



Foreign and Commonwealth Office

London SW1A 2AH

16 March 1984

Dear John

AR 15/3.

Visit of M Thorn: Commission Paper on Budget Imbalances

When he sees the Prime Minister at lunchtime, M Thorn may give the Prime Minister a copy of the enclosed Commission paper on budget imbalances. I enclose a note on which the Prime Minister may wish to draw in reply.

I am copying this letter and enclosure to John Kerr (Treasury) and David Williamson (Cabinet Office).

Yours sincerely
Chris Brannel

PP (R B Bone)
Private Secretary

A J Coles Esq
10 Downing Street

COMMISSION PAPER ON BUDGET IMBALANCES

BACKGROUND

1. The main points in the Commission paper are as follows:

Good points

- (a) Establishment of a limit (which the paper calls a threshold) related to relative prosperity. This limit is adjusted each year on the basis of linear growth as a function of relative prosperity.
- (b) Financing on the revenue side.

Bad points

- (a) Takes as measurement of the imbalances the VAT share/- expenditure share gap and thus excludes our "excess" levies and duties. Appears to redefine the VAT share in damaging way.
- (b) Duration ("the same as that of the new own resources") is obscure and unsatisfactory.
- (c) Compensation above the limit is of only a part of the excess burden.
- (d) The financing arrangements appear to imply that the UK might have to contribute to other people's refunds (eg German refunds, if they were to qualify). This is not acceptable.
- (e) Redefinition of administrative expenditure to exclude a part of it from the allocated budget (thereby reducing the UK's apparent burden).
- (f) An obscure reference to transitional arrangements during enlargement but which again implies some attempt to reduce the real burden and hence our compensation.

POINTS TO MAKE

2. Have seen the Commission text. Glad to note that it approaches the problem in the way we have been discussing it for almost a year ie establishment of a threshold based on relative

prosperity and with an upper limit on a Member States' contribution expressed as a percentage of GDP.

2. Also pleased to note proposal for financing on revenue side of the budget.

3. Commission text therefore provides a basis for negotiation but there are a number of aspects which would need to be changed.

(a) Treats levies and duties as if they were VAT and therefore, leaves uncovered an element in our true budget burden averaging 330 mecu over the last 5 years. Must have a system which covers the full burden. Recognise that it is possible to draw parameters of a VAT share/expenditure share scheme tightly so that, in the first year (1982 figures/relative prosperity in the enlarged Community), it could leave UK with a net contribution in the region of the 400-500 mecu of which I spoke at Athens. But there will be no guarantee that this could be sustained given possible fluctuations in levies and duties element. Must have system which leaves us with net contribution of the order of which I spoke in year one and provides sustainable, predictable results.

(b) Once we have a system which defines what the limit of a Member State's net contribution should be, in relation to its relative prosperity, there is no reason why compensation above the limit should not be 100%. Text as drafted suggests a surcharge or ticket modérateur and thus catches the UK twice, first in its initial definition of its burden and the second time by not providing full compensation above the limit.

(c) Definition of VAT share is difficult to follow. Grateful for explanation and for figure which your definition would give on 1982 figures. [If Thorn gives a figure less than 1680 mecus (which is the correct definition of the VAT share/expenditure share gap for 1982)]: Commission appear to have made an arbitrary redefinition of the VAT share which is quite unacceptable.

(d) Commission proposal to change allocation of

administrative expenditure quite arbitrary and unacceptable. This is simply a device for reducing our apparent burden.

(e) Period of validity as defined in the Commission paper is unsatisfactory. The scheme must form part of the revised own resources decision and should at the very least last as long as that decision. The presumption is that the scheme should continue unless there is unanimous agreement to change it. Commission text implies that if a new ceiling was reached then the system would expire. This is not acceptable.

(f) Reference to transitional arrangements during enlargement. If, as we think, this passage is designed to make the UK pay extra for the costs of enlargement. At Athens, I said UK would be prepared to pay 4-500 mecu net contribution (based on 1982 figures). This was on the assumption of an enlarged Community. UK would not be prepared to pay on top of this.

(g) Long way to go before Commission text could be made satisfactory. Provides a basis for negotiation.

DEFINITION OF VAT SHARE

The meaning of the definition of the VAT share is extremely obscure, but we have reason to believe that it may be another Commission/French device to reduce the apparent size of the UK budgetary problem by 'distorting mirrors', as explained below.

Previous versions of the VAT share/expenditure share scheme (including recent German proposal) had envisaged applying the UK's percentage share of Community VAT (about 20%) to the allocated budget and subtracting from this our expenditure receipts in order to calculate the measured gap.

For 1982, this produces a figure of 1680 mecus compared with our actual net contribution of 2036 mecus (which includes our excess levies and duties). This method can be described as treating our levies and duties as if they were VAT.

Commission officials consulted by UKRep (confidences to be respected) believe the definition in Thorn's paper means that the UK contribution would be calculated simply as the VAT payments it actually made in each year up to the 1% level. In other words customs duties and levies would be excluded from the calculation altogether - not even embodied as if they were VAT. The effect of this approval is to reduce our measured gap for 1982 to 300 mecus as follows:-

	<u>mecu</u>
- UK's actual VAT payments	2,900
- UK's expenditure receipts	2,600

We suggest that PM simply asks M Thorn what his para one formula means and what measured gap it would give on the 82 figures. If it turns out to be around 300 mecus as suggested above, the PM will want to make clear to M Thorn that he will not want to circulate a text including such a self-evidently preposterous slight of hand

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MIPT: EUROPEAN COUNCIL - BUDGETARY IMBALANCES

1. FOLLOWING IS TEXT OF THORN'S PAPER
BEGINS

CORRECTION OF THE BRITISH BUDGET IMBALANCE

1. MEASURE OF THE IMBALANCE: GAP BETWEEN VAT RECEIPTS SHARE AND SHARE IN ALLOCATED EXPENDITURE:
- VAT SHARE : DEFINED ON THE BASIS OF TAX RECEIPTS RECEIVED CORRESPONDING TO ONE POINT OF VAT IN THE YEAR UNDER CONSIDERATION
 - ALLOCATED EXPENDITURE : ADMINISTRATIVE EXPENDITURE NOT INCLUDED EXCEPT FOR A FIXED AMOUNT ATTRIBUTED TO THE TWO COUNTRIES WHERE THE INSTITUTIONS ARE SITED.

2. DEFINITION OF THRESHOLD
A "REFERENCE AMOUNT" IS CALCULATED ON THE BASIS OF THE GAP MENTIONED IN POINT 1, APPLIED TO ALLOCATED BUDGET EXPENDITURE. THIS IS AFTERWARDS EXPRESSED AS A PERCENTAGE OF GDP.

THE IMBALANCE ONLY GIVES RISE TO COMPENSATION IF IT EXCEEDS A THRESHOLD EXPRESSED AS A PERCENTAGE OF GDP. THIS THRESHOLD IS ADJUSTED EACH YEAR (LINEAR GROWTH AS A FUNCTION OF RELATIVE PROSPERITY).

3. CALCULATION OF THE COMPENSATION

3. CALCULATION OF THE COMPENSATION
THE COMPENSATION IS A FRACTION OF THE PART OF THE REFERENCE
AMOUNT WHICH EXCEEDS THE THRESHOLD. ITS LEVEL IS FIXED EACH YEAR
(DECREASING LINEARLY AS A FUNCTION OF RELATIVE PROSPERITY).

4. FINANCING

THE COMPENSATION IS MADE BY REDUCING THE VAT CONTRIBUTION IN THE
FOLLOWING YEAR, THE COST BEING MET BY THE OTHER MEMBER STATES
ACCORDING TO THEIR VAT SHARES.

5. PERIOD OF VALIDITY

REFERENCE WILL BE MADE TO THE ABOVE COMPENSATION MECHANISM IN THE
DECISION ON NEW OWN RESOURCES. AS A CONSEQUENCE, THE VALIDITY OF
THESE MECHANISMS WILL BE THE SAME AS THAT OF THE NEW OWN RESOURCES.

6. TRANSITIONAL ARRANGEMENT DURING ENLARGEMENT

IN THE LIGHT OF THE PERIOD AND MEASURES APPLIED IN THE TRANSITIONAL
PERIOD, THE POSSIBILITY MAY BE ENVISAGED OF NEUTRALISING, AT THE
BEGINNING OF THE TRANSITIONAL PERIOD, THE ELEMENTS LINKED TO
ENLARGEMENT IN THE CALCULATION OF VAT AND ALLOCATED EXPENDITURE
SHARES.

ENDS

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EUROPEAN COUNCIL: BUDGETARY IMBALANCES

1. THORN AGREED LATE YESTERDAY EVENING TO RELEASE TO US THE PAPER HE HAD PREPARED TO DISTRIBUTE AT VAL DUCHESSE ON 12 MARCH (WHEN CHEYSSON ASKED HIM NOT TO DO SO). HE WOULD PROBABLY HAVE GIVEN IT TO THE PRIME MINISTER AT LUNCH TODAY BUT AGREED THAT IT MADE MORE SENSE TO GIVE US THE PAPER IN ADVANCE OF HIS ARRIVAL. IT IS NOT CLEAR WHETHER HE HAS GIVEN THE PAPER TO OTHER HEADS OF GOVERNMENT HE HAS BEEN VISITING. HIS STAFF THINK HE DID NOT GIVE IT TO CRAXI BUT MAY HAVE GIVEN IT TO KOHL. TEXT IN MIFT.

2. THORN'S CABINET TELL US THAT WHEN THORN TAXED THE GERMANS YESTERDAY WITH THE ILL-JUDGED CIRCULATION OF THE COMMENTARY TO THEIR DRAFT CONCLUSIONS (MY TELNO 962) KOHL ADVISED HIM NOT TO TAKE IT TOO SERIOUSLY. GENSCHER ACKNOWLEDGED THAT THE REFERENCE TO THE FRENCH KEY WAS PARTICULARLY UNHELPFUL BUT CLAIMED THAT STOLTENBERG HAD INSISTED ON ITS INCLUSION.

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