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Prime Minister

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PRIME MINISTER

BUDGET COUNCIL 18/19 JULY

Ian Stewart will be attending the Budget Council in Brussels on 18/19 July. The Council will have to consider some difficult issues on the 1984 and 1985 Budgets and on the financing of our 1000 mecu 1984 refund. I attach a paper prepared by officials, analysing the problems. My own views are set out below.

2. The Council will have before it both the Commission's Preliminary Draft Budget (PDB) for 1985 and a draft Supplementary Budget for 1984 to finance the agricultural overrun of about 2 billion ecus. It will also have before it a draft of the revised Own Resources Decision, providing both for our 1984 refunds and the Fontainebleau mechanism. The Commission are proposing that additional own resources should come into effect in late 1985, so as to finance higher budgetary expenditure, in particular on the CAP, in excess of the 1 per cent VAT limit by 1.9 billion ecu as well as our refunds in respect of 1984.

3. The central problems we will have to face at the Council are as follows. First, a majority of other member states, with France in the lead, will be pressing us to agree to finance at least some of the agricultural overruns both in 1984 and 1985.

4. For 1984 they will be asking us to agree to a regulation under Article 235 of the EC Treaty, under which member states would finance the overrun by "special advances" paid on the Community's normal budgetary VAT key, to be reimbursed from 1986 onwards. This would be extremely unwelcome to us. Our net contribution in 1984 (and thus in the current financial year, 1984-85) would rise by between £105 million - £125 million. Because our refund in respect of 1984 is the flat-rate 1000 mecus, we would not benefit from the 66 per cent correction in respect of this extra burden. Moreover, to agree to the Article 235 regulation would undermine the validity of both the new and old VAT ceilings and be inconsistent with our stance on budgetary discipline.

5. As regards the 1985 Budget, all other member states except Germany seem ready to accept that the higher VAT ceiling should be made available during the course of 1985, even if the initial 1985 PDB has to be brought back within the 1 per cent ceiling. The higher VAT own resources would be used to finance both our 1984 refund and the 1.9 billion ecu excess on agriculture in 1985. But the introduction of a Supplementary Budget for these purposes during 1985 would also give the European Parliament the opportunity to add a further 1 billion ecus on to non-obligatory expenditure. The outcome could be a VAT rate of 1.3 per cent or over, depending on how much agricultural spending had been carried over from 1984. Such an outcome would be widely seen in the House of Commons as wholly contradicting all we had said on the need for budgetary discipline and the control of agricultural spending.

6. Second, if we reject any proposal to bring the own resources increase forward into 1985 or to provide some other form of supplementary financing in that year, the corollary is that we will probably not get our 1000 mecu refund in respect of 1984 before 1986, though it might be possible to ensure that it falls in financial year 1985-86. This delay would carry a small interest cost - perhaps of the order of £15 million - compared with the alternative of receiving it in October 1985; and would be unattractive politically. It would also bring the Community close up to the 1.4 per cent ceiling in 1986 itself, because of the need to finance both our 1984 and 1985 abatements and any carry-over of agricultural spending from 1985. Nevertheless the deferment may arguably be an acceptable price to pay for better budgetary discipline in 1985.

7. It is desirable that either at, or in the run-up to, the Budget Council we should try to reach an agreement with our main Community partners on how to deal with the 1984 and 1985 budget overrun. While we must continue to press for the maximum possible savings on agriculture for both years, it is simply not realistic to assume that the whole of the gap can be bridged in this way. If we are unwilling to show any flexibility, there is a risk that we shall be completely isolated at the Budget Council. This could provoke the new European Parliament into blocking our 1983 refunds; and there would be no agreed arrangement for implementing the 1984 refund either.

8. There are two possible "packages" we could put to the French and Germans for dealing with the financing problem. The first package would confine any concessions to dealing with the 1984 problem. It would be as folows:

(a) the 1984 overrun would be reduced to the maximum possible extent by savings and deferment;

(b) we would be willing to accept that the remaining gap should be financed exceptionally and temporarily by the national intervention agencies in each member state, whose costs would be reimbursed from the Community Budget in 1985 or 1986. Our contribution to the reimbursement in 1985 or 1986 would then benefit from the 66 per cent corrective factor agreed at Fontainebleau and would thus be reduced to about a third of the £105-£125 million figure mentioned above;

(c) the 1985 Budget would be brought back within the 1 per cent ceiling. We would seek to impose the brunt of the cuts on agricultural spending and to protect priority areas like the Social Fund from which we do well. But it may be necessary at the end of the day for Ian Stewart to accept broadly equal cuts in agricultural and non-agricultural spending;

(d) new own resources would not come into effect until 1 January 1986. Our 1984 refunds would accordingly have to be deferred until 1986.

9. It must, however, be doubtful whether this package will be sufficient to buy any agreement from the French. Ian Stewart will need to decide the best tactics on the spot, but in the last resort I think we should not exclude bringing forward new own resources into autumn 1985, provided the initial Budget for 1985 is brought back within the 1 per cent ceiling and the additional own resources limited to the minimum necessary to finance our 1984 refund and any unavoidable agricultural overrun. As a fall-back, therefore, I recommend that we should be prepared to agree to bringing the new own resources into play in October next year. But we should aim to limit this by writing into the Own Resources Decision a special VAT ceiling for 1985 only of, say, 1.1 per cent, so as to circumscribe the Parliament's powers to increase the Budget.

10. If you and other colleagues agree to this approach, I suggest our officials should sound out the French and Germans Governments as soon as possible.

11. I am sending copies of this letter to the Foreign Secretary, the Minister for Agriculture and Sir Robert Armstrong.

(N.L.)

11 July 1984

BUDGET COUNCIL, 19 JULY

NOTE BY OFFICIALS

THE AGENDA

1. The Budget Council on 19 July will be faced with:

(a) the PDB for 1985, which exceeds available own resources within the 1% limit by 1.9 billion ecus;

(b) the Commission's draft of a new own resources decision which will propose inter alia that ratification should be completed by October 1985, but that a new VAT rate should then be made retrospectively valid back to 1 January 1985. This also provides for both our refund of 1000 million in respect of 1984 and the subsequent 66% corrective system.

(c) an Article 235 regulation providing as a contingency measure for the own resources gap to be bridged between January and October 1985 by loans or advances;

(d) an extra-ordinary regulation providing for advances to meet the 1984 overrun (under Article 235 or others);

(e) a Supplementary and Amending Budget for 1984 providing for additional expenditure of around 2 billion ecu mostly on agriculture (on the assumption that the Regulation referred to in (e) will be adopted);

2. This note sets out our objectives in relation to those of other Member States and considers what approach we should adopt at the Budget Council.

UK OBJECTIVES

3. The UK's objectives are to ensure that:-

(a) the 1985 budget is adopted within the 1% VAT ceiling, that a substantial proportion of the necessary cuts falls on FEOGA Guarantee, consistently with the European Council agreement that agricultural spending should grow less rapidly than the own resources base.

(b) Article 235 or similar regulations are ruled out as a means of providing supplementary finance in 1984 or 1985;

(c) the 1984 overrun should be covered so far as possible by savings and deferments or, if necessary, a short suspension of payments, with any unavoidable financing gap being met in ways (eg national financing) which ensure that the UK either makes no additional net contribution at all or is compensated through the 66% system for any addition to its net contribution.

(d) if new own resources are to be made available during 1985, these should be confined to meeting the cost of the UK's 1000 mecu refund for 1984 and any clearly unavoidable costs in excess of the 1% ceiling arising from earlier years' commitments or circumstances beyond the Community's control;

(e) no part of the Fontainebleau agreement is put at risk and in particular that there should be no doubts raised concerning the application of the 66% formula from 1985 onwards or the payment of our 1984 1000 mecu refund.

THE PROBLEMS

4. It is clear that we shall be pressed hard at the Budget Council by France and a majority of other Member States to agree to provide supplementary Community financing in 1984 to meet that year's Budget overrun through an Article 235 Regulation or an informal "gentleman's agreement" (the German position). The Commission are asking for a sum of 2.1 billion ecus. Were we to agree to this the net public expenditure cost to the UK on programme 2.7 would be of the order £105m - £125m, depending on our share in the receipts. We should get no reimbursement for this, since our 1984 refund is fixed at 1000 mecu. There would be a major political embarrassment to the Government in defending this additional bill to Parliament on top of our agreement to increase the VAT ceiling to 1.4% and we would have agreed to a most unwelcome precedent for circumventing the VAT ceiling.

5. The French are already claiming that there was a decision in principle at Fontainebleau. This is not so. It was agreed at Fontainebleau only that the 1984 overrun should be referred to the Budget Council. There was no agreement to the French

Presidency's demand for a commitment to covering the overrun by the additional money.

6. There is also likely to be pressure on us at the Budget Council to agree to some arrangement for financing the potential 1985 overrun. The majority of other Member States, including both France and Germany, will want to avoid cuts in agricultural provison for 1985 of the order which we believe are necessary. Only the Dutch seem likely to give worthwhile support on this issue. Whilst the Germans are adamant that the 1985 Budget must be kept within the 1% ceiling they envisage the bulk of the cuts falling on non-agricultural expenditure and intend to start by arguing for 1 billion ecu reductions in agriculture, and will probably fall back to 600 mecu.

7. The French appear to be ready to bring forward the Own Resources increases into 1985. Only the German and perhaps the Dutch Finance Ministries seem likely to resist this. Moreover, (though this does not appear in the texts and did not come up in the plenary sessions) the French agreement at Fontainebleau to drop their demand for a second ad hoc refund was linked with their understanding that we were ready to consider bringing the Own Resources increase forward.

8. There is a definite possibility that, if we make no hint of any move on financing the 1984 and 1985 overruns, we will indeed have a 9 to 1 line-up against us at the Council. The risk would then be that the Parliament might block our 1983 refunds and that there will be no agreement on how to pay the

1984 refund. (If the latter is to be financed by abatement of our 1985 VAT rate, that will require a VAT rate of more than 1 per cent to be paid by either Member States). In the absence of an agreement we could then be publicly under presure in the autumn to concede the financing of the 1984 and 1985 overruns or jeopardise the implementation of the Fontainebleau package.

ASSESSMENT AND TACTICS

9. We are clearly likely to face some awkward tactical choices at the Council and achieving the aims set out in paragraph 3 will be extremely difficult, if not impossible.

10. For the reasons set out in paragraph 4 we can agree neither to the adoption of a 1985 budget in excess of the 1% ceiling, nor to the use of Article 235 regulations to finance the 1984 and 1985 overruns.

11. On the other hand for the reasons given in paragraph 8 we wish to avoid being isolated on all issues at the Council. A difficult situation would arise if the 1985 budget were brought within the 1% VAT ceiling wholly or predominantly by cuts in non-agricultural expenditure, while the UK was alone in resisting the Commission's Article 235 Regulations to meet the overruns or some equally unacceptable variant of them. UK Ministers could also be open to criticism if doubts were left at the end of the Council as to the financing of our 1984 refund. Almost equally bad would be a situation in which the Budget Council broke up in disorder because it was unable to agree on a 1985

bduget or anything else, and with the UK in a similar 1:9 position.

12. The central tactical difficulty with which we are faced concerns the timing of the increase in own resources. If our 1000 mecu refund is to be paid by abatement of our 1985 VAT rate, as the Fontainebleau conclusions provide, then a VAT rate in excess of 1 per cent will be required in 1985. Other Member States would, however, insist that the increased VAT own resources should likewise be available to finance the 1985 agricultural overrun together with any overrun carried over from 1984. Moreover, if a supplementary budget is allowed for agriculture in 1985, the European Parliament could extend it to non-obligatory expenditure. On their interpretation of the "maximum rate" governing non-obligatory expenditure, they could add over 1 billion ecus to the budget. The result of all this could be a 1985 VAT rate in excess of 1.3 per cent and the Government would clearly be open to the charge that it had abandoned budgetary discipline.

13. On the other hand, if we do not agree to bringing forward additional own resources into 1985, there is no way in which we could get our 1000 mecu refund in respect of 1984 paid before the first quarter of 1986. The burden of this additional expenditure <u>plus</u> the 1985 agricultural overrun could then entail a VAT rate in 1986 of close to 1.4 per cent.

<u>RECOMMENDATIONS</u>

14. Against this background the best approach seems to be to

try to reach an understanding with the French and Germans on the following lines:-

(a) no Article 235 Regulations for meeting either the 1984 or 1985 overruns;

(b) any unavoidable 1984 overrun (after savings and economies) to be met exceptionally by temporary funding by national intervention agencies, reimbursable not earlier than 1985.

(c) the 1985 Budget to be brought within the 1% VAT ceiling, if necessary through broadly proportionate across the board cuts, but on the understanding if that were done that we would accept that payment of our 1984 refund would be deferred to 1986, with the increased own resources coming into effect for 1 January 1986.

(d) alternatively, if (c) proves unnegotiable, we would be prepared to agree to an increase in own resources to come into effect in 1985, together with a supplementary budget to meet unavoidable agricultural financing needs. We would want if possible to limit this to a specific low figure. If this course were adopted it would be necessary to write into the Own Resources Decision a VAT ceiling for 1985 of about 1.1% in order to prevent the European Parliament's exercising its powers (cf paragraph 12 above) to increase non-obligatory expenditure.