

PO-CH/NL/0408

PART C

Part C.

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Begins: 21/9/87
Ends: 30/11/87.

PO -CH /NL/0408

PART C

Chancellor's (Lawson) papers

TAX APPROXIMATION AND
VALUE ADDED TAX REFORM

PO -CH /NL/0408
PART C

DD's: 25 Years

[Handwritten Signature]

19/12/95.

BF 22/9



FROM: J M G TAYLOR

DATE: 21 September 1987

PAYMASTER GENERAL

cc: Mr Lavelle
Mr Scholar
Mr P R H Allen - C&E**TAX APPROXIMATION AND THE INTERNAL MARKET: MEETING OF OD(E)
ON 1 OCTOBER**

The Chancellor has seen Mr Allen's minute and enclosure of 14 September. He is content to circulate a paper himself, and has made some amendments to the draft on which he would be grateful for the Paymaster General's comments.

2. The amendments are:

Paragraph 1, last sentence: Redraft to read: "A first Ministerial discussion, essentially of a political nature, is planned to take place, probably without officials present, on the morning of the December meeting of ECOFIN, by which time the report of the EPC study will be in Ministers' hands."

Paragraph 2, first sentence: delete "now".

Paragraph 3, first sentence: Redraft to read "It is clear that public and parliamentary opinion in the UK would be strongly opposed to acceptance of the principle that the UK's right to set its own tax levels should be any further constrained by EC law."

Paragraph 3, last sentence: redraft last part of sentence to read "...others are likely to have the same basic objections as the UK."

Paragraph 4, second sentence: delete this sentence.

Paragraph 4, last sentence: delete this sentence. Replace with: "The proposals strike at the heart of national economic

JMG
To
PS/AMG
2/9



policy making. This is seen most clearly in the case of those Member States who would be obliged to effect a sharp reduction in their indirect tax yield, which would have to be offset by a sharp increase in income tax, or on Government borrowing, or by a sharp reduction in public expenditure".

Paragraph 5, first sentence: amend to read: "The Commission's proposals would also increase opportunities for tax fraud....".

Paragraph 7, third sentence: amend to read "Real progress could be achieved by concentrating on the gradual reduction of frontier controls...".

Paragraph 7: add at end of paragraph: "It is significant that in the United States, the variation on sales taxes from State to State (although slightly greater than that which the Commission is prepared to tolerate within the Community) is constrained by market forces and only by market forces: any attempt by the Federal Government to dictate to the individual States would be unconstitutional."

A handwritten signature in dark ink, appearing to be "JMG".

J M G TAYLOR

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BF 28/9



FROM: S P JUDGE
DATE: 22 September 1987

PS/CHANCELLOR OF THE EXCHEQUER

cc Mr Lavelle
Mr Scholar
PS/Customs & Excise
Mr P R H Allen - C&E

TAX APPROXIMATION AND THE INTERNAL MARKET: MEETING OF OD(E) ON 1 OCTOBER

The Paymaster General has seen your minute of 21 September to me.

He is content with the revised draft, although he agrees with Mr Lavelle's suggestion that the end of the last sentence in **paragraph 1** should read "... by which time a report of the EPC study will be available". This reflects the likelihood that the EPC may well not have produced a formal report in time for the December ECOFIN.

The Paymaster will be at the Budget Council when OD(E) meets on October 1, but notes that OD(E) will mesh well with his meal with EDG MEPs in London on October 5.

The Paymaster notes that he could have a further word with the Chancellor on latest developments after Prayers - either on October 2 (if he has returned) or on October 5 itself.

Deborah Francis.

pp. S P JUDGE
Private Secretary

PS/AMG
To
PS/CH
22/9

prep for OD(E)

CONFIDENTIAL

FROM: P R H ALLEN
DATE: 22 SEPTEMBER 1987

PAYMASTER GENERAL

cc. PS/Chancellor
Mr Lavelle
Mr Scholar

TAX APPROXIMATION AND THE INTERNAL MARKET : MEETING OF OD(E) ON 1 OCTOBER

ALLEN
to
AMG
22/9

1. Mr Taylor's note to you of 21 September included a number of amendments which the Chancellor has made to the draft OD(E) paper which I submitted to him on 14 September.

2. We are a little concerned about the third amendment (paragraph 3, first sentence). This is less in relation to OD(E) where discussion will necessarily be on a fairly general level and where the context is clear, but in terms of public presentation. The Chancellor's amendment could be taken to mean that the UK is not prepared to accept any future constraint on its tax levels by EC law. This could be regarded as ruling out changes in VAT status from exempt to

Internal circulation:	CPS	Mr Finlinson
	Mr Knox	Mr Kent
	Mr Jefferson Smith	Mr Cockerell
	Mr Nash	Ms French

taxable (and vice versa) under the 18th and 19th VAT Directives and could also be seen as suggesting that the UK was prepared to reject an adverse verdict by the European Court of Justice in the current VAT zero rates case. When the UK response to the Commission's proposals on tax approximation is made public, we feel that the context of our rejection of future EC constraints over UK tax levels will need to be made clear.

~~RA~~.

P R H ALLEN



Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

RESTRICTED

FROM: B H KNCX
DATE: 23 September 1987

CHANCELLOR OF THE EXCHEQUER

cc. Mr Lavelle
Mr Scholar
Mr A S C Edwards

TAX APPROXIMATION : GERMAN INTENTIONS

1. In his minute of 18 September, Mr Taylor asked me to explore urgently the intentions of the German Finance Ministry on tax approximation in the light of the comments by Frau Adam-Schwaetzer of the German Foreign Ministry that they wished to make significant progress in this area during their Presidency.
2. From our contacts in the German Finance Ministry it would appear that they see themselves as being hustled by the Foreign and Economics Ministries to ensure that there will be "some progress - any progress" during the German Presidency. Finance Ministry officials are still examining the Cockfield proposals, but have considerable reservations. Although they appear to be less concerned than we are about the question of fiscal sovereignty, they see serious problems in relation to some of the excise duty proposals and with the VAT clearing house scheme, (where, because the Laender share in the VAT revenue the position is highly complicated). Their current view appears to be that the tax approximation proposals will not be acceptable, that they would like to delay progress on the substantive issues and that Stoltenberg's opposition will prevent significant progress during the German Presidency.

Internal circulation:

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Mr Jefferson Smith

Mr Nash

Mr Finlinson

Mr Allen

Mr Kent

Mr Cockerell

Ms French

Mr Walton (UKREP)

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3. On the other hand, the line from the German Foreign Ministry is as indicated by Frau Adam-Schwaetzer to Mrs Chalker. They argue that the increases in excise duties which the Cockfield proposals would require would make up the revenue lost by the intended German direct tax cuts and could conveniently be blamed on "Brussels". Their view is that Genscher calls the shots in relation to priorities in this area.

4. It seems fairly clear from this that, despite what Frau Adam-Schwaetzer suggested, the German position on tax approximation is by no means settled. At this stage it is difficult to judge what their approach will eventually be. It seems unlikely, however, that they will be in the vanguard of those opposing the Cockfield proposals. Indeed, a likely tactic of their Presidency may well be to pick certain areas of the proposals for detailed study in the hope of making progress, if only in limited areas.

5. We shall be keeping in touch with our German contacts and will let you know if and when anything emerges which alters the position described above.

Bryce Knox

B H KNOX

ANNEX C

1. cc by bag Mr Peter Allen
Reference: Mr Martin }
Mr Sinclair } They

NOTE FOR THE RECORD

- 2. Mr Wall
- 3. Mr Thomson

NOTE OF A MEETING BETWEEN THE SECRETARY OF STATE FOR TRADE AND INDUSTRY AND PRESIDENT DELORS : 22 SEPTEMBER

Those present

Lord Young
 Sir David Hannay
 Miss Neville-Rolfe
 Dr Walker
 Mr Bender

President Delors
 Mr Baer

cc Mr Knox
 Mr Jefferson Smith
 Mr Gowerell
 Mr Kent
 Mr French

23/9/87

RA
29/9

INTERNAL MARKET

1. The Secretary of State said that he proposed making a serious effort to raise the consciousness of the services and manufacturing sectors of British industry to the opportunities of the single market. He planned a conference next spring, possibly in Lancaster House, bringing together interests from British business. Perhaps the President might be persuaded to come over. President Delors said that this might be possible. The Commission office in London would, meanwhile, be at our disposal. Miss Neville-Rolfe said that she had already had contacts with Mr Drew.

2. The Secretary of State said that not enough of British industry looked positively at Europe or played a real part. The next four years would shape the subsequent 25. President Delors noted that the European Council had drawn priorities, including standardisation, public purchasing and capital movements. It was very important for the credibility of the internal market that momentum could be demonstrated to the entrepreneur. The Secretary of State said that he was very keen to work towards a single market for goods and services, which he regarded as more important than fiscal harmonisation. President Delors said that he thought that the fiscal decision would be the last to be taken. But he was very concerned about the need for approximation of corporate taxation: there could not in his view be full liberalisation of capital without this. Sir D Hannay said that the difference between the Commission and the UK was that we were sceptical about the legislative route, and took the view that, if the barriers were removed, there would be pressures to bring tax levels closer together. President Delors said that, if the Community liberalised capital and built a financial space with the possibility of fiscal evasion, it would be difficult to present to national Parliaments that there would be a fiscal regime for those in employment, but not for capital. The Secretary of State said that the UK's own experience, with the abolition of exchange controls overnight, had demonstrated that there need be no problem in practice. President Delors said that the right answer might lie in reinforcing mutual assistance between fiscal administrations. This might lead to a practical approximation of tax regimes over 10 years or so, which would not be possible by legislative decisions. The problem in the pragmatic approach was, however, Luxembourg.

.../...

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(2)

3. The Secretary of State said that he believed that important progress could be made in goods and services over the coming years which could have a greater effect on wealth creation. President Delors said that it was important that Finance Ministers saw Lord Cockfield's proposals as a starting point for reflection, and no more. If there could be agreement on future financing in December, the German Presidency could be wholly devoted to the internal market. There was a need to convince the German people of the necessity of achieving the internal market.

4. The Secretary of State said that it was important that progress was fair. We had a number of problems on financial services. President Delors said that if the Council could agree on the last stage of capital liberalisation, which he hoped could be done early next year, this would give a dynamic momentum to liberalisation of financial services. Sir D Hannay said that this was the right way round; if things were done the other way round, there would be a risk of too much central regulation. For example, we feared the risk of an illiberal insurance regime. President Delors thought that progress on banking might be easier, as there was less tradition of tough rules and greater progress towards mutual acceptance. The fiscal problem could be solved through mutual assistance of fiscal regimes.

INNER CITIES/STRUCTURAL FUNDS

5. President Delors said that he was looking for ways of including inner cities in the Structural Funds package: the problem was how to include them in programmes under the second objective. Sir D Hannay said that we welcomed this aspect of the Commission's proposals, although he agreed that there was a long way to go. President Delors said that the time was right for common reflections. The Secretary of State said that the need was to get entrepreneurship back to inner cities. The problems must be common among the Member States. We were all looking for new techniques, and it made sense to pool information.



23 September 1987

B G BENDER



H M Customs and Excise

With Compliments

from RICHARD ALLEN.

C&E 763

F269 (AUG. 1972)

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DEFENCE AND OVERSEA POLICY COMMITTEE

SUB-COMMITTEE ON EUROPEAN QUESTIONS

25/9/87.

TAX APPROXIMATION

Note by the Chancellor of the Exchequer

1. The Commission's package of tax approximation proposals will formally be presented by Lord Cockfield to the next Economic and Financial Affairs Council (ECOFIN), probably on 16 November if, as seems likely, the October meeting is cancelled. It was agreed at the informal ECOFIN on 11-13 September that the proposals would be remitted for further study to the Economic Policy Committee (EPC). A first Ministerial discussion, essentially of a political nature, was planned to take place, probably without officials present, on the morning of the December meeting of ECOFIN, by which time the report of the EPC study was intended to be available, but if the October ECOFIN is cancelled, the timetable may slip into early next year.
2. It is unlikely therefore to be clear how these issues are to be taken forward until the turn of the year at the earliest. Nevertheless, we need to agree a basic approach. More detailed and specific briefing can then be developed for use in Brussels and at home to explain the Government's position.
3. It is clear that public and parliamentary opinion in the UK would be strongly opposed to acceptance of the principle that the UK's right to set its own tax levels should be any further constrained by EC law. Opposition would be

C O N F I D E N T I A L

ased not simply on the principles involved but also on their practical manifestation, in the shape of unwelcome changes to VAT zero rates and excise duties (where sharp reductions in the price of drink and tobacco would provoke the health lobby). Although some Member States may feel - despite the difficulties which elements of the Commission's proposals would cause them - that political agreements at European Council level have to some extent committed them to a surrender of sovereignty in this area, others are likely to have the same basic objections as the UK.

4. Quite apart from the issue of sovereignty, there are considerable practical, administrative and technical drawbacks in the Commission's proposals, and we could not offer any assurance that they could be made to work satisfactorily even if the political problems could be overcome. Many Community industries would be unable to absorb the very large changes in tax rates and allied market conditions without serious damage. National social policies (eg on the pricing of drinks and tobacco for health policy purposes) would be jeopardised. The proposals strike at the heart of national economic policy making. This is seen most clearly in the case of those Member States who would be obliged to effect a sharp reduction in their indirect tax yield, which would have to be offset by a sharp increase in income tax, or in Government borrowing, or by a sharp reduction in public expenditure.

5. The Commission's proposals would also increase opportunities for tax fraud, whereas the countermeasures they suggest (in effect, enhanced mutual assistance between national administrations) would almost certainly prove inadequate. The VAT clearing system would give insufficient certainty as to the collection of national revenues, would be fraught with administrative difficulties and would provide insufficient control against tax fraud. On both issues, national administrations are accountable to national parliaments. I could not give the necessary assurances that the new systems were economic, efficient, effective and secure. On excise duties the Commission has implicitly conceded defeat; fiscal frontiers (ie border tax adjustments and the associated controls) would remain, and - quite possibly - new restrictions on wholesale transactions would be required to prevent abuse.

6. Given the overwhelming practical, technical and political difficulties in the package to be faced to a greater or lesser extent by all Member States, it may be that the Community will spend the next few months seeking a way to extricate itself from its difficulties over approximation. Although more work will be required to flesh out proposals for a constructive alternative approach, the outline of a strategy has already been prepared by officials.

7. It can basically be summarised as follows. The difficulties posed by tax approximation are too great for the Commission's package to be considered a realistic starter, but that is no reason to cease all work on the tax obstacles to freer movement. Real progress could be achieved by concentrating on the gradual reduction of frontier controls (which would have immediate practical benefits for intra-Community trade and travel) while holding open the possibility of their removal in the longer term. This would avoid the economic and political drawbacks of the Commission's tax approximation proposals while increasing the scope for market forces to provide a growing (but more politically and economically acceptable) constraint on the divergence of Member States' tax rates. We believe this line of argument has the best prospect of successfully rejecting the proposals whilst projecting a constructive image in Brussels. It is significant that in the United States, the variation in sales taxes from state to state (although slightly greater than that which the Commission is prepared to tolerate within the Community) is constrained by market forces: any attempt by the Federal Government to dictate to the individual states would be unconstitutional.

8. This leaves problems of timing and tactics - both in Brussels and at home. Although there seems to be a general reluctance among our Community partners to enter into substantive discussions about the Commission's proposals, Lord Cockfield's presentation to the October ECOFIN may arouse renewed domestic concern. Forthright public opposition to the proposals by the UK at this stage may not be appropriate, not least since no detailed Ministerial Debate is planned until December. However, we will need to guard against accusations of readiness to "sell out" and be ready to make clear that the remit to EPC is for re-examination, not implementation of the Commission approach.

On balance, I believe our interests may be best served by assessing the reactions of other Member States and encouraging those who share our desire to extricate the Community from the proposals to assist us in achieving this end. The precise mix of arguments we should ourselves deploy in the EPC discussions, including the extent to which we should set out our views about alternative approaches, will require further consideration and will doubtless need to be reassessed as discussion goes forward. I shall have to bear in mind developments on the domestic front and if pressure for a very forthright statement of the Government position becomes great I shall reconsider the tactics.

10. I invite the Committee to note the basic line summarised in paragraph 7 and to endorse the suggested tactical approach outlined in paragraph 8-9.

NIGEL LAWSON

C O N F I D E N T I A L

ANNEX
B

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return to N. Budd

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FRAME GENERAL

YRTEL NO 455: TAX APPROXIMATION

SUMMARY

1. FRENCH LARGELY COMMITTED TO THE PRINCIPLE OF TAX APPROXIMATION AS ESSENTIAL ELEMENT IN THE COMPLETION OF THE INTERNAL MARKET, WILL BE PREPARED TO MAKE SOME SACRIFICES TO BRING IT ABOUT, AND WILL EXPECT OTHERS TO DO SO TOO. THEY WILL NOT WANT TO SEE ZERO RATES CONTINUE. BUT DOUBTS ABOUT THE PRESENT COMMISSION PROPOSALS, AND NO RUSH TO MOVE THINGS FORWARD. THEY SEE THE NEXT STEP AS SERIOUS QUESTIONING OF THE COMMISSION.

DETAIL

2. WE HAVE SPOKEN TO VILLEMUR (QUAI) AND LEBRUM (FISCAL DIVISION, MINISTRY OF FINANCE) TO FOLLOW UP MRS CHALKER'S CONVERSATION WITH BOSSON, AND EARLIER CONVERSATIONS WE HAVE HAD WITH CONSTANS (SGCI, ROUGHLY EQUIVALENT TO EUROPEAN SECRETARIAT, CABINET OFFICE), AND RAYMOND (BANQUE DE FRANCE). WE HAVE ALSO RAISED THE SUBJECT WITH BIANCO (SECRETARY GENERAL ELYSEE), RODOCANACHI (MATIGNON) AND GUIGON. WITH ONE EXCEPTION (PARAGRAPH 7 BELOW) THESE CONVERSATIONS WERE ALL CONSISTANT WITH THE FOLLOWING ACCOUNT BY VILLEMUR.

3. VILLEMUR (QUAI) CONFIRMED TO US, AS BOSSON HAD TO MRS CHALKER, THAT THE FRENCH REGARDED TAX APPROXIMATION AS AN ESSENTIAL ELEMENT IN A SINGLE MARKET IN WHICH FRONTIER CONTROLS WERE TO BE REMOVED. HE IMPLIED THAT THIS HAD NOT BEEN AN EASY DECISION TO REACH. THE PATIONAT HAD HAD GRAVE DOUBTS, INITIALLY ARGUING THAT VAT WAS A NEUTRAL TAX, BUT HAD BEEN BROUGHT ROUND. THERE HAD BEEN CONCERN TOO ABOUT THE REVENUE LOSS FROM THE REDUCTION OF THE 33 1/3 PER CENT LUXURY VAT RATE, AND CONCERN THAT THE SWITCH FROM INDIRECT TO DIRECT TAX WHICH WOULD BE NEEDED TO COMPENSATE FOR IT WOULD RUN COUNTER TO THE GOVERNMENT'S ECONOMIC THINKING. (LEBRUN, FINANCE MINISTRY, DENIED THAT THERE WOULD NECESSARILY BE A REVENUE LOSS, ARGUING THAT INCREASED PRODUCTION FLOWING FROM LOWER TAX RATES AND OTHER SUPPLY SIDE MEASURES WOULD GENERATE EQUIVALENT REVENUE. NOBODY ELSE HAS KEEN THIS VIEW).

4. VILLEMUR SAID THAT THESE DOUBTS HAD BEEN MORE THAN OUTWEIGHED BY FRENCH COMMITMENT TO THE INTERNAL MARKET AND BY THEIR BELIEF THAT IF FRONTIER CONTROLS WERE TO BE REMOVED, TAX APPROXIMATION WAS ESSENTIAL IF GENUINE COMPETITION WAS TO BE ESTABLISHED AND DISTORTIONS AVOIDED. HE SAID THAT THE FRENCH WERE EQUALLY CLEAR, HOWEVER, THAT THE PRESENT COMMISSION PROPOSALS WOULD NOT DO. THERE WAS A REAL RISK THAT THE REMOVAL OF FRONTIERS PLUS APPROXIMATION ON COMMISSION LINES WOULD INCREASE RATHER THEN REMOVE DISTORTIONS. THIS WAS PARTLY A QUESTION OF RATES. A SIX POINT RANGE WAS TOO GREAT. BUT IT WAS ALSO A QUESTION OF THE STRUCTURE. THE COMMISSION PROPOSALS TOOK INSUFFICIENT ACCOUNT OF THE DIFFERING VAT BASES IN MEMBER STATES, AND OF DIFFERING ADMINISTRATIVE MECHANISMS. THE PROPOSALS FAILED TO COME TO GRIPS WITH A HIGHLY COMPLEX SUBJECT.

5. VILLEMUR SAID THAT FRENCH THINKING ON DETAILS WAS AT A PRELIMINARY STAGE. THEY SAW THE NEXT STEPS AS BEING TO PUT BASIC QUESTIONS TO THE COMMISSION. HE ADDED THAT ONE IDEA UNDER CONSIDERATION ON RATES WAS TO NARROW THE COMMISSION'S PRESENT TWO BANDS AND TO ADD A THIRD, HIGHER, VAT RATE, AT LEAST AS A TEMPORARY MEASURE.

6. LIKE OTHERS TO WHOM WE HAVE SPOKEN, VILLEMUR SAW EXCISE DUTIES AS A SEPARATE ISSUE. HERE TOO, CONSIDERATION OF THE DETAILS IS AT AN EARLY STAGE. THERE IS CLEAR ACCEPTANCE OF THE POLITICAL DIFFICULTY IN RAISING DUTIES ON TOBACCO AND WINE (THOUGH THE CREATION OF A NEW PRICE INDEX WITHOUT TOBACCO MAY MAKE THE FORMER SLIGHTLY EASIER) AND CONCERN ABOUT THE REVENUE LOSS FROM LOWERING THEM ON PETROLEUM PRODUCTS. LEBRUN SAID THAT EXCISE DUTY WAS A BAD TAX, AND SHOULD NOT BE RAISED. (THIS LINE HELPS THE FRENCH ON TOBACCO AND WINE, BUT NOT PETROL).

7. THE EXCEPTION AMONG OUR FRENCH INTERLOCUTORS WAS BIANCO, WITH WHOM I RAISED THE SUBJECT ON 25 SEPTEMBER. HE TOLD ME HE WAS VERY SCEPTICAL ON POLITICAL GROUNDS ABOUT THE POSSIBILITY OF ACHIEVING FAR-REACHING TAX APPROXIMATION AND DID NOT REGARD IT AS AN ESSENTIAL ELEMENT IN MEETING THE 1992 OBJECTIVE. HE DID NOT SEE HOW THE REVENUE LOSS COULD BE MADE GOOD. IN ANY CASE, IN TERMS OF ACHIEVING UNDISTORTED MARKET CONDITIONS THERE WERE OTHER FACTORS WHICH WERE ARGUABLY EVEN MORE IMPORTANT THAN TAX RATE ANOMALIES E.G. THE WIDE DIVERGENCIES BETWEEN MEMBER STATES IN SOCIAL SECURITY CONTRIBUTIONS. BIANCO THEREFORE THOUGHT THAT WE SHOULD TAKE A LONG VIEW: IN THE SHORT TO MEDIUM TERM WE COULD LIVE WITH SOME INTER-STATE NON-APPROXIMATION OF TAXES (AS IN THE UNITED STATES) WITH SOME

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SYSTEM OF OFFSETTING COMPENSATION AT FRONTIERS WHERE FEASIBLE.

8. WE HAVE SINCE FOLLOWED UP THIS CONVERSATION BY TALKING TO MADAME GUIGOU AT THE ELYSEE. SHE TOLD US (PLEASE PROTECT) THAT WHAT WE WERE HEARING FROM BIANCO WAS VERY MUCH HIS LONGSTANDING PERSONAL RESERVATIONS, AND THAT THEY DO NOT AFFECT THE GENERAL CENTRE OF GRAVITY FOR THE EVOLUTION OF POLICY WITHIN THE FRENCH ADMINISTRATION (PARAS 3-6 ABOVE) ALTHOUGH THEY DO BRING OUT WHAT A PARTICULARLY DIFFICULT SUBJECT IT IS. I AM INCLINED TO ACCEPT MADAME GUIGOU'S WORD ON THIS, ALTHOUGH ON THIS SUBSTANCE BIANCO MAY HAVE A POINT (MOREOVER HE IS CLOSER TO THE POLITICIANS THAN OUR OTHER INTERLOCUTORS.

COMMENT

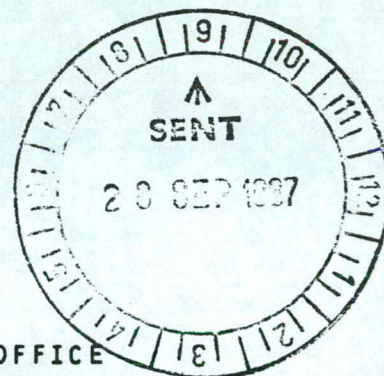
9. I THEREFORE CONCLUDE THAT WHATEVER DIFFERENCES THERE MAY HAVE BEEN ABOUT THE PRINCIPLE OF TAX APPROXIMATION HAVE NOW BEEN LARGELY SUNK, AT LEAST IN PUBLIC. ALL THOSE TO WHOM WE HAVE SPOKEN (BAR BIANCO) HAVE SUNG VIRTUALLY THE SAME TUNE. THERE CAN BE LITTLE DOUBT ABOUT THE FRENCH COMMITMENT TO APPROXIMATION AS PART OF THE COMPLETION OF THE INTERNAL MARKET, NOR ABOUT THEIR WILLINGNESS TO MAKE SOME SACRIFICE TO ACHIEVE IT. THEY WILL CERTAINLY CONTINUE TO PRERESENT THEMSELVES AS DOING SO - AS OVER RECENT VAT REDUCTIONS ON CARS AND RECORDS - AND WILL EXPECT OTHERS TO DO SO TOO. EVERYONE TO WHOM WE HAVE SPOKEN HAS ARGUED AGAINST CONTINUANCE OF ZERO RATES. BUT THE FRENCH ARE EQUALLY UNHAPPY WITH THE PRESENT COMMISSION PROPOSALS, AND WILL BE IN NO GREAT HURRY TO MOVE MATTERS FORWARD.

FERGUSSON

YYYY

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ANNEX
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ANNEXE A

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YOUR TELNO 455: INTERNAL MARKET: TAX APPROXIMATION

SUMMARY

1. THE GERMANS CONFIRM THAT THEY ARE CONSIDERING MAKING PROGRESS ON TAX APPROXIMATION A THEME FOR THEIR PRESIDENCY. SOME OPPOSITION TO THIS WITHIN THE GOVERNMENT BUT THE IDEA IS GATHERING MOMENTUM. AS THEY STAND THE PROPOSALS WILL CAUSE SOME PRACTICAL DIFFICULTIES FOR THE GERMANS BUT NONE THAT ARE INSURMOUNTABLE.

DETAIL

2. THE FEDERAL MINISTRY OF FINANCE AND THE AUSWAERTIGES AMT HAVE TOLD US THAT NO DECISIONS HAVE YET BEEN TAKEN ON THE HANDLING OF THIS ISSUE. MINISTRIES HAVE BEEN INSTRUCTED TO EXAMINE THE PROBLEMS CAUSED BY THE COMMISSION PROPOSALS AND TO DISCUSS POSSIBLE WAYS FORWARD. FOUR WORKING GROUPS HAVE BEEN ESTABLISHED WHICH WILL BEGIN WORK IN EARNEST NEXT WEEK. WHEN ONCE THE FEDERAL GOVERNMENT HAS DECIDED ITS POSITION, THE LAENDER WILL HAVE TO BE CONSULTED BECAUSE OF THEIR INTEREST IN THE MAJOR TAXES AFFECTED - RECEIPTS FROM EACH INDIVIDUAL TAX IN THE FRG ARE APPORTIONED IN ADVANCE TO FEDERAL, LAND AND MUNICIPAL LEVELS OR A COMBINATION OF THE THREE. THE FINANCE MINISTRY POINTED OUT THAT WHILE THE VAT PROPOSALS THEMSELVES WILL CAUSE MINIMAL PRACTICAL DISRUPTION IN THE FRG, ANY MOVES WHICH TOUCH ON THE LAENDER'S CONSTITUTIONAL RIGHT TO A SHARE OF TAX RECEIPTS CARRY DOMESTIC POLITICAL IMPLICATIONS WHICH WILL NEED CAREFUL HANDLING. IN ADDITION, THE PROPOSALS CONCERNING EXCISE DUTY WILL CAUSE AN INCREASE IN THE BEER TAX AND THE IMPOSITION OF NEW DUTY ON WINE - AT PRESENT ONLY SPARKLING WINE IS SUBJECT TO EXCISE DUTY.

3. THE FINANCE MINISTRY AGREE THAT NONE OF THESE PROBLEMS IS INSURMOUNTABLE AND ACKNOWLEDGE THAT CONSIDERABLE POLITICAL STEAM IS BUILDING UP WITHIN THE GERMAN GOVERNMENT FOR SOME PROGRESS TO BE MADE. THEIR INTENTION IS TO PLAY IT AS LONG AS POSSIBLE. THEY EXPECT THE 12 OCTOBER ECOFIN TO BE LIMITED TO A PROCEDURAL DISCUSSION OF THE FUTURE HANDLING OF THE SUBJECT. THEY DO NOT WANT IT TO FORM THE MAIN THEME OF THE GERMAN PRESIDENCY. THE AUSWAERTIGES AMT ON THE

OTHER HAND BELIEVE THAT THEY HAVE THE SUPPORT OF THE ECONOMICS AND TRANSPORT MINISTRIES AND ARE WORKING FOR A FIRM GERMAN POSITION BY THE DECEMBER ECOFIN. BOTH MINISTRIES HAVE STATED THAT THEY ARE NOT YET IN A POSITION TO COORDINATE A POSITION WITH OTHER MEMBER STATES, INCLUDING OURSELVES AND THE FRENCH. PARIS MAY BE ABLE TO COMMENT ON WHETHER THERE HAVE IN FACT BEEN BILATERAL DISCUSSIONS ON THIS POINT.

COMMENT

4. AS WE KNOW FROM THE COMMENTS OF RUHFUS, ADAM-SCHWAETZER AND OUR CONTACTS, THE AUSWAERTIGES AMT HAVE SEIZED ON TAX APPROXIMATION AS A LOGICAL SUBJECT ON WHICH TO CONCENTRATE DURING THE GERMAN PRESIDENCY. THE FINANCE MINISTRY ARE OBVIOUSLY FIGHTING A REAR-GUARD ACTION AGAINST THIS, BUT THEY MAY BE TOO LATE BECAUSE OF THE MOMENTUM WHICH THE IDEA APPEARS TO HAVE GATHERED. THE ESTABLISHMENT OF WORKING GROUPS INDICATES HOW SERIOUSLY THE GOVERNMENT IS CONSIDERING THE IDEA. WHILE HIS OFFICIALS ARE INTENT ON SLOWING DOWN THE ATTEMPT, STOLTENBERG, UNDER FIRE FOR HIS FISCAL POLICIES AND PRE-OCCUPIED BY THE UNCERTAINTY OVER THE LAND GOVERNMENT IN HIS HOME BASE OF SCHLESWIG-HOLSTEIN, MAY NOT FEEL SURE ENOUGH TO FIGHT A POLITICAL BATTLE SHOULD IT COME TO THAT. INDEED, HE MAY SEE ACTION ON PROPOSALS AFFECTING VAT AND EXCISE TAXES AS A WELCOME SMOKE-SCREEN FOR UNPOPULAR DECISIONS, PROBABLY INVOLVING RAISING SOME TAXES, TO FINANCE THE PLANNED 1990 TAX REDUCTION PROGRAMME TO WHICH THE KOHL GOVERNMENT IS COMMITTED. MOREOVER, THE POLITICAL DIFFICULTIES OF RAISING THE BEER TAX, PARTICULARLY IN BAVARIA, STILL SMARTING FROM WHAT IS SEEN AS BRUSSELS' MEDDLING WITH THE PURITY LAW (REINHEITSGEBOT), MAY BE BALANCED OUT BY THE FINANCIAL ADVANTAGE TO THE LAENDER, TO WHOM BEER TAX REVENUE ACCRUES. THIS WOULD APPLY EVEN MORE IF THE FEDERAL GOVERNMENT ALSO AGREED TO THE LAENDER GETTING A SHARE OR ALL OF ANY DUTY ON WINE.

BULLARD

YYYY

DISTRIBUTION

19

ADVANCE

19

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Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

*MS X!
VAG or VAG-1
VAG or VAG-1*

FROM: P JEFFERSON SMITH
DATE: 29 September 1987

PAYMASTER GENERAL

cc **Chancellor**
Chief Secretary
Mr Anson
Mr Gilmore
Mr Scholar
Mr Pirie
Mr Burr
Mr Cropper

VAT : PROPOSALS FOR GRANT-MAINTAINED SCHOOLS

1. The Government's proposals for giving greater autonomy to schools pose a VAT problem, arising from the special treatment enjoyed by local authorities. In broad terms, schools which opt into the new scheme would cease to be maintained by local education authorities; they would become corporate bodies with charitable status.

2. This would change their VAT status, and the purpose of this note is to alert you to the position and to propose the line to take if you are approached on the topic.

THE PROBLEM

3. Local authorities are entitled to recover from this department the VAT they incur on the purchases they make for the purposes of undertaking their non-business activities under the provisions of section 20 of the VAT Act 1983. Most local authority education is not provided by way of business, being funded essentially out of the rates and the rate support grant. Local authorities can therefore recover the VAT they incur in providing this education.

Internal distribution: CPS
Mr Knox

Ms Barrett
Mr G Taylor
Mr Ruston

4. The proposed grant-maintained schools will provide free education and, like local authority schools, they will not be in business in providing this education. But, having severed their connection with local authorities, they will not be able to recover the VAT they incur on their purchases. They will be outside the provisions of section 20; and they will not be able to recover the tax under the normal input tax credit mechanism because this is possible only where a business makes supplies on which VAT is chargeable.

5. The consultation paper on grant-maintained schools circulated by DES says that 'the Government intends that the establishment of a grant-maintained school should leave the Local Education Authority and its rate or community charge payers in the same financial position as they would have been, had the LEA continued to maintain the school'. It goes on to say that the recurrent (annual) grant will be based on the funding of LEA schools and that the full amount of the annual grant will be recovered from the LEA. It is evident, therefore, and this has been confirmed at a meeting with DES, that they had overlooked the VAT implications of the new proposals: the net cost to an LEA of running a school does not include VAT, because the VAT can be recovered under section 20. Grant-maintained schools, on the other hand, will not be able to reclaim the VAT they incur and, taking the proposals in the consultation paper at face value, there would be a funding shortfall equal to this unrecovered VAT.

6. If the Government's aim implicit in introducing a scheme of grant-maintained schools is to be achieved, it is clear that this shortfall will have to be made up. In essence, there are three ways in which this could be done: by recovering the gross (ie VAT inclusive) cost from LEAs (which would create an additional burden on local taxpayers); by topping-up the grant from central funds; or by including grant-maintained schools in section 20. It is likely that Treasury Ministers will be pressed to adopt this third

course, but in our view there are very serious objections: indeed, to adopt this course would cut across the policy adopted by successive Governments for this section and could have substantial repercussive effects.

SECTION 20 POLICY

7. Section 20 was originally enacted to fulfil an undertaking given by the Conservative Party before the start of the tax that VAT would not be allowed to fall as a direct burden on the rates or the rate support grant. The vast majority of the bodies covered by the section are therefore local authorities or other rate funded bodies, which have a wide range of non-business activities and which cannot reclaim the tax they incur under the normal input tax credit mechanism. In effect, the provision is simply one of the means by which the bodies to which the section refers are financed by central Government.

8. Because of the valuable fiscal subsidy it would provide, there has been constant pressure over the years for the inclusion of new bodies in the section. These have ranged from non-departmental public bodies to charities, and voluntary bodies which receive financial support from local authorities and which undertake activities which they claim would have to be done by local authorities themselves if they did not undertake them on their behalf. In fact, the only bodies which have been added to the section since the tax started have been bodies with cast iron credentials: bodies which undertake local authority functions and which are financed, wholly or in part, direct from the rates. The most recent additions include some of the bodies brought into being on the abolition of the GLC and the Metropolitan County Councils, and Probation and Magistrates' Court Committees.

9. Against this background, grant-maintained schools would be very poor candidates for inclusion in section 20. They will be charities; they will not, by deliberate intention, be an arm of

local government; and they will not be funded direct from the rates. If they were to be included, it would be very much more difficult to refuse the inclusion of many other bodies, not least of which would be charities generally and voluntary bodies, and in the end this could lead to a loss of revenue which is difficult to quantify but likely to be substantial.

10. To complete the picture, it should be said that the original legislation specified a few bodies for section 20 which do not meet the normal criteria for inclusion, notably the BBC and ITN. There were special reasons for this. The BBC was included to avoid an increase in the licence fee to compensate for VAT incurred on expenditure - or an equivalent reduction in the money available for broadcasting services. ITN was included so that it would not be less favourably treated than the newspapers for which zero rating was provided. No direct analogy can be drawn with these and the proposed grant-maintained schools; a closer comparison lies with private sector schools which charge fees and are exempt from the tax. These schools cannot recover the tax on their expenditure, while if the proposed grant-maintained schools were included in section 20, the effect would be to treat them as though they were zero-rated. It is our firm recommendation, therefore, that any pressure for their inclusion in section 20 be resisted.

NEXT STEPS

11. DES did not consult us on the proposals at the formative stage prior to the Election. Immediately after the Election, and in the light of the commitment in the manifesto, we warned DES that there were likely to be VAT problems with the proposals, which were still then in very general terms, and of the need to consult us. They were, however, slow to respond and it is only in the last ten days that we have been able to make them fully aware of the financing problem. We understand that DES intend to approach Treasury and, if the approach is at Ministerial level, we will, of course, offer a draft reply on the section 20 point.

However, we are informed that drafting of the Bill is already in hand with the aim of presentation in November. If, therefore, you agree to the line we have proposed, we would propose to take the matter forward on the above basis at senior official level, explaining that the problem of the additional VAT burden is not to be solved by refunds through the VAT system.

ph ~

P JEFFERSON SMITH

CONFIDENTIAL

1. MR LAVELLE^m
2. CHANCELLOR

FROM : M PARKINSON
30 September 1987

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Edwards
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Mortimer
Mr F K Jones
Mr Tyrie
PS/C&E

COMPLETION OF THE INTERNAL MARKET : OD(E)(87)18 AND 19

These papers are expected to occupy the last twenty minutes of OD(E). Lord Young's paper is largely a reminder of existing priorities, suggests a further stocktaking at the turn of the year and (the main new point) proposes commitment to a campaign to raise business awareness. Your own paper on tax approximation explains why the Commission package is not a starter but that we can take up a constructive posture by advocating reduced frontier controls. If time runs short, it may be necessary to ward off a bid for a separate later discussion of tax approximation.

The DTI paper

2. The DTI paper recommends that:
 - i. a sharper negotiating strategy is adopted, identifying positive negotiating objectives, areas where a tough line is required, and possible packages and trade-offs;
 - ii. officials should be asked to develop negotiating objectives in a number of areas likely to be discussed by Councils in the next 15 months, including public purchasing, capital movements, insurance, financial services and tax approximation and other areas of less direct interest to the Treasury;

iii. a campaign for increasing business awareness should be approved.

3. The paper advocates that we need progress in those areas which should bring us substantial benefits (including financial services), a firm strategy for heading off unwelcome proposals, notably some concerning "Europe without frontiers"; we need to head off burdensome or unnecessary proposals, such as those in company law.

Objectives

4. You will want to support the general objectives proposed by Lord Young, while sounding a note of caution about the idea of a business conference involving the Prime Minister and the scope for new initiatives in the financial area.

- NB
Mrs Lomax's
note below
75

Line to take

5. In discussing Lord Young's paper, you might like to draw on the following points:

- We have no problem with what the paper says about the general strategy, further work by officials and an initial campaign for increasing business awareness.
- But more work needs to be done in defining the message of the awareness campaign. In considering a conference involving the Prime Minister next year, we have to bear in mind the possibility that the discussions on future financing may well not have been completed.
- Brussels European Council priorities. On public purchasing policy, we should adopt a positive attitude in Brussels. But we do have differences with the Commission. In particular, we do not believe that bodies operating commercially should be made subject to rules designed for government bodies, and cannot see why privatised undertaking should be covered. On capital movements, there was a useful discussion in the September Council of Finance Ministers and no new initiative is required. A major continuing

objective will be to ward off proposals for powers to impose exchange controls vis-a-vis third countries. On insurance, we agree with the need to work towards a liberal non-life insurance services directive.

- Additional UK priorities. Lord Young's description of financial services (including banking in this context) is acceptable. But closer definition is required of "initiatives" on financial services. [The more important proposals on the table affect banks and building societies rather than the 'DTI' financial services interest]. Officials would need to prepare the ground more thoroughly before you could endorse proposals in this area.

6. On tax approximation, Customs are providing a more detailed brief. You may wish to make the following main points in discussion:

below.

- there is no evidence of a widespread desire outside the Commission to make swift progress in this area;
- although not all countries share our views on the sovereignty issue, there seems a reasonable chance that we could gather support for the idea of making progress by reduced frontier controls;
- officials will be fleshing out the details of this strategy;
- if a separate Ministerial discussion is suggested, we see no need. The story could be picked up when Ministers next come back to the general internal market stocktaking.

Mark Parkinson

M PARKINSON

FROM: MRS R LOMAX
DATE: 30 September 1987

RL
to
CH.
30/9

CHANCELLOR

cc Mr Lavelle
Mr Ilett

OD(E): INTERNAL MARKET (FINANCIAL SERVICES)

Your brief warns you to be wary of "initiatives" on financial services - at least until we have some idea what Lord Young has in mind. DTI officials' thinking on this subject is notably half-baked. I think we need to keep a firm grip on this area ourselves.

2. Insurance aside, there are now two major initiatives affecting financial services:

- liberalisation of capital movements, where it has been agreed that this need not wait for harmonisation of supervisory standards (an important point which we must hang on to);
- credit institutions, where there is a group of directives, aimed at "mutual recognition" of EC banks and building societies, based on harmonising minimum supervisory standards (including capital adequacy). This should secure complete freedom of banking services within the EC.

3. We are in the lead in both these areas. The banking directives are going well, though there is a problem of overlap with the new Financial Services regime which we are trying to sort out. There is, as yet, little of any substance in the DTI part of the financial services work. But the Commission have been flirting with an initiative code-named "Euro-Gower" - in effect a Europe-wide Financial Services Act. DTI quite fancy this idea, but it is most unlikely to get anywhere without very active UK support - and maybe not even then, since not

many other EC countries are attracted to the financial services regime, and most anyhow find it more natural to use banking directives as the vehicle for opening up the internal market in financial services.

4. We are instinctively sceptical of "Euro-Gower". It is far too soon to try and export the Financial Services Act: if it turns out to be a disaster, embedding it in EC law will not save us, since the competition is largely outside the EC. Nor will advocacy of "Euro-Gower" necessarily sit well with the position we have taken up on the liberalisation of capital movements. It could even snarl up the banking directives.

5. We know that Lord Young is being advised to give "financial services" a high priority in his internal market initiative over the next few months, though it is not clear what message he will be trying to get across. In prospect are visits to "Balladur's Ministry" to see if some kind of deal can be struck with the French, consultation with "City interests", and a bid to have "financial services" transferred from ECOFIN to IMC. The DTI want to set up an inter-departmental working group, under their chairmanship, to "co-ordinate the negotiating effort in financial services".

6. This is a key area: if it goes wrong, it will affect the shape of our domestic legislation in years to come. I think you should make our interest very clear. If there has to be new inter-departmental machinery (God forbid), it should be chaired by Cabinet Office, not DTI.

RL.

RACHEL LOMAX

C&E BRIEF: TAX
APPROXIMATION

COVERING CONFIDENTIAL



H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE

Please Dial my Extension Direct:
Use Code '01)-382 followed by
Extension Number 5023.....

FROM: P R H ALLEN

DATE: 30 September 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Cassell
Mr Scholar
Mr Edwards
Miss Sinclair
Mr Mortimer
Mr Culpin
Mr Parkinson
Mr Hudson
Mr Cropper
Mr Tyrie

Handwritten initials in red ink: "M" and "K"

OD(E) MEETING, THURSDAY, 1 OCTOBER : TAX APPROXIMATION

1. OD(E) on 1 October will consider two papers dealing with internal market issues. Treasury officials are briefing separately on Lord Young's paper about the UK's overall approach to the internal market initiative. This note gives briefing on your paper about tax approximation.
2. The DTI paper is not expected to raise much in the way of comment, and discussion may therefore focus on the tax approximation paper. The aim is to get the Committee's endorsement of the basic line and tactical approach

Internal circulation: CPS Mr Knox Mr Jefferson Smith Mr Nash
Mr Finlinson Mr Cockerell Mr Kent
Mr Allen Ms French

outlined in the paper. We do not expect other Departments to take issue with the policy line (ie rejection of the package) or the reasoning behind it. Where there is likely to be discussion is over presentation and tactics.

3. On presentation, the Foreign Office is known to have reservations about our proposed line of argument and alternative strategy. It is possible that they will suggest further Ministerial discussion. The paper acknowledges (para 6) that further effort is needed to work up an alternative to the Commission's approach and it has already been agreed at official level (EQS) that a working group should be set up. In the circumstances there seems little need for further Ministerial input at this stage and we suggest that a remit to officials to report back to OD(E) next time the latter considers internal market issues would be appropriate.

4. As far as tactics are concerned, both the Foreign Office and DTI can be expected to argue that the UK should maintain as low a profile as possible both in Brussels and at home for as long as possible, to avoid jeopardising our interests in other internal market areas. The strength of these arguments is recognised in the paper. The fact that the proposals are to be remitted to EPC for further study, should help to keep them out of the limelight in the UK, as well as allowing us to identify those Member States who share our misgivings about approximation. Although the latest information we have from Bonn and Paris (see annexes A & B respectively) suggests that the German and French responses will be positive, there is no evidence of widespread enthusiasm for the proposals. Most, if not all, Member States will be happy to play discussions long. Even the Commission (in the shape, at least, of M Delors) is apparently beginning to acknowledge the difficulties tax approximation entails (see annexe C). All of these factors support the proposition that we should not put our heads unnecessarily above the parapet too early by taking a firm public stance at this stage. If the situation continues to develop favourably in Brussels, domestic pressure for a forthright statement of the Government's position may in any case not materialise. At the same time, there is clearly some scope for a different line in Brussels and in domestic presentation,

and colleagues will no doubt understand that you will want to keep domestic presentation under review in the light of developments.

RA.

P R H ALLEN
DPU1

Ch/ This is the EM on
tax approximation.

30/9/87

8199

25
14/110 [Global Communication]

POLICY IMPLICATIONS

Tax approximation raises wide-ranging policy issues, ~~concerning the Chancellor's and Parliament's right to fix national tax policy.~~ It would limit the Chancellor's room to introduce changes to the tax structure and as such would ~~remove~~ ^{weaken} one of the most important tools of fiscal management. It would have a marked impact on the pattern of revenue accrual in the UK, increasing the revenue from VAT and reducing revenue from the excise duties on alcoholic drinks, tobacco products and hydrocarbon oils. The effects of the proposals on the price of alcohol and tobacco and of goods currently zero rated would also raise major social issues. ~~Tax changes of the magnitude envisaged would have a highly disruptive effect on the domestic market in excise products and those affected by the VAT changes with largely unpredictable consequences.~~

FINANCIAL IMPLICATIONS

If the package were adopted in the form outlined in this document, and assuming the UK introduced a reduced rate of VAT of 4%, the net revenue effect would be an increase of the order of £1,000 million in a full year.

TIMETABLE

The target date for implementation of the proposals outlined in this document is 31 December 1992.

The European Parliament and Economic and Social Committee have to be consulted.

Peter Brooke

PETER BROOKE
Paymaster General
HM Treasury

POLICY IMPLICATIONS

[Process of convergence of excise + VAT rates]

This draft Directive needs to be considered in the context of the packages of proposals of tax measures submitted by the Commission. It is closely linked to the proposals for VAT and excise duty rate approximation and it would not be appropriate for it to be adopted ~~unless some agreement~~ ^{in the absence of} on the general shape (at least) of any approximated tax system ~~were reached.~~

By imposing constraints on the size and nature of changes in certain of the UK's indirect taxes, the proposal would limit the Chancellor's ^{room to introduce} ~~and Parliament's~~ ^{changes to the tax structure} ~~freedom to decide national tax policy~~ during the period leading up to full implementation of the Commission's tax approximation package. It also leaves no room for the possibility that the Commission's package may not be achieved in the form proposed - if at all. The scope for innovation and change in the tax system would thus be reduced - possibly unnecessarily.

FINANCIAL IMPLICATIONS

The proposal would prevent the UK from increasing or maintaining the real value of its excise duties on alcoholic beverages, tobacco products and certain hydrocarbon oils, because our duties on these products are higher than those proposed by the Commission. This would cost about £125 million in a full year for each 1 percentage increase in the RPI.

LEGAL AND PROCEDURAL ISSUES

8204

[Cigarettes]

i) Treaty Basis

The Commission's proposals are based on the EEC Treaty, with particular reference to Article 99.

ii) Co-operation Procedure

Not applicable.

iii) Voting Procedure

Unanimity required.

iv) Impact on United Kingdom law

The matters covered by the present proposal are governed by Community legislation in Council Directive 72/464/EEC of 19 December 1972 (O.J. No. L303 of 31.12.1972 p.1) as amended, and by United Kingdom law in the Customs and Excise Management Act 1979 and the Tobacco Products Duty Act 1979 as amended by subsequent Finance Acts. If the proposal were adopted changes in United Kingdom primary legislation would be required.

POLICY IMPLICATIONS

The draft Directive needs to be considered in the context of the package of tax measures submitted by the Commission.

(PTO)

8204
(contd)

By fixing the rate of tax applicable to cigarettes, the proposal would limit the Chancellor's and Parliament's freedom to decide national tax policy. *room 65 introduce changes to tax structure.*

The proposal would require the UK to reduce the tax (excise duty and VAT) on cigarettes by about 10% or 12p per packet of typically-priced 20 Kingsize cigarettes. A reduction of this size could be expected to lead to an increase in consumption of about 4% with consequences for *the nation's* health, policy and expenditure.

The reduction in the specific duty element would put the UK industry at a disadvantage in the face of competition from cheap imports.

FINANCIAL IMPLICATIONS

It is estimated that adoption of this proposal would result in a revenue loss (including VAT) of about £330 million in a full year.

TIMETABLE

The European Parliament and Economic and Social Committee have to be consulted.

The deadline for full implementation contained in the directive is 31 December 1992.

Peter Brooke

PETER BROOKE
Paymaster General
HM Treasury

[Alcoholic beverages
and other products
containing alcohol.]

iv) Impact on United Kingdom law

The proposed Directive covers matters at present governed by the Alcoholic Liquor Duties Act 1979, as amended by subsequent Finance Acts. If the proposal were adopted changes in United Kingdom primary legislation would be necessary.

POLICY IMPLICATIONS

This draft directive needs to be considered in the context of the whole package of tax measures proposed by the Commission. It raises the following particular issues:

- a) By harmonising the excise duty rates applicable to alcoholic drinks, the proposal would ^{limit} ~~remove~~ the Chancellor's ^{power to introduce changes} ~~and Parliament's freedom to decide~~ ^{to no tax structure.} ~~national tax policy in this area.~~
- b) Adoption of the proposals would require reductions in all the UK's alcoholic drinks duty rates. These would range from about 40 percent - in the case of spirits duty (a fall of £2.30 per 75 cl. bottle of spirits at 40 percent volume), to about 85 percent in the case of table wine (a fall of 70p per 70 cl bottle). Changes of this magnitude would have ^{social} ~~unpredictable~~ ^{national's health.} ~~consequences for the alcoholic drinks market and the~~ ~~industries concerned.~~

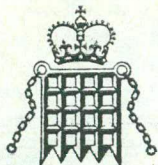
(PTO) →

8207
(could)

- c) By proposing that similar volumes of beer and wine at standard strengths should be taxed at the same rate, the draft directive has departed from the principle embodied in the jurisprudence of the European Court of Justice that these drinks should be taxed by reference to their relative alcoholic strengths. As a result, the UK would have to tax (mainly domestically produced) beer comparatively more highly than (imported) wine, albeit at very much reduced rates. The ratio between the duties on spirits and wine would increase from about 2:1 to about 8:1, with possible adverse consequences for UK spirits producers, both in terms of the domestic market and exports.
- d) By proposing substantial reductions in the absolute levels of excise duty borne by alcoholic beverages in the UK, the draft directive would have implications both for health and law and order policy.
- e) The proposals would entail harmonisation of the structures of the excise duties, something which extensive discussion among Member States has failed to achieve since the Commission tabled its proposals in 1972.

FINANCIAL IMPLICATIONS

It is estimated that adoption of this proposal would result in a revenue loss (including VAT) of about £2,300 million in a full year.



FROM: B H KNOX

8 OCTOBER 1987

Board Room
HM Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

PAYMASTER GENERAL

cc. Chancellor ✓
Chief Secretary
Financial Secretary
Economic Secretary
Mr Lavelle
Mr Scholar
Mr Cropper

TAX APPROXIMATION : MEETING WITH BEN PATTERSON, MEP

1. Further to my note of 21 August, we met Mr Ben Patterson, MEP on 5 October, to discuss the technical aspects of the Commission's package of tax measures; he was accompanied by Mr Peter Beazley and Mr Brian Cassidy.
2. We covered the VAT and excise proposals in some detail. One significant feature to emerge from the meeting was the extent to which Mr Patterson and his colleagues shared our view of both the political and practical problems the proposals would present for a number of Member States. (The notable exception was the question of sovereignty which, we would infer, Mr Patterson would find difficult to accept as a legitimate objection to tax approximation). The meeting was, I think, of use to both sides and, at Mr Patterson's request, we have offered to meet him again in the future.
3. In looking at the difficulties on the VAT side, discussions centred initially on approximation of rates. Mr Patterson said that the consensus view in the European Parliament was that the base line of 4% for the reduced rate band was right, but he thought it might be possible to argue persuasively that the reduced rate band should run from 0% to 7%. He believed that each Member State would present the Commission with a "shopping list" of goods which they wanted to be included in the reduced rate band, and he was interested to know what the UK would want a reduced rate band of, say, 0% to 7% to cover. We commented that as officials we would assume that the UK would want such a rate to cover those items currently zero-rated.

Internal circulation:	CPS,	Mr Jefferson Smith	Mr Nash
	Mr Finlinson	Mr Allen	Ms French

4. We discussed the clearing house system at some length, outlining some of the problems we foresee with the proposed system; the uncertainties of revenue flows; possible increased burdens on businesses; difficulties of treatment of certain services and complicated commercial transactions and so on. It seems that in Committee, the EP discussed the possible use of estimates of gross trade figures to re-allocate revenue, as an alternative to the clearing mechanism and we were asked if we thought this would be feasible. We pointed out that under the present system of transaction by transaction documentation and border controls, statistical information, which might form the basis of calculations, is available. But the Commission's aim and the whole purpose of the package of measures, is to remove both border controls and documentation so that intra-Community trade statistics were likely to be very much less accurate.

5. On the excise side, the MEP's were well aware of the difficulties arising from the wide disparities in existing rates (and structures). They were particularly interested in, and appreciative of, the problems associated with the linked warehouse system. They also asked if it would be feasible to abolish specific excise duties and replace them by high levels of VAT on dutiable commodities to compensate. We pointed out that to produce the same amount of revenue as now, it would mean introducing VAT rates of several hundred percent.

6. In looking at how discussions might develop, Mr Patterson foresaw a number of Member States pressing hard for an agreement on approximation, with the remainder resolutely opposed to the Commission's package as it stands. He envisaged perhaps the original six Member States plus possibly Spain agreeing to approximate their indirect tax rates while the others accepted derogations of indefinite length allowing them to maintain existing national systems. We commented that this did not seem a particularly attractive proposition either for those within the approximated system or those outside it and it seemed unlikely that unanimous agreement to such a proposal would be forthcoming. But Mr Patterson intends to ask the Commission to set up a variety of models to show what the implications of changes in the tax approximation package, including those of a "two-tier Europe", might be.

7. Finally, Mr Patterson left with us a paper he has prepared (copy attached) which raises a number of questions aimed at the Commission. A number of them were brought out at the meeting. Perhaps the most interesting thing about the paper is the extent to

which Mr Patterson's assessment of the flaws and inadequacies in the Commission's approach mirrors our own. It is clear that he is particularly concerned about the issue of zero rating and he and his colleagues will fight the UK's corner hard in Strasbourg. It also seems likely that he will want a clearer indication of the UK's line when he meets you and the Chancellor on 23 October. It looks now as though the amount of common ground will be greater than we thought. We will, of course, provide briefing nearer the time.

Bryce Knox

B H KNOX

SOME PRELIMINARY QUESTIONS ON THE COMMISSION'S TAX PROPOSALS

Draftsman: G. B. PATTERSON

- The Global Communication	COM(87)320 final
- VAT Rates Directive	COM(87)321 final
- Fiscal Frontiers Directive	COM(87)322 final
- Clearing Mechanism Working Document	COM(87)323 final
- Convergence Directive	COM(87)324 final
- Cigarettes Directive	COM(87)325 final
- Manufactured Tobacco Directive	COM(87)326 final
- Mineral Oils Directive	COM(87)327 final
- Alcoholic Beverages Directive	COM(87)328 final

1. ARE THESE "MINIMUM" PROPOSALS ?

The Commission states clearly in the Global Communication that the package of measures presented 'is not an attempt to design an ideal fiscal system for the Community, but a blueprint for the abolition of fiscal frontiers'.

It is argued that 'a considerable measure of approximation of indirect taxes' is required if the objective is to be achieved. But the degree of approximation should be only the minimum: 'the Commission has refrained from proposing anything which is not strictly necessary for that purpose.'

The Commission draws attention to the fact that there are 'pressures from one quarter or another to use the approximation process as a vehicle for achieving other fiscal changes or even non-fiscal policy objectives'. These, the Commission states, it has resisted. However, it also states that 'every effort has been made to avoid running counter to other policy objectives, and to bear the wider economic social and regional implications in mind...'

a) Is approximation/harmonisation needed at all ?

It might be argued that the simplest road to the abolition of fiscal frontiers is simply to abolish them - the so-called 'Irish solution'. The Commission, however, argues that 'the removal of fiscal frontiers necessitates approximation of VAT and the main excise duties if unacceptable levels of distortion of competition, diversion of trade, and tax fraud are to be avoided.' A similar conclusion was reached by the UK House of Lords ('Indirect Taxation and the Internal Market' 1986): 'there would be substantial cross-border movements of excisable goods on a serious scale, both by

traders and individuals, to take advantage of widely varying duty systems in different Member States'.

b) Is the argument equally valid for all goods and services ?

The danger of cross-border movements alone cannot be an argument for the approximation of all indirect taxation. Certain goods and services - for example immovable property - are clearly untradable. In other cases, transport costs in relation to the amount of taxation involved would make substantial cross-border movements unprofitable.

The trade-diversion case for approximation clearly applies with greatest force to low-volume, high-value commodities (for example, jewellery); or to goods where the tax advantages to be gained are unusually high (for example wine moving from France to the UK).

The Commission's case for approximation, however, also rests on considerations of competition. In arguing for the abolition of zero-rating, for example, it states that: 'Zero rating, by giving a price advantage to the products of one Member State, distorts competition within the Community; this is particularly true when applied to supplies which feed through into industrial and commercial costs.'

At present, since all goods are zero-rated on export and re-taxed on import at the rates of the consumer country, the competition aspect is of lesser importance. Under the Commission proposals, however, goods would be exported inclusive of tax at the exporting country's rates, and would be subject to no further tax on import. Hence the provisions of the 6th VAT Directive that zero-rating shall cease altogether once the zero-rating of exports ceases.

Competition, however, is not merely affected in this way by indirect taxation. Direct taxation and social security payments are perhaps equally important. All tax distortions, it might be thought, must be considered together.

Should not a strictly minimal programme for the abolition of frontiers, therefore, imply approximation of indirect taxation only where tax differentials between certain goods, or across particular frontiers (e.g. Denmark/Germany) would threaten to distort cross-frontier trade ?

2. IS THERE A BETTER WAY ?

A substantial body of opinion exists - notably within national administrations - which holds:

- i) that approximating rates will not be enough to stop fraud;
- ii) that it is not necessary, in any case, to change tax rates in order to avoid the costs of fiscal frontiers.

a) A Postponed Accounting System

Were the 14th VAT Directive adopted, it would be possible at least to abolish the payment of VAT by traders at the Community's internal frontiers. Goods would still be exported at zero rate; but the taxation of imports would take place through normal VAT returns: i.e. up to three months later.

Member States have hitherto declined to adopt the 14th Directive. Indeed, one Member State - the UK - has moved in the opposite direction on the grounds that Postponed Accounting in conditions of zero-rated exports actually gives importers a cash-flow advantage over domestic suppliers.

In addition, frontier controls of some kind would still be necessary under this system. Without them, there would be considerable scope for fraud: for example, goods declared for export and thus zero rated could remain in the country of export.

b) Electronic Data Interchange systems

However, opponents of the Commission proposals argue that the complete abolition of frontier controls is in fact unnecessary. The cost of internal frontiers to the Community's economy, they argue, could be substantially reduced through the use of modern data interchange technology, without the large political problems involved in fiscal approximation.

A system might be devised, for example, which would combine:

- the retention of zero rating for all exports;
- a Postponed Accounting System for payments;
- the reduction of data requirements at frontiers to a minimum (e.g. through a further simplification of the Single Administrative Document); and
- the use of computerised data interchange systems to reduce waiting time at frontiers to the minimum. In essence, tax and other information would pass directly from a computer in the

exporting country to one in the country of import. The only checks needed at frontiers would be to verify that the goods had in fact crossed - perhaps by means of spot checks.

The principal defect of such a system is that it could apply only where the traders concerned were registered for VAT in their own Member States. The movement of goods across frontiers by private individuals or non-VAT-registered traders would need to be controlled by other means. Hence:

i) Ordinary travellers - tourists, businessmen, trans-frontier commuters, etc. - would in practice experience little change from the present situation, with the result that the "Internal Market" would appear something of a fraud. It would certainly be inconsistent with the idea of a "Citizen's Europe".

ii) It would be extremely difficult to prevent massive frauds through the moving of goods from the VAT-registered to the non-registered sector.

Nevertheless, it may be that solutions can be found to these defects. Should the Commission's current proposals prove politically unacceptable, does it have a "fall-back position" along these, or other lines ?

3. THE RATES: ARE THEY EQUITABLE ?

The Commission's detailed proposals for approximated rates of VAT and excise duties are based on differing criteria.

For VAT, two rate bands are proposed: one of 6 percentage points (the "standard" rate band running from 14% to 20%); and one of 5 percentage points (the "reduced" rate band running from 4% to 9%). The justification for rate-bands of this kind is generally accepted to be the US experience with Sales Tax rates. A variation of 2.5% either side of a "norm" is held to be consistent with open frontiers.

The Commission, however, does not provide much background to its proposal. In the case of the standard rate, the principal criterion appears to be the maximisation of the number of Member States whose rates would fall within the band.

In the cases of the lower band, the Commission states that national rates "currently vary from 1% to 10% but the lowest rates apply only to a very few products". Hence the choice of a narrower 4-9% band.

1% can be considered as a rate of VAT, however, why is 8% also not considered a rate? Were it to be so considered - for example, by describing the UK's zero rate as its reduced rate - (the criteria for the reduced band would be altered.

Why has the Commission, then, not proposed a 'reduced rate' band of, say, 0 to 7%, which would provide no difficulties for 9 Member States, and few difficulties for any Member State except Denmark?

In the case of excise duties, the Commission argues, not for bands, as in the case of VAT, but for complete harmonisation. This is because VAT is charged on the price of goods inclusive of excise duty, and 'any flexibility in the rates of duty... would be compounded with the permitted margin for VAT rates' producing 'tax-induced price-differentials well in excess of 5%'.

These harmonized rates are calculated on various bases:

Alcohol (spirits):	arithmetic average (alcohol)
Wine, beer, intermediate:	weighted average (volume)
Cigarettes & tobacco:	arithmetic average
Petrol and LPG:	arithmetic average
Diesel, heavy fuel oil:	weighted average

The simplest criterion, it might be thought, is the pure arithmetic average of rates in the Member States. The Commission also states that it is 'the most equitable approach since it gives equal weight to each Member State, irrespective of size' (Cigarettes Directive). (Why this is the most equitable approach, however, is not quite explained. The Commission might elaborate.)

The other basis used is the arithmetic average weighted by consumption. Besides having its own claims to equity, this method of calculation gives a revenue-neutral effect for the Community as a whole, although revenues in some Member States would rise, in others fall.

The Commission appears to have chosen between the pure and weighted averages on a pragmatic basis. In the case of alcoholic beverages, the arithmetic average is chosen for spirits since this would minimise 'revenue disruption for the three Member States which would be obliged to reduce significantly their current levels of taxation' (Denmark, UK and Ireland). The Commission also points out, however, that 'those Member States which currently apply very low rates of tax on spirits will of course be required to raise their rates considerably' (Greece, Italy, Spain and Portugal).

But in the case of wine the Commission argues that the high rates of tax in Denmark, UK and Ireland 'dramatically inflate the Community arithmetic average rate', which it thus considers 'an unacceptable basis for the approximation of excise duty..' (The weighted average is also rejected, on the grounds that the high-consumption, low-tax countries produce too low a figure). Hence the choice of an entirely different basis: taxation of wine and beer on a liquid quantity basis, at a rate designed to maintain revenue, at Community level, on both drinks taken together.

It would be interesting to know what other approaches the Commission has examined, and why they were rejected.

4. WILL THE CLEARING SYSTEM WORK?

A VAT Clearing System, the Commission argues, is a necessary consequence of treating 'sales and purchases across Intra-Community borders in the same way as those within Member States'. Once border controls are eliminated, the zero-rating of exports must also end (see above).

It is also a consequence of another assumption, however: that VAT is a tax on final consumption rather than a real tax on value added. Under the Commission proposals, VAT will be charged by the vendor in the country of export, and deducted by the purchaser in the country of import. Were VAT a true tax on value added, the Exchequer in the exporting country would then receive the revenue from the value added in that country; the Exchequer in the importing country the revenue from any subsequent value added.

The consequence of treating VAT as a true tax on added value, however, would be a transfer of revenue from net importing countries to net exporting countries: i.e. to Belgium, Luxembourg, the Netherlands and Germany from the rest. The Clearing System is intended to rectify this by returning the net revenues to the consuming countries.

a) Will the documentation required be such as to outweigh any savings from the abolition of fiscal frontiers?

The original Commission proposal was for all taxable importers to declare on an enlarged VAT return, or a separate document, 'a breakdown of the total value of goods obtained from each Member State and the corresponding amount of tax paid to taxable persons in each of these States'. Each Member State would then prepare figures in respect of each other.

A much simpler alternative, of course, would be to base the central clearing, not on detailed documents, but on figures for net imports and exports between Member States. The current methods for collecting these statistics would of course end with the abolition of frontier controls; but alternatives might be devised - for example, though sampling.

However, the Commission rejects this on the grounds that "a system based on a purely macro-economic approach is unlikely to provide an acceptable level of accuracy." It would be interesting to know what systems of this kind the Commission has examined, and what margins of error were involved.

Instead, the Commission proposes a system under which:

- Each registered trader would merely fill in two new boxes on the VAT return: VAT charged on exports to all other Member States together; and VAT deducted for imports from all other Member States together.
- Each Member State would aggregate these figures monthly, producing a net sum owed to or from a central account.
- This would be a "running" system: i.e. there would be no need for periodic calculations of any Member State's net position, annual reconciliation, etc.

b) But will the system be solvent ?

Experience with the calculations of the Community's "own resources" indicate that national VAT statistics are not all of equal accuracy. In addition, there will be an incentive for each Member State to understate imports and overstate exports in order to improve their net position vis-a-vis the central Clearing System fund. In these circumstances, is there not a danger that the fund will run into deficit ?

The Commission notes the important fact that while the system "encompasses at the output stage practically all the cross-frontier VAT charged on intra-Community sales, the input tax claims against the clearing account will relate only to claims made by registered persons..." The result will be "a surplus in the clearing account approximately equal to the VAT charged on intra-Community sales to VAT exempt businesses and other entities as well as to private persons."

It is important, however, to be precise about this matter: does the Commission have a "working model" of the System, based on present trade flows, which would indicate the probable cash flows into and out of the account ?

5. REVENUE EFFECTS

Member States will be sensitive to the revenue implications of the proposals. The Commission's "tentative global qualitative assessment of the likely overall effect" shows the following revenue effects:

- Luxembourg, Spain and Portugal: a substantial gain;
- Germany, the UK and Greece: a modest gain;
- Belgium, Italy and NL: the same revenue;
- France: a small loss; and
- Denmark and Ireland: a substantial fall.

As far as precise quantitative estimates are concerned the Commission states that "the task of evaluating the effects of these proposals for individual Member States is... primarily a task for the Member States themselves."

The Commission's "tentative assessment", however, is based on the proposals being accepted as a whole. However, it is also necessary to examine the revenue effects of implementing only some of the proposals, and of possible changes (e.g. the retention of zero VAT in the UK). Is this in hand ?

6. OTHER ISSUES

In its proposals for alcoholic beverages, the Commission appears to reject its previous view (COM(79)261) that "all alcoholic drinks are more or less in competition", for a system which taxes beer, wine and intermediate products according to volume, but spirits according to alcoholic strength. This "is consistent with the general practice of the majority of Member States in taxing spirits highly".

While this criterion is not necessarily wrong, there is bound to be renewed dissension unconnected with the removal of fiscal frontiers: the treatment of fermented, "agricultural" as compared to distilled, "industrial" products.

Similarly, in the case of cigarette taxation, the Commission has decided upon a system which combines a harmonized specific duty (19.5 ECU per 1000) with a relatively high level of ad valorem duty (52-53% of retail selling price). The effect would be to strengthen the competitive position of the cheaper as against the higher quality brands.

There is also the question: is a tax levied on the final selling price feasible without either frontier controls, or controls on the selling price of each particular brand ?

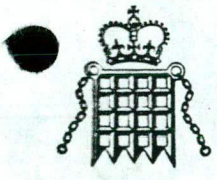
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CONFIDENTIAL

P.M.G.

BIF 21/10

6/27/10



Mrs X: what name at home?

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

FROM: MRS V P M STRACHAN
DATE: 14 OCTOBER 1987

P/S PAYMASTER GENERAL

P

cc PS / Chancellor
Mr RIG Allen

[Signature]
14/10

VAT INVESTIGATION - OPERATION KENNEDY

X The Paymaster General may wish to be aware of a major Investigation Division investigation, codenamed 'Kennedy' involving the suspected suppression of approximately £250,000 VAT by purveyors of take-away refreshments at large sporting events and 'pop' concerts. It is planned to bring the investigation to a conclusion at Wembley Stadium on Wednesday 14 October 1987 around 2230 hours, following the England-Turkey soccer match, and after the crowd has dispersed. In a series of co-ordinated visits 80 Officers assisted by Police will interview the operators of the mobile refreshment units, and search premises associated with the principals.

[Handwritten signature]

(MRS V P M STRACHAN)

Internal distribution: Chairman
Mr Knox
Mr Lawrence

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Ch/ The full submissions
are enclosed separately, below.



FROM: S P JUDGE
DATE: 14 October 1987

25 14/10
PS/CHANCELLOR OF THE EXCHEQUER

cc Mr Scholar
Mr R I G Allen
Ms French - C&E

TAX APPROXIMATION PACKAGE

You have copies of Mr Kent's submissions of 29 September, 2 and 7 October - and the attached 9 Explanatory Memoranda on the Commission's proposals.

The Paymaster has now signed the Memoranda. Before releasing them to Parliament, he would like the Chancellor to see the "Policy Implications" pages of 8199, 8203, 8204 and 8207 - perhaps in that order. These are attached.

S P JUDGE
Private Secretary

EM 8203 has been revised in two places: I attach the new version.

Thanks! I have
made a note of
your comments - generally
I have done pretty well.

CHANCELLOR

From: I C R BYATT
20 October 1987cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir G Littler
Mr Scholar
Mr Edwards
Miss Sinclair
Mr Mortimer
Mr Riley
Mr Ford*Ch/ Content with Mr B's approach?
20/10**OK*PS/C & E
Mr Knox (C&E)
Mr Allen (C&E)
Ms French (C&E)

Mr Walton (UKREP)

TAX APPROXIMATION: REMIT TO ECONOMIC POLICY COMMITTEE (EPC)

1. The informal ECOFIN on 12/13 September agreed that consideration of the Commission's tax approximation package should be remitted, in the first instance, to EPC. On normal conventions this conclusion would be formally endorsed at the next (October) ECOFIN - without any more specific remit being given and EPC asked to report back to this December ECOFIN. With the cancellation of the October ECOFIN, the formal procedure is less clear. The EPC has arranged to meet on 27 November, so there can scarcely be much more than an interim report ready for the December ECOFIN.

2. Our objective at this stage is to slow down progress on the package. There is much to be said, therefore, for getting EPC to look at as many as possible of the meatier economic issues which the Commission proposals raise. The kind of issues Customs and I think EPC could usefully cover are listed in the attached annex.

3. I have spoken informally to Mr Andreas Kees, the German Secretary of EPC, about the kind of topics the group should tackle. His thinking appeared to be on pretty well the same lines as ours. I agreed with Mr Kees (and Customs are happy to go along with the idea) that it would be sensible for EPC to put a short report to ECOFIN in December, setting out a framework for discussing the subject which brought into play issues which have

not yet been properly covered. Such a framework would go well beyond a simple evaluation of the Commission's proposals and could be expected to keep EPC busy for several months. It would then be for ECOFIN to give guidance in December on what work EPC should follow up.

4. Mr Kees was intending to speak to other leading members of EPC and canvas their views before a meeting of its 'inner circle' which I am due to attend on 23 October. Although I have had no feedback from Mr Kees about his discussions, there must be a good chance that we will be able, informally, to agree a substantial agenda for the group's work (on the lines of the annex) at next week's meeting which could then be worked up into a programme of work by the full EPC in November.

5. I gather that, in procedural terms, the Council should formally agree a written remit to EPC. I understand from UKREP's contacts with the Presidency that, insofar as they have considered the issue at all, they would propose a simple draft remit asking EPC to evaluate the Commission's proposals. Ironically, given the Danes known dislike of approximation, such a remit would be narrower than anything EPC might come up with itself, and thus more restrictive than we would favour. There is no reason to suppose that the Danes would be adverse to a much wider remit if EPC were to propose one for itself and, if you agree with the general line of action proposed above, I intend to suggest that Mr Kees feed anything we come up with next week in to the Presidency and the Council Secretariat for consideration.

6. I'm sorry that this has been delayed by the weather. It would be very helpful to have your views before Thursday's meeting.

T. Hauser
PP I C R BYATT

POSSIBLE AGENDA FOR ECONOMIC POLICY COMMITTEE DISCUSSIONS OF TAX APPROXIMATION

1. Assessment of wider economic benefits and costs of removal of fiscal frontiers including

benefits

- economic growth within the Community
- reduction of costs to trade

costs

- transitional adjustment problems
- longer term problems (eg. Community's outlying regions)

2. Assessment of means adopted to achieve wideeconomic benefits under 1. -

- approximation of tax rates or tax structures?
- relative importance of harmonising indirect taxation while big divergence remains on direct taxation, social security systems
- how much indirect taxation harmonisation necessary to achieve economic objectives? and over what time span?

3. Assessment of how far various options open would achieve wider economic benefits under 1

- Commission approach
- other options - eg.
 - (i) Free Market" approach

- (ii) Trade facilitation
- (iii) Separate action on VAT or excises?

4. Evaluation of Commission's proposals

- effect on prices;
- effect on revenue\budget deficits;
- effect on timing of revenue accrual (including consequences of clearing mechanism);
- effects on compliance costs;
- transitional effects on supplying industries;
- effects on other policy objectives
 - (i) health - alcohol and tobacco taxes
 - (ii) transport - hydrocarbon oil duties
 - (iii) energy - hydrocarbon oil duties
 - (iv) income distribution
 - (v) implications for future determination of indirect rates
- effects on administrative costs.



pmf

FROM: J M G TAYLOR
DATE: 21 October 1987

MR BYATT

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir G Littler
Mr Scholar
Mr Edwards
Miss Sinclair
Mr Mortimer
Mr Riley
Mr Ford

PS/C&E
Mr Knox - C&E
Mr Allen - C&E
Mr French - C&E

Mr Walton - UKREP

TAX APPROXIMATION: REMIT TO ECONOMIC POLICY COMMITTEE (EPC)

The Chancellor has seen your minute of 20 October. He is content with your suggested approach.

JMG

J M G TAYLOR



Treasury Chambers. Parliament Street. SW1P 3AG

The Earl of Stockton
European Committee Against Taxing Books
10 Bedford Square
London WC1B 3HJ

22 October 1987

Dear Alexander,

Thank you for the letter which you and Nora David sent me on 18 September, about VAT on books and publications. You also wrote to John Major, and I hope you will accept this as a reply to both.

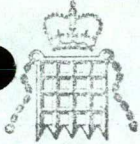
As you know, it is customary for the Government to express its intentions on taxation at Budget time - and only then. In the wholly exceptional circumstances of the General Election campaign, the Prime Minister gave undertakings about a number of specific VAT zero rates. These are firm commitments which we stand by. But, that apart, the customary convention to which I have already referred holds good.

As for the European Commission's proposals to "approximate" VAT rates, the Prime Minister has made the position perfectly clear. Decisions on the proposals will require the unanimous agreement of the Member States and the Prime Minister has already given a firm commitment to reject any proposals which would restrict the Government's ability to use zero-rating.

Lms ever

Pm

PETER BROOKE



H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5.023

From: P R H Allen
Date: 22 October 1987

Paymaster General

cc. Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Edwards
Mr Scholar
Mr Cropper

TAX APPROXIMATION: MEETING WITH BEN PATTERSON MEP ON 23 OCTOBER

1. As promised in Mr Knox's note of 8 October, I attach briefing on tax approximation for your meeting with Mr Patterson tomorrow.
2. Our meeting with Mr Patterson on 5 October revealed that he is more sympathetic to the UK's way of thinking on tax approximation than we had expected. He is known to share the UK's declared concern about the future of VAT zero rating. He is also clearly aware of the potential problems arising from the clearing mechanism and of the shortcomings, from a UK point of view, of the excise proposals. We expect Mr Patterson to concentrate on the VAT element of the approximation package and to ask the sort of questions he raised with us. The briefing takes the form of likely questions and answers, supplemented by short general background information about the kinds of difficulties we foresee on which you can draw in discussing the issues the package raises.

Internal circulation: CPS, Mr Knox, Mr Jefferson Smith, Mr Finlinson
Mr Cockerell, Mr Kent, Ms French

3. In line with the conclusions of OD(E) on 1 October, you should still be aiming to conceal the full extent to the UK's opposition to the approximation package. At this stage, the simplest way to do so is to say that the Government is still considering its reaction. But you can make clear what our sticking points in relation to VAT zero rating are, as well as indicating our misgivings about the excise proposals and expressing scepticism about the likelihood of the clearing mechanism functioning properly.

4. The meeting would also provide an opportunity to find out from Mr Patterson what he expects the European Parliament's view of the proposals to be and what the EDG's line on the package is.

RA.

P R H ALLEN

DPU

MEETING WITH BEN PATTERSON MEP: FRIDAY, 23 OCTOBER

TAX APPROXIMATION

What is UK Government's attitude to package?

Still considering detail - but already clear that we have major difficulties with Commission approach. Secure future for VAT zero rating is crucial. Also have misgivings about consequences of excise proposals, especially effects on health/social policy of alcohol and tobacco changes. Expect other Member States to have problems too. Willing to enter into discussions about appropriate tax measures.

Will UK argue for, say, 0-7% reduced rate band to safeguard zero rate?

No final conclusions reached on what we will be seeking from discussions. Likely to cause problems for other Member States (French already known to be against continuation of zero rating).

What zero rates would UK insist on retaining?

Have simply said we want to retain right to apply zero rate. Do not have 'shopping list' at this stage - but appropriate to think in terms of current zero rates (ie most food; printed matter; newspaper advertisements and services; fuel and power; construction; caravans and houseboats for permanent habitation; medicines and aids for the handicapped; some supplies by charities; water and sewerage services; transport; young childrens' clothing and footwear).

How would UK view limited approximation of rates (ie only for certain items which commonly traded across frontiers where tax differentials high eg cars)?

Does not look attractive. Bound to complicate VAT systems and could lead to increase in number of rates. Anyway most goods are traded across frontiers. But may be something will need to consider at later stage.

How would UK view a 'two-speed' Europe ie some Member States embracing Commission system, others remaining outside?

Difficult to see Member States agreeing. Anyway, clearly incompatible with creation of single market. If all Member States cannot accept Commission package, it would seem sensible to look for alternative approaches to achieving the Internal Market.

BACKGROUND

1. Indirect tax approximation - the UK view: There is no doubt that tax approximation raises problems for the UK. The weight to be given to these problems may be open to debate, but it has to be recognised that they are a source of considerable controversy in this country. The main issues are:

- loss of parliamentary sovereignty is certain to raise considerable political controversy in the UK and cannot be ignored; but it is likely to weigh heavily with some other Member States too.
- fiscal management and the nature of the constraints approximation would impose; it cannot be assumed that the EC's twelve economies would develop identically after 1992, yet approximation would virtually eliminate Member States' scope for matching tax changes to differing economic circumstances (policy decisions of all kinds would be affected: for example, how would the system cope with revalorisation of the excise duties if Member States had markedly different rates of inflation; how would a Member State's desire to alter the balance between direct and indirect taxes be accommodated?)
- impact on UK industries (eg distilling, brewing, tobacco, oil refining, motor) and serious social repercussions (eg UK spirits duty down by about 40% and cigarette tax down by about 10%). The issue of greatest political significance for the UK is the future of our VAT zero rates which the Commission's plans assume would eventually be abolished.

The difficulties raised by these issues outweigh the fact that the narrow budgetary impact for the UK would not be great (the reductions in excise duties being broadly offset by an increase in VAT revenue - assuming abolition of the zero rate).

2. In addition to political and fiscal policy difficulties, the Commission's proposals also raise a number of purely practical and administrative problems

- integrating the VAT and excise systems across borders would not work without greatly improved mutual assistance between Member States; experience to date does not suggest that an efficient and effective system of co-operation could be set up quickly, and this would undoubtedly increase the uncertainty of the tax system, putting at risk principles such as equity and consistency, and is likely to encourage fraud.
- there is continuing doubt about whether the proposed VAT clearing system can be made to function properly. The Commission have not convinced anyone that their clearing system would allow the right revenue to accrue to the right Member State at the right time. Nor have they demonstrated that it would not lead to increased administrative burdens on importers and exporters, who would have both to provide more information about intra-Community trade on their VAT returns and to cope with different systems for intra-Community and 3rd country transactions.
- agreeing the scope and coverage of a two rate VAT system between 12 Member States would be a major task in itself; it would also mean setting up a bureaucratic apparatus to deal with borderline problems and disputes.

3. Other Member States: We think that most Member States would share our analysis of the problems. For some, the consequences of approximation could be far worse than for the UK - in particular, for those Member States with high excise duties and VAT rates (notably Denmark and Ireland) who would suffer large budgetary losses. Others would be faced with politically difficult changes, such as the introduction of a wine duty in Germany and Italy. The Danes have already made it clear that they are opposed to approximation and it seems likely they would block any proposals. The Irish and Luxembourgers too would face major difficulties and the Greeks and Spanish have hinted that they would expect compensation for any harmful effects of approximation. Only the Germans and French have so far openly expressed any enthusiasm for the proposals.

Jonathan: The PMG have not replied to this but they do receive a number of these type Letters which they send a Standard reply to. (See attached)

Thanks

T—


CABINET OFFICE
OFFICE of the MINISTER
for the CIVIL SERVICE

*BF 30/10
to Jonathan*

*The Minister of State
Privy Council Office*
The Rt. Hon. Richard Luce MP

Horse Guards Road
London SW1P 3AL

Telephone: (01)-270 5929

*Nigel 11
Pse find out
whether PMG
has replied yet
26
9/11*

C87/4399

Lord Stockton and Baroness David
European Committee against Taxing Books
19 Bedford Square
LONDON WC1B 3HJ

23 October 1987

Dear Howard & Lord David,

Thank you for your letter and enclosures of 18 September registering your concern at the possibility of approximation of VAT rates by the European Community and its effects on books.

I understand that you have written in similar terms to Nigel Lawson and that he will be replying substantively. It would not be useful for me to anticipate that reply, but I should like to thank you for letting me know your views.

I am copying this letter to Nigel Lawson.

Warm regards

RICHARD LUCE

Richard

CH/EXCHANGER	
REC.	26 OCT 1987
ACTION	PMG
COPIES TO	



FROM: B H KNOX

DATE: 3 November 1987

Handwritten: 6/11

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

Handwritten initials

PAYMASTER GENERAL

Handwritten notes in red ink:
When will this be announced?
But in Budget, Finance will want that long Mr.

- cc Chancellor ✓
- Chief Secretary
- Financial Secretary
- Economic Secretary
- Mr Edwards
- Mr Scholar
- Miss Sinclair
- Mr Cropper
- Mr Publicover, FCO
- Mr Parker, Cabinet Office

EUROPEAN COMMUNITY PROPOSAL FOR AN EIGHTEENTH COUNCIL DIRECTIVE AMENDING THE EC SIXTH VAT DIRECTIVE

INTRODUCTION

1. This submission reports recent developments in Brussels which bear upon our current line in negotiations on the draft Eighteenth VAT Directive; it seeks approval of the revision to our line-to-take in future discussions in Brussels. There is some urgency because the draft directive appears on the agenda of the ECOFIN Council of 16 November in an attempt by the Danish Presidency to give it political impetus.

Internal distribution:-

- | | | | |
|--------------------|-------------|--------------|------------------|
| CPS | Mr E Taylor | Mr Cockerell | Mr Walton, UKREP |
| Mr Jefferson Smith | Mr Tracey | Mr Hamilton | |
| Mr Allen | Ms Barrett | Mr Craske | |
| | Mr G Taylor | Mr Toll | |

BACKGROUND

2. The EC Sixth VAT Directive provides the basis for a common system of VAT throughout the Community. However, to facilitate its adoption in 1977, a number of derogations were incorporated which allow member states to retain, for a transitional period, certain taxation policies which they used at that time. In particular, Annexes E and F of the Sixth Directive list certain supplies which member states may tax where exemption is the Sixth Directive rule (Annex E); and vice versa (Annex F). The draft Eighteenth VAT Directive, first proposed in November 1984 and amended in June 1987, seeks the abolition of most of those derogations.

TIMING OF ABOLITION OF DEROGATIONS

3. The Commission has proposed that the Annex E and F derogations be abolished in three phases, beginning with those regarded by it as most easily conceded by member states and ending with those which pose greatest difficulty for them. Although the draft directive has recently been amended, the dates proposed in it for the three phases remain 1 January 1986 (clearly impossible), 1988 and 1990.

PRESIDENCY COMPROMISE

4. The Danish Presidency has now put together a more modest compromise package which proposes the abolition on 1 January 1989 of all but two of the items included in the Commission's first phase and calls for a decision on the remainder of the Commission's proposal before 1 January 1992. The Presidency intends to put the package to the ECOFIN Council on 16 November in an attempt to give political impetus to the draft directive.

UK POSITION

5. Ministerial approval was given in October 1985 to a line-to-take in official level discussions; the approach was, basically, that we should defend established national policy on the grounds that it is not distortive to Community trade, but at the same time, seek further information on the likely effects of conforming fully with the tax regime envisaged in the Sixth

Directive. All member states were equally reluctant initially to abandon use of their own derogations but recently all of them except the UK have shown willingness to forgo derogations as part of a meaningful Community measure and in recognition that the derogations were intended to be transitional, not permanent. The result is that while most member states still maintain one or two reservations, the UK is isolated on six items included in the Presidency compromise package. With ECOFIN on the horizon, it is appropriate to reconsider the UK position.

CONSIDERATIONS

6. The Appendix to this submission discusses in detail each of the items which concern the UK and which may be discussed at ECOFIN. In summary, if we had to end our derogations, the implications would be as follows:

Annex E, items 4 and 5. We would have to exempt "certain services closely linked to sport or physical education supplied by non-profit making organisations" and "certain cultural services and goods closely linked thereto supplied by bodies governed by public law and by other cultural bodies recognised by the member state."

The revenue loss from exempting the sports services would be around £5-10 million; that from exempting the cultural services is very uncertain because of the imprecise scope of the provision but could at worst run into tens of £millions. The sports provision would favour local authorities and non-profit making sports clubs in competition with commercial bodies. The cultural provision would favour those whom it was decided should benefit (eg publicly owned historic buildings, museums and zoos or the subsidized theatre) against commercial operations (eg private stately homes or zoos or the commercial theatre). There would be continued pressure to extend the exemption to bodies seen as worthy, matched by complaints of foul play from those who suffered unfair competition. Other member states appear to cope with these problems, but they probably start from a different position in terms of public

financial support for sport or culture. To appear helpful in forwarding the Eighteenth Directive, while minimising future political difficulties in the UK, we suggest making our ending of these derogations subject to a proviso, to be incorporated in the Directive, allowing us to limit eligibility for exemption, even in the case of public bodies, where distortion of competition would otherwise result. There is already precedent for this in the Sixth Directive. We should wish to stick on this point for cultural services but not for services linked to sport. Presentationally it would be advantageous to insist on both now but be prepared to concede on services linked to sport during negotiations.

Annex E, items 9 and 10. We would have to exempt agency commissions for dealing in securities and management charges in relation to unit trusts. The revenue cost would be about £25m and £15m respectively. This is the principal objection, since there are no other reasons of policy for hanging on to either of these derogations.

Annex F, items 21 and 22. We would have to tax the fuelling and provisioning of private boats and aircraft proceeding outside national territory (at present zero-rated). There would be a small revenue gain, likely to be in the order of a few million. The change might be unpopular with those immediately affected, but otherwise we see no real difficulty about extending the tax to an area of purely discretionary expenditure not the subject of any current ministerial pledges.

Annex F, item 23. Under the Commission's proposals - but not included in the Presidency compromise - we would have to tax military aircraft, at present zero-rated. Administratively, this would be simpler than maintaining the present zero-rating, but the MOD vote would have to be increased to compensate for the revenue increase. This does not seem a sound reason for maintaining the derogation if the other member states who use it are prepared to drop it.

7. Thus the sports/cultural items would involve revenue loss and would be administratively and politically awkward subsequently; the two financial items would involve revenue loss. Nevertheless, we would recommend that all the derogations could be given up, provided that we get the safeguards proposed above in relation to distortion of competition, and provided that other member states make equally significant sacrifices.

8. Among the derogations enjoyed by other member states is that which enables the Irish to exempt racehorses and greyhounds. This has long been a source of complaint by the British bloodstock industry. We can fairly claim that this derogation, unlike many of the others, really does distort competition between members of the Community. It must be a sticking point for the UK that the Irish abandon this derogation, and on the same date as other member states abandon theirs. Our present stance should be that we will block the directive unless the Irish move on this.

FUTURE DEVELOPMENTS

9. The future of the draft directive is uncertain. It may be that member states and the Commission will accept that agreement to a first phase of abolition is better than no agreement at all. If that is so, a curtailed Eighteenth VAT Directive may, after ECOFIN consideration, be formally proposed and adopted. In that case, the likelihood is that member states would be obliged to consider the abolition of the remaining derogations before 1 January 1992. In accepting the present measure, the UK would be signalling its agreement only to future consideration of abolishing other derogations but not at this stage agreeing to abolition itself. For example, the UK is one of several member states with particular concerns over the current exemption given to funeral services, building land and zero-rating of passenger transport. It might have to be made clear domestically that we had done nothing to prejudice the future of these reliefs.

OWN RESOURCES

10. For items E9 (Securities transactions), F21-22 (Fuelling and provisioning private craft) and F23 (Military aircraft) adjustments are at present made to our Own Resource (OR) calculations to reflect the taxing intentions of the Sixth Directive. Thus, removing our

derogations for these items would have no OR effect.

For items E4 (Sport and Physical Education) and E5 (Cultural Services) and E10 (Unit Trusts) no adjustments are made to the OR payment on the basis that calculation is difficult given the varying interpretations in the member states or that the amounts are small. This works to the net detriment of the United Kingdom. Abandoning the derogations and correctly applying the Sixth Directive would produce an OR saving of the order of £5m.

CONCLUSION

11. We recommend that, in order to demonstrate a willingness to make some progress on the completion of the Internal Market and to achieve a meaningful Community measure, all the UK reservations to the proposals in the Presidency's compromise solution should now be lifted provided that:

- (a) a proviso is included in the text of the Directive to enable member states to take action as necessary to prevent distortion of competition
- (b) all member states make equally significant sacrifices
- (c) the Irish give up their derogation for bloodstock.

We seek your agreement to that recommendation.

Bryce Knox

B H KNOX

APPENDIX

I DEROGATIONS TO TAX WHERE SIXTH DIRECTIVE ENVISAGES EXEMPTION
(ANNEX E)

Annex E, Item 4: Sport and Physical Education

(i) The Sixth Directive exempts "certain services closely linked to sport or physical education supplied by non-profit making organisations to persons taking part in sport or physical education."

(ii) Current UK policy:

On the basis that Government policy has been to tax discretionary expenditure, UK has applied VAT to, for example, subscriptions to sports clubs and to coaching fees. The result is that distortion of competition between commercial, non-profit making organisations and local authorities and between different categories of recreational/leisure activity is avoided.

(iii) Recommendation:

Although the current system of taxation results in few complaints, abandoning the derogation would lead to a greater distortion of competition between commercial bodies, non profit making bodies and bodies governed by public law. This is exacerbating the fact that the distortion of competition provisions of the Sixth Directive (Article 13A 2(a)), which can be used to limit the scope of exemption, may not be applied to bodies governed by public law. Thus, for example, the provision of squash courts and hire of equipment could be exempt when supplied by a local authority but taxable when supplied by a commercial club in direct competition. The estimated revenue loss from abandoning our use of the derogation is estimated to be in the region of £5-10

million, although it is impossible to attach a precise figure as local authorities do not account separately for sports activity income and expenditure.

The cost would be limited if we had a proviso restricting the use of the exemption where there would be distortion of competition. Such a proviso would, it is suggested, be required in respect of the next item (E5: cultural services), and there seems no reason why it should not also extend to the sports etc, services provided by bodies governed by public law.

The revenue implications of losing the derogation are not serious and the possibility of an increase in the number of complaints from organisations adversely affected should not be seen as a sticking point. We recommend that our reservation should be withdrawn.

Annex E, Item 5: Cultural Services

(i) The Sixth Directive exempts:

"certain cultural services and goods closely linked thereto supplied by bodies governed by public law and by other cultural bodies recognised by the member state."

(ii) Current UK policy:

The UK policy here is on similar grounds to Annex E, Item 4 above. It is based on a policy of taxing discretionary expenditure and thus avoiding distortion of competition between commercial, non-profit making bodies, and public law bodies; and between different categories of recreational/leisure activity. Encouragement of the arts sector to draw funding from non-Government sources, coupled with direct assistance in the form of grants, is recognised as providing a more efficient support for the arts sector than VAT relief.

(iii) Recommendation:

Although all other member states have indicated that they are able to apply this exemption, the particular difficulty for the UK with this item appears to stem from the unique structure of the arts sector in this country. The fact that we draw no distinction between cultural services supplied by "bodies governed by public law", "other bodies recognised by the member state" and any other bodies, will pose real administrative difficulties and make the proposed exemption difficult to operate in the UK. For example, there would continue to be taxation of entrance charges to privately owned stately homes, zoos, museums etc, but exemption for their publicly owned counterparts. There would potentially be strong pressure on the Government to extend the exemption by "recognising" bodies as "cultural", with complaints from those not so recognised. The difficulties would be very serious in the field of live entertainment.

Depending on the scope of the exemption, the tax cost could run into tens of £millions. However, we suggest that we could be willing, in principle, to abandon our derogation if a proviso is included in the text of the directive itself to limit exemption where distortion of competition would otherwise result. This would reduce the borderline unfair competition problems and likewise limit the revenue cost.

Annex E, Item 9: Transactions in Securities

(i) The Sixth Directive exempts transactions, including negotiations, in shares, debentures and other securities.

(ii) Current UK policy:

To tax agency commissions for dealings in securities. Since the Big Bang, however, stockbrokers have been able to avoid tax by acting as principals in their dealing in securities. In addition, the 1987 Finance Act exempted

commissions (including underwriting) in relation to the issue of new securities. (This last measure was to alleviate the impact of the new stricter partial exemption rules on businesses seeking to raise capital.)

(iii) Recommendation:

The principal objection to exemption in the past was the potential revenue loss (£80m per year prior to the Big Bang). The revenue cost is now substantially less (perhaps £25m), and exemption would do away with the anomalous difference in treatment between stockbrokers acting as principals and those acting as agents. Independently of the Eighteenth Directive, the question of exemption has been discussed with the Stock Exchange twice in the last 18 months. They are, we understand, divided among themselves, and have decided not actively to seek exemption in advance of any agreement on the Directive. We therefore recommend lifting our reservation so long as Ministers are willing to accept the loss of revenue.

Annex E, Item 10: Management of Unit Trust Funds

(i) The Sixth Directive exempts "the management of special investment funds as defined by member states." The term is defined in other (non-tax) Directives so as to apply to unit trusts in the UK.

(ii) Current UK policy:

To tax management charges in relation to unit trusts. Net revenue is currently about £15m.

(iii) Recommendation:

The principal objection to conceding is the revenue loss. The unit trust industry is not pressing for exemption; the beneficiaries, if the tax reduction is passed on, would be the holders of individual units. Other than the revenue cost, however, there are no compelling reasons for

retaining the derogation, and it is a concession which will need to be made if a compromise agreement on the Directive is to be reached. If Ministers are willing to accept the revenue loss, we recommend withdrawing our reservation.

II DEROGATIONS TO EXEMPT WHERE SIXTH DIRECTIVE ENVISAGES TAXATION (ANNEX F)

Annex F, Items 21 and 22: Fuelling and provisioning of private boats and aircraft proceeding outside the national territory.

(i) The Sixth Directive requires taxation of goods for fuelling and provisioning supplied to private boats and aircraft.

(ii) Current UK policy:

We zero rate - i.e. exempt with refund. The current UK line is to resist the proposed abolition of the derogation on the grounds that there is a problem in distinguishing "private" vessels and aircraft from others and that "private" vessels and aircraft can easily be converted either to commercial use, or for long journeys outside the Community, where entitlement to duty and tax-free stores is the Community rule. The draft duty-free stores directive, which we wished to see adopted at the same time as this provision, has not been discussed since October 1984 and is at an impasse largely because of the stance adopted by the UK.

(iii) Recommendation:

Ending the current exemption of fuelling and provisioning of private boats and aircraft would pose problems of definition. It would be unpopular with those immediately affected but would be unlikely to cause a more general outcry. We could defend a policy of taxation on grounds that other leisure pursuits are taxed and those whose recreation involves private boats and aircraft are among

those most able to afford to have them taxed. There would be some practical control problems, but these would not be insurmountable. The imposition of tax would also be in line with the current policy of taxing discretionary expenditure, though the revenue gain would be insignificant.

We recommend that the UK reservation should be withdrawn.

Annex F, Item 23: Military aircraft

NB This item is excluded from the Presidency compromise proposal and is therefore unlikely to be on the table for consideration.

(i) The Sixth Directive taxes the supply, repair, maintenance, etc, of military aircraft. This item is closely linked with F25, which gives an equivalent derogation for warships; F25 is currently proposed by the Commission for abolition in phase 2.

(ii) Current UK policy:

To zero-rate supplies of and repairs etc, to warships and military aircraft. We are not therefore shown by the Commission as using the derogations, which allow exemption. We regard our zero-rating as being equivalent to exemption with right to refund of input tax under conditions existing in the member state concerned. At the Financial Questions Group meeting in July 1987, it was ascertained that at least Belgium, of the other member states, exempts with refunds.

(iii) Recommendation:

We are already obliged to calculate and make an own resources payment to the Community budget for items zero-rated. The effect of ending the derogation would be to reduce the administrative burden on Customs and Excise, not merely in relation to own resources but also in relation to liability disputes and difficulties between

ourselves, MoD and their contractors. We would therefore welcome the ending of this derogation. Nevertheless we recognise that there could be a presentational problem in relation to the size of the Defence Budget. To preserve the current real levels of expenditure on warships and military aircraft, the MoD vote would have to be increased by an amount running into tens of £millions to compensate for the extra VAT burden. In the final analysis, however, there seems no good reason for resisting in Brussels the ending of this derogation, as long as there is a similar willingness by Netherlands, Belgium, Italy and Greece to give it up.



Board Room
 H M Customs and Excise
 King's Beam House
 Mark Lane London EC3R 7HE

*Sh. Content for Mr Knox
 to proceed as proposed?*

*Spoke
 Mrs*

*OK. sufficient
 for Miss Sinclair
 to represent HMV.*

From: B H Knox
 Date: 4 November 1987

- cc. Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Sir G Littler
- Mr Byatt
- Mr Cassell
- Mr Scholar
- Mr Edwards
- Miss Sinclair
- Mr Cropper
- Mr Tyrie

CHANCELLOR

TAX APPROXIMATION: HOUSE OF LORDS ENQUIRY

1. Sub-Committee A of the House of Lords Select Committee on the European Communities is considering whether or not they should produce a follow-up to their report on 'Indirect taxation and the internal market', published in April 1986, in the light of the Commission's detailed tax proposals. To help them make up their minds, the Clerk has asked us to give informal, oral evidence to the Sub-Committee on Wednesday, 11 November.

Internal circulation: CPS, Mr Jefferson Smith, Mr Finlinson, Mr Nash,
 Mr Cockerell, Mr Kent, Mr Allen, Mr M Knox, Ms French

2. We have discussed with FP how to respond to this unusual request for informal briefing. The Treasury has from time to time in the past been asked to give informal evidence to Parliamentary Committees. Their line has always been that there is no halfway house between an 'on the record', or formal, session with the Committee and the normal informal contacts with the Clerks to these Committees. But rather than decline the Committee's request, we think it would be wise to accept, but to treat the meeting as though it were a formal session, so as to reduce the risk of possible embarrassment if the Committee subsequently decided to use or publish the evidence we gave, on what is a very sensitive subject. If you are content with this approach, I propose to attend from here, accompanied by Ms French and either Mr Scholar or Miss Sinclair from FP.

3. We do not know exactly what ground the Sub-Committee want to cover. We understand from the Clerk that they are particularly interested to find out the reactions of other Member States to the proposals and to identify the issues which are likely to cause greatest difficulties in discussion in Brussels. In replying to questions along these lines, we would restrict our comments to providing facts about the effects of the Commission's proposals on tax rates in other Member States. Following on from that we would identify likely areas of difficulty for Member States, but we would steer clear of speculating about what their overall attitude to the proposals might be. We may also be questioned about both the handling of the discussions in Brussels and on the UK's response to the proposals. On the former we would stick to a factual explanation of the likely agreement by ECOFIN to remit consideration to the EPC. As regards the latter, we would go no further than giving a factual explanation of the proposals' effects. Anything further than this would be appropriate for the Committee to put to Ministers.

4. We have no reason to think the newly constituted Sub-Committee (see attached) will have any particular axe to grind and this informal briefing may lead them to decide not to follow up their earlier report. If they do decide to follow it up they can be expected to range fairly widely: they are virtually certain to see Lord Cockfield and may well seek the views of trade and other organisations.

5. I would be grateful for your consent to proceed along the lines indicated in paras 2 and 3.

Bryce Knox

B H KNOX

SUB-COMMITTEE A:
FINANCE, TRADE AND INDUSTRY

Chairman

Lord Kearton

Members

Lord Murray of Epping Forest

Lord Seebohm

Lord Ardwick

Lord Butterworth

Lord Benson

Lord Geddes

Lord Greenhill of Harrow

Lord Kissin

Lord Macle hose of Beoch

Lord Mefton

Lord Roll of Ipsden

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Board Room
HM Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

M. J. A.

FROM: J B UNWIN
DATE: 6 NOVEMBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Economic Secretary
Sir Peter Middleton
Mr Byatt
Mr Edwards

TAX APPROXIMATION: ECOFIN

You will receive detailed briefing for the next ECOFIN in the usual way. You may just like to know, however, that I asked Lord Cockfield last evening how he saw matters being taken forward after ECOFIN.

He told me that he did not intend to allow matters to be delayed by being shunted off into EPC. The formal remit to EPC would no doubt be endorsed, but he was determined that full further consideration of his proposals by the Commission should continue at the same time. Otherwise, the EPC study would be no more than a delaying exercise.

X I pass this on since it is clear that if we are to succeed in our immediate delaying objective you will want to establish clearly at ECOFIN that no further substantive progress can be made until you and your colleagues have the benefit of a thorough EPC review.

J B UNWIN

Internal distribution: Mr Knox
Mr Allen



FROM: J M G TAYLOR
DATE: 9 November 1987

MR B H KNOX

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Byatt
Mr Cassell
Mr Scholar
Mr Edwards
Miss Sinclair
Mr Cropper
Mr Tyrie

TAX APPROXIMATION: HOUSE OF LORDS ENQUIRY

The Chancellor has seen your minute of 4 November, and is content for you to proceed as proposed.

A handwritten signature, likely of J M G Taylor, consisting of stylized initials.

J M G TAYLOR



FROM: J M G TAYLOR
DATE: 10 November 1987

MR J B UNWIN - Customs & Excise

cc PS/Economic Secretary
Sir P Middleton
Mr Byatt
Mr Edwards

Mr Knox - C&E
Mr Allen - C&E

TAX APPROXIMATION: ECOFIN

The Chancellor was grateful for your minute of 6 November. He has noted the need to establish clearly at ECOFIN that no further substantive progress can be made pending a thorough EPC review, if we are to succeed in our immediate delaying objective.

A handwritten signature in black ink, appearing to be 'JMG'.

J M G TAYLOR



Papers pse -> m

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

FROM: B H KNOX
DATE: 12 November 1987

*Quis Customs: SGA
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substantiated if it had it not
Mr.*

- cc. Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Sir G Littler
- Mr Byatt
- Mr Cassell
- Mr Scholar
- Mr Edwards
- Miss Sinclair
- Mr Cropper
- Mr Tyrie

CHANCELLOR

TAX APPROXIMATION : HOUSE OF LORDS ENQUIRY

1. As foreshadowed in my note of 4 November, Sub-Committee A of the House of Lords Select Committee on the European Communities yesterday took informal, oral evidence from Customs and Excise and Treasury Officials on the Commission's tax approximation package.

2. The Committee were well aware of the political sensitivities both in relation to sovereignty and to zero rates. The Chairman suggested that since the Single European Act (SEA), had been ratified by both Houses, the UK had effectively already relinquished sovereignty and that this was therefore no longer an acceptable argument for inaction. The prospect of a "two tier" Europe, with several Member States adopting approximation and others maintaining existing

Internal circulation: CPS, Mr Jefferson Smith, Mr Finlinson, Mr Nash, Mr Cockerell, Mr Kent, Mr Allen, Mr M Knox, Ms French

national systems was raised, but the Chairman (Lord Kearton) quickly dismissed this scenario and commented that all Member States had rejected such a possibility during discussions on the SEA. On the excise side, the Committee indicated that although members recognised the proposals could have significant implications for industries and for domestic markets, such a price may be worth paying.

3. As envisaged, we restricted our comments to providing facts about the effects of the proposals on tax rates in the UK and in Member States and the expected handling of the package in the short term. The Committee was particularly interested to find out whether examination of the proposals had begun and what findings, if any, were emerging. They hoped the UK was taking a positive line in looking for solutions to problems. We explained that the Economic Policy Committee would be carrying out a macro-economic evaluation of the package and that at present we are studying the proposals at a technical level to assess their implications.

4. The session lasted about 45 minutes. In his summing up Lord Kearton said it was unlikely that the Committee would want to follow-up to their 1986 enquiry. I gather Lord Kearton will shortly be writing to you to inform you of the proceedings and to indicate the Committee's intended course of action.

Bryce Knox

B H KNOX

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

12 November 1987

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Dear Alex,

VALUE ADDED TAX ON NEWSPAPERS

Mr. Rupert Murdoch, Lord Stevens and Mr. Conrad Black came to see the Prime Minister this evening to put the case against imposing VAT on newspapers. The Economic Secretary was also present.

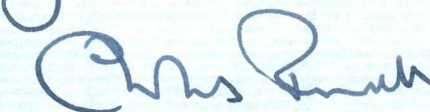
Lord Stevens said that the Prime Minister was no doubt well aware of the arguments against imposing VAT on newspapers. But he would like to put them to her formally on behalf of his fellow proprietors. The imposition of VAT on newspapers, magazines or published material would greatly increase the costs for newspapers which had to operate in a very competitive market and had made great efforts to modernise and become more efficient in recent years. VAT on newspapers would put them at an unfair disadvantage compared to free newspapers and also to other parts of the media such as the BBC. There was no valid argument in relation to the internal market in the European Community since newspapers were sold abroad only in very limited quantities. In the case of his own group, a fifteen percent VAT rate would add £45 million a year to costs and would inevitably affect modernisation plans. Mr. Black added that the newspaper industry was facing a constant squeeze on costs for instance from the rising price of newsprint. He understood that six out of twelve Member States of the European Community did not apply VAT to newspapers. Mr. Murdoch said that price rises for books, magazines and newspapers always led to reduced circulation and therefore reduced profits.

The Prime Minister said that she did not believe that harmonisation of VAT was necessary to the completion of a real common market. Nor did she want to see our tax system determined by the European Community. She had already made clear publicly that the United Kingdom would not accept proposals which restricted our right to apply zero rating. Since any such proposal would require unanimity, we had the ability to veto it. The Economic Secretary added that the Commission had instituted infraction proceedings relating to

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zero rating for a number of products, including news services. The Prime Minister continued that, in regard to our own practice, she could say no more than that she had heard and registered the points which had been made. Her visitors would understand why she could not go beyond this.

I am copying this letter to Lyn Parker (Foreign and Commonwealth Office).

Yours sincerely,


(CHARLES POWELL)

Alex Allan, Esq.,
HM Treasury

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FRAME ECONOMIC

COREPER LUNCH 12 NOVEMBER: APPROXIMATION OF INDIRECT TAXES

SUMMARY

1. LORD COCKFIELD OUTLINES AMBITIOUS WORK PROGRAMME, WHICH HE WILL PRESENT TO MONDAY'S ECOFIN COUNCIL, AIMING AT ADOPTION OF ALL COMMISSION'S PROPOSALS BY THE END OF 1988.

DETAIL

2. AT TODAY'S COREPER LUNCH LORD COCKFIELD DESCRIBED AND CIRCULATED AN AMBITIOUS THREE STAGE TIMETABLE FOR COUNCIL CONSIDERATION OF THE COMMISSION'S PROPOSALS ON VAT AND EXCISE DUTY APPROXIMATION WHICH HE WILL PRESENT AT MONDAY'S ECOFIN.

3. THE FIRST STAGE WOULD RUN UNTIL ECOFIN ON 18 APRIL NEXT YEAR. DURING THIS PERIOD COREPER AND WORKING GROUPS WOULD EXAMINE:

- (A) ON VAT SIDE, THE PROPOSAL TO REMOVE FISCAL FRONTIERS (TECHNICAL AMENDMENTS NEEDED TO 6TH VAT DIRECTIVE), THE CLEARING SYSTEM AND OUTSTANDING PROPOSALS TO COMPLETE THE VAT BASE (12TH, 18TH AND 19TH DIRECTIVES):
- (B) ON THE EXCISE SIDE, PROPOSALS ON THE DUTY STRUCTURES FOR MINERAL OILS, ALCOHOLIC BEVERAGES, AND TOBACCO PRODUCTS OTHER THAN CIGARETTES (STRUCTURE OF CIGARETTES IS CLOSELY LINKED TO THE QUESTION OF RATES AND SHOULD BE LEFT TO THE SECOND STAGE:
- (C) THE PROPOSAL FOR CONVERGENCE OF VAT RATES.

4. THE SECOND STAGE WOULD RUN FROM 18 APRIL (BY WHICH TIME THE COMMISSION WOULD EXPECT THE EP TO HAVE DELIVERED ITS OPINION AND THE MEMBER STATES TO HAVE COMPLETED THEIR 'MACROECONOMIC STUDIES') UNTIL THE 6 JUNE ECOFIN. DURING THIS PERIOD WORK SHOULD FOCUS ON:

- (A) PROPOSALS ON THE NUMBER, LEVEL AND SCOPE OF VAT RATES:
- (B) PROPOSALS ON THE EXCISE DUTY RATES, INCLUDING THOSE ON CIGARETTES.

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5. THE COUNCIL SHOULD AIM TO DECIDE IN PRINCIPLE ON THESE PROPOSALS ON 6 JUNE.

6. THE THIRD STAGE WOULD COMMENCE AFTER 6 JUNE ECOFIN COUNCIL AND WOULD BE GIVEN OVER TO NEW FURTHER COMMISSION PROPOSALS ON, FOR EXAMPLE, PASSENGER TRANSPORT, WORKS OF ART, GOLD AND THE EXCISE-LINKED WAREHOUSE SYSTEM AND TO RESOLVING INDIVIDUAL PROBLEMS AND REQUESTS FOR DEROGATIONS.

7. THE COMMISSION WOULD LOOK TO THE COUNCIL TO ADOPT ALL THE COMMISSION'S FISCAL PROPOSALS BY THE END OF 1988, IN ORDER THAT THE MEMBER STATES MAY HAVE SUFFICIENT TIME AND ROOM FOR MANOEUVRE TO IMPLEMENT THEM AS THEY SEE FIT, BUT IN ANY EVEN TO NO LATER THAN 31 DECEMBER 1992.

8. THIS TIMETABLE CAME WITH MUCH RHETORIC ABOUT THE CRUCIAL IMPORTANCE OF THE ABOLITION OF FISCAL FRONTIERS FOR THE COMPLETION OF THE INTERNAL MARKET AND THE NEED FOR THE COMMISSION TO BE ABLE TO MAKE CLEAR IN ITS REPORT ON THE INTERNAL MARKET DUE IN DECEMBER 1988 THAT IRREVERSIBLE PROGRESS HAD BEEN MADE TOWARDS THE COMMUNITY'S OBJECTIVES FOR 1992.

9. IN DISCUSSION, NIEMAN (NETHERLANDS) WONDERED WHETHER THE COPENHAGEN EUROPEAN COUNCIL SHOULD BE ASKED TO GIVE ITS BLESSING TO RAPID WORK ON FISCAL APPROXIMATION. ESPER LARSEN (PRESIDENCY) RULED THAT THE COPENHAGEN EUROPEAN COUNCIL ALREADY HAD ENOUGH ON ITS PLATE WITH FUTURE FINANCING.

10. THERE WERE NO OTHER COMMENTS APART FROM EXPRESSIONS OF GENTLE GOODWILL AND REMINDERS THAT, FOR SOME MEMBER STATES, THE CHANGES ADVOCATED BY THE COMMISSION WOULD BE VERY DIFFICULT. ALL OF MY COLLEAGUES WERE TOO POLITE TO VOICE THEIR OBVIOUS FEELING THAT LORD COCKFIELD'S TIMETABLE WAS LAUGHABLY UNREALISTIC.

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MIPT: MY MEETING WITH GENSCHER, 11 NOVEMBER
OTHER EC ISSUES

SUMMARY

1. STAND-OFF ON POST-CHERNOBYL. GERMANS PROMISED NO EXCESSIVE ZEAL ON TAX HARMONISATION DURING THEIR PRESIDENCY. INCONCLUSIVE EXCHANGE ON AIR TRANSPORT/GIBRALTAR.

DETAIL

2. GENSCHER ASKED WHY THE SPECIAL FAC LAST WEEKEND ON POST-CHERNOBYL HAD FAILED. I SAID THAT WE, LIKE THE FRENCH AND SPANISH, HAD MOVED FROM OUR INITIAL POSITION TO ONE OF READINESS TO ACCEPT THE PRESIDENCY COMPROMISE. THERE HAD BEEN NO CORRESPONDING MOVE FROM THE GERMANS. GENSCHER SAID THAT, AGAINST THE BACKGROUND OF A GERMAN POLICY OF SEEKING IMPROVED STANDARDS OF PROTECTION, THEY COULD NOT ACCEPT LOOSER STANDARDS. GERMANY HAD BEEN MORE AFFECTED BY CHERNOBYL RADIATION THAN THE UK, AND ITS PUBLIC OPINION WAS CORRESPONDINGLY MORE SENSITIVE. AT THE VERY LEAST WE SHOULD STICK WITH THE STATUS QUO. I POINTED OUT THAT THE COMMUNITY HAD SOUGHT SCIENTIFIC ADVICE, AND THAT OUR ORIGINAL POSITION HAD BEEN BASED ON THE ARTICLE 31 GROUP'S THE PRESIDENCY HAD NOW PROPOSED MUCH LOWER LEVELS. IN THE INTERESTS OF FINDING A PRACTICAL SOLUTION, WE COULD ACCEPT THESE. BUT IF THE FRG INSISTED ON STILL LOWER FIGURES, AND WERE NOT PREPARED TO MAKE COMPARABLE MOVES, WE DID NOT SEE A BASIS FOR AGREEMENT.

3. TAX APPROXIMATION: I EXPLAINED OUR DIFFICULTIES OVER ANY ATTEMPT TO LIMIT VAT ZERO RATES. OUR IMMEDIATE GOAL SHOULD BE TO REDUCE FRONTIER DELAYS, EG BY PRESSING ON WITH THE FOURTEENTH VAT DIRECTIVE. I HOPED THE GERMAN PRESIDENCY WOULD NOT GIVE UNDUE PRIORITY TO THIS DOSSIER. GENSCHER SAID THAT THEY WOULD NOT AND TRUMPF ADDED THAT GERMANY HAD ITS OWN PROBLEMS WITH THE COCKFIELD PROPOSALS OTHER THAN ON VAT. THEY WOULD KEEP WORK ON TAX HARMONISATION GOING, BUT WOULD NOT BE MAKING A SPECIAL FEATURE OF IT. THEY REGARDED DENMARK, NOT THE UK, AS THE MAIN PROBLEM. (IN THE MARGINS TRUMPF TOLD KERR THAT THE DANES HAD DRAWN FRG ATTENTION TO THE DANISH DOMESTIC IMPACT OF ANY MAJOR CAMPAIGN ON

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VAT HARMONISATION IN WHAT WOULD BE A DANISH ELECTION YEAR.)
4. AIR TRANSPORT AND GIBRALTAR: I EXPLAINED BRIEFLY OUR EFFORTS TO REACH AGREEMENT WITH THE SPANIARDS. GENSCHER ASKED IF WE WOULD NOT BE SATISFIED WITH A DISCLAIMER. KERR SAID THE PROBLEM WAS THAT THE SPANIARDS WERE LOOKING FOR MORE: THEY WANTED TO USE THE EC AVIATION NEGOTIATIONS AS A LEVER TO IMPROVE THEIR GRIP OVER THE AIRPORT. I EXPLAINED THAT THE EXISTING BARRIERS OF DISTRUST WERE DIFFICULT TO SURMOUNT. WE HAD TO TRY TO PERSUADE THE SPANIARDS TO WOO GIBRALTAR. TRUMPF DREW ATTENTION TO THE RISK THE EUROPEAN PARLIAMENT WOULD TRY SIGNIFICANTLY TO AMEND THE THAT AVIATION PACKAGE.

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FROM: MISS M P WALLACE
DATE: 16 November 1987

MR B H KNOX - Customs

TAX APPROXIMATION: HOUSE OF LORDS ENQUIRY

The Chancellor has seen your minute of 12 November. He has commented that the Committee Chairmen's suggestion that the UK had effectively relinquished sovereignty is quite untrue: SEA requires unanimity for tax changes, and we would not have submitted to it had it not done so.

M.P.W.

MOIRA WALLACE

No.10 Briefing on Ecofin

1. Tax approximation

17/11/87.

Line to take

The discussion of tax approximation in Ecofin yesterday was, purely procedural.

The Council awaits the report of experts on the economic effects of the Commissions proposals. The Chancellor ~~reminded the Council of the United Kingdoms requirements in terms of preserving zero rates.~~

made it clear that ^{there} ~~there~~
 could be in question of the UK
^{permitting} ~~to~~ ^{to} come into force
 proposals which are ⁱⁿ ~~in~~ ^{conflict} ~~in~~ ^{with} ~~with~~ ^{pledges} ~~pledges~~
 given ~~to~~ ^{to} the UK's zero rates.
~~proposals~~ ^{proposals} ~~can~~ ^{can} ~~be~~ ^{be} ~~adopted~~ ^{adopted} ~~unless~~ ^{unless}
 a unanimous approval of all
 member states.

ECOFIN COUNCIL 16 NOVEMBER

2. International Economic and Monetary Situation

The text below was agreed by EcoFin ^{yesterday} ~~this morning~~ and will be used by the Presidency in briefing the press.

2. An attempt by the Southern Member States to include a reference to "cohesion" was seen off, as were efforts by the Belgians and Italians to refer explicitly to interest rate policy and tax reform.]

3. The Presidency agreed, at the Chancellor's suggestion, to brief the press in addition that Ministers had underlined the need for all countries to resist pressures for protectionism.

"Within the framework of the EEC-EcoFin-Council the European Finance Ministers today discussed the most recent developments on the financial and foreign exchange markets.

Taking note of some improvements during the last days they agreed that a more stable market situation is very important for the further economic development in Europe and worldwide.

For this purpose common and coordinated efforts by all countries are needed."

It is of high importance that the fiscal and monetary cooperation agreed at the Louvre be continued and the commitments undertaken implemented by all parties in full and without delay. Especially urgent are early and appropriate decisions on a further substantial reduction of the US budget deficit for fiscal 1988 and fiscal 1989. A further decline of the dollar would aggravate the disadvantages for the world economy including the US. \

The European countries are determined to improve the conditions for further internally-generated non-inflationary growth and to contribute to the reduction of external imbalances. The European countries intend to cooperate actively with other countries in decisions to ensure a more stable development of world financial and foreign exchange markets.

The events of the last weeks have emphasised the advantages within the context of the objectives of the European Single Act of setting up a large integrated European market of goods and services and capital. The progressive realisation of these objectives will create in the coming years new opportunities for growth in Europe.

The EMS has played and will play an important role in the coordination of policies between the member countries and in preserving stable relationships between European currencies. All member countries will continue to meet in full their obligations within the existing margins of the EMS. Recent developments have demonstrated that the EMS has been strengthened in appropriate ways by the September decisions of Basle and Nyborg."

No.10 Briefing on Ecofin

1. Tax approximation

Line to take

The discussion of tax approximation in Ecofin yesterday was, purely procedural.

The Council awaits the report of experts on the economic effects of the Commissions proposals. The Chancellor made it clear that there could be no question of the UK permitting to come into force any proposals which in any way conflicted with the pledges given concerning the UK's zero rates. No proposals can, of course, be adopted without the unanimous approval of all Member States.

ECOFIN COUNCIL 16 NOVEMBER

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[Handwritten signature]

Ch

PM's questions

No 10. have asked for a line on
tax approximation for questions this
p.m. (They have also asked for a

Copy of the agreed text on the
international economic situation - they
received one yesterday, but we shall
send them another for good measure)

Content with the enclosed?

No. Too weak.

I have written

[Handwritten initials]
17/11

The European countries are determined to improve the conditions for further internally-generated non-inflationary growth and to contribute to the reduction of external imbalances. The European countries intend to cooperate actively with other countries in decisions to ensure a more stable development of world financial and foreign exchange markets.

The events of the last weeks have emphasised the advantages within the context of the objectives of the European Single Act of setting up a large integrated European market of goods and services and capital. The progressive realisation of these objectives will create in the coming years new opportunities for growth in Europe.

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INDIRECT TAX APPROXIMATION: MEETING OF THE ECONOMIC POLICY
COMMITTEE (EPC) : 26/27 NOVEMBER 1987

SUMMARY

1. MAJORITY OF DELEGATIONS CLAIM TO SUPPORT THE GENERAL OBJECTIVE OF APPROXIMATING INDIRECT TAXES AS A CONTRIBUTION TO COMPLETING THE INTERNAL MARKET, BUT IDENTIFY MANY AREAS WHERE FURTHER IN-DEPTH STUDY REQUIRED OF COSTS AND BENEFITS OF COMMISSION'S PROPOSALS. COMMISSION'S STUDY OF COSTS OF 'NON EUROPE' (AVAILABLE BY THE END OF JANUARY 1988) SHOULD HELP TO QUANTIFY GAINS AND LOSSES. CURRENT VAT SYSTEM ACCEPTED AS BROADLY NEUTRAL IN COMPETITION TERMS FOR TRADE BETWEEN MEMBER STATES. DESPITE HESITATIONS FROM DENMARK, EPC CHAIRMAN TO PRESENT AN INTERIM REPORT (ROUGH TEXT IN MIFT) ON HIS OWN AUTHORITY, TO 7 DECEMBER ECOFIN COUNCIL. AIM IS TO COMPLETE WORK BY BEGINNING OF MARCH 1988.

DETAIL

2. ALL DELEGATIONS GAVE THEIR PRELIMINARY VIEWS ON THE DESIRABILITY AND NECESSITY OF THE COMMISSION'S PACKAGE OF TAX APPROXIMATION PROPOSALS. UK, ITALY, DENMARK AND LUXEMBOURG REMAINED THE MOST RESERVED ABOUT THE NECESSITY OF FISCAL APPROXIMATION AS A PRE-REQUISITE FOR THE COMPLETION OF THE INTERNAL MARKET, BUT AGREED WITH OTHER DELEGATIONS THAT PROGRESS ON DEVELOPMENT OF THE INTERNAL MARKET WAS OF MAJOR IMPORTANCE. EVEN THE COMMISSION'S OWN STUDIES SUPPORTED THE VIEW THAT THE CURRENT VAT SYSTEM WAS NOT DISTORTIVE IN INTRA-COMMUNITY TRADE (EXCEPT FOR VAT EXEMPT TRADERS), AND THAT DIFFERENT VAT RATES WERE NOT AN IMPORTANT FACTOR IN CONSUMER PRICE DIFFERENCES.

3. MOST DELEGATIONS COMMENTED ADVERSELY ON THE PROPOSED VAT CLEARING MECHANISM, CONSIDERING IT UNDULY BURDENSOME AND BUREAUCRATIC. THE EXCISE DUTY PROPOSALS ALSO CAME IN FOR CRITICISM ON THE GROUNDS THAT THE INTERACTION WITH BROADER POLICIES, EG HEALTH, TRANSPORT, ENVIRONMENT, NEEDED MUCH MORE STUDY, AS WELL AS THE POTENTIAL EFFECTS ON THE INDUSTRIES INVOLVED. GERMANY

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PREDICTABLY QUESTIONED THE NECESSITY FOR A TAX ON WINE.

4. HARMONISATION OF TAX STRUCTURES WAS CONSIDERED DESIRABLE, BUT THE SPREAD OF THE PROPOSED VAT RATES, PARTICULARLY THE STANDARD RATE (14-19 PER CENT), WAS CONSIDERED TOO BROAD BY NETHERLANDS AND FRANCE.

5. THE PROBLEMS WHICH WOULD BE CAUSED FOR MANAGEMENT OF FISCAL POLICY (BALANCE BETWEEN DIRECT TAX AND INDIRECT TAX, REVENUE CONSEQUENCES) WERE AMPLY COMMENTED ON, AS WAS THE LACK OF ANY FIGURES SHOWING THE ECONOMIC IMPACT OF THE COMMISSION'S PROPOSALS BOTH SECTORALLY AND GLOBALLY FOR EACH MEMBER STATE.

6. AFTER REFLECTING OVERNIGHT ON DELEGATIONS' COMMENTS THE CHAIRMAN (MILLERON) SKETCHED OUT THE SORT OF INTERIM REPORT WHICH HE INTENDED TO PRESENT, ON HIS OWN AUTHORITY, TO THE ECOFIN COUNCIL ON 7 DECEMBER, DESCRIBING IN GENERALLY NEUTRAL TERMS THE FIRST REACTIONS OF EPC, THE WORK WHICH STILL HAD TO BE UNDERTAKEN, IDENTIFYING SOME OF THE DIFFICULT AREAS, AND AIMING FOR A FINAL REPORT DURING THE NEXT THREE MONTHS. DENMARK HAD SOME HESITATIONS ABOUT THE REACTION OF THE PRESIDENT OF THE ECOFIN COUNCIL TO THIS APPROACH, AND QUESTIONED WHETHER SUCH A REPORT WAS REALLY USEFUL. BUT MILLERON STUCK TO HIS GUNS, AND PROMISED A FULL TEXT BY 2 DECEMBER.

7. OUTLINE OF CHAIRMAN'S REPORT TO ECOFIN CONTAINED IN MIFT.

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MIPT : INDIRECT TAX APPROXIMATION : MEETING OF ECONOMIC POLICY
COMMITTEE (EPC) ON 26/27 NOVEMBER 1987

1. FOLLOWING IS OUTLINE OF REPORT WHICH CHAIRMAN OF EPC INTENDS
TO MAKE TO 7 DECEMBER ECOFIN COUNCIL :

' 'INTRODUCTION

THE EPC HAS UNDERTAKEN A FIRST EXAMINATION OF THE ECONOMIC
EFFECTS OF FISCAL HARMONISATION, TAKING ACCOUNT OF THE WORK OF THE
COUNCIL AD HOC GROUP ON THE ELIMINATION OF FISCAL FRONTIERS. EPC'S
ANALYSIS SHOULD BE SEEN AS COMPLEMENTARY TO THIS WORK.

~~IMPORTANT MICRO-ECONOMIC ASPECTS ARE RAISED BY FISCAL
HARMONISATION, INCLUDING CONDITIONS OF COMPETITION AND AGREEMENT ON
THE STIMULUS WHICH A GREATER OPENNESS OF MARKETS WOULD GIVE TO THE
ECONOMY. THE MACRO-ECONOMIC ANALYSIS WILL COVER THE CONSEQUENCES OF
FISCAL HARMONISATION ON MAJOR ECONOMIC VARIABLES, EG ON THE BUDGET
AND PRICES. A QUANTITATIVE ANALYSIS WOULD BE LIMITED BY THE LIMITS
OF THE TOOLS AVAILABLE.~~

FIRST REACTIONS OF THE COMMITTEE

AT ITS FIRST MEETING EPC UNDERLINED THE IMPORTANCE OF PURSUING
PROGRESS ON THE INTERNAL MARKET AS A MEANS OF INCREASING EUROPEAN
COMPETITIVENESS. REDUCTION OF FRONTIER BARRIERS SHOULD PLAY AN
IMPORTANT ROLE TO HELP TO CREATE CONDITIONS SIMILAR TO THOSE IN
LARGE UNIFIED MARKETS SUCH AS USA AND JAPAN. EPC AGREES THAT IN THE
LONG TERM (COMMENT - THIS IS LIKELY TO BE CHANGED TO REFER TO
WORKING IN THE FRAMEWORK OF THE SEA) THE COMPLETION OF THE INTERNAL
MARKET MUST BE ACCOMPANIED BY A GREATER HARMONISATION OF INDIRECT
TAXATION.

EPC ALSO AGREED IT WAS NECESSARY TO HAVE A TIMETABLE FOR THIS.
HOWEVER, THERE ARE IMPORTANT ISSUES WHICH STILL HAVE TO BE RESOLVED
ABOUT THE CHOICE OF PRECISE TIMETABLE AND THE KIND OF MECHANISMS TO
ACHIEVE FULL HARMONISATION OF INDIRECT TAXATION.

VAT

EPC REAFFIRMED THE ESSENTIAL ADVANTAGES OF VAT WHICH IS A NEUTRAL BROAD-BASED TAX ON CONSUMPTION. BUT THERE ARE PROBLEMS CONCERNING STRUCTURE AND RATES.

VAT STRUCTURE

THERE WAS AGREEMENT TO FINISH, AS QUICKLY AS POSSIBLE, HARMONISATION OF A COHERENT TAX BASE. EPC ALSO CONSIDERED AT THE PRESENT TIME THAT IT WOULD BE IMPORTANT TO SIMPLIFY AND, WHERE POSSIBLE, REDUCE THE NUMBER OF RATES.

RANGE OF RATES

EPC NEEDS TO EXAMINE FURTHER THE PROBLEMS RELATING TO THE RANGE OF VAT RATES PROPOSED BY THE COMMISSION, AND THEIR EFFECT ON TRADE BETWEEN MEMBER STATES. THERE COULD BE DISTORTIONS OF CROSS-BORDER TRADE PARTICULARLY FOR MEMBER STATES AT THE EXTREME ENDS OF THE RANGE OF RATES. (COMMENT - CHAIRMAN SUGGESTED ADDING 'PROBLEMS WITH RANGE OF RATES ARE PERHAPS MORE IMPORTANT FOR GOODS IN THE STANDARD RATE FOR GOODS IN REDUCED RATE'.)

EXCISE DUTIES

EPC NOTED THAT EXCISE DUTIES ARE LESS NEUTRAL THAN VAT. THERE ARE PARTICULAR PROBLEMS BECAUSE EXCISES ARE LINKED TO LARGE DIFFERENCES IN NATIONAL OBJECTIVES CONCERNING HEALTH, TRANSPORT, ENERGY, ENVIRONMENT ETC. EPC FELT THE NEED TO DEVELOP A CONCEPTUAL FRAMEWORK WHICH WOULD ALLOW IT TO TAKE ACCOUNT OF THESE CONSIDERATIONS. LINKING TAXATION TO THE ECU WOULD POSE PROBLEMS IF PARITIES CHANGED. THERE COULD BE A PROBLEM FOR MANAGING THE EMS. REGULAR INDEXATION COULD MAKE STABILISATION POLICY MORE DIFFICULT.

FURTHER STUDIES

EPC WILL CONSIDER THE CLEARING MECHANIM, BASED ON THE ECONOMIC AND ADMINISTRATIVE PROBLEMS LINKED TO ITS FUNCTIONING. IN SUBSEQUENT WORK, EPC WILL ALSO EXAMINE VARIOUS TYPES OF ARRANGEMENTS FOR ACHIEVING FISCAL HARMONISATION AND COMPENSATION, TAKING INTO ACCOUNT ALL THE DIFFICULTIES OF IMPLEMENTATION.

ON THE BASIS OF FURTHER ANALYSIS EXPECTED FROM THE COMMISSION, EPC AIMS TO COMPLETE ITS FURTHER WORK DURING THE NEXT 3 MONTHS.'

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