to the Budget.

Order of Events

5. The main theatres where, initially at least, the action will take place are the ECOFIN Council, the Agriculture Council and the Budget Council. The Foreign Affairs Council is likely to take a close interest as well and, on past precedent, may take the lead if and when raising the 1.4 per cent VAT ceiling becomes a live issue.

6. So far as the order of events is concerned, two preliminary stages of the budgetary process have taken place already. First, ECOFIN has set the reference framework for 1987 in accordance with the budget discipline conclusions, subject to caveats about the Court case on the 1986 Budget, any supplementary budget which may be agreed for 1986, the so-called "cost of the past" in the structural funds and enlargement. Second, the Commission have outlined their proposals for a 1986 Supplementary Budget and for the 1987 Budget. The next major events, with possible timings, will be:

- end-June/early July (before 10 July): the European Court will give judgment on the disputed 1986 Budget.

- mid-July: the Budget Council is due to meet under the Minister of State's chairmanship to adopt a draft Supplementary Budget for 1986 and a First Reading Draft Budget for 1987, possibly with prior guidance from the June ECOFIN.

- September/October: the Parliament meets to adopt the 1986 Supplementary and to give its First Reading to the 1987 Budget.

- November: the Council gives its Second Reading to the 1987 Budget.

- December: the Parliament adopts the 1987 Budget.

If agreement within the Council or with the Parliament on the 1986 supplementary proves elusive, a further meeting of the Budget Council may be needed in September.

7. The above timetable assumes that the European Court will find in favour of the Council or the Parliament on the 1986 Budget. If the Court should find that no valid budget exists, so that the Community has to revert to a regime of 'provisional twelths' pending agreement on a valid budget, our aim as Presidency would be to secure agreement as quickly as possible, preferably in July, to a valid budget for 1986 which might either be a stop-gap budget, pending the 1986 supplementary, or subsume the required supplementary provision.

8. Later in the year, there is likely to be a crescendo of argument that the 1.4 per cent ceiling needs to be raised again. The Commission have said that, before the end of this year, they will produce the "ex novo" review of the Fontainebleau system foreshadowed in the Fontainebleau conclusions. They are likely to propose inter alia an increase in the VAT ceiling from 1.4 to 1.6 per cent from 1 January 1988. The Council is likely to begin discussion on the Commission's proposals in February, after the German election, and then to spend much of the rest of 1987 discussing the Commission's proposals.

9. A separate but related issue is CAP reform, where there may be scope for a UK Presidency initiative.

1986 Supplementary Budget and 1987 Budget

10. The supplementary budget for 1986 and the 1987 budget will present formidable problems for the UK, both nationally and as Presidency, in the second half of this year. Annex 1 discusses the prospects in some detail, together with the strategy and tactics for the UK.

11. The proposals which the Commission have put forward, and the (similar) figures which are likely to emerge, against the UK's wishes, from the budgetary processes in the Council and the Parliament, involve:

(a) using up all or virtually all the resources within the 1.4 per cent VAT ceiling both this year and next;

(b) a substantial overrun of the agricultural expenditure guideline this year (some 750 mecu), reflecting the exceptional depreciation of the dollar;

(c) substantial overruns of the budget discipline limits on non-obligatory expenditure both this year (some 2 billion ecu) and next (a further 340 mecu after building in the 1986 overrun), which the Commission justify partly by reference to enlargement but mainly by the need to pay off past commitments: this year's figure for non-obligatory expenditure, after the proposed supplementary, would be well in excess of the figure illegally adopted by the Parliament in December;

(d) substantial postponements of expenditure from 1986 (around 500 mecu on agriculture and 420 mecu on non-obligatory expenditure) and from 1987 (up to 2 billion ecu on agriculture) to later years;

(e) the danger of a delay of 1-2 years in payment of some 300 mecu of the abatement due to us in respect of 1986.

The figures are summarised in table 2.

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TABLE 2

COMMISSION PROPOSALS

	1986 Budget (after supplementary) (mecu)	1987 Budget (mecu)	Change (per cent)
Agricultural guarantee			
Guideline (EC 10)	21360	21649	+ 1.4
Enlargement	567	1312	+131
Non-obligatory	8596	9632	+12.1
Other obligatory	4602	4084	[-11]
TOTAL	32125	36677	+ 4.4

MEMORANDUM ITEMS

	1986	1987
Headroom within 1.4% ceiling		
a. 1640 mecu UK abatement in 1987	0	[303]*
b. 1950 UK abatement in 1987	0	[-144]*
Excesses over:		
c. Agricultural expenditure guideline	740	0
b. Non-obligatory expenditure guideline	2060	340

* The Commission envisage that the appropriations added by the Parliament as its "margin" (some 348 mecu) would use up this uncommitted headroom.

12. For the reasons discussed at length in annex 1, there is little prospect of obtaining a qualified majority in the enlarged Council, or agreement with the European Parliament, for figures significantly below the Commission's proposals (though it may be possible to restrain the growth of non-obligatory expenditure in 1987 to the maximum rate of increase of 8.1 per cent as against the 12.1 per cent proposed by the Commission). The budget discipline totals will be substantially exceeded this year (though it should be possible to defend the overrun on agricultural expenditure as being a consequence of the exceptional circumstance of the 25 per cent depreciation of the dollar against the ecu). Next year, both budget discipline and the 1.4 per cent ceiling will be under threat. The UK will wish to press hard at the June ECOFIN for a remit to the Commission and the Agriculture Council to identify ways of living within the agricultural expenditure guideline in 1987. The likely outcome of the budgetary process, however, is that expenditure will only just be contained within the 1.4 per cent ceiling this year and next, by means of postponing substantial amounts into 1988 and later years. The pressures on the 1.4 per cent ceiling in 1988 and after will be intensified correspondingly.

1.4 per cent VAT ceiling

13. As the above analysis implies, we are likely to find increasingly that the 1.4 per cent ceiling, rather than the budget discipline agreement, will be the effective constraint on expenditure. All those in the Community who dislike restraint on expenditure will therefore be anxious to raise the ceiling as soon as possible and in the meantime to have supplementary financing through inter-governmental agreements.

14. The Fontainebleau conclusions provide that the ceiling may be raised to 1.6 per cent on 1 January 1988 by unanimous decision of the Council and after agreement has been given in accordance with national procedures. The Commission are mandated to produce an "ex novo" review of the workings of the Fontainebleau system one year before the 1.4 per cent ceiling is reached. For some time now, they have clearly been preparing the way for proposing an increase in the ceiling from 1 January 1988, and the Budget Commissioner, Mr Christophersen, has recently confirmed that the Commission will indeed produce their "ex novo" review before the end of this year, with a view to raising the ceiling from 1 January 1988.

15. When once the Commission have published this review and their proposals on the VAT ceiling, the Council will certainly want to discuss them. These discussions will probably begin in earnest in February 1987, after the German election. A considerable negotiation over the 1.4 per cent ceiling and related matters during 1987 seems unavoidable.

16. Present indications are that a large majority of member states will support the case for raising the ceiling. Certainly the Italians, Greeks and Irish will do so from the outset. The Spanish and Portuguese are likely to join them. Belgium and Denmark will probably be concerned to see that adequate provision is available for agriculture. The Netherlands will probably resist an increase or claim an open mind initially but then switch to supporting one on general Community grounds. Germany and France, too, may well resist an increase initially but then go along with one if they think (as they probably will) that extra resources wil be needed for agriculture. Their preferred route would be to hold down expenditure on the structural funds, to which they are net contributors. But the ratchet effect of the Parliament's powers under the "maximum rate" provisions of the Treaty precludes this.

17. The UK will doubtless wish to resist any suggestion that discussions on this matter should begin during the current year. If however discussions do begin, as seems inevitable, early in 1987, it would be extremely difficult to pursue an empty chair policy: we shall have in practice to participate.

18. In the view of officials, the right line for the UK to take, in the early stages of the negotiation at least, must be to "camp" on the 1.4 per cent ceiling. The French or Germans may well decide to take a similar line initially. In that case, it should be posssible to "camp" without too much difficulty for several months.

19. Initially at least, we shall be able to argue convincingly, with considerable help from the Commission's own recent paper, "financial perspectives, 1987-90", that there is no need to raise the ceiling. We shall be able to point out that, on the contrary, the present ceiling provides the Community with just the budgetary

discipline which it so badly needs. If the will is there, we can argue, the Community can manage perfectly well within the existing ceiling.

20. In April/May 1987, the Commission will concentrate minds by publishing a preliminary draft budget for 1988 which is virtually certain to provide for expenditure substantially in excess of the 1.4 per cent ceiling. They will want to provide not just for current pressures but also for expenditure postponed from 1986 and 1987 (see above). Any member states who have previously opposed raising the ceiling may well conclude at that stage that the writing is on the wall. The extent of the pressures to raise the ceiling will depend in considerable part on developments in world agricultural markets. If world prices rise, the situation may be more manageable. If prices remain at present levels or fall further, it will then be the more likely that France and Germany will switch their support to raising the ceiling.

21. If that happens, the UK may well find itself by the summer of 1987 in a minority of one in wishing to adhere to the 1.4 per cent ceiling. The question which Ministers would need to address then is whether to continue camping on the 1.4 per cent ceiling or whether there are any worthwhile quids pro quo which we might realistically obtain in return for agreeing to raise it.

22. The option of continuing to "camp" on the ceiling, even if we are in a minority of one, clearly has great attractions. An early concession by the UK on this occasion would encourage the big spender member states to conclude that the new ceiling would likewise be capable of being raised without undue difficulty and need not therefore be regarded as more than a temporary obstacle to the fulfilment of their ambitions. Retention of the present ceiling, on the other hand, would arguably be a good outcome for the Community as well the UK: there is, in truth, no good reason why the Community should have more revenue. Retention of the ceiling would be far more effective than any alternative form of budget discipline. It could help to promote some transfer of the financing of agricultural expenditure from the Community budget to member states. There would also be substantial support

domestically for continuation of the "camping" option and probably considerable difficulty in securing Parliamentary approval for an increase in the ceiling.

23. In terms of public expenditure, too, there are strong arguments for keeping the 1.4 per cent ceiling if we possibly can. If we assume that the 66 per cent Fontainebleau abatement would remain intact, and that the extra spending of some £2.5 billion made possible by a move to 1.6 per cent would be divided between agriculture and non-obligatory expenditure in the same proportions as now, with the UK's percentage shares of the programmes remaining constant, an increase in the VAT ceiling to 1.6 per cent would raise our net contribution after abatement by something of the order of £65-70 million a year from the very high level which it has reached already (see paragraph 2 above). The total increase in public expenditure would be substantially greater than this - of the order of £240 million a year on the assumptions made above. The total effect on public expenditure has to take account not just of the increase in our net contribution to the rest of the Community but also of the extra agricultural market support expenditure in the UK itself: this adds to public expenditure whether it is financed directly by the UK or indirectly through the Community budget.

24. In one important respect, the UK's negotiating position will be stronger than it was last time round. Last time, we risked having no budget refunds if we declined to raise the 1 per cent ceiling. This time, the Fontainebleau abatement continues unless and until we (and others) agree to change it, though the Council and the Parliament could both be tempted to tamper with it.

25. It has, however, to be recognised that the pressures on the UK inside the Community to concede an increase in the 1.4 per cent ceiling will be severe. If we are in a minority of one, we should incur great hostility for disrupting the Community and standing in the way of progress. The longer we maintained our position, moreover, the more serious such hostility would become, and the more public attention the whole dispute would attract. Some member states, and possibly the Commission as well, would seek to argue that the Community was being prevented from

carrying out its legal obligations with regard to agricultural expenditure and commitments undertaken in the structural funds. They might threaten an IGA à onze in order to deal with the problem. A further difficulty is that the maximum rate of increase in non-obligatory expenditure laid down in the Treaty tends to exceed the rate of growth of own resources. Hence we might find that there was not enough room inside the ceiling to accommodate the maximum rate of increase in this expenditure as well as the requirements of agricultural expenditure and our abatement. In such circumstances the Parliament and others would claim once again that the Community was in breach of the Treaty. The more acrimonious the dispute became, the more likely it would become that the Commission, the Council or the Parliament would increase the pressures by finding ways of discriminating against the UK in expenditure policies or tampering with the abatement.

26. The likelihood of such pressures underlines the case for thinking ahead. If pressures did mount in the way suggested, Ministers might at some stage feel obliged to consider the possibilities for changing the UK's posture. It would, however, be difficult, not least in terms of public presentation, to concede an increase in the ceiling without obtaining something valuable in return. Ministers would need therefore to consider whether, realistically, there existed any quids pro quo which might justify a concession on the ceiling. The two main areas where quids pro quo might be sought, in principle at least, are (a) amendment of the budgetary articles of the Treaty to strengthen the hands of the moderates in the Community against the big spenders and possibly to incorporate some elements of budget discipline, and (b) more effective protection of the UK's net budgetary position.

27. Taking these in order, the prospects for obtaining agreement to Treaty amendment will depend importantly on the Court's judgment on the 1986 budget. If this is unsatisfactory from the Council's point of view, the Northern member states in particular might well insist on Treaty amendment to ensure that, in the event of a future dispute between the Council and the Parliament on the amount of non-obligatory expenditure, the lower bidder must win. The UK would like in addition to see other changes designed to strengthen the position of moderate spenders in the Council

against the big spenders, and of the Council against the Parliament, mitigate the ratchet effect of the "maximum rate" provisions of the Treaty, and give Treaty embodiment to some elements at least of budget discipline. Realistically, however, we could not hope to obtain agreement to changes such as these unless at least some other member states were on our side.

28. Within the possible changes mentioned above, those designed to alter the balance of power between the moderates and the large spenders would represent a greater prize than incorporating some of the budget discipline agreement in the Treaty. It would not in practice be possible to incorporate the Council's budget discipline conclusions on non-obligatory expenditure in the Treaty, since these are no more than a set of principles for the Council's own guidance in its dealings with the Parliament. Incorporation of the agriculture guideline would be rather more useful. But the provision for "exceptional circumstances" would inevitably remain, and might even be reinforced, in any Treaty text; and this would continue to provide a convenient loophole for the big agricultural spenders to exploit.

29. So far as the UK's net budgetary position is concerned, a natural line for the UK would be to argue that our public expenditure and balance of payments burdens in the Community were already as much as we could afford, or more, and that we would have therefore to look to the Community to ensure that the increase in the 1.4 per cent ceiling did not further worsen our net budgetary position.

30. There are various ways in which such a result might be achieved. The simplest (though as a tactical matter we might well prefer not to raise this ourselves, certainly at the outset) would be to raise our VAT abatement percentage from the present 66 per cent of our VAT/expenditure gap to a higher figure. The Community might be willing to offer us something in this area. The UK could reasonably argue, at the appropriate time, that, since Fontainebleau, and despite the brave words in the Fontainebleau conclusions about correcting imbalances on the expenditure side of the budget, the UK's shares of all the main programmes of the Community - agricultural guarantee expenditure and the structural funds

- have fallen sharply. The proposed increase in the VAT ceiling would add substantially to the imbalance. Our calculations suggest that, to offset these two features, and restore the position on our VAT/expenditure gap as envisaged at Fontainebleau, our rate of abatement would need to rise from 66 per cent to something in the region of 70-75 per cent. An improvement of this kind would be unlikely to cover the full public expenditure costs of raising the ceiling (see paragraph 23 above) but would be a valuable, bankable and visible quid pro quo.

31. A possible complication is that re-opening of the Fontainebleau formula might lead to demands for changes which would disadvantage the UK. In particular, the Germans might be prompted to ask for an abatement as well. If we had to contribute to this, the costs to the UK could be considerable. On balance, however, we do not see major risks in this area. So far as general re-opening of the formula is concerned, the UK would not, presumably, agree to any change which disadvantaged us: the other member states would hardly expect this of us. As regards a possible German abatement, the main point is that, ex hypothesi, the context would be one where the Germans wanted an increase in the ceiling. They would not be in a position, therefore, to demand an abatement as well. Certainly the other member states would fiercely reject any such demand, especially when Germany's balance of payments surplus is as large as it now is. The Germans might fall back on seeking more generous relief from their contribution to our abatement. But any change which they secured would probably be relatively minor. A subsidiary point is that if, against all the expectations, the Germans did succeed in securing an abatement for themselves, there would be no technical problem about ensuring that the UK did not contribute to it, though the French and others would naturally be loud in protest.

32. A related issue is whether, in the scenario envisaged, the UK would want a limited negotiation, designed to produce minimal changes in the Fontainebleau system apart from raising the ceiling from 1.4 per cent to 1.6 per cent, or a more wide-ranging negotiation, possibly including re-examination of the UK's earlier ideas for reforming the Community budget, as set out by Sir Geoffrey Howe in the Hague Speech of 1981 and in the UK's papers on the "safety

net" in 1983. There must be considerable doubts about whether the Community would be ready to agree on radical reforms at this stage. On the other hand, the Commission are known to favour a broader rather than a narrower negotiation. They may well propose more far-reaching reforms (and higher figures than 1.6). Their porposals are likely strongly to influence the subsequent negotiation.

33. Another related question is whether the UK would prefer the negotiation to be short and quiet or long and noisy. We may well not in practice be in a position to determine which course the negotiation takes. That said, there would clearly be considerable attraction in a short negotiation which did not excite too much publicity. On the other hand, there are excellent reasons for "camping" on the 1.4 per cent ceiling for a substantial period, at least; and this in itself will lead to an enhanced public profile. This posture having been taken, moreover, it would be the more difficult for the UK to concede an increase in the ceiling without significant quids pro quo; and these would in practice not be likely to be achieved without substantial negotiation and argument.

34. It is too early to reach firm conclusions now on these questions. What does seem clear is that, for the forseeable future at least, the best posture for the UK will continue to be to reaffirm that we see no case for increasing the VAT ceiling again: the Fontainebleau agreement includes no provision for reviewing the ceiling before 1988, and there will be no increase in 1988 or thereafter save by unanimous agreement of the Governments of member states and their Parliaments.

Longer-term perspective

35. A fundamental question which arises on the preceding discussion is how the upward surge of expenditure can be stopped in the longer term. If the VAT ceiling were raised to 1.6 per cent, how long would it last? Will the Community not simply expand its expenditure to use up all the resources available, whatever the ceiling may be, and then demand still further increases? Where will it all stop?

36. There are perhaps two ways in which the leviathan of Community expenditure might be brought under control. One would be to remove the motivation which member states now have for increasing expenditure. The problem at present is that member states who receive back from any increase in Community expenditure programmes significantly more than they put in have a strong incentive to expand the budget. A simple solution would be to introduce a system on the lines sketched in Sir Geoffrey Howe's Hague speech of 1981, whereby the net contributions and receipts of member states would be deliberatel decided and fixed on the basis of national incomes and relative prosperity. Under such a system, member states would have to bear the costs of increases in Community expenditure themselves. No other change would be likely to dampen the ardour of the big budget proponents so effectively. A second possibility would be to change the budgetary provisions of the Treaty, as discussed earlier, so as to enable the more moderate member states to insist on strict control of the budget both inside the Council and in the annual negotiations with the Parliament.

37. In the fullness of time, the Community may well be obliged by circumstances to adopt a new budgetary system on the lines of the Hague speech, and the net contributor member states may be able to insist at some point on desirable Treaty changes of the kind suggested. There seems little prospect, however, of obtaining agreement to either of these changes in the forthcoming negotiation.

ECOFIN and CAP reform

38. The budgetary troubles discussed in this paper result in large part, though by no means entirely, from the problems of CAP expenditure. There is also widespread argreement that reform of the CAP is needed in its own right. It is for consideration, therefore, whether there is anything the UK could usefully do during the Presidency to pave the way for such reform and in particular to ameliorate the budgetary and financial impact of the CAP.

39. One possibility which Ministers may like to consider is whether to use our Presidency role to arrange for a wide ranging discussion of the CAP in ECOFIN, perhaps in October, with a view

to ECOFIN commissioning from the Community's Economic Policy Committee an economic study of the CAP, with special reference to the recent Commission Green Paper and ways of achieving the best possible value for money.

40. The Economic Policy Committee includes senior economists from the Finance Ministries of member states. Our judgement is that it should be easier to persuade the ECOFIN Council to commission such a study from this Committee than from some new and separate high level group.

41. There could, of course, be no guarantee that such an initiative would produce anything of particular value, and it would be important to consult informally in advance with key delegations and people before launching it. In the shorter term, however, there could be advantage for Ministers during the Presidency in being seen to be doing something about the CAP.

Conclusion

42. The purpose of this paper, and of the fuller discussion of the 1986 and 1987 budgets in annex 1, has been to discuss the UK's broad strategy and tactics with regard to the Community budget and the 1.4 per cent VAT ceiling over the rest of this year and beyond. Ministers may wish to consider whether they endorse the broad conclusions reached in the paper and in annex 1, which may be briefly summarised as follows:

i. General: the broad aim should be to maximise the chances of containing expenditure within the 1.4 per cent ceiling, both in 1986 and 1987 and beyond, and to stick as closely as possible to the budget discipline rules within the ceiling.

ii. ECOFIN remit: to this end, we should seek to persuade the ECOFIN Council in June to invite the Commission and Agriculture Council as a matter of urgency to identify the savings which are needed to enable the Community to live within the agricultural expenditure guideline in 1987.

iii. 1986 supplementary budget: the objective should be to secure full provision for the supplement to our abatement; to ensure that excesses over the agricultural expenditure guideline can be convincingly justified by reference to the abnormal depreciation of the dollar; and to support France and Germany in their efforts to prune the Commission's proposals on non-obligatory expenditure; while recognising as Presidency that only a supplementary budget on the lines proposed by the Commission, which uses up nearly all the remaining headroom within the 1.4 per cent ceiling, is likely in practice to command a qualified majority in the Council and approval by the Parliament.

iv. 1987 budget: we need to do all we can to steer the Budget Council towards a budget for 1987 which respects budgetary discipline on agriculture and non-obligatory expenditure and leaves a margin for contingencies within the 1.4 per cent ceiling.

v. 1.4 per cent ceiling: the UK should maintain for the foreseeable future the present line that we see no case for raising the ceiling: the Fontainebleau Agreement makes no provision for reviewing the ceiling for 1986 or 1987, and it can be raised in 1988 or subsequently only by the unanimous agreement of Member States and their Parliaments.

vi. CAP reform: we should seek to persuade ECOFIN during our Presidency to commission from the Community's Economic Policy Committee a substantial economic study of CAP spending, with special reference to the Commission's Green Paper and the need to maximise value for money.

EC Group, HM Treasury
20 May 1986

ANNEX 1

1986 SUPPLEMENTARY BUDGET AND 1987 BUDGET

1. This annex oulines the Commission's proposals for the 1986 Supplementary Budget and the 1987 Budget and discusses what the UK's strategy and tactics should be, both nationally and as Presidency.

1986 Budget: Commission's proposals

2. The Commission have said that their supplementary budget proposals will use up all the headroom that remains this year within the 1.4 per cent ceiling - some 3100 mecu on the basis of the Council's second reading budget and some 2500 mecu on the basis of the Parliament' adopted budget, which the Commission are taking as their starting point. Their proposals are:

TABLE 1

	payment appropriations mecu
UK abatement (expenditure equivalent)	707
Agriculture	915
Structural funds	750
Refunds to Spain and Portugal	145
TOTAL (rounded)	2,500

3. Taking these items in turn, the ECOFIN Council committed itself last October to correcting the UK's 1985 abatement in a supplementary budget this year, in the light of the latest budgetary information on expenditure as well as VAT payments. We estimate that the extra sum due to us is some 500 mecu. The Commission have accepted this. Since we do not contribute to our own abatement and the Germans contribute only two-thirds of their normal share, our abatement raises the highest rates of VAT (paid by other Member States) by more than a corresponding amount of normal expenditure would do and thus uses up more headroom within the 1.4 per cent ceiling. An additional 500 mecu for the UK uses up rather over 700 mecu within the ceiling, the multiple being about 1.4 (sic).

4. On agricultural guarantee expenditure, the Commission estimated earlier in the year that additional needs this year, almost entirely on account of the depreciation of the dollar, would be 790 mecu. The decline in the dollar will increase CAP spending by raising export restitutions. These basically bridge the gap between EEC prices and export prices in world markets. Since many commodities are traded in dollars (eg cereals), the decline in the dollar has led to a fall in world prices in ecu terms, and has therefore increased the level of export restitutions. In addition, some commodities (oil seeds, protein crops and cotton) are subsidised by EEC production aids linked to world prices. The effect of the dollar depreciation on these aids is much the same as on export restitutions.

5. The latest Commission estimate is that expenditure requirements will increase by 900 mecu in 1986 if the exchange rate settles at $1 = 1.10 ecu for 1986 as a whole, and by a further 650 mecu, if it stabilises at $1 = 1.02 ecu.

6. The Commission estimate that the EMS realignment will increase expenditure on the CAP by up to 388 mecu in 1986 and 664 mecu in 1987. The main reason for this is that the decision to change sterling's EMS central rate at the realignment led to a devaluation of the ecu in terms of all EMS currencies (except sterling and the French franc). This will lead to increased expenditure in Member States in ecu terms (though not necessarily in national currency terms), and increases the scope for the Community to raise the level of export restitutions and those production aids linked to world prices. The realignment also led to a change in the pattern of MCA's, with consequential expenditure effects in each Member State.

7. The Commission now say that, in the light of all the recent developments, at least a further 600 mecu of provision for agriculture will be needed, making some 1,400 mecu in all. In view of the limited headroom inside the VAT ceiling, however, they propose to make do with an extra 915 mecu in total this year and to shift the remaining 500 mecu or so into next year. All these figures need to be probed further.

8. For the "structural" funds - the regional development, social and agricultural guidance funds - the Commission are proposing further provision of 750 mecu this year on top of the 460 mecu already added unilaterally by the Parliament in December (within the 629 mecu total additions to the Council's Second Reading Budget). Their recent report on the structural funds argues that the amount strictly needed is 1,169 mecu (sic), but they propose that, given the pressure on resources within the 1.4 per cent ceiling, they should make do with 750 mecu and push off the remaining 420 mecu into later years.

9. The Commission, the Parliament and the net benficiary Member States are all using the "cost of the past" problem as a means of permanently jacking up the levels of these funds. The UK's argument has been that, on the Commission's own figures (which probably overstate the problem), the level of provision in each of the funds is more than enough to cover both (a) the "cost of the past" obligations falling due and (b) the Community's obligations to Spain and Portugal, and still leaves substantial amounts over for expenditure under new commitments: the Table at Annex 2 summarises the figures. We have pointed out that what the argument is really about is how many <u>new commitments</u> the Commission can undertake. The solution, we have suggested, should be for the Commission to limit new commitments to the amounts which they are able to finance, this year and prospectively, within the available payment appropriations (even if this means that a substantial proportion of the commitment appropriations in the budget cannot in fact be used).

10. Characteristically, the Germans and Dutch take the view that we cannot get away with this. Although the Commission themselves have admitted that commitment appropriations are authorisations to spend, not obligations, the Germans and Dutch feel that the

Council is obliged to provide extra payment appropriations to enable the Commission to use the excessive level of commitment appropriations which resulted from the budgetary procedure. The only way of mitigating the problem, on this view, is to make as few advanced and accelerated payments as the regulations permit, so as to push payments off into later years, and to minimise the growth of commitment appropriation in future years (while recognising that the Parliament will insist that commitment appropriations should grow by the maximum rate of increase laid down in the Treaty).

11. The increase in transitional refunds to Spain and Portugal, which comprise the last item in the Commission's supplementary budget proposals, results directly from application of the agreed transitional period arrangements to the extra provisions proposed for agriculture, the structural funds and the UK abatement.

1986 Supplementary Budget: Policy

12. The UK's preferred outcome, clearly, would be one which coupled full provision for uprating the UK's abatement, as proposed by the Commission, with an increase in agricultural expenditure limited to the 170 mecu of headroom within the guideline limit for this year and no further increase, beyond the Council's Second Reading Budget level, in non-obligatory expenditure. Given the pressures on the agricultural budget, however, from the dollar depreciation, the EMS realignment and the accumulation of stocks, there is no realistic prospect of agreement in the Council on any significant reduction in what the Commission have proposed for agricultural expenditure. There is likewise no realistic prospect of agreement in the Council, or with the Parliament, to limit expenditure on the structural funds to the Council's Second Reading Budget level.

13. A rather less hard-line approach, which would still have some merit, would be to argue for -

(a) limiting the extra provision for agricultural expenditure to the 170 mecu which remains within the guideline plus an amount which can be firmly associated with the abnormal depreciation of the dollar (say, in excess of 10 per cent): the Commission's proposed figure of 915 mecu would almost certainly be defensible in these terms; and

(b) limiting the extra provision for non-obligatory expenditure to a figure below the 460 mecu added by the European Parliament in December.

The idea underlying this approach would be to enable the overrun on agricultural expenditure to be justified as an "exceptional circumstance" in terms of the budgetary discipline conclusions (an important point to preserve if at all possible) and on non-obligatory expenditure to avoid the embarrassment of appearing to win the Court battle (assuming that this is the outcome) only to lose the war.

14. Unfortunately, it seems unlikely that a qualified majority will be found in the Council for an approach on the lines of the previous paragraph, which would leave upwards of 750 mecu unused within the 1.4 per cent ceiling. Thus:

- The Member States who benefit from the structural funds will press strongly for adding the full 750 mecu proposed by the Commission plus the 460 mecu unilaterally added by the Parliament in December. Italy, Greece and Ireland will certainly argue in this sense, and there must be a strong probability that Spain or Portugal will join them: it is very much in the longer term interests of the two newly acceding countries to jack up the levels of the structural funds since they will be substantial net recipients from them. In addition, the Commission may well persuade some Member States with the argument that failure to spend the full amount proposed this year will necessitate an excess over the 1.4 per cent ceiling next year. This assumes, of course, that the Commission's only option is to postpone expenditure to next year. If as the UK has argued the Commission were to cut back on the making of new commitments, even if this means not using some of the commitment appropriatic available, containment of spending this year would ease, not exacerbate, the problems of next year.
- The French and Germans, and probably the Dutch as well, will be concerned to limit additional provision for the structural funds and to leave as much provision as possible available for agriculture; they will probably argue for larger provision for agriculture than the Commission have suggested, ostensibly so as to relieve the pressures next year. But since they are not, apparently, prepared to join us in arguing that the solution must be for the Commission to limit the new commitments they take on in the structural funds to those which the available payment appropriations will support, their case will be found to have no substance, and they will almost certainly collapse into acquiescing in the Commission's proposals or something very close to them.

15. The unpalatable conclusion which emerges is that a qualified majority is likely to be forthcoming in the Council only for a supplementary budget which uses up all, or very nearly all, the remaining headroom within the 1.4 per cent ceiling. The composition of this supplementary budget, moreover, can hardly be very different from that proposed by the Commission. It might be possible to shade the figures a little so as to leave a small margin in hand within the ceiling. But if the Council were to propose significantly less extra provision for the structural funds than the Commission have recommended, the Parliament would be likely to reject the supplementary budget; and the Council would almost certainly respond by falling in with the Parliament's wishes.

16. If the above assessment is correct, and a qualified majority in the Council, together with the Parliament's approval, will be forthcoming only for a supplementary budget on the lines put forward by the Commission which uses up all, or virtually all, the remaining headroom within the 1.4 per cent ceiling, there remain two questions relating to the UK's national interests:

(i) what balance of expenditure between the structural funds and agriculture would be in our interests?

(ii) how should the UK vote in the Budget Council?

17. On the first question, the UK's share of agricultural expenditure is so low that there is a general presumption in favour of holding this expenditure down as much as possible. A further important consideration is that the increases in UK public expenditure associated with extra CAP spending generally far exceed those associated with extra structural fund spending, where the non-additionality policy applies. Against this, however, reduced provision for agriculture this year will undoubtedly exacerbate the problems of staying within the 1.4 per cent ceiling next year, and there is not the same problem in agriculture as in the structural funds that an increase in one year will ratchet up the level of expenditure for the rest of time through the 'maximum rate' provisions of the Treaty. As regards expenditure from the structural funds, the UK's net budgetary position is generally more favourable than on agriculture: we are now close to balance in these funds. Expenditure from the social fund, in particular, is politically popular, especially with MEPs, local authorities and others who benefit. On the other hand, we face the prospect of being net contributors to the structural funds in the years ahead, and any additions to the levels of these funds this year will feed through to 1987 and later years, through the ratchet effect of the maximum rate provisions of the Treaty, thus making retention of the 1.4 per cent ceiling more difficult. On balance, therefore, the UK's interest this year probably lies in holding back the growth of provision for the structural funds if possible, though we can (and should) allow the French and the Germans to take the lead in arguing for this. In practice, for the reasons explained earlier, there is unlikely to be a qualified majority for any major changes to the Commission's proposals, and the Council seems likely to collapse on to these proposals or something close to them.

18. The question how best to use the UK's 10 votes in the Budget Council will need to be resolved finally in the light of circumstances at the time. Although as Presidency we shall need to work hard for an agreement and a qualified majority, it would be consistent with the UK's line in the autumn of last year, and with our continuing attachment to budget discipline, to cast our national votes <u>against</u> a supplementary budget which involves a further excess over budgetary discipline levels. On the other hand, the UK's 10 votes could turn out to be decisive in obtaining a qualified majority for a lesser as against a greater evil.

<u>1986 Supplementary Budget: Handling</u>

19. The above analysis has assumed that the Council will either win or lose the Court case on the 1986 Budget. An alternative scenario is that the Court might find that <u>no</u> valid budget exists for 1986: the Council and the Parliament might be invited to get together and reach an agreement. In such a scenario, the substantive outcome, and the considerations affecting it, would be likely to be similar. The difference would be that, formally, the discussion might be about establishing a valid budget for 1986 rather than about supplementing a 1986 budget already established. The pressures for early action would however be increased, and the UK as Presidency would have a special responsibility for obtaining agreement on a new budget at the earliest opportunity (preferably in July). Officials are working accordingly on contingency plans against such an eventuality.

Possible tampering with UK abatement by European Parliament

20. There is some risk that the European Parliament, especially if it disapproved of the UK's general budgetary posture or the supplementary provision for the structural funds recommended by the Council, might decide to retaliate by tampering with the supplementa provision for the UK abatement. The Parliament might, for example, delete the abatement provision altogether, or reduce it, or transfer it to the expenditure side of the budget. The UK would then have to decide, depending on exactly what the Parliament had done, how to react. Officials are considering this on a contingency basis with the Government's legal advisers. The danger that the Parliament might be tempted to act in this way needs to be borne in mind in considering the UK's posture. It cannot, however, materially affect the UK's approach on the major budgetary issues discussed in this paper.

1987 Budget: Commission Proposals

21. The Table on the next page summarises the Commission's preliminary draft budget proposals for 1987, with the corresponding figures from the reference framework for 1987 established by ECOFIN last month. The Commission have explained that their proposals envisage using up all except some 300 mecu of the expected headroom within the 1.4 per cent ceiling next year. They say that this sum approximates to the Parliament's "margin" of half the maximum rate of increase (some 348 mecu) and that their purpose in leaving it uncommitted is to enable the Parliament to make additions where it pleases.

22. Taking the items in the table in turn, the figure of 2,377 mecu for the UK's abatement is calculated to enable the UK to receive an abatement of 1,640 mecu. This is a reasonable estimate of our abatement entitlement in respect of 1986 <u>except</u> that it ignores the extra 310 mecu of VAT which we expect to pay in August of this year under the annual VAT adjustment procedure. Provision for abatement to cover this as well would use up a further 450 mecu approximately of headroom within the VAT ceiling. The Commission have said that they will propose an amending letter to the 1986 Budget to make provision for this. Contrary to the strong representatic we have made, however, they have not left enough headroom within the 1.4 per cent VAT ceiling to accommodate it. They will have therefore to propose other changes as well, either increases in revenue estimates or reductions in expenditure or both, as part of the amending letter; and there seems little prospect that the Council will accept this, especially as we cannot claim any absolute right to receive this extra abatement in 1987 rather than as part of the corrections made during 1988. The Council is likely to consider this matter in October. We shall doubtless wish to argue then for adjusting the 1987 Budget to accommodate the extra abatement. If no agreement is forthcoming on that, we can argue in the alternative, as last year, that the correction be made in a supplementary and amending budget for 1987 rather than left over until 1988. Given the proximity of the 1.4 per cent ceiling, however, the prospects for obtaining agreement even on that seem less bright this year.

23. The agricultural guarantee expenditure figure respects the budget discipline guideline for the Community of Ten with the addition

of 1,312 mecu for Spain and Portugal. The Commission have warned, however, that with the present exchange rate of 1.02 ecu to the dollar, an overshoot of approximately 2 billion ecus is threatened and that the Council will need to take positive action, in the form of savings and/or some redistribution of the burden between the Community budget and Member States, if the guideline is to be respected in practice.

24. On non-obligatory expenditure, the Commission are envisaging a further increase of some 12.1 per cent (well above the 8.1 per cent maximum rate for the year) on top of the large figures for 1986 which result from the additions made by the European Parliament last December and proposed in the latest supplementary budget. They justify these increases by reference to the continuing need to pay off the cost of the past and to increase the flow of expenditure from the structural funds to Spain and Portugal.

1987 Budget: Policy

25. In the view of officials, agreement by the Council to a budget on the lines proposed by the Commission, which limits provision for agricultural spending to the guideline figure but devotes the whole of the rest of the remaining headroom within the 1.4 per cent ceiling to non-obligatory expenditure, would make the task of holding the VAT ceiling in 1988, and indeed in 1987 itself, much more difficult. In recent years, the "maximum rate" of increase in non-obligatory expenditure, on which the Parliament has the right to insist under the Treaty, has risen faster than own resources. This trend is likely to continue. If, therefore, all the headroom within the ceiling is devoted to non-obligatory expenditure in 1987, a maximum rate of increase in this expenditure in 1988, coupled with a guideline figure for agriculture, would almost certainly take the budget over the ceiling. The UK could, and doubtless would, argue strongly, that the 1.4 per cent ceiling itself must be the binding constraint in such circumstances and that either non-obligatory expenditure or agricultural expenditure or both must be scaled down accordingly. But the hard fact is that those who wish to raise the ceiling would have a powerful extra argument in such circumstances. So far as 1987 itself is concerned, it would clearly be a high-risk strategy for the Community to have a budget which left no margin for contingencies within the own resources ceiling.

26. Against this background, it seems clear that the UK's objective should be to get the 1987 Budget established

- with a significant margin for contingencies within the 1.4 per cent ceiling;
- within budget discipline levels (that is, with the guideline figure for agricultural spending and only the maximum rate of increase in non-obligatory payment appropriations); and
- including, if possible, the extra provision of 310 mecu for the UK's abatement.

27. The implications of the above approach are illustrated in Table 2 above (right hand column). If we assume that the Commission's

1987 BUDGET : IMPLICATIONS OF CONTAINING WITHIN BUDGET DISCIPLINE LIMITS

	1986 Budget (after SB as proposed by Commission)	1987 Budget (Commission's PDB)		1987 Budget (Reference Framework)		1987 Budget (Budget discipline applied to 1986 base)	
	mecu	mecu	% increase	mecu	% increase	mecu	% increase
Agricultural guarantee:							
Guideline (EC10)	20619	21649	+ 5	21649	+ 5	21649	+ 5
Enlargement	567	1312	+131	1312	+131	1312	+131
Other	741	-	-	-	-	-	-
Non-obligatory	8596	9632	+12.1	7950	- 7.5	9292	+ 8.1
Other obligatory	4602	[4084]	-11	4393	- 4.5	4084	-11
Total	**35125**	**36677**	**+4.4**	**35304**	**+0.5**	**36334**	**+3.4**
Headroom within 1.4% ceiling	0	[303]*		1676		650	
(a) UK abatement of 1640 mecu	N/A	[303]*		1676		650	
(b) UK abatement of 1950 mecu	N/A	-144		1216		200	

*** NOTE : The Commission envisage that the appropriations added by the Parliament as its 'margin' would use up this uncommitted headroom**

1604/13

ANNEX 2

STRUCTURAL FUNDS :
Payment Appropriations Available in 1986

mecu

Regional Fund

Council's second reading budget	2063
Of which:	
pre-1986 commitments	1502
enlargement	257
Available to cover new commitments	+304

Social Fund

Council's second reading budget	1773
Of which:	
pre-1986 commitments	1323
enlargement	159
Available to cover new commitments	+291

Agricultural Guidance

Council's second reading budget	890
Of which:	
pre-1986 commitments	373
enlargement	55
Available to cover new commitments	+462