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FROM: D A HILL
ECONOMIC AND SOCIAL DIVISION
6 OCTOBER 1992

- cc PS/PUS (L&B) - B
- PS/Mr Fell - B
- Mr Semple - B
- Mr Ledlie - B
- Mr Thomas (L&B) - B
- Mr Watkins - B
- Mr Steele - B
- Mr Dowdall, DFP - B
- Mr Blackwell - B
- Mr Cornick, RCB - B
- Mr Quinn - B
- Mr Cooke - B
- Mr D J R Hill (L&B) - B
- Mr Leach - B
- Mr Woods, DFP - B
- Mr Dunn - B
- Dr McCormick - B

MR BELL (L&B) - B

FINANCE AND THE NEW INSTITUTIONS

I attach a revised version of my draft of 2 September. This takes account of comments both from Mr Dowdall and Mr Quinn. As you will see, I have cut down the paper to some extent, and if anything it concentrates more closely on the split block issue than before. There is also a short covering submission, to make the material more digestible for Ministers.

2. There is a degree of consensus that if, at least in the medium term, there will be a "peace dividend" because the security situation improves following the setting up of new institutions, and if the Treasury are accommodating on pressures to meet new security demands in-year, retaining the existing block is on balance preferable. If these conditions are not met, however, consideration should be given to the "safety first" option of splitting the Block. It is debatable whether these two conditions will be met. First, it may prove impossible to get any satisfactory assurances from the Treasury about sympathetic treatment on additional demands for security expenditure in-year

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(although we should not underestimate our own political hand with the Treasury if the survival of new institutions is at stake). As for the other condition, it is impossible to know whether in the medium term (say in two or three years after the new institutions are set up) the security situation will improve. My own view (reflected in the submission) is that if security does not begin to improve within two or three years of the new institutions being set up it is unlikely that they will survive. On that basis it may not be unreasonable to plan on the basis that if there are new institutions they will enjoy a peace dividend. But I would welcome the views of others on this issue which is central to the paper.

3. I would also welcome any views on who might most appropriately put this submission to Ministers.

4. Mr Ledlie, Mr Steele and Mr Leach did not see earlier papers: but given the emphasis on security I think they should be on the circulation list.

5. Could I ask for comments by 14 October? I would hope that we might then put the submission to the Secretary of State on 16 October.

SIGNED: D A HILL

D A HILL
ESL Division
OAB Ext 6495
2 October 1992

PS The annexes are omitted to save paper.

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Mr Quinn - B
Mr Cooke - B
Mr D A Hill - B
Mr D J R Hill
(L&B) - B
Mr Woods, DFP

1. PS/MR MATES (DFP, L&B) - B
2. PS/SECRETARY OF STATE (L&B) - B

FINANCE AND THE NEW INSTITUTIONS

Whilst the Strand 2 Talks have been proceeding officials have been following up the work done in Strand 1. When and if a broad agreement is reached there will be a good deal of work to be done filling and elucidating the Strand 1 conclusions with the parties. There is no need for Ministers to address most of those issues yet. But it would be helpful to have a steer for Ministers on the question of finance now. Finance will be a major factor in relations between the Government and the new institutions. But more immediately, we need to be prepared to move quickly, once an outline agreement is in place, to secure maximum advantage from the Treasury. In the period between a broad outline agreement and a full agreement on the detail of new institutions, we will be in a position to bargain for the best possible arrangements from the Treasury.

2. The principal issue is whether the existing Northern Ireland Block should be retained or whether in future finances for the NIO and for the new institutions should be matters of separate negotiation with the Treasury. The arguments are complex and are covered fully in the attached paper. But to summarise, the great

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prize of maintaining the block is that, if in the medium term the security situation improves, there will be substantial resources made available to the new institutions through the operation of the Block mechanism. These would certainly be lost if the Block were split; even if the Block remains, the Treasury might try to claw some back, but there would be a good chance of retaining at least part. The parties wish to retain the Block for precisely this reason.

3. The disadvantages of maintaining a block are that:

- a) If security pressures increase, or even if they remain at the same level, there will be a tendency for security expenditure to squeeze out marginal expenditure by the new institutions (politically very unpopular);
- b) It would be politically very difficult to claw back expenditure from new institutions to meet new security demands in-year.

4. It is therefore a question of weighing possible substantial future benefits against perhaps more certain short-term disadvantages, if the Block is maintained. The Treasury would certainly like the Block to continue; and splitting up the block could in practice prove contentious. Furthermore, once the block was split it would be impossible to put it back together again. If, on the other hand, it is split, the short-term disadvantages will be lessened, but not eliminated; but the longer-term advantages will be forgone. On balance, we believe that we should begin negotiations with the Treasury on the basis that the block should be maintained, but seek to secure that the Treasury give satisfactory assurances that in-year pressures may be more readily met by access to the contingency reserve to meet the likely short term pressures. If this proves impossible we should look again at splitting the Block.

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5. This strategy depends on Ministers agreeing with our assumption that security is likely to improve in the medium term (in the short term it may deteriorate) following the establishment of new institutions. It is impossible to know what will happen, although, to be realistic, if security does not improve in the medium term, the new institutions may well not survive anyway. In other words the survival of the new institutions into the medium term will probably only be accompanied by an improving security situation;

6. The paper covers two other issues which might be taken up at the same time with Treasury. The first is additionality. We believe that the present additionality rules would be extremely difficult to work if there were new institutions. It would be much better to move to a system whereby EC receipts were clearly additions to the Block. In principle, this could be done on a cost-free basis, but the Treasury would argue that it went against the non-additionality policy in the rest of the UK which is vital to control of public expenditure. However, we will be able to argue, with some force, that the situation in Northern Ireland would be unique, and will not set a strong precedent.

7. The other possible matter to raise with the Treasury is a "dowry". Additional expenditure does not seem negotiable in the present PE climate; but we will need at least to consider at the time whether it is worth making some bid, if only because the parties expect us to.

8. We would be grateful to know whether Ministers endorse the conclusions (para 28 and 29) of the attached paper, so that we can be ready to move with the Treasury at the right time. Officials would be happy to discuss this paper further.

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FINANCE AND THE NEW INSTITUTIONS - PAPER BY OFFICIALS

Introduction

1. This paper considers how financial arrangements for new institutions might operate. The existing financial arrangements - in which the NIO and the NI Departments are treated on a (more or less) equal footing - cannot continue, since they depend on a unified Secretary of State command. We take the Sub-Committee report on "Financial Arrangements For New Institutions" (see Annex A) as a guide to future arrangements, but do not assume that the judgements made by the parties in that document cannot be reopened. We will concentrate on the question of the interface between the Secretary of State and the new institutions on finance matters, which is where change will be concentrated and which, whatever the arrangement, is likely to be the focus of considerable political difficulty because resources will always be limited relative to the competing demands upon them. We also attach at Annex B a description of how the present financial system works as background to this paper; any new system will be built on this existing system.

Objectives

2. Our objectives in designing the new system are:

- a) To maximise the resources available to Northern Ireland within the Government overall PE totals;
- b) To optimise the distribution of those resources;
- c) To avoid political conflict as far as possible between the Secretary of State and new institutions;

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d) **Compatibility with the new constitutional settlement:**

Common Ground

3. There is a good deal of common ground between ourselves, the Northern Ireland parties and, we believe, the Treasury on some elements of a new system:

a) The Secretary of State should be responsible for securing resources for the new Northern Ireland institutions. The Secretary of State's position in Cabinet makes this inevitable, and the parties accept this. Direct contacts between the new institutions (in the form of the Panel) and the Treasury should not be precluded, and the new institutions would want them (see Annex A para 6).

b) The new institutions should, within their overall allocation, have maximum flexibility in determining the allocation of resources. PE resources in Northern Ireland currently constitute a single allocation, within which resources can be moved at the discretion of the Secretary of State (subject to certain exceptions such as the ring-fenced allocation for social security). The parties would want this flexibility (see Annex A para 3) to continue within their allocated resources, and it is unlikely that the Treasury would oppose this.

c) Resources available to the region should continue to be based on comparability in preference to some form of new needs assessment formula. The present system (whereby NI resources are automatically increased (or decreased) in line with increases (or decreases) in comparable expenditure in UK Departments) should, if possible, be retained. Comparability has given the NI system a fixed

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base-line on a non-contentious basis without precluding the possibility of bidding for additional resources. The desirability of retaining comparability has been accepted by the NI parties. It should be noted, however, that HMT have expressed an interest in a formula-based approach to territorial finance in the context of the devolution debate in GB and they could press for a similar approach in Northern Ireland.

d) The new institutions should be able to raise additional resources through local taxes (eg the rates). There is wide agreement that this would be acceptable. The Treasury take the view that the level of funding for NI will take account of a set level of revenue raised through the rates (as it does now); but this will not preclude additional resources being raised, which the parties say they would wish to be able to do.

e) The new institution should still satisfy the Treasury that resources are spent with due regard for value for money. The parties accept this as reasonable, and it is an important concern for the Treasury. There may be future tensions on matters such as market-testing and privatisation.

f) The relative roles of the Panel, Assembly, and Heads of Department in the financial arrangements will also be important. Annex C contains the parties' views on this (on which there is an SDLP reserve). This description seems acceptable from the Government's point of view.

A Finance White Paper

4. This is not a complete description of "common ground", and many details of the precise working of new financial arrangements will need to be set out (eg the role of the Northern Ireland Comptroller

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and Auditor-General; voting on Estimates). These might best be covered in the White Paper which sets out the new constitutional arrangements as a whole. It will be important to cover those financial arrangements that do not depend on statute in an authoritative statement of Government policy.

Contentious Issues - A Single Block for the Secretary of State and New Institutions?

5. We will now turn to issue most likely to prove contentious between the Secretary of State and the Treasury, and the Secretary of State and the new institutions. The Sub-Committee Report concluded that "maintaining the integrity of the Block ... should ... mean that Northern Ireland should expect to benefit from future savings in operational programmes, whether through achieving greater economy or, for example, as result of a reduction in security-related expenditure".

6. Annex B gives some details on how the current Block works. The Block is a series of conventions whereby a level of PE resources is set for Northern Ireland as a whole during the PES; those resources are allocated to the various (competing) departments; and allocations are adjusted within the financial year to take account of changing demands for resources. Since the Secretary of State is the political head of the Northern Ireland Departments and the NIO, this unified system works well. It optimises the use of resources, and a block arrangement should certainly be maintained for those areas for which the new institutions are responsible (see para 3(b)). The question is whether there should be a single Block embracing both the Secretary of State's and the new institutions' responsibilities, or whether the current block should be spent. This is a complex question, which depends on an assessment of likely future developments, and on what may prove negotiable with Treasury. We need to work towards the outcome which most nearly meets objectives in para 2. But it is far from easy to calculate the best strategy. We therefore make no apology for going into this issue in detail.

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The Possibilities for Future Block Arrangements

7. At present, the Secretary of State negotiates with the Treasury for a single block of resources for Northern Ireland. He might either continue to do this on the present basis (which is likely to be most acceptable to the Treasury) or he might negotiate for separate amounts for the new institutions and for the NIO.

A Single Block?

8. The advantage of maintaining a single block based on comparability is that flexibility in the use of resources would be optimised. For example, this arrangement provides the best prospect of ensuring that any reduction in security expenditure could be fed into social and economic programmes (the so-called "peace dividend"). Furthermore, such a system would provide an incentive for the new institutions to pursue policies which complemented the Secretary of State's security policies, since they could expect to benefit from any reductions in security expenditure. However, the maintenance of a single block would carry the implication that, as far as possible, increases in demand for security expenditure should be met within the total generated by comparability, and thus denied to or removed from the new institutions' programmes. Bids to the Treasury for additional resources for security matters would not be precluded under these arrangements but, with the advent of the new top-down controls on PE, bidding is becoming a less effective medium. There is the potential for considerable political difficulty between the Secretary of State and the new institutions if NIO expenditure continues the pattern of recent years and significantly pre-empt resources from the remainder of the Block. The Secretary of State would be the arbiter in deciding the balance of allocations of funds between NIO and transferred functions. Although he would clearly have an interest in maximising benefits for Northern Ireland as a whole, there would be a suspicion on the part of the new institutions that he would look to NIO interests first.

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A Split Block?

9. The alternative - splitting the Block and breaking the link between NIO expenditure and comparability - might, at the margins, make it possible to negotiate more aggressively for higher security expenditure; but this is not precluded under the existing arrangements (although the single Block arrangement means that HMT routinely and legitimately deflect NIO pressures onto the Block). The political advantage of a split block would be to establish a clearer boundary between the Secretary of State's and the local administration's funding. This would not eliminate friction but, if other things were equal, should reduce its scope by eliminating in year reallocations.

Dividing the Annual PE Settlement

10. If the Secretary of State conducted separate negotiations for NIO resources and for those of the new institution, there would be no further necessity to divide whatever resources were secured from Central Government. But if the Secretary of State received a single block of resources, it would be his duty to divide those resources between the new institutions and the Northern Ireland Office. There are two ways in which he might set about this task: either the resources might be divided on the basis of some formula (a "formulaic" approach) or on the basis of individual negotiation. A formulaic approach is in principle attractive. It would distance the Secretary of State from the settlement given to the new institutions and protect him from the inevitable allegation that he had looked more to the particular interests of NIO rather than the wider interests of Northern Ireland in devising a settlement. But such a formulaic approach would sit badly with the very volatile levels of expenditure on security. Any formula could, in easily envisaged circumstances, compel the Secretary of

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State to make cuts in security expenditure. Since that would be unacceptable the formula would need to be put aside or renegotiated. In practice, any formulaic approach might well become a negotiated approach whereby the levels were set each year. Therefore, we believe that the negotiated approach would be inevitable, if a single block is maintained. Such a negotiated approach might give rise to possible allegations of the Secretary of State looking to the NIO, rather than the wider NI interests. More significantly, it would inevitably draw him, to some extent, into discussions of the amount of resources required for security.

In-Year Adjustment

11. Under the present Block arrangement the Secretary of State has the power to re-allocate expenditure amongst the Northern Ireland Departments and the NIO. In practice, because security expenditure is volatile, transfers have tended to be from Northern Ireland Departments to the NIO, although there have also been substantial transfers amongst the Northern Ireland Departments themselves. The Treasury attach a great deal of importance to these arrangements because they minimise recourse to the Contingency Reserve. There is little doubt that maintaining single Block arrangements for in-year adjustment would be difficult, since in certain circumstances the Secretary of State would have to instruct that possible expenditure be forgone by the new institutions in order to meet additional security-related expenditure. Furthermore, such in-year arrangements depend for their successful working on a degree of transparency of information, and it would be difficult for new institutions to accept a reduction in their resources without good information about the quality of the security bids for which those resources were taken. That would give again them entree into security policy. There would also be the inevitable suspicion that the Secretary of State would look to the narrow interests of NIO rather than the overall interests of Northern Ireland.

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12. It may be that these difficulties could be lessened. The political difficulties of removing resources from the new institution would make arguments for bidding on the Contingency Reserve for increased security demand more compelling. If satisfactory guarantees of readier access to the Contingency Reserve could be secured when there would be unacceptable political consequences in demanding transfers it would be possible to live the arrangements. But remains to be seen how far the Treasury might be prepared to go (there are grounds for pessimism in the present economic circumstances).

A Split Block or Not

13. It is a reasonable presumption that, with resources limited, the financial interface will always be politically sensitive whatever arrangements are established. It is clear however that a single block arrangement has particular potential for friction between the Secretary of State, with his direct interest in NIO funding, and the local administration who would be dependent on his decisions about their share of the block. Whether this extra degree of political difficulty is worth contemplating depends to a large extent on an assessment of the pattern of resource requirements following the establishment of new institutions. This, in turn, depends primarily on the future course of the security situation.

Effects of Security Expenditure

14. The Law and Order programme currently absorbs almost 20% of the Block (less benefits). The sustained pressure on the security front in recent years has consistently resulted in the programme absorbing a much higher proportion of Northern Ireland's Survey settlement than its strict share of comparability would imply. Our

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best estimate is that, taking the last 4 Surveys (ie 1988-9991 inclusive), the comparability read-across for the Law and Order programme for the years 1991/92 and 1992/93 together was in the region of £100-100m, whereas the baseline for those years was in fact increased by a total of £225m. These figures must be interpreted cautiously but are nevertheless illustrative of the extent of the additional pressure which financing counter-terrorist measures has imposed on the Block. In addition, in year transfers from the social and economic programmes to Law and Order are expected to amount to some £50m in those years. It should also be noted that even if the security problems remain at their present level, simply maintaining the current effort would require more resources each year than the comparability formula will deliver and the share of the Block devoted to Law and Order will continue to rise at the expense of other programmes.

A Peace Dividend?

15. There is, of course, the prospect that following the establishment of new institutions, the pressures on the security front could ease and offer the potential for a 'peace dividend'. It is extremely difficult to predict the phasing of any development of this nature. It may well be, for example, that success in the talks could result in a period of increase violence. However, on the assumption that this is followed by a gradual improvement some broad quantification of the benefits is possible. Any savings in the early years are likely to be modest, coming mainly from reductions in police overtime and bomb damage compensation which might amount to between £10 and £20m per annum. In the longer term, there could be very large savings indeed. If, for example, the law and order situation were ever to normalise to the extent that per capita expenditure could be reduced to, say, about a third about that in Scotland (the next highest in the UK), this would be equivalent to a total spend of about £400m (92/3 prices) compared to actual expenditure currently of over £800m - ie a gross peace dividend of the order of £400m.

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16. To a large extent the case for and against a single block depends on the view taken of the security prospects after an agreement on new institutions. If it is believed that the security problems will continue at the same or at a worse level, then the balance is firmly in favour of a split block. Recent pressures from the Law and Order programme have made the block almost unmanageable. If this continued the problems would be clearly exposed in the interface with a devolved administration and would be a source of considerable aggravation. If, on the other hand, it is expected that the security situation will improve, even if this improvement is a medium term rather than a short-term prospect, the importance of maintaining a stable level of public expenditure and being able to redeploy spending to ease the effects of structural change, suggest that it would be worth accepting some political disadvantages to try to maintain a single block. (Our tentative view is that the survival of new institutions will be called into question in the medium term if security does not improve, so that new institutions will only be present in the medium term if security improves. Hence it is not unreasonable to base our thinking on this issue on the prospect of an improvement in security.)

Adverse Effects of Security Run-Down

17. The regional economy has become highly dependent on public expenditure. An easing of the security problems should improve the region's prospects in a number of ways but, after more than 20 years of civil unrest, there will be significant problems of structural adjustment during the transition to "normality" as security-related expenditure and employment decline. If security-related expenditure were to fall more rapidly than the economic benefits of peace build up then the difficulties of the local economy would increase markedly. In these circumstances the Secretary of State and the regional administration would need as much control as possible over the level of PE in order to ease the

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transition. Without this, there is a risk that improvements in the security situation would be self-defeating. Reduced security expenditure would have a deflationary impact which would increase the region's underlying economic problems and feed renewed civil unrest.

18. A single block offers more control over the level of PE as it gives the Secretary of State the first claim on all resources within the baseline. It is, of course, likely that even with a single block, any "peace dividend" could be eroded by Treasury over time (either through failure to meet otherwise reasonable bids or by "raids" backed by needs assessment). Nevertheless, a structure under which Treasury must try to claw back security savings is preferable to a split block arrangement under which these resources would be automatically surrendered, and which would leave the Secretary of State to try to recover them by mounting bids (which would be in the context of the new public expenditure arrangements which have considerably strengthened Treasury's hand).

Effect on Relations with New Institutions

19. The judgement of this issue could have a material effect on the relationship between the Secretary of State and the new institutions in their formative period. If the "peace dividend" materialised and if HMT left a substantial proportion of it to NI, then the relationship would get off to a flying start. On the other hand, if the "peace dividend" did not materialise (or was clawed back by HMT) and substantial constraints on the new institutions' programmes were required to meet Law and Order requirements, then the relationship could be soured - particularly if a single Block system had been "sold" on the prospect of the "peace dividend".

Conclusion

20. It seems to us that, provided there is a prospect in the medium term of an improved security situation, the objectives set

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out in paragraph 2 would most nearly be met if we maintained in our negotiation with the Treasury a single block based on the notion of comparability which would be allocated between the NIO and the Northern Ireland Departments by the Secretary of State on the basis of negotiated approach. In-year transfers between the NIO and the Northern Ireland Departments would, in principle, remain possible, but there would need to be an understanding that access to the Contingency Reserve would be much readier than at present. If the Treasury were unwilling to give ground on the access to the Contingency Reserve (and the current public expenditure situation may make them more restrictive than in the past), it is possible that a split block in which the NIO and new institutions money were handled separately would be preferable - though again this would hinge on the extent of the in-year pressure relative to the potential for longer term gain. The Treasury would prefer to maintain Block arrangements, and accept the continuation of comparability; that view is shared by the parties. Privately, they see the difficulties with in-year arrangements. There is the further consideration, that once the single block is abandoned, it would be very difficult to reinstate it. On the other hand, if new institutions begin with a single block arrangement there could well be scope effectively to press HMT into a split block, if experience demonstrates that this is where the advantage lies. Our view is therefore that the Secretary of State should in negotiation with the Treasury, lean towards maintaining the Block (which the Treasury favour) on the understanding that a satisfactory assurance from the Treasury be forthcoming on readier access to the Contingency Reserve for in-year pressures in the NIO. If such an assurance is not forthcoming we should reconsider splitting the Block.

Additionality

21. The Sub-Committee report recorded that:

"the local administration would also intend to give higher

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priority to the earning of EC receipts the intention would be that the resources should be used to fund additional local expenditure."

At present the global level of expenditure is supposed to take account of likely EC receipts; and those receipts, when received by Government Departments, are credited to the Consolidated Fund since the necessary resources will already have been made available through the PE system. This system has (so far) satisfied EC requirements on additionality. It also has the great advantage that funding for projects is certain and not dependent on the vagaries of EC finance.

22. However, particularly from the point of view of new institutions, the system has some disadvantages:

- a) Because the extent of any real additionality is impossible to establish the perception of NI politicians is that the resources are not additional;
- b) The system gives no incentive to seek additional resources from Brussels, and tends to make Departments lukewarm in their dealings with the Commission; the need to hold the line on the present UK policy on additionality also makes them defensive and undermines the political presentation of EC programmes;
- c) Cross-border projects with the Republic (which treats EC receipts as wholly additional) are far more complex to set up and administer than might otherwise be the case.

In addition, if new institutions came into being, it is not impossible that its political representatives would encourage the Commission to take a more critical view of the current additionality arrangements. Our view is that the existing policy

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on the additionality of EC resources would be difficult, if not impossible, to sustain if there were new institutions. We should therefore seek a system whereby EC receipts are additional to the Block, even if (as is almost certain) the Treasury seek a corresponding reduction in the Block.

25. The treatment of EC receipts is contentious within Government and the limited changes under the Kerr/Millen agreement earlier this year to meet EC pressure has not addressed the lay question of ensuring genuine additionality at regional level. Our view is that if new institutions came into being it would be the best possible time to try to change the present arrangements, and it would be possible for Government plausibly to argue that the change was limited to the special circumstances of Northern Ireland.

A Dowry?

26. The parties have already put down a marker for additional resources (see Annex A para 7). The Secretary of State will wish to consider, if a settlement is reached, whether a bid could plausibly be made in the prevailing PE climate.

Timing

27. These issues (the future of the Block, additionality and a dowry) should be taken up with the Treasury at the best moment to maximise pressure. We expect that this will be when once a broad agreement has been reached (eg Heads of Agreement) and the important details of new institutions are being worked up by the parties. While we could not argue that concessions in this area are essential to an agreement, we can certainly plausibly argue that the optimum financial arrangements are important in new institutions are to prove successful.

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Conclusion

28. The Secretary of State is invited to endorse the following points in the paper:

a) he is content that the Common Ground identified in para 3 should be the basis of the financial section of any White Paper on the new arrangements, if the talks prove successful;

b) if the security judgement is that there is the prospect of a significant peace dividend in the medium term, then the first preference should be to retain the single block system, accepting that this might make for a somewhat more difficult interface with the new institutions on resource issues. The extent to which HMT is prepared to smooth these difficulties by agreeing on more ready access to the Contingency Reserve to meet in-year pressures on the NIO will be an important consideration. If Treasury are not willing to consider more flexible in-year arrangements the case for a split block would need to be reconsidered in the light of the trade-off between political advantages and resource benefits;

c) if new institutions are agreed, a strong case for EC Resources being seen to be additional to the NI Block should be made to the Treasury;

d) the possibility of a "dowry" for the new institutions should be considered if a settlement is reached, in the light of the PE climate.

e) no formal approach should be made to the Treasury until we can exercise the maximum political leverage; the timing of this is a matter for judgement but will probably arise when a broad agreement is reached and important detail is under negotiation.

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