

PO-CH/NL/0494 Part C

Part .C.

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Begins: 6/2/89.
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to CH | NL | 0494.
PT.C.

Chancellor's (Lawson) Papers:
Harmonisation of Taxation Issues
Following the Implementation of the
Single European Market.

DD's: 25 Year



23/2/98.

to CH | NL | 0494.
PT.C.

CONFIDENTIAL

FROM: N J ILETT
DATE: 6 FEBRUARY 1989

Handwritten signature

PRINCIPAL PRIVATE SECRETARY

cc: PS/FST
PS/PMG
PS/EST
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Scholar
Mr R I G Allen
Mr Culpin
Mr Odling-Smee
Mr Peretz
Mrs Brown
Mr Gieve
Mr Pirie
Mr Sharples

Mr Isaac)
Mr Corlett) I/R
Mr O'Conner)
PS/IR)

Mr Bostock - UKREP
Mr Hewitt Bank

Handwritten notes:
Parent m/b
Nick 16/89
Ch. content?
OK in stub
6/2

WITHHOLDING TAX

We need a press line on the withholding tax, as the Commission is expected to adopt the draft directive on Wednesday 8 February, and the main details are likely to reach the press one way or another on that day.

2. I attach a draft press line. This gives a line to take; (a) for use before the Commission has made the details known (we must not reveal detailed advance knowledge); and (b) in more detail, for use once the details are out. The latter may need amendment if there are changes to the Commission's draft.

3. I would be grateful for clearance in the course of Tuesday if possible so that the UKREP press officer and relevant posts can be briefed in advance.

Handwritten signature

N J ILETT

DRAFT WITHHOLDING TAX: PRESS LINE

A. General

1. ~~There is no link between~~ the obligation on member states to remove their remaining exchange controls (in most cases including that of France) by 1 July 1990 ~~and~~ *is on no way conditional on* the adoption of this draft Directive.

2. As a tax measure, the withholding tax directive has to be approved by the Council acting unanimously.

3. In the UK view, the Commission proposal is unnecessary. It is not required to complete the internal market or to make capital liberalisation work. We believe the fears of some member states about the consequences of abolishing exchange controls are misplaced. The UK experience provides no evidence that the abolition of exchange control leads to a increase in tax evasion. (If pressed: the existence of exchange control does not of course prevent people from evading tax - they merely break exchange control as well as tax law when they place money abroad to evade tax.)

4. In any case somebody who is determined to evade tax (commit "fiscal fraud" in Community jargon) will be free to place money outside the Community. All they have to do is move funds into a Community country which has no exchange controls

against third countries, and then move funds outside the Community. So there is no point in imposing ^a withholding tax within the Community.

5. UK attitude is pragmatic. We have a number of withholding-type taxes (such as composite rate tax on bank and building society deposits, deduction of tax at source on a range of other interest payments). We do not, however, impose withholding taxes where they would simply drive business offshore.

B. Specific: to be used if details of draft directive are not released.

6. There is a danger that the proposal would damage financial markets within the Community (not just ~~from~~ London), drive business outside the Community, push up the cost of borrowing and perhaps actually reduce tax revenue from savings.

Essential that eurobonds are excluded; otherwise this highly mobile market will move offshore. Same applies to wholesale money markets.

C. Specific: to be used if Commission publishes text [NB - check text is as we anticipate]

8. As drafted, this proposal would damage financial markets within the Community, drive business outside the Community, push up the cost of

borrowing and perhaps actually reduce tax revenue from savings. It could also impose unwelcome structural rigidities in retail markets (if pressed - more discussion needed on precisely what the directive is intended to achieve).

9. Note sensible exclusion of eurobonds. But wholesale money markets must also be excluded; present draft may be intended to achieve that but does not succeed. [Detail: The exclusion of "commercial and industrial" interest which the Commission proposes is unworkable; a bank cannot identify whether the beneficial owner of funds is a commercial or industrial company, nor - supposing that it could - that the funds were "commercial or industrial" in character. The wholesale markets trade in large sums; mostly inter-bank and inter-company; and often on a global basis. There is no way in which participants in the markets can identify the residential or tax status of the counterparties to transactions, and so no alternative to excluding the markets from the application of the withholding tax.]

10. [If pressed Other points of detail:

- (i) The proposals on deep discount instruments are unnecessary and unworkable; like other marketable

securities, deep discount bonds could change hands between holders with different tax status, and it is not clear how the tax could actually be collected;

(ii) The reference to prizes is irrelevant;

(iii) The timing is very tight indeed, and quite impractical for any measures which involve changes to bank or tax authority administrative systems, computers etc.

(iv) we will probably wish to raise further technical questions with the Commission ^{when} we have had time to examine the text in detail.

MUTUAL ASSISTANCE BETWEEN TAX AUTHORITIES

We are studying the Commission's proposals and will of course be prepared to discuss them.

Prof

FROM: R I G ALLEN
DATE: 7 FEBRUARY 1989

CHANCELLOR

Thanks. Index glowing. for page contents.

cc Paymaster General
Economic Secretary
Mr Wicks
Mr Lankester
Mrs Brown
Mr Mercer
Ms Symes
Mr Tyrie

Tom RIGBY

PS/Inland Revenue
PS/Customs & Excise

Mr Bostock UKREP

MADAME SCRIVENER

You might be interested to see the attached extract from a book by Giscard d'Estaing (sent to me by a colleague in the Dutch Embassy) describing his impressions of Mme Scrivener. The portrait is glowing: Mme Scrivener being described as "an excellent Secretary of State for Consumer Affairs" and as having "le charme serein des Alsaciennes et leur fermeté de caractère".

RIG

R I G ALLEN

From: "Le Pouvoir et la Vie"
By Valéry Giscard d'Estaing
Pages 261 and 262

VI

LES FEMMES DANS LA VIE PUBLIQUE

Pendant mon septennat, le gouvernement a toujours compté plusieurs femmes, chargées de responsabilités importantes. Cela répondait à une intention délibérée de ma part. Je pensais que le mouvement d'émancipation des femmes par rapport à la situation de dépendance où notre société les avait longtemps maintenues, était une occasion à saisir pour la France. Elles pouvaient apporter à notre vie publique les éléments dont celle-ci est souvent démunie : un plus grand réalisme, davantage de prudence dans la formulation du jugement, une intuition plus juste des réalités de la vie quotidienne.

Il m'avait fallu batailler pour les nommer, à l'exception de Simone Veil, pour laquelle Jacques Chirac m'avait donné immédiatement son accord.

Cette opposition tenait moins à leur nature de femme qu'au fait que les places étant rares, et les promesses nombreuses, le milieu politique ne voyait pas pourquoi on compliquerait encore le problème en « réservant » des places à des ministres féminins.

Je me suis réjoui de leur présence et de leur contribution aux travaux du Conseil des ministres. Trois d'entre elles y ont laissé une marque particulière.

Ce ne sont pas toujours les membres du gouvernement les plus connus du grand public qui accomplissent le meilleur travail. Ainsi, Christiane Scrivener a été un excellent secrétaire d'État à la Consommation.

Je l'avais connue au ministère de l'Économie et des Finances, lorsqu'elle dirigeait l'Agence pour la Coopération technique qui dépendait de la direction des Relations économiques extérieures. Elle avait réussi à lui donner une allure efficace et moderne, échappant à la pesanteur bureaucratique. Elle avait fait, je crois, des études supérieures aux États-Unis. En s'entourant d'une équipe réduite, mais de très bon niveau, elle a défini en quelques mois une politique de la consommation libérale et intelligente, évitant la provocation, sans céder pour autant aux lobbies. Les textes nécessaires ont été adoptés par le Parlement rapidement et sans bruit. On n'a pas fait mieux depuis.

Quand elle présentait au Conseil des ministres ses communications, elle était économe du temps des autres, et parlait d'une voix douce et précise, avec le charme serein des Alsaciennes et leur fermeté de caractère.

Je souhaitais qu'elle soit candidate aux élections de 1978, soit dans le Haut-Rhin, soit à Versailles, et qu'elle reste ainsi au gouvernement. Pour des raisons personnelles, elle l'a refusé. Un an plus tard, elle figurait en bonne place sur la liste européenne.

★ ★

Simone Veil a atteint la notoriété à la suite du débat parlementaire sur l'interruption volontaire de grossesse.

On la connaissait déjà pour son passé : celui d'une jeune fille, belle et fraîche, arrêtée à Nice avec sa mère et sa sœur en raison de ses origines juives, sans même

Mr Allan -
12/2

Handwritten red scribbles and initials, possibly "USA" and "BSE".

9410718

09.02.89 09:10

MORNING PRESS

INTERNATIONAL MONETARY FUND

WEDNESDAY, Feb 8/89 DA

EXTERNAL RELATIONS DEPARTMENT

DOLLAR MOVES NARROWLY. News agencies reported that the U.S. dollar moved narrowly in quiet exchange markets. Dealers said the market is waiting for indications of any policy changes from a two-day meeting of the Federal Open Market Committee ending today, and from tomorrow's budget revisions by President George Bush. Exchange rates: German mark 1.8725 (1.8720), yen 129.45 (129.50), sterling \$1.7415 (1.7325), French franc 6.3740, Swiss franc 1.5925, Canadian dollar 84.56c and lira 1365. Gold fell \$1.70 to \$390.55. The SDR was \$1.30701 (1.30596).

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JAPANESE ECONOMIC PLAN SEES 4% GROWTH, SMALL FALL IN TRADE SURPLUS. Reuters reported from Tokyo that the Japanese Government approved a fiscal 1989 economic outlook, which projects 4% real growth in the year starting April 1, and an \$88B trade surplus (compared with 4.9% and \$93B in the current fiscal year). A spokesman said Japan will strive to sustain economic growth led by domestic demand. Economists questioned whether a \$5B drop in the trade surplus would satisfy the U.S. that Japan is doing all it could to put world trade into better balance.

POEHL SAYS IMPACT OF GERMAN WITHHOLDING TAX WORSE THAN EXPECTED. AP-DJ reported from Frankfurt that German Bundesbank President Karl Otto Poehl strongly criticized the Government for levying a withholding tax on interest income from Jan 1 and for not abolishing the turnover tax on securities transactions. The detrimental effect of the withholding tax on the German capital market exceeded the Bank's most pessimistic expectations and has also made its money supply management more difficult, since many depositors have switched savings into cash to avoid the tax. Poehl added that an EEC committee on monetary union, of which he is a member, has made more progress than he expected, and is set to publish a report soon on options for an EEC central bank and other forms of cooperation. He said a surprising degree of consensus on many fundamental questions was reached.

EEC COMMISSION PROPOSES MINIMUM 15% WITHHOLDING TAX. News agencies reported from Brussels that the EEC Commission proposed a minimum 15% withholding tax on most investment income of residents, and also proposed stronger cooperation among national tax authorities. Both are aimed at coping with tax evasion which some governments fear will result from liberalization of capital movements, due to start from July 1990 at the latest. Diplomats said opposition from Britain and Luxembourg, which do not tax investment income for non-residents, could water down the measures to such an extent that France, which wanted them in the first place, would find them unacceptable.

AMATO SAYS G7 CURRENCY STABILITY POLICY IS COSTLY TO THE WORLD. AP-DJ reported from Rome that Italian Treasury Minister Giuliano Amato said in a TV interview that the way the G7 maintains stable currencies through interest rates is costly to the world, and that fiscal rather than monetary policies should be used to keep markets stable to promote the international adjustment process. Italy argued strongly at last week's G7 meeting that major nations have reached the limit of their capacity to maintain currency stability using monetary policies. These policies are counterproductive, since fighting inflation through interest rate increases strengthens currencies and worsens trade imbalances. High interest rate levels are suffocating LDC debtors and also hurting Italy, which has a high budget deficit.

ARGENTINE CURRENCY DROPS 30% AS GOVERNMENT ENDS INTERVENTION. News agencies reported from Buenos Aires that the Argentine austral fell 30% yesterday to 25 to the dollar from 17.65 previously, after the Government ended its policy of open market dollar sales to end a drain on reserves. Demand for foreign currency had surged last week on expectations that a six-month-old plan to stabilize the austral would fail. The agency said Argentine officials returned last week from the U.S. with little hope of raising fresh funds to help finance the country's \$60B of foreign debt. Banks, which are owed \$2.5B in interest arrears, want the IMF to endorse Argentina's policies before providing any new money. But IMF demands for tough austerity measures are unlikely to be heeded just months before Argentina's presidential elections, bankers said.

ARGENTINA PARTLY FREES EXCHANGE RATE. dpa said in a Buenos Aires report that Argentina continued its efforts to control its drifting economy, three months ahead of presidential elections, with a partial freeing of its exchange rate, a suspension of official dollar sales to support the austral and the establishment of a special market for specified export transactions. Observers said the measures should help curb inflation which reached 8.9% in January, after 6.8% in December. Ldn Fin Times, Feb 7, p7, noted speculation that the Government might introduce measures designed to persuade the IMF of its serious intent to cut public spending, a stumbling block thus far to any new agreement with the IMF. Argentina has been involved in negotiations for a new IMF standby since mid-1988.

MEXICO SAID NOT HAPPY WITH TERMS OF U.S. LOAN OFFER. Ldn Fin Times, Feb 7, p7, reported from Mexico City a Mexican Government announcement that it will not require a \$3.5B U.S. bridging loan made available last October, since the decline in its foreign reserves has been stemmed. Bankers and analysts said a return of flight capital since the inauguration of President Carlos Salinas de Gortari has offset Mexico's current BOP deficit. Mexico reportedly was not happy with the terms of the U.S. loan offer. The accord, which may have included unacceptable conditions demanded by the IMF, was apparently never signed, the paper said.

VENEZUELA TO ALTER ECONOMIC POLICY COURSE. Ldn Fin Times, Feb 7, p7, reported from Caracas that Venezuela's new Government plans economic and monetary policies contrasting sharply with those of the previous Administration, to deal with large BOP and budget deficits, depleted foreign reserves, high inflation, and weak investor confidence. The main thrust of the measures, which are still being developed, is away from widespread price controls and heavy state interference in the economy. Price controls will be eased, fixed interest rates gradually ended, the unwieldy exchange rate system eliminated and the bolivar floated, and the fiscal deficit reduced.

PERU WANTS TO REPAY CREDITORS, MINISTER SAYS. AFP reported from Lima that Peruvian Economy Minister Carlos Rivas Davila said Peru wants to repay its creditors, and will pay \$3.5M of its \$120M of arrears to the IADB. This payment shows Peru's willingness to meet its obligations, he said, while adding that the sums paid must reflect the country's actual ability to pay.

CHINA SAYS END-CENTURY POPULATION COULD TOP FORECAST BY 100M. News agencies reported from Beijing that Chinese experts said the country's population could exceed 1.3B by the turn of the century, or 100M higher than the current official forecast. They blamed laxity in enforcing China's birth control policy, especially in rural areas, for the trend.

PHILIPPINES SEES AID PLAN STARTING THIS YEAR. Reuters reported from Manila that a Philippine official told newsmen that a multi-billion dollar plan to rebuild the country's economy may start this year, with at least 12 countries and the IBRD taking part. Roberto Villanueva, head of a government panel for the aid plan, said the Philippines wants to speed up implementation of the plan, which will be integrated with the economic adjustment program being drawn up with the IMF. A planned preparatory meeting of potential donors has been scrapped, and donor countries will go straight into a pledging session to be held in Tokyo, possibly earlier than the originally-planned one in June. The IBRD will play an advisory technical role and the Philippines will be open to its suggestions. He added that it is too early to determine how much the program will be worth. Kyodo reported that Villanueva said the U.S. and Japan want the IBRD to oversee implementation of the aid plan.

CONABLE RULES OUT ADVANCE IBRD BANK LOAN GUARANTEE COMMITMENTS. AP-DJ reported from Washington that IBRD President Barber Conable told newsmen the IBRD is willing to consider guarantees for loan packages arranged by major LDC debtors in some cases, but neither borrowing countries nor commercial banks should expect advance commitments of such guarantees. There is no advantage, from the IBRD's point of view, in providing loan guarantees rather than direct loans to LDC debtors. Conable said he will discuss LDC debt problems in Japan, the Philippines, Australia and New Zealand, including a proposed \$10B multilateral loan to the Philippines. The IBRD could participate in such a lending package, but Conable noted that the U.S. and other industrial countries concerned have not yet decided how the credits may be arranged.

BUSH SEES \$5B REVENUE GAIN FROM CAPITAL GAINS TAX CUT. WSJ, pA3, reported from Washington that U.S. officials said President George Bush is counting on an extra \$5B of revenue next year from reducing the capital gains tax. The estimate is certain to be among the most-controversial elements in the budget Bush will unveil tomorrow. It will be based on forecasts of slightly higher interest rates than the widely-criticized projections of the previous Administration. This will add to the projected deficit for fiscal 1990, but the impact would be largely offset by slightly greater-than-expected economic growth in the 1988 fourth quarter. NYT, pA1, reported that officials said Bush will challenge Congress to set new budget priorities, by proposing that military spending be tied to inflation in the next fiscal year.

BAKER TO VISIT BONN NEXT WEEK FOR TALKS ON AREAS OF FRICTION WITH GERMANY. AP-DJ reported from Bonn that German Government sources said U.S. Secretary of State James Baker will arrive there next week for official talks on a Libyan chemical plant and other issues that have created tensions in German/U.S. relations.

COLLAPSE OF SPANISH LABOR TALKS RAISES FEARS OF STRIFE. News agencies reported from Madrid that the collapse of negotiations between the Spanish Government and labor unions over unemployment and pension benefits raised fears of increased labor unrest. Labor Minister Manuel Chaves said unions flatly rejected government proposals for a global accord or partial agreements.

IMF, IBRD TURF FIGHT BURDENS G7 MEETING. Handelsblatt, Feb 3/4, p2.

NO VISIBLE RESULTS FROM G7 MEETING. Neue Zuercher Zeitung, Feb 7, p9.

G7 MINISTERS DID EXPECTED MINIMUM BUT NO MORE. Le Monde, Feb 5/6, p13

U.S. CONGRESS KILLS PLANNED 5% PAY INCREASE. WP, pA1, NYT, pA1, WSJ, pA1.

CONFIDENTIAL



Board Room
H M Customs and Excise
New King's Beam House
22 Upper Ground
London SE1 9PJ
Telephone: 01-620 1313

FROM: THE CHAIRMAN

DATE: 8 February 1989

CHANCELLOR OF THE EXCHEQUER

**INDIRECT TAXATION IN THE SINGLE MARKET:
DISCUSSIONS WITH SPANISH OFFICIALS**

You may like to know that, at their invitation, I visited Madrid on 6 February for discussions with the Directors General for Taxation and for Customs and Excise about prospective developments in Community consideration of indirect taxation in the Single Market.

2. Our discussions were very cordial and established a useful basis for further contact. But the Spanish did not give a lot away about their own views. This is in part because of a punctilious view of their position as current holder of the Presidency, and in part because they have simply not made up their own minds. This should, however, ensure a reasonably open-minded approach as these issues are progressed through various Community fora in the coming months.

cc

Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Scholar
Mr R I G Allen
Mr Gilhooly

Mrs M E Brown
Ms Symes
Mrs Chaplin
Mr Tyrie
Mr Call

Sir D Hannay UKREP

Mr Lavelle Cab Off

Mr Jefferson Smith
Mr Nash
Mr Finlinson
Mr Wilmott
Mr P R H Allen
Mr Cockerell
Mr Savins
Mr Gaw
Mr Kent
Mr Knox

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3. I stressed that, while we are strongly in favour of achieving the Single Market, the rigid Cockfield approach was neither necessary nor acceptable as a basis for Community agreement. I outlined the broad details of our approach and explained the thinking underlying them. I referred in particular to the recent French endorsement of retaining the destination system and to Mme Scrivener's more open approach and argued that we should take advantage of this to press ahead under the Spanish Presidency with practical proposals for removing fiscal frontiers by 1993 or soon after.

4. On VAT harmonisation, the Spanish said that they understood our problems but, though they were not content with all the details, could broadly accept the Commission's proposals - including abolishing their 33% higher rate of VAT and increasing their 12% rate to 14%. They appeared to accept, however, that the proposals on excise duty rates were defunct, but felt that some development of the Commission's ideas on linked bonded warehouses to deal with commercial traffic could be generally agreed. Indeed, we are probably not very far apart on this.

5. They also appeared to agree that the VAT clearing house proposals needed to be greatly modified, but seemed content to await the outcome of technical discussions in Brussels. While they seemed prepared to contemplate the maintenance of UK zero rates (which they linked with their desire to continue to avoid imposing an excise duty on wine), they felt that some UK zero rates (eg food and young children's clothing) could give rise to trade distortion. I contested this and emphasised the strength of the Government's pledges.

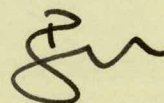
6. I argued at some length that centrally stipulated VAT rate bands were unnecessary, but of course their general philosophy is traditionally more regulatory than our own. As an indication of a possible, more open approach, I gave them a copy of the IFS

pamphlet which suggests that a minimum rate is all that might be needed. Their reaction was that this might not go far enough to resolve certain cross-border problems (eg Denmark 22% VAT rate and Germany 14% VAT rate) but they did not rule it out - particularly as a minimum rate could be advantageous to Spain.

7. Given that no one as yet has been able to come up with an acceptable solution, we did not get very far on the question of alcohol and tobacco duties and cross-border shoppers. The Spanish accepted the validity of our health arguments, but with very low or nil rates they start from a very different position.

8. As regards preventive controls on drugs, etc, their position is not at all clear. They accepted my arguments on the need to maintain preventive checks at internal frontiers until such time as the external frontier controls are as effective. But there seemed to be some split within the Spanish administration on whether to move away from the frontiers or not.

9. Overall, I suspect that the Spanish will sit on the fence and see how matters develop in Brussels. But, particularly if Mme Scrivener preserves her more open approach, it will give us a chance to develop our ideas in a more receptive and pragmatic context. The immediate key is to try to keep close in bed with the French. I think we can do this and the French Director General is coming to see me here next week to discuss the paper he recently circulated.



J B UNWIN



FROM: J M G TAYLOR
DATE: 10 February 1989

PS/ECONOMIC SECRETARY

cc Mr Ilett
Ms Symes

A large, stylized handwritten signature in dark ink, possibly reading 'JMG' or similar, located to the right of the distribution list.

WITHHOLDING TAX

... The Chancellor has seen the attached extract from the IMF Press Summary, reporting that Poehl has complained that the detrimental effect of the withholding tax on the German capital market exceeded the Bundesbank's most pessimistic expectations. The Economic Secretary may find this useful at ECOFIN.

A smaller handwritten signature in dark ink, possibly reading 'JMG', located below the main text.

J M G TAYLOR

Mr Allan -
12/2

[Handwritten signature]
[Handwritten initials]

9410718

09.02.89 09:10

MORNING PRESS

INTERNATIONAL MONETARY FUND

WEDNESDAY, Feb 8/89 DA

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FROM: J M G TAYLOR

DATE: 10 February 1989

A large, stylized handwritten signature in the top right corner of the page.

MR UNWIN - C&E

**INDIRECT TAXATION IN THE SINGLE MARKET:
DISCUSSIONS WITH SPANISH OFFICIALS**

The Chancellor was grateful for your note of 8 February.

A small handwritten mark or signature consisting of a few loops, located above the typed name.

J M G TAYLOR

RESTRICTED
FM UKREP BRUSSELS
TO IMMEDIATE FCO
TELNO 402
OF 131911Z FEBRUARY 89
INFO PRIORITY EUROPEAN COMMUNITY POSTS

ADVANCE COPY

FRAME ECONOMIC

MY TELNO 333

ECOFIN COUNCIL 13 FEBRUARY 1989: TAXATION OF SAVINGS

SUMMARY

1. COMMISSION PRESENTS PROPOSALS. SUPPORT FOR WITHHOLDING TAX FROM FRANCE, SPAIN, PORTUGAL, ITALY, DENMARK, GERMANY, BELGIUM. OPPOSITION FROM UK, NETHERLANDS, LUXEMBOURG. GREECE AND IRELAND UNDECIDED. HIGH LEVEL GROUP STARTS WORK NEXT WEEK. TO COUNCIL AGAIN IN APRIL.

DETAIL

2. THIS WAS THE ONLY SUBSTANTIVE ITEM ON TODAY'S AGENDA. MRS SCRIVENER (COMMISSION) PRESENTED THE PROPOSALS SUMMARISED IN TUR AND THERE WAS A TABLE ROUND OF PRELIMINARY REACTIONS.

MEETING WITH POOS

3. BEFORE THE COUNCIL THE ECONOMIC SECRETARY MET POOS (LUXEMBOURG) AT THE LATTER'S REQUEST. POOS BEGAN BY SAYING HOW DEEPLY OPPOSED LUXEMBOURG WAS TO THE WITHHOLDING TAX. THEY HAD FUNDAMENTAL OBJECTIONS OF PRINCIPLE WHICH THEY WOULD PLACE FIRMLY ON RECORD TODAY AND WHICH THEY WOULD MAINTAIN THROUGHOUT ANY NEGOTIATION FOR AS LONG AS WAS NECESSARY TO SEE OFF THE COMMISSION'S PROPOSAL. THEY WERE RATHER CONCERNED ABOUT ~~WHEN~~ DISCUSSING THE MATTER AT WORKING GROUP LEVEL IN CASE THIS GAVE THE COMMISSION'S UNACCEPTABLE PROPOSAL A SPURIOUS VALIDITY BUT THEY HAD CONCLUDED THAT A BATTLE OVER WHETHER OR NOT TO WORK ON THE PROPOSAL AT ALL WOULD BE TOO CONFRONTATIONAL AND RISK LOOKING LIKE AN 'EMPTY CHAIR' APPROACH. THERE MIGHT BE A CASE FOR TAKING THE ISSUE TO THE MADRID EUROPEAN COUNCIL IF ONE COULD BE SURE OF KILLING IT OFF THERE.

4. MR LILLEY SAID WE WERE FIRMLY OPPOSED TO THE COMMISSION PROPOSAL. WE CONSIDERED IT TECHNICALLY FLAWED AND CONCEPTUALLY UNSOUND. IT WAS UNDERSTANDABLE THAT THOSE WHO HAD LIVED LONG BEHIND THE BARRIERS OF EXCHANGE CONTROLS SHOULD BE NERVOUS ABOUT THE

CONSEQUENCES OF LIFTING THEM BUT IT WAS MISGUIDED. WE WELCOMED THE OPPORTUNITY THE HIGH LEVEL GROUP WOULD PROVIDE TO IDENTIFY AND UNDERLINE BOTH THE UNDESIRABILITY OF A TAX ON SAVINGS FROM THE POINT OF VIEW OF EUROPE'S FUTURE AS A FINANCIAL CENTRE AND ALSO ITS TECHNICAL FLAWS. IT WOULD BE EASIER TO DECIDE WHETHER OR NOT THE ISSUE SHOULD BE TAKEN TO THE MADRID EUROPEAN COUNCIL A BIT NEARER THE TIME.

PRESENTATION BY THE COMMISSION

5. MRS SCRIVENER SUMMARISED THE COMMISSION'S PROPOSALS, ADDING NOTHING OF SUBSTANCE TO THE ACCOUNT IN TUR BUT EMPHASISING THE FOLLOWING POINTS:

- A. THE COMMISSION WAS NOT AIMING FOR THE COMPLETE HARMONISATION OF TAXES ON SAVINGS OR MAKING PROPOSALS AIMED AT THE TOTAL ELIMINATION OF TAX FRAUD. THE OBJECT OF THE EXERCISE WAS TO MAKE THE LIBERALISATION OF CAPITAL MOVEMENTS TOLERABLE.
- B. THERE WAS NO INTENTION OF CALLING INTO QUESTION THE DOUBLE TAX AGREEMENTS WHICH EXIST AMONG MEMBER STATES.
- C. IT WOULD BE IMPORTANT TO SEEK AGREEMENT WITH THIRD COUNTRIES WITHIN THE FRAMEWORK OF THE WITHHOLDING TAX DIRECTIVE, AS ARTICLE 9 OF THE COMMISSION'S PROPOSAL PROVIDED.
- D. THE COMMISSION WAS READY FOR COMPROMISE BUT THE COUNCIL SHOULD REACH AGREEMENT BY THE END OF JUNE AS REQUIRED BY THE 1988 CAPITAL MOVEMENTS DIRECTIVE.

COUNCIL REACTIONS: IN FAVOUR

6. BEREGOVY (FRANCE), COLOMBO (ITALY), CADILHE (PORTUGAL), MAYSTADT (BELGIUM - WITH A DIG AT LUXEMBOURG), HELVIG PETERSEN (DENMARK), PEREZ (SPAIN) AND STOLTENBERG (GERMANY) EXPRESSED VARYING DEGREES OF SUPPORT FOR THE COMMISSION'S PROPOSAL, ALL OF THEM REGARDING IT AT LEAST AS A GOOD BASIS FOR DISCUSSION. STOLTENBERG, UNDER WHOSE PRESIDENCY THE CAPITAL MOVEMENTS DIRECTIVE WAS AGREED, SAID THAT THERE WAS A MORAL OBLIGATION ON ALL MEMBER STATES TO SEEK AND AGREE SOLUTION. PEREZ, HELVIG PETERSEN AND BEREGOVY SAID THAT THEY WOULD HAVE PREFERRED A SOLUTION BASED ON STRICT REPORTING OBLIGATIONS FOR BANKS: BUT A GENERALISED WITHHOLDING TAX WAS AN ACCEPTABLE SECOND BEST SOLUTION. CADILHE AND COLOMBO SAID THAT THE COMMISSION'S PROPOSAL SHOULD BE MERELY THE FIRST STEP ALONG A ROAD WHICH WOULD ALSO APPROXIMATE THE TAXATION OF DIVIDENDS, CAPITAL GAINS, INHERITANCE ETC.

7. THE SUPPORTERS OF THE COMMISSION'S PROPOSAL RAISED THE FOLLOWING DETAILED QUESTIONS AND CRITICISMS.

- A. SHOULD EUROBONDS BE EXEMPTED? (CADILHE, COLOMBO, MAYSTADT, HELVIG

PETERSEN) BEREGOVY REGARDED THE TREATMENT OF EUROBONDS AS AN OPEN ISSUE.

B. TREATMENT OF SMALL SAVERS. CADILHE THOUGHT THERE WAS A RISK THAT ANY CONCESSION COULD BE ABUSED. STOLTENBERG WONDERED WHETHER SMALL SAVINGS ACCOUNTS SHOULD BE SUBJECT TO THE WITHHOLDING TAX BUT EXEMPT FROM NORMAL INCOME TAX, AS IN GERMANY.

C. THE RATE. STOLTENBERG EXPRESSED A PREFERENCE FOR 10 PERCENT, BEREGOVY SAID THAT 15 PERCENT SHOULD BE REGARDED AS A BASIS FOR DISCUSSION.

D. TREATMENT OF EC NON-RESIDENTS. CADILHE OBJECTED TO THEIR BEING GIVEN MORE FAVOURABLE TAX TREATMENT THAN EC RESIDENTS.

E. EXISTING DEBT. COLOMBO SAID THAT THERE WOULD BE GREAT DIFFICULTIES IN APPLYING THE WITHHOLDING TAX TO DEBT INSTRUMENTS BEFORE THE DIRECTIVE CAME IN FORCE.

COUNCIL REACTIONS: UNDECIDED

8. ROUMELIOTIS (GREECE) AND REYNOLDS (IRELAND) REFRAINED FROM REACTING TO THE PROPOSAL UNTIL THEY HAD HAD A CHANCE TO STUDY IT MORE FULLY. REYNOLDS EXPRESSED CONCERN ABOUT THE IMPLICATIONS OF A WITHHOLDING TAX FOR THE ATTRACTIVENESS OF IRISH GOVERNMENT DEBT, ROUMELIOTIS ABOUT THE TAXATION OF GREEK MIGRANT WORKERS.

COUNCIL REACTIONS: OPPOSED

9. RUDING (NETHERLANDS) GAVE A LENGTHY AND CAREFULLY WEIGHED ASSESSMENT OF THE COMMISSION PROPOSALS.

A. THE WITHHOLDING TAX PROPOSED WOULD NOT EFFECTIVELY COMBAT TAX EVASION. EITHER THE PROPOSED 15 PERCENT MINIMUM RATE OR THE RATES OF WITHHOLDING TAX IMPOSED BY MEMBER STATES ON THEIR NON-RESIDENTS AT THE MOMENT WERE SIGNIFICANTLY BELOW THE MARGINAL TAX RATE TO WHICH SAVERS WERE LIABLE IN THEIR COUNTRY OF RESIDENCE. SO IF THE COMMISSION'S PROPOSAL WERE ADOPTED, TAX EVASION WOULD CONTINUE WITH THE SOLE DIFFERENCE THAT EVADERS WHO PLACED THEIR MONEY IN ANOTHER COMMUNITY MARKET WOULD PAY AT LEAST 15 PERCENT RATHER THAN AT LEAST ZERO.

B. THE BETTER SOLUTION WAS TO IMPOSE A GENERAL OBLIGATION ON BANKS TO REPORT ON INTEREST PAYMENTS TO THE TAX AUTHORITIES. THE COMMISSION SHOULD HAVE BEEN MUCH TOUGHER ON BANKING SECRECY AND NOT PUSSY FOOTED AROUND THE ISSUE WITH ITS MODEST PROPOSAL TO AMEND THE 1977 MUTUAL ASSISTANCE DIRECTIVE. THE COMMISSION HAD PROPOSED THAT MEMBER STATES NEED NOT IMPOSE A WITHHOLDING TAX ON THEIR OWN RESIDENTS IF THEIR BANKS WERE OBLIGED TO COMPLY WITH STRICT REPORTING OBLIGATIONS. ANY SUCH EXEMPTION SHOULD LOGICALLY APPLY TO THE RESIDENTS OF OTHER COMMUNITY COUNTRIES AS WELL.

C. THE PROPOSED EXEMPTION FOR THIRD COUNTRY RESIDENTS WAS IN

PRINCIPLE CORRECT. ON THE OTHER HAND BONA FIDE THIRD COUNTRY RESIDENTS WOULD BE REQUIRED TO GO THROUGH POSSIBLY ELABORATE REQUIREMENTS TO IDENTIFY THEMSELVES: AND COMMUNITY RESIDENTS MIGHT BE ABLE TO EXPLOIT THIS LOOPHOLE BY CHANNELLING INVESTMENTS THROUGH THIRD COUNTRIES.

D. THE PROPOSAL MIGHT LEAD TO A RISE IN INTEREST RATES AND PROVOKE RATHER THAN AVOID CAPITAL FLIGHT. WHEN THE GERMAN WITHHOLDING TAX HAD BEEN ANNOUNCED AND INTRODUCED THERE HAD BEEN A LARGE OUTFLOW OF CAPITAL AND A SUSTAINED RISE IN LONG TERM GERMAN INTEREST RATES RELATIVE FOR EXAMPLE TO DUTCH INTEREST RATES.

E. EXCLUSION OF THE EUROBOND MARKET WOULD REDUCE THE FLIGHT OF CAPITAL FROM THE COMMUNITY BUT WOULD TEND TO DISADVANTAGE BORROWERS ON THEIR OWN MARKETS (FOR EXAMPLE MEMBER STATES) BY COMPARISON.

F. EVEN IF AGREEMENT WAS REACHED BY THE END OF JUNE 1989 IT WOULD BE IMPOSSIBLE TO INTRODUCE NATIONAL LEGISLATION BY THE BEGINNING OF JULY 1990.

10. THE ECONOMIC SECRETARY SAID THAT THE UNITED KINGDOM COULD NOT ACCEPT THE PROPOSAL WHICH THE COMMISSION HAD PUT FORWARD FOR A WITHHOLDING TAX. THE UNITED KINGDOM'S EXPERIENCE SUGGESTED THAT SUCH A MEASURE WAS UNNECESSARY. THE ABOLITION OF UK EXCHANGE CONTROLS HAD NOT LED TO AN INCREASE IN FISCAL FRAUD. NOR WOULD A WITHHOLDING TAX REDUCE TAX EVASION. THOSE WHO WISHED NOT TO PAY THEIR TAXES WOULD SIMPLY PLACE THEIR MONEY OUTSIDE THE COMMUNITY. THE COMMISSION RECOGNISED THIS: HENCE THEIR PROPOSAL FOR INTERNATIONAL NEGOTIATIONS. BUT IN PRACTICE, AGREEMENT WITH ALL THIRD COUNTRIES CONCERNED WAS AN UNREALISTIC HOPE. THE INTRODUCTION OF A GENERALISED WITHHOLDING TAX WOULD HOWEVER HAVE SIGNIFICANT DISADVANTAGES FOR THE COMMUNITY. THERE WOULD BE AN OUTFLOW OF CAPITAL. THERE WOULD BE A DISINCENTIVE TO THIRD COUNTRY RESIDENTS TO INVEST IN THE COMMUNITY: THE NEED TO IDENTIFY THEMSELVES WOULD BE A POWERFUL DISINCENTIVE TO MANY THIRD COUNTRY RESIDENTS. THE WHOLESALE MARKETS WOULD BE DAMAGED AND MUCH LEGITIMATE BUSINESS WOULD BE DRIVEN OUTSIDE THE COMMUNITY. THE COMMUNITY SHOULD NOT REPRODUCE THE DISADVANTAGES WHICH HAD ACCOMPANIED THE GERMAN WITHHOLDING TAX: A FLIGHT OF CAPITAL AND A SITUATION IN WHICH THE SWEDISH GOVERNMENT COULD BORROW SIGNIFICANTLY MORE CHEAPLY IN DEUTSCHEMARKS THAN COULD THE GOVERNMENT OF THE FEDERAL REPUBLIC.

11. POOS ECHOED MR LILLEY'S OBJECTIONS. THE COMMISSION'S PROPOSAL WAS UNNECESSARY, AND WOULD HAVE PERVERSE AND DAMAGING CONSEQUENCES. LUXEMBOURG WAS OPPOSED.

LINKS WITH THE LIBERALISATION OF CAPITAL MOVEMENTS AND INDIRECT TAX

APPROXIMATION

12. BEREGOVY SAID THAT THERE WAS A POLITICAL LINK BETWEEN AGREEMENT ON THE COMMISSION'S PROPOSAL AND THE LIBERALISATION OF CAPITAL MOVEMENTS REQUIRED UNDER THE 1988 DIRECTIVE. COLOMBO SEEMED TO GO FURTHER, SUGGESTING THAT IT WOULD BE DIFFICULT TO EMBARK ON THE NEW PROGRAMME OF LIBERALISATION REQUIRED WITHOUT AGREEMENT ON THE COMMISSION'S PROPOSALS. RUDING, POOS AND MR LILLEY RESPONDED THAT THE OBLIGATIONS TO LIBERALISE CAPITAL MOVEMENTS UNDER THE 1988 DIRECTIVE WERE IN NO SENSE CONDITIONAL UPON AGREEMENT ON THE COMMISSION'S PROPOSALS. THE TREATY MADE NO CONNECTION BETWEEN LEGISLATION IN THESE TWO AREAS. THE COUNCIL'S ONLY OBLIGATION IN RESPECT OF TAX UNDER THE 1988 CAPITAL LIBERALISATION DIRECTIVE WAS TO REACH A POSITION ON THE COMMISSION'S PROPOSALS BY THE END OF JUNE THIS YEAR. THAT POSITION COULD BE POSITIVE OR NEGATIVE.

13. STOLTENBERG AND BEREGOVY SUGGESTED THAT THERE WAS A POLITICAL LINK BETWEEN PROGRESS ON THE TAXATION OF SAVINGS AND ON THE INDIRECT TAX MEASURES REQUIRED AS PART OF THE ESTABLISHMENT OF THE INTERNAL MARKET. RUDING DISAGREED AND ARGUED THAT GREATER PRIORITY SHOULD BE GIVEN TO THE PROGRAMME OF WORK ON INDIRECT TAX. MRS SCRIVENER AND SOLCHAGA (PRESIDENCY) ACCEPTED THAT INDIRECT TAX REMAINED A HIGH PRIORITY: BUT THE COUNCIL MUST RESPECT THE DEADLINE IN THE CAPITAL MOVEMENTS DIRECTIVE SO FAR AS THE TAXATION OF SAVINGS WAS CONCERNED.

PROCEDURE

14. AFTER A BRIEF REPLY FROM MRS SCRIVENER (THE EXCLUSION OF EUROBONDS MIGHT BE DIFFICULT FOR SOME DELEGATIONS BUT WAS ESSENTIAL FOR OTHERS: A WITHHOLDING TAX WOULD REDUCE THE RISK OF TAX EVASION EVEN IF IT DID NOT REMOVE THAT RISK ENTIRELY) SOLCHAGA CONFIRMED THAT IT WAS THE PRESIDENCY'S INTENTION TO OBTAIN AGREEMENT IN THE COUNCIL BY THE END OF JUNE. TO THAT END, A HIGH LEVEL GROUP WOULD BEGIN WORK ON THE COMMISSION'S PROPOSALS ON 21 FEBRUARY AND WOULD REPORT, THROUGH COREPER, TO THE APRIL ECOFIN.

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TELEGRAMS

FRAME ECONOMIC

ECOFIN COUNCIL: 13 FEBRUARY 1989
SUMMARY TELEGRAM
(X DENOTES ITEMS NOT REPORTED ELSEWHERE)

1. THE ECONOMIC SECRETARY (MR LILLEY) REPRESENTED THE UK.

A POINTS

2. ALL AGREED AS IN DOCS 4625/89, 4626/89 AND 4660/89 - I.E. THE BANK BRANCH ACCOUNTS DIRECTIVE WAS DEFINITELY ADOPTED, DENMARK HAVING FINALLY LIFTED ITS PARLIAMENTARY SCRUTINY RESERVE.

TAXATION OF SAVINGS

3. COMMISSION PRESENTS PROPOSALS. SUPPORT FOR WITHHOLDING TAX FROM FRANCE, SPAIN, PORTUGAL, ITALY, DENMARK, GERMANY, BELGIUM. OPPOSITION FROM UK, NETHERLANDS, LUXEMBOURG. GREECE AND IRELAND UNDECIDED. HIGH LEVEL GROUP STARTS WORK NEXT WEEK. TO COUNCIL AGAIN IN APRIL. FOR DETAILS SEE MY IFT.

LUNCH DISCUSSION

4. MOST OF LUNCHTIME WAS DEVOTED TO THE INTERNATIONAL ECONOMIC SITUATION AND IN PARTICULAR TO THE RECENT G7 MEETING. IN THE COURSE OF THE DISCUSSION IT WAS AGREED THAT THE COMMISSION WOULD PREPARE A DISCUSSION PAPER ON THE PROBLEMS OF THE MIDDLE INCOME DEBTORS FOR THE COUNCIL'S NEXT MEETING (STOLTENBERG COMMENTED THAT IT WAS IMPORTANT TO KEEP THIS SUBJECT UNDER THE CONTROL OF FINANCE MINISTERS): THAT THE COMMISSION WOULD SIMILARLY PREPARE A PAPER ON PAYMENTS IMBALANCES WITHIN THE COMMUNITY: THAT THE COMMISSION WOULD PROBABLY PREPARE A PAPER TO COMMEMORATE THE 10TH ANNIVERSARY OF THE EUROPEAN MONETARY SYSTEM IN MARCH: AND THAT THE APRIL ECOFIN WOULD TAKE PLACE ON MONDAY 17 APRIL, RATHER THAN TUESDAY 18 APRIL, A DAY FAMOUS AS THE ANNIVERSARY OF LUXEMBOURG INDEPENDENCE.

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INFO PRIORITY EUROPEAN COMMUNITY POSTS, STRASBOURG

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INDIRECT TAX : VISIT TO BRUSSELS BY UK CUSTOMS OFFICIALS
STRASBOURG FOR FEAN AND GOODWORTH, UKREP BRUSSELS

SUMMARY

1. MEETINGS BETWEEN CUSTOMS AND COMMISSION OFFICIALS USEFUL IN
EXPOUNDING UK ALTERNATIVE APPROACH AND REVEAL A MODICUM OF
FLEXIBILITY FROM COMMISSION. PROGRESS LIKELY TO BE SLOW.

DETAIL

2. A TEAM FROM HM CUSTOMS AND EXCISE (JEFFERSON SMITH, COCKERELL,
BROWN AND KNOX) VISITED BRUSSELS ON 9 AND 10 FEBRUARY TO DISCUSS
SINGLE MARKET FISCAL ISSUES AND FRONTIER CHECKS WITH COMMISSION AND
COUNCIL SECRETARIAT OFFICIALS.

TAX

3. THE UK TEAM SAID WE WERE DEVELOPING OUR THINKING ON HOW TO
COLLECT VAT AND EXCISE DUTIES IN A WAY WHICH WOULD NOT REQUIRE
HARMONISATION OF RATES AND DID NOT DEPEND ON FRONTIER CONTROLS. VAT
AND EXCISES ON FREIGHT COULD BE COLLECTED BY SYSTEMS WHICH DID NOT
INVOLVE AN ACCOUNT OF THE GOODS AS THEY CROSSED THE FRONTIER BUT
DEPENDED ON PERIODIC RETURNS AND AUDIT-BASED VERIFICATION AT
TRADERS' PREMISES. THERE WERE SOME PROBLEM AREAS. IN PARTICULAR,
TRAVELLERS' ALLOWANCES FOR TOBACCO AND ALCOHOL WOULD CONTINUE TO BE
A DIFFICULTY, BUT AS THE CHANCELLOR HAD SUGGESTED IN HIS PAPER
CIRCULATED TO THE INFORMAL ECOFIN IN CRETE, THESE SHOULD BE
SUBSTANTIALLY INCREASED. THERE WAS A CONTINUING NEED FOR PREVENTIVE
CONTROLS, BUT THESE MUST BECOME INCREASINGLY SELECTIVE AND TARGETED
TO THE MAJOR THREATS OF DRUGS, TERRORISM AND THE LIKE.

4. IN THEIR REACTIONS, COMMISSION OFFICIALS SHOWED LITTLE SIGN OF
FLEXIBILITY IN THEIR THINKING ON THE MAIN POLITICAL ISSUES. THEY
EMPHASISED THAT THEIR EXISTING PROPOSALS REMAINED ON THE TABLE, AND
THEY WERE NOT PREPARED TO RETREAT FROM THEM OR ABANDON THE
THEORETICAL CONCEPTS (SUCH AS SWITCHING FROM THE DESTINATION
PRINCIPLE TO ORIGIN FOR LEVYING VAT) WHICH THEY CONSIDERED LAY
BEHIND THE SINGLE EUROPEAN ACT. BUT THEY SAID THEY WERE PREPARED TO

HAVE WIDE RANGING DISCUSSIONS IN THE CONTEXT OF THE COMMISSION WORKING GROUP - WHICH STARTED WORK LAST WEEK ON THE CLEARING HOUSE AS LONG AS THE CLEARING HOUSE REMAINED THE FOCUS FOR DISCUSSION. THEY SHOWED SOME SIGN OF WELCOMING ALTERNATIVE IDEAS: FOR EXAMPLE FOR THE CONTROL OF THE LARGEST TRADERS, THEY WOULD BE RECEPTIVE TO AUDIT-BASED CONTROLS SIMILAR TO THOSE BEING TRIALED BY THE UK, WHILE PRESERVING AN ORIGIN BASED SYSTEM AND POSSIBLY A CLEARING HOUSE FOR SMALL TRADERS. IN TECHNICAL DISCUSSIONS, THEY EXPRESSED AN INTEREST IN STUDYING HOW MEMBER STATES TACKLED EXISTING PROBLEMS OF FRAUD AND CONTROL OF TRADERS OPERATING BETWEEN DIFFERENT ADMINISTRATIVE AREAS.

5. COMMISSION OFFICIALS WERE AMBIVALENT ABOUT THE PROPOSALS RECENTLY CIRCULATED BY THE FRENCH SUBSTITUTING FOR FISCAL FRONTIERS A SYSTEM SIMILAR TO COMMUNITY TRANSIT. THEY ADMITTED THAT SUCH PROPOSALS HAD A CHANCE OF ACHIEVING CONSENSUS, MORE SO, THEY BELIEVED, THAN THE MORE RADICAL AND SIMPLER UK IDEAS. BUT THEY SHOWED CONCERN THAT, IF THESE IDEAS BECAME THE SUBJECT OF NEGOTIATION BETWEEN MEMBER STATES, THE RESULT WOULD BE AN EXTREMELY BUREAUCRATIC SYSTEM INVOLVING A PROLIFERATION OF OFFICIAL FORMS. (IT EMERGED FROM THE DISCUSSION THAT THE BELGIANS ARE ABOUT TO CIRCULATE A PAPER PROBABLY ALONG SIMILAR LINES TO THE FRENCH.)

6. ON EXCISE DUTIES COMMISSION OFFICIALS AGREED THAT FURTHER STUDY IS REQUIRED OF TECHNICAL SOLUTIONS TO CONTROL OF TRAFFIC BETWEEN MEMBER STATES IN A SITUATION WHERE TAX RATES WERE NOT HARMONISED, INCLUDING THE USE OF BANDEROLES. THEY EXPECTED THE COMMISSION TO TABLE NEW PROPOSALS ON EXCISES BEFORE THE END OF THE SPANISH PRESIDENCY. THEY ARGUED HOWEVER THAT, AS A PRELIMINARY, THE COUNCIL MUST ANSWER THE QUESTION WHICH LORD COCKFIELD POSTED AT THE DECEMBER ECOFIN: WHAT DEGREE OF FREEDOM DO MEMBER STATES REQUIRE IN SETTING EXCISE RATES AND WHAT DEGREE OF FLEXIBILITY DO THEY REGARD AS COMPATIBLE WITH THE ABOLITION OF FISCAL FRONTIERS?

7. PINI (COUNCIL SECRETARIAT) WAS PESSIMISTIC. HE THOUGHT THE TECHNICAL PROBLEMS INTRACTABLE. ON RATES AND RATE STRUCTURES, HE EXPECTED SOME DISCUSSION AT A POLITICAL LEVEL DURING THE SPANISH PRESIDENCY, NOT IN THE EXPECTATION OF USEFUL RESULTS, BUT BECAUSE THE PROBLEM COULD SCARCELY NOT BE DISCUSSED.

8. IN THE DISCUSSION OF TAX RATES THE UK TEAM ARGUED THAT HARMONISATION WAS NOT REQUIRED. THESE TECHNICAL PROPOSALS OFFERED A WAY OF REDUCING AND REMOVING FISCAL FRONTIERS WITHOUT HARMONISATION. THEY RECEIVED NO IMPRESSION OF ANY PRESENT THINKING IN THE COMMISSION ABOUT MODIFYING THE COCKFIELD PROPOSALS FOR VAT

HARMONISATION BEYOND A HINT THAT ZERO RATES COULD UNTIMATELY BE DEALT WITH BY A DEROGATION SUBJECT TO REMOVAL ONLY BY UNANIMITY. IT SEEMS UNLIKELY THAT THE COMMISSION WILL PRESENT ANY REVISED PROPOSALS IN THIS AREA BEFORE THE EUROPEAN PARLIAMENT ADOPTS ITS OPINION ON THE PRESENT PACKAGE.

FRONTIER CONTROLS

9. IN A MEETING WITH FORTESCUE (COMMISSION CO-ORDINATOR ON FRONTIER ISSUES) CUSTOMS STRESSED THAT, WHILE DRUGS CONTROLS NEEDED TO BE RETAINED, THERE WAS A COMMITMENT TO CO-OPERATION WITH THE COMMISSION AND AUTHORITIES OF OTHER MEMBER STATES, WHICH SHOULD LEAD TO GREATER ALL ROUND EFFECTIVENESS AND ULTIMATELY GREATER RELIANCE ON THE EXTERNAL BORDER. FORTESCUE INDICATED THAT THE COMMISSION WAS SOFTENING ITS APPROACH ON TREATMENT OF PORTS AND AIRPORTS - APART FROM FERRY PORTS THESE SHOULD BE TREATED AS EXTERNAL FRONTIERS. THE COMMISSION WAS ALSO NOT CONCERNED WITH POLICE CONTROLS OR FRONTIER CHECKS WHICH COULD BE DESCRIBED AS SUCH. THE COMMISSION HAD LAID DOWN A JUNE DEADLINE FOR THE PRODUCTION OF A FRONTIERS ACTION PLAN WHICH HE DID NOT THINK REALISTIC, BUT HE ACCEPTED THAT THE REPORT WOULD HAVE TO BE PRODUCED DURING THE SPANISH PRESIDENCY.

COMMENT

10. I AM MOST GRATEFUL FOR THE EFFORT CUSTOMS AND EXCISE PUT INTO EXPLAINING THE EVOLUTION OF OUR THINKING. IT IS CLEAR THAT, WHILE THE LOGJAM HAS NOT YET BROKEN, IT IS SHIFTING AND THE NEXT FOUR MONTHS ARE LIKELY TO SEE A CONSIDERABLE MOVEMENT IN THE COMMISSION'S AND IN OTHER MEMBER STATES' THINKING ON INDIRECT TAX ISSUES. IT IS IMPORTANT THAT WE SHOULD INFLUENCE THIS AND PICK UP SUPPORT FOR THE APPROACH THE CHANCELLOR SET OUT LAST SEPTEMBER IN CRETE AND AT THE DECEMBER ECOFIN. TO THIS END WE NEED NOW TO CIRCULATE INFORMALLY TO OTHER MEMBER STATES AND TO THE COMMISSION AN OUTLINE PAPER EXPLAINING HOW WE BELIEVE IT SHOULD BE POSSIBLE TO REMOVE FISCAL FRONTIERS WITHOUT HARMONISING TAX RATES. THIS WILL GREATLY STRENGTHEN OUR HAND IN THE DEBATE WHICH IS NOW BEGINNING.

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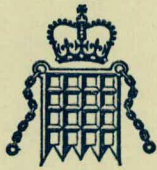
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Ch. Are you content for the paper to be circulated now? (Shld. you let PM know first?).

CHANCELLOR

FROM: MR P JEFFERSON SMITH

DATE: 13 FEBRUARY 1989

* Did you agree with Sir G Howe that you would send another note to PM, on the more general issue, connected with a note from him? If so, I will commission a draft.

INDIRECT TAX HARMONISATION: DISCUSSIONS IN BRUSSELS

I took a small team to Brussels last Thursday and Friday for talks with UKREP and with Commission officials. The object was to explain our current thinking on tax collection without fiscal frontiers, and to assess what seems likely to happen in the next few months, as the new Commission gets into its stride. UKREP is reporting by telegram, and this note pulls together the main themes.

behind!

Harmonisation of VAT and excise rates

1. There seems no sign of rethinking: indeed the message I kept getting was "Cockfield may have gone, but his proposals remain those of the Commission, in furtherance of a view of the Single European Act which has in no way changed". There is general recognition of the UK's problems over zero rating; but the

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Commission line is that we have been given plenty of hints that derogations could be provided if only we asked for them. I pointed out that the very idea of a derogation is unacceptable because it by nature temporary; this produced the interesting response from one senior Commission official that a derogation might be devised, like the present one which authorises our zero rates, which appeared to be time limited but was drafted in such a way that it could be ended only by unanimity. I did not pursue this point, and think it a very long time before it will become relevant.

2. Although the Presidency will continue to allocate time to rate harmonisation, there seems to be little enthusiasm. The Council Secretariat expects that discussion will rise to political level before the end of the Spanish Presidency, but only because no Presidency which wished to look efficient could avoid discussion of such an important issue. For the UK, the best that seems likely to come out of these discussions is that those Member States which accept harmonisation en principe can be made to reveal their practical difficulties with the detail.

3. Attempts to get to see Madame Scrivener and members of her cabinet fell through, no doubt because they were too preoccupied with taxation of savings. If they have formed a view of indirect tax harmonisation, it does not seem to have filtered down to Commission officials. It is thought that the Commission will not in any case wish to put forward modifications to the Cockfield proposals before the European Parliament has formally adopted its opinion on them - though equally the Parliament may be chary of giving its opinion before the Commission makes any modifications.

Technical issues

4. The same lack of any departure from the Cockfield proposals appears to colour the technical discussions which have just started on the clearing house though the reality is different. Even though

Madame Scrivener may dislike the clearing house, I do not think it will be quickly withdrawn. What is likely to happen however is that, as long as no one challenges the pure doctrine of the origin system, the Commission will allow the discussions, nominally about the clearing house, actually to range much wider. As well as the French paper proposing that intra-Community movements could be covered by a sort of Community transit system, the Germans have put in a paper on the clearing house, and the Belgians are promising one. When I explained our thinking on controlling freight without resort to frontier documents and by audit-based control at traders' premises, this sounded at first too strong meat for the Commission. But in fact they showed that they are thinking on the same lines for trade between subsidiaries of multi nationals. Their plan would be for tax free exchange of goods for the very largest companies, covering the highest proportion by value of intra Community trade, and an origin based system with a clearing house for the rest. They intend to study the practicalities of existing systems and would like to visit the UK, which I am encouraging.

5. As long as we stay off doctrinal battles, there may be something here on which we could build. What we do not want are bureaucratic paper chases - whether as originally proposed for the clearing house, or the Community transit alternative put forward by the French, even though the French support for the destination principle is very welcome. This suggests that the time is now right to launch our own paper. I attach a version which takes account of comments from other departments. I have removed from the text you previously approved a reference to a minimum rate of VAT but have kept in paragraph 12(d) a reference to minimum rates of excise duties, since these have already been referred to in your paper for the Crete ECOFIN.

Perceptions of the UK

6. Our line that we have a genuine alternative path to achieving the Single European Market without fiscal frontiers has one presentational weakness, which is apt to provoke critical comment, that is our retention of preventive controls. While our views on the handling of freight can be seen to be both constructive and radical, it is very noticeable that we would still need to retain travellers' allowances for alcoholic drinks and tobacco, and the sceptics think that this in practice would lead to retention of frontier controls over everything. It is noted too that we insist on the necessity for and validity of our frontier controls on drugs etc. Those with experience of continental land frontiers treat our case for the effectiveness of our frontier controls with scepticism. For many people, the measure of our commitment to 1992 will be the length of the queue at Dover.

7. We have attempted to counter these perceptions of the UK by vigorous use of the material in our drugs brief. But that is defensive, and I conclude we need to be positive too. There are two areas where this could be done.

8. Firstly, we have been cultivating Fortescue, the official under Bangemann who will be taking the lead in the work of the co-ordinators set up following the Rhodes summit. Fortescue seems to be helpful and broad-minded, and would be receptive to a positive approach by the UK towards building up co-operation between Member States and attempting to raise standards of control at all external frontiers to the level of existing best practice. One may be a bit sceptical about this, for example for Greek islands, but it seems to be in our interest to show ourselves willing to get in with this work. We will be seeking to ensure that the Home Office involves us in meetings of the co-ordinators.

Indirect Tax Collection in the Internal Market after 1992

The present system

1. In all Member States, indirect taxes are collected by the authorities of those states, and, subject to payment of the Community's own resources, accrue for the benefit of their national finances. These are consumption taxes; whatever the systems of tax collection, the broad principle is that the burden should fall on consumption within the country levying them. This is achieved by levying tax on suppliers of goods or services within the national territory, charging the same tax on imports and relieving exports.

2. Systems for taxation of imported goods follow a common pattern whether the goods are imported from other Member States or from third countries. In essence all imports are brought under official control at the frontier. In some cases the imports are documented and examined and any duty or tax payable is collected at the frontier itself; in others the goods are allowed to be removed inland before these procedures are completed. The extent to which the goods must be declared or documented when crossing the frontier may vary between the extremes of full documentation and simple production of a commercial invoice sufficient to identify the goods and their consignee. But the principle is that the goods come into official cognisance at the frontier and are subject to control until all duties due are paid.

3. In addition to controls for fiscal purposes there are other purposes for official intervention at frontiers. The three main ones are:

- (a) Community regimes: for third country trade, bringing goods into free circulation in the Community; for intra Community trade, monetary compensation amounts; for all goods not in free circulation, Community transit (a system which ensures that goods remain under official control as they pass from one Member State to another); a range of commercial policy controls;
- (b) effective operation of national prohibitions or restrictions, permitted by the Treaty;
- (c) compilation of Community and national trade statistics.

4. The procedures above apply to commercial traffic. But goods imported by passengers are also subject to frontier controls, and must be declared unless they are within the limits which are relieved by Community legislation. Controls permitted by Article 36 also apply in this area.

5. Exports are subject to frontier controls, though in general these are much lighter. For indirect tax purposes the controls exist so that Member States can satisfy themselves that goods for which remission of tax has been claimed as exports have genuinely been exported. The three other purposes - Community regimes, national prohibitions and restrictions, and trade statistics - also apply to exports.

6. There can be practical differences in the treatment of intra-Community and third country goods. But the broad principles are the same.

The Future System: Proposals

7. The creation of the Single European Market will introduce a fundamental change of concept. As a result of the gradual establishment of the internal market foreseen in the SEA, controls for customs purposes at frontiers within the Community will be abolished except insofar as preventive checks remain necessary for the purposes of protecting public security, health and morality (eg checks to detect illegal imports of drugs and firearms).

Frontier controls between member states and third countries will however need to be retained.

8. Although there are many differences between the Commission and Member States on basic issues, there should be agreement on the fundamental principle of the Single Market. This can be expressed as follows.

9. Trade between Member States may not be controlled at the frontier. Where goods pass between Member States, whether carried by passengers or in freight, customs intervention should take place only in the following circumstances:

(a) where intra-Community and third country goods are handled in the same location (eg at international airports), to the extent necessary to bring the third country goods under control;

(b) for the purpose of preventive checks upon prohibited or restricted goods so far as permitted by the safeguards in the Treaty.

10. Systems for collecting indirect taxes on imports from other Member States or relieving exports to other Member States must not depend on frontier controls. Commercial importers should be subject to regimes which as closely as possible mirror the regimes applicable to domestic traders, any differences being proportionate to the problems to be dealt with. In any event the treatment of importers and exporters may be no more onerous than under the corresponding domestic regimes.

11. The practical implications must be considered for each area separately.

Excise

12. For exciseable goods, it will remain necessary to ensure that the duty on goods will accrue to the country in which they are finally sold or consumed. Mechanisms, other than frontier controls, to ensure that this principle is achieved may include

the following:

- (a) goods passing between Member States by way of trade must do so under a duty suspension regime. Traders importing from other Member States for resale must account for the duty and must be registered or otherwise authorised or must operate bonded warehouses for this purpose;
- (b) to back up this regime, it may be necessary to prescribe that all movements of goods duty free whether between or within Member States must be accompanied by documentation. On safe receipt the consignee must provide the consignor with an acquittance discharging the latter from his responsibility for the duty;
- (c) in addition, goods may have to bear a fiscal stamp (banderole) or otherwise be marked to indicate the country in respect of which duty has been paid;
- (d) there may be minimum rates of excise duty;
- (e) there may be restrictions on the amounts which citizens of one Member State can acquire in other Member States for personal use.

13. It may not be necessary to adopt all these mechanisms; adopting some will render others less necessary, and the right balance may vary between Member States. But some aspects are certainly required in order to ensure that duty accrues correctly. If the combination of measures adopted was such as to ensure that tax was correctly charged where the goods were ultimately consumed (the destination system), it would not for fiscal reasons be necessary in addition to prescribe harmonisation of duty rates.

Value added tax

14. In the absence of fiscal frontiers under the continuing destination system, goods would be relieved of VAT at export and chargeable with VAT at import, at the rate applicable in the importing country. Value added tax is collected on an

accumulative basis, and this fact assists in the administration of tax without frontiers. In the absence of frontiers, it will be necessary to put the responsibility for accounting for tax on any person acquiring goods from another Member State for use in his business or for resale.

15. Where businesses are registered for VAT in respect of their transactions within a Member State, in making their returns they could also account for VAT on goods obtained from other Member States and for services subject to the reverse charge applied by Article 21.1(b) of the Sixth VAT Directive. Other unregistered businesses which obtained goods for resale or use in their businesses or services subject to the reverse charge would have to account for VAT. They could be obliged to register and account for VAT subject to the same rules including turnover as would apply to their domestic transactions; alternatively they might be required to notify the tax authorities that they would be importing and could then be designated "authorised importers" and account for VAT as such.

16. For purposes of VAT there would be no documentation or control at the frontier. Correct accounting for VAT on imports would be governed by verification of traders' accounts in the same way as for domestic transactions.

17. Other importations by other unregistered businesses or by private citizens for their personal use from other Member States would be unrestricted, provided that VAT had been borne and no relief given in the Member State of despatch. (This would require Community-wide enforcement and probably a change in the law, to allow zero-rating of exports only on goods consigned to other registered or "authorised" traders). It is improbable that any significant distortions would result from this, and in so far as they did, the consequence would be a pressure on Member States to bring their rates nearer together.

Other frontier controls

18. It is necessary to consider also the three other purposes for frontier controls mentioned in paragraph 3.

- (a) Community regimes. For CAP goods, in the absence of frontier controls, it will be necessary either to abolish MCAs or to devise a means of registering all traders importing or exporting products liable to MCAs from or to other Member States. For goods not in free circulation, it will not be possible to verify movements at frontiers. The principle would be that the trader and the administration which had originally admitted the goods into the Community would be responsible for the duty payable until they obtained an acquittance from the administration of another Member State or export from the Community.
- (b) prohibitions and restrictions. Where goods were prohibited or restricted within a Member State and subject to controls including licencing or seizure within that State, it will be permissible to maintain parallel controls consistent with the Treaty on such goods entering or leaving the Member State's jurisdiction;
- (c) trade statistics. Member States should be allowed to obtain returns of goods traded with other Member States by whatever method is most effective and least burdensome to businesses. These could include periodic surveys on a sample basis and regular returns, using electronic data transmission, by importers and exporters.

Convergence

19. Frontierless controls as outlined above represent a radical change which will present many difficulties for Member States. The major step is likely to be abandonment of the principle that all imports are brought under a form of official supervision or control. Yet this is the key step which must be taken if there is

to be a Internal Market without fiscal frontiers. The Member States must adapt their existing systems to move towards this goal. Some may be able to adjust unilaterally in many respects, as the United Kingdom will be doing. In many cases new Community instruments must be devised. It must be an early aim of the Commission and Council to develop these instruments. To a substantial extent, they will be needed whatever solution if any is found to the problems of divergent tax rates. This work must be advanced without delay if the many technical changes required can be in place before the end of 1992.

27 14/2

67. 21/2

[Handwritten mark]



FROM: J M G TAYLOR
DATE: 14 February 1989

MR JEFFERSON SMITH - C&E

- cc PS/Chief Secretary
- PS/Financial Secretary
- PS/Paymaster General
- PS/Economic Secretary
- Sir P Middleton
- Mr Wicks
- Mr Lankester
- Mr R I G Allen
- Mr Culpin
- Mrs Chaplin
- Mr Tyrie
- Mr Call

PS/IR

- Mr Unwin - C&E
- Mr Nash - C&E
- Mr Wilmott - C&E
- Mr P R H Allen - C&E

- Sir D Hannay - UKREP
- Mr Lavelle - Cab. Office

INDIRECT TAX HARMONISATION: DISCUSSIONS IN BRUSSELS

The Chancellor has seen your note of 13 February.

2. He agrees that the technical paper should be circulated to the Commission and to other Customs Administrations. He is inclined to inform the Prime Minister first. He thinks that the best course is to let the Prime Minister know that he will be circulating the text now minus the minimum rate of VAT reference, but that we may need to return to the point at a later stage. He would be grateful for a draft note from Mr R I G Allen.

3. The Chancellor agrees that a presentation to UK MEPs, after the elections, would be helpful.

[Handwritten signature]

J M G TAYLOR

RESTRICTED

ec1.bk/meb/15.2.4

CHANCELLOR

FROM: MRS M E BROWN
DATE: 15 FEBRUARY 1989

*Ch. PM is likely to invite you
to say a few words about
the ECOFIN.*
2/15/2

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr R I G Allen
Mr Odling-Smee
Mr Ilett
Ms Symes (or)

CABINET, 16 FEBRUARY: TAX ON SAVINGS

1. I attach:

- (i) a speaking note on Monday's ECOFIN meeting;
- (ii) the telegram reporting the ECOFIN discussion.

Mary Brown.

MRS M E BROWN

ec1.bk/meb/15.2.5

TAXATION OF SAVINGS: SPEAKING NOTE

1. Council of EC Finance Ministers met on Monday: Economic Secretary attended. Taxation of savings the only item.

2. New Commissioner, Mme. Scrivener, presented her proposals. Discussion went much as expected:

- *The UK, Netherlands and Luxembourg have withdrawn tax*
UK, Netherlands and Luxembourg firmly opposed;
- France, Germany, Italy, Portugal, Belgium, Denmark and Spain supported in principle, though raised various specific problems. Major political issue for French in particular;
- Greece and Ireland undecided.

3. Lengthy discussions ahead, though Presidency is giving priority and - probably unrealistic - aim is for decisions at Madrid Council. Unanimity required. UK will continue to press view that tax is unnecessary, *& wrong* ~~would not prevent tax evasion anyway, and will as drafted damage financial market in the Community and drive business away. [As yet open question whether a more modest proposal might at the end of the day be acceptable to UK - in which case we would have a useful bargaining counter. But it is far too early to hint at this yet.]~~

RESTRICTED



OFFICE OF THE UNITED KINGDOM
PERMANENT REPRESENTATIVE
TO THE EUROPEAN COMMUNITIES
ROND-POINT ROBERT SCHUMAN 6
1040 BRUSSELS

FROM THE PERMANENT REPRESENTATIVE

TELEPHONE 230 62 05

P Jefferson Smith Esq
Deputy Chairman
HM Customs & Excise
New King's Beam House
22 Upper Ground
LONDON SE1 9PJ

16 February 1989

Dear Peter,

INDIRECT TAX HARMONISATION

1. Thank you for sending me a copy of your report on your recent visit to Brussels. You will have seen my telegram UKRep No 393.
2. I would not greatly differ from most of your conclusions. But on one point, briefing UK MEPs, I think your proposed timetable is far too leisurely. The key moment for the European Parliament is April 1989. That is when the Plenary Session will debate the Cockfield proposals. It could very well be the only occasion when they get in on the act since Article 99 legislation only gives them one shot at it (unlike the cooperation procedure for other single market measures). So we need to make our main effort with them before that. When I briefed the EDG in Strasbourg on 15 February, I told them we were making good progress towards defining more clearly the Chancellor's approach in Crete - removal of fiscal frontiers without harmonisation. They were intrigued and asked very insistently to be briefed well in advance of the April Plenary.
3. There would seem to me to be a number of possibilities. We could make available our new paper (assuming the Chancellor has agreed to its use with other member states). We could recommend a Treasury Minister to give a briefing (that can be done on a party basis to UK EDG members only). Or we could brief all UK MEPs. These possibilities are not necessarily mutually exclusive. Perhaps we could discuss them and any other points arising from your visit here at the Cabinet Office meeting on 24 February.

Yours sincerely
Daniel Hannay
D H A Hannay

/cc:

RESTRICTED



cc : Chief Secretary, HMT
Paymaster General, HMT
Financial Secretary, HMT
Economic Secretary, HMT ✓
Sir Peter Middleton, HMT
N Wicks Esq, HMT
T Lankester Esq, HMT
R I G Allen Esq, HMT
R P Culpin Esq, HMT
Mrs Chaplain, HMT
A Tyrie Esq, HMT
M Call Esq, HMT

PS/Inland Revenue

Chairman, HM Customs & Excise
P Nash Esq, HM Customs & Excise
P Wilmott Esq, HM Customs & Excise
B Cockerell Esq, HM Customs & Excise
P Allen Esq, HM Customs & Excise
R Brown Esq, HM Customs & Excise
B Knox Esq CB, HM Customs & Excise

R G Lavelle Esq CB, Cabinet Office

Mr Norgrove, UKREP

CONFIDENTIAL

FROM: R I G ALLEN
DATE: 17 FEBRUARY 1989

CHANCELLOR

cc Chief Secretary
 Paymaster General
 Financial Secretary
 Economic Secretary
 Sir P Middleton
 Mr Wicks
 Mr Lankester
 Mrs M Brown
 Mr Culpin
 Mrs Chaplin
 Mr Tyrie
 Mr Call

PS/Inland Revenue
 PS/Customs & Excise
 Mr Jefferson Smith, C&E
 Mr P R H Allen, C&E

OK on a... (BOM)
PS. The 1st AH's letter is to be sent to the PM; No 'gang' up, because of the situation. Always clear on an inter forces approach.

Ching, wk

Ch/ Pps. behind, on two separate strings (to distinguish the "technical" correspondence from the "substantive" correspondence). I don't like the idea of a joint minute. It would make the PM feel she was being ganged up on, + so provide her to look out. Agree ∴ that GH writes as proposed, + you follow as proposed? 25/17/2

INDIRECT TAX HARMONISATION: DISCUSSIONS IN BRUSSELS

I have seen Mr Taylor's two minutes of 14 February reporting on the outcome of your bilateral meeting with Sir G Howe last weekend and your comments on Mr Jefferson Smith's submission of 13 February concerning the Customs' technical paper "Indirect Tax Collection in the Internal Market after 1992". In brief, your view was that: (a) we shall need to return to the Prime Minister on the question of a minimum standard rate of VAT but that, in the first instance, Sir G Howe should take the initiative in minuting her; and (b) the Prime Minister should be alerted to the fact that we propose to circulate Customs' technical paper informally to other Member States and to the Commission.

2. On (a), I attach a draft of the minute which Sir G Howe proposes to send the Prime Minister. As you will see, the FCO wish to associate you with the second sentence in the second paragraph: "... Nigel Lawson and I believe that the price would be well worth paying". Are you content with this formulation?

3. I foresee something of a problem on (b). The technical paper is no more than that term implies (subject to the deletion of the reference to minimum rates of excise duty). As you will have seen

from the personal comment by Sir D Hannay at the end of UKREP Telno. 393 reporting on Customs' recent visit to Brussels, it is UKREP's strong view that the time is ripe to circulate the paper more widely. Because the paper is both technical and informal, Hannay (supported by FCO and the Cabinet Office) sees no particular need for it to be shown to the Prime Minister. Its informality could be reinforced by having it circulated by Mr Unwin to his follow heads of Customs' administrations and likewise to Commission officials. As an informal document, the paper could be withdrawn or modified at a later stage if the ideas in it fall on deaf ears: withdrawal might be more difficult if the paper were to be given the seal of Prime Ministerial approval.

4. You may nevertheless feel that you should let the Prime Minister know about the technical paper and how we propose to handle it. I attach a draft which makes (as I think it must) a brief reference to Mr Powell's letter of 9 February and to the question of minimum rates: the read across to Sir G Howe's minute will avoid creating the impression that you are content with letting matters rest with the Powell reply. The drafts of the two minutes have been agreed with Customs and the FCO. It would be possible, if you wished, to amalgamate the two texts into a single minute, signed jointly by the Foreign Secretary and yourself. FCO prefer this course, but I see attractions in separate minutes: it helps to keep the two issues - minimum rates and administrative procedures - separate and distinct.

5. FCO will not move with their minute until you have agreed the points of handling set out above: but it would be sensible for your Private Office to ensure that submission to No.10 is arranged so that your minute follows closely behind that of the Foreign Secretary.

6. Given his interest in the subject (he may wish to submit a minute of his own and I think we should encourage him to do so), I would propose that a copy of your minute should be sent to Lord Young but not to other members of OD(E).

RAA

R I G ALLEN

I can see why Hannay thinks this. But it would surely be a bit disingenuous not to refer to the pps. If you have to write to the PM on the more substantive issue, do you do.

DRAFT MINUTE FROM THE CHANCELLOR TO THE PRIME MINISTER

Suggests, it may be human

My minute of 6 February mentioned that the next stage of discussion in Brussels was likely to focus on two separate, but related issues: the question of administrative procedures (including the VAT clearing house) and the question of VAT and excise rates and rate structure.

Charles Powell's letter of 9 February to Alex Allan records your comments on the second of these two areas. For the present we shall remain silent in Brussels on the question of a minimum standard rate of VAT. But as Geoffrey Howe's minute of [] February ~~says, he and I may want~~ to revert to this at a later stage, depending on developments in Brussels.

The first area (administrative procedures) is ^{*human*} quite separate. You will appreciate that progress on this is absolutely central to the UK's market-based approach to indirect tax approximation which I outlined last September at the Crete informal ECOFIN. It provides a basis for securing our ultimate objective - the dismantling of fiscal barriers to trade - without the need for any centrally-determined harmonisation of tax rates. Customs have been working up their proposals over the last few months, and I now believe that the time is ripe to circulate them informally to other Member States and to the Commission. They are technical in nature and do not stray onto the sensitive ground of tax rates and rate structures. If we are to influence the debate, I believe it is important to make an early move: the Commission are showing willingness to take their original clearing house proposals back to the drawing-board, and other Member States (notably the French) have been considering alternative formulations. These have some similarity with Customs' proposals, but the latter are significantly more radical in reducing bureaucratic burdens on businesses. This is an aspect on which we should be giving a lead to the

Community. To stress the technical nature of the proposals, and to distance them from the politically sensitive area of rate harmonisation, I intend that the paper should be circulated by the Chairman of Customs and Excise to his colleagues in other Customs administrations, and to Commission officials.

I attach the paper which I propose to instruct Customs to circulate, on this informal basis, at an early opportunity.

I am copying this minute to Geoffrey Howe, David Young and Sir R Butler.

[NL]

DRAFT MINUTE FROM THE SECRETARY OF STATE TO THE PRIME
MINISTER

VAT

I have seen Charles Powell's letter of 9 February in response to the Chancellor's minute of 6 February on Indirect Tax issues.

I certainly see no immediate need to show willingness to consider a VAT minimum rate. But if - as now seems possible - to do so would at some future stage obtain for us the major prize of ensuring that fiscal barriers to trade within the Community were largely eliminated, and that we secured a permanent legislative underpinning for our pledged VAT zero rates, and with no change to our 15 per cent rate, and no centrally-imposed "approximation", ~~Nigel Lawson and I~~ believe that the price would be well worth paying. [It also strikes me that a minimum rate of VAT of, say, 12 per cent, would in fact be helpful to the UK, for it would prevent the competitive downward bidding of rates which would disadvantage us.] And as a constraint on us it would be academic, for we would not in any case wish to reverse our successful policy of shifting the UK tax burden from direct to indirect taxation.

If in due course it were to become clear that the prize was indeed coming within reach, perhaps I could discuss this with you and Nigel? Copies of this minute go to him, to David Young, and to Sir Robin Butler.

R E S T R I C T E D



FROM: S M A JAMES
DATE: 21 February 1989

PS/CHANCELLOR

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr Lankester
Mr R I G Allen
Mr Culpin
Mrs Chaplin
Mr Tyrie
Mr Call

PS/IR

Mr Unwin - C&E
Mr Jefferson-Smith - C&E
Mr Nash - C&E
Mr Wilmott - C&E
Mr P R H Allen - C&E

Sir D Hannay - UKREP
Mr Lavelle - Cabinet Office

INDIRECT TAX HARMONISATION

The Economic Secretary has seen Sir D Hannay's letter to Mr Jefferson-Smith of 16 February.

2. He would favour briefing all UK MEPs rather than UK EDG members only.

S M A JAMES
Private Secretary

PhP

CONFIDENTIAL AND PERSONAL

Oh, This looks OK (pretty Inkwarm endorsement)

Richard Allen Esq
HM Treasury
Parliament Street
London SW1

of the main point of substance, which is confined to the last para! Content?

Department of Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

** See, however, latest unhelpful letter from Mr Powell, Mr. J. M. G. Taylor*

23/2

Direct line
Our ref
Your ref
Date

215 4641

22 February 1989

Do you have any comments on the attached draft when I have fiddled with a

on wh. side? Comment v. wide?

Dear Richard

Ref.

23/2

Better than! v. good!

VAT APPROXIMATION

Following our conversation, I attach a draft of the sort of minute we would recommend Lord Young to send to the Prime Minister in support of the Chancellor and the Foreign Secretary. We would aim to put this to him on his return from India on Friday.

Any comments would be welcome, in my absence, to Bill Stow please on 215 4709. I am copying this to John Kerr.

Yours sincerely

Bill Stow

M MARIANNE NEVILLE-ROLFE
Head Internal European Policy Division

(Dictated by Miss Neville-Rolfe and signed in her absence.)

cc: Mr Stow IEP DTI



543/2

DRAFT MINUTE FROM SOS TO THE PRIME MINISTER

I have followed the correspondence ending with Nigel Lawson's minute to you of 22 February, on the next steps in the ~~negotiation~~ ^{Brussels discussions} on indirect tax. It may be helpful to put this in the context of our Single Market objectives.

Nigel Lawson makes the important distinction between ~~tax~~ ^{of tax rates and structures} approximation on the one hand, and the abolition of fiscal checks at frontiers on the other. We have consistently argued that the Commission's proposals for ~~tax~~ ^{of rates} approximation are unnecessary to creation of the Single Market, as well as being bureaucratic and regulatory. We have made progress with that line in Brussels and I think it is understood by British industry.

The dismantling of fiscal checks at frontiers is a different matter. These checks can cause significant delays, and therefore costs to UK business. Their removal would be a real and important contribution to the Single Market - and entirely consistent with the deregulatory, liberalising thrust of our policy towards the EC. In any case, the Attorney-General's advice of last August implied that we are, in effect, committed by the Single European Act, to reducing ~~fixed~~ ^{fiscal} controls at frontiers to a level at which they are an insignificant barrier to trade. The proposals Customs have worked up ~~would~~ ^{centrally -} show that this objective can be met without imposed tax approximation.

I therefore [strongly] support Nigel Lawson's suggestion that we should now float these technical proposals informally with other Member States and the Commission.

The question of a minimum VAT rate is [much] more difficult, and ~~is~~ ^{may} not be for now. But if agreement to minimum rates brought us the prize of removal of fiscal barriers to trade, with ~~minimum~~ ^{reduced} bureaucratic burdens on business, a permanent zero-rate derogation, and ~~an end to~~ ^{no centrally-imposed} tax approximation, the balance of advantage would have to be carefully considered.

NOTE FOR THE RECORD

*It might
I must get a
phone message
to Ruding*

Mr Alex Allen

cc : J O Kerr Esq CMG, FCO
R G Lavelle Esq CB, Cab Office
N Wicks Esq HMT
T Lankester Esq, HMT
A J G Isaac Esq CB, Inland Rev
M Jenkins Esq CMG, THE HAGUE
Mr Bostock
Mr Thomson

*You may want to show this
to the Commission. The Dutch
embassy report at x hour
we will eventually do a deal
must be a guess on their
part: we have certainly
given no hint of
compromise.*

TAX ON SAVINGS

cc
MR Allen
Mr Ulett
Mr Odling-Smee
Ms Sykes

22/2/89.

*R
ref*

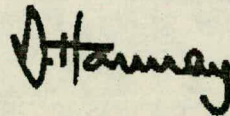
1. The Netherlands Permanent Representative telephoned on 22 February to say that his Finance Minister regretted that he had not made more clear in the ECOFIN Council on 13 February his fundamental opposition to the Commission proposal for a tax on savings. Ruding had just come off a plane from Washington, accepted the speaking notes he was given, and believed he had put up too defensive and tentative a performance. He now wanted to firm up his opposition to the tax on savings. Nieman added that one of the reasons the speaking notes were not as clear cut in their opposition as Ruding would have wished was that the Foreign Ministry in the Hague was continually trying to water down Ruding's opposition to the Commission proposal.
2. Nieman then probed me rather hard about our own attitude. Would we fight to the very end? Ruding had no wish to find himself isolated in opposition and forced to give in. The Dutch Embassy in London was reporting that at some stage, we would probably do a deal.
3. I said I thought that it did not make much sense for the three strong opponents of the measure (Luxembourg, Netherlands, UK) to go around demanding sacred oaths of each other and fussing already about whether or not they might be isolated at the end of the day. The simple fact was that we were all three determined in our opposition to this proposal. We had a whole raft of excellent arguments to support our opposition and our objective was to see the thing off. The important thing at this stage was to concert carefully between the three so that we marshalled our arguments in a supportive way. This was the more important in view of the fact that there was a

*180
1/2*

RESTRICTED

division between the Netherlands on the one hand and the UK and Luxembourg on the other over the question of banking secrecy and the possibility of strengthened reporting requirements on a Community basis. We did not have a system like the Dutch, nor were we prepared to introduce one. The Luxembourgers took an even more restrictive view than we did. But none of this need prevent us all three working hard to defeat the proposal. Nieman firmly agreed.

4. Nieman concluded by saying that he believed it likely that Maas (Treasurer-General at the Finance Ministry) might wish to come to London soon to discuss this issue with us. I gave him the names of Mr Lankester and Mr Isaac as those who were principally dealing with the issue on our side.



D H A Hannay

22 February 1989

cc CST, FST, PMG, EST
 Sir P. Middleton
 MR WICKS.
 MR Lancaster.
 MRS Brown
 MR Culpin
 MRS Chapman



RIG
 ALLEN

Treasury Chambers, Parliament Street, SW1P 3AG
 01-270 3000

PRIME MINISTER

MR Tyne
 MR Call
 PS/IL PS/CAE
 MR Jethersaw - Smith
 MR PRH ALLEN

VAT

22/2/89.

My minute of 6 February mentioned that the next stage of discussion in Brussels was likely to focus on two separate, but related issues: the question of administrative procedures (including the VAT clearing house) and the question of VAT and excise rates and rate structure.

Charles Powell's letter of 9 February to Alex Allan records your comments on the second of these two areas. For the present we shall remain silent in Brussels on the question of a minimum standard rate of VAT. But as Geoffrey Howe's minute of 22 February suggests, it may be necessary to revert to this at a later stage, depending on developments in Brussels.

The first area (administrative procedures) is, however, quite separate. You will appreciate that progress on this is absolutely central to the UK's market-based approach to indirect tax approximation which I outlined last September at the Crete informal ECOFIN. It provides a basis for securing our ultimate objective - the dismantling of fiscal barriers to trade - without the need for any centrally-determined harmonisation of tax rates. Customs have been working up their proposals over the last few months, and I now believe that the time is ripe to circulate them informally to other Member States and to the Commission. They are technical in nature and do not stray onto the sensitive ground of tax rates and rate structures. If we are to influence the debate, I believe it is important to make an early move: the Commission



are showing willingness to take their original clearing house proposals back to the drawing-board, and other Member States (notably the French) have been considering alternative formulations. These have some similarity with Customs' proposals, but the latter are significantly more radical in reducing bureaucratic burdens on businesses. This is an aspect on which we should be giving a lead to the Community. To stress the technical nature of the proposals, and to distance them from the politically sensitive area of rate harmonisation, I intend that the paper should be circulated by the Chairman of Customs and Excise to his colleagues in other Customs administrations, and to Commission officials.

... I attach the paper which I propose to instruct Customs to circulate, on this informal basis, at an early opportunity.

I am copying this minute to Geoffrey Howe, David Young and Sir Robin Butler.

A handwritten signature in dark ink, appearing to be 'N.L.' with a horizontal line underneath.

[N.L.]

22 February 1989

Indirect Tax Collection in the Internal Market after 1992

The present system

1. In all Member States, indirect taxes are collected by the authorities of those states, and, subject to payment of the Community's own resources, accrue for the benefit of their national finances. These are consumption taxes; whatever the systems of tax collection, the broad principle is that the burden should fall on consumption within the country levying them. This is achieved by levying tax on suppliers of goods or services within the national territory, charging the same tax on imports and relieving exports.

2. Systems for taxation of imported goods follow a common pattern whether the goods are imported from other Member States or from third countries. In essence all imports are brought under official control at the frontier. In some cases the imports are documented and examined and any duty or tax payable is collected at the frontier itself; in others the goods are allowed to be removed inland before these procedures are completed. The extent to which the goods must be declared or documented when crossing the frontier may vary between the extremes of full documentation and simple production of a commercial invoice sufficient to identify the goods and their consignee. But the principle is that the goods come into official cognisance at the frontier and are subject to control until all duties due are paid.

3. In addition to controls for fiscal purposes there are other purposes for official intervention at frontiers. The three main ones are:

- (a) Community regimes: for third country trade, bringing goods into free circulation in the Community; for intra Community trade, monetary compensation amounts; for all goods not in free circulation, Community transit (a system which ensures that goods remain under official control as they pass from one Member State to another); a range of commercial policy controls;
- (b) effective operation of national prohibitions or restrictions, permitted by the Treaty;
- (c) compilation of Community and national trade statistics.

4. The procedures above apply to commercial traffic. But goods imported by passengers are also subject to frontier controls, and must be declared unless they are within the limits which are relieved by Community legislation. Controls permitted by Article 36 also apply in this area.

5. Exports are subject to frontier controls, though in general these are much lighter. For indirect tax purposes the controls exist so that Member States can satisfy themselves that goods for which remission of tax has been claimed as exports have genuinely been exported. The three other purposes - Community regimes, national prohibitions and restrictions, and trade statistics - also apply to exports.

6. There can be practical differences in the treatment of intra-Community and third country goods. But the broad principles are the same.

The Future System: Proposals

7. The creation of the Single European Market will introduce a fundamental change of concept. As a result of the gradual establishment of the internal market foreseen in the SEA, controls for customs purposes at frontiers within the Community will be abolished except insofar as preventive checks remain necessary for the purposes of protecting public security, health and morality (eg checks to detect illegal imports of drugs and firearms).

Frontier controls between member states and third countries will however need to be retained.

8. Although there are many differences between the Commission and Member States on basic issues, there should be agreement on the fundamental principle of the Single Market. This can be expressed as follows.

9. Trade between Member States may not be controlled at the frontier. Where goods pass between Member States, whether carried by passengers or in freight, customs intervention should take place only in the following circumstances:

(a) where intra-Community and third country goods are handled in the same location (eg at international airports), to the extent necessary to bring the third country goods under control;

(b) for the purpose of preventive checks upon prohibited or restricted goods so far as permitted by the safeguards in the Treaty.

10. Systems for collecting indirect taxes on imports from other Member States or relieving exports to other Member States must not depend on frontier controls. Commercial importers should be subject to regimes which as closely as possible mirror the regimes applicable to domestic traders, any differences being proportionate to the problems to be dealt with. In any event the treatment of importers and exporters may be no more onerous than under the corresponding domestic regimes.

11. The practical implications must be considered for each area separately.

Excise

12. For excisable goods, it will remain necessary to ensure that the duty on goods will accrue to the country in which they are finally sold or consumed. Mechanisms, other than frontier controls, to ensure that this principle is achieved may include

the following:

- (a) goods passing between Member States by way of trade must do so under a duty suspension regime. Traders importing from other Member States for resale must account for the duty and must be registered or otherwise authorised or must operate bonded warehouses for this purpose;
- (b) to back up this regime, it may be necessary to prescribe that all movements of goods duty free whether between or within Member States must be accompanied by documentation. On safe receipt the consignee must provide the consignor with an acquittance discharging the latter from his responsibility for the duty;
- (c) in addition, goods may have to bear a fiscal stamp (banderole) or otherwise be marked to indicate the country in respect of which duty has been paid;
- (d) there may be restrictions on the amounts which citizens of one Member State can acquire in other Member States for personal use.

13. It may not be necessary to adopt all these mechanisms; adopting some will render others less necessary, and the right balance may vary between Member States. But some aspects are certainly required in order to ensure that duty accrues correctly. If the combination of measures adopted was such as to ensure that tax was correctly charged where the goods were ultimately consumed (the destination system), it would not for fiscal reasons be necessary in addition to prescribe harmonisation of duty rates.

Value added tax

14. In the absence of fiscal frontiers under the continuing destination system, goods would be relieved of VAT at export and chargeable with VAT at import, at the rate applicable in the importing country. Value added tax is collected on an

accumulative basis, and this fact assists in the administration of tax without frontiers. In the absence of frontiers, it will be necessary to put the responsibility for accounting for tax on any person acquiring goods from another Member State for use in his business or for resale.

15. Where businesses are registered for VAT in respect of their transactions within a Member State, in making their returns they could also account for VAT on goods obtained from other Member States and for services subject to the reverse charge applied by Article 21.1(b) of the Sixth VAT Directive. Other unregistered businesses which obtained goods for resale or use in their businesses or services subject to the reverse charge would have to account for VAT. They could be obliged to register and account for VAT subject to the same rules including turnover as would apply to their domestic transactions; alternatively they might be required to notify the tax authorities that they would be importing and could then be designated "authorised importers" and account for VAT as such.

16. For purposes of VAT there would be no documentation or control at the frontier. Correct accounting for VAT on imports would be governed by verification of traders' accounts in the same way as for domestic transactions.

17. Other importations by other unregistered businesses or by private citizens for their personal use from other Member States would be unrestricted, provided that VAT had been borne and no relief given in the Member State of despatch. (This would require Community-wide enforcement and probably a change in the law, to allow zero-rating of exports only on goods consigned to other registered or "authorised" traders). It is improbable that any significant distortions would result from this, and in so far as they did, the consequence would be a pressure on Member States to bring their rates nearer together.

Other frontier controls

18. It is necessary to consider also the three other purposes for frontier controls mentioned in paragraph 3.

- (a) Community regimes. For CAP goods, in the absence of frontier controls, it will be necessary either to abolish MCAs or to devise a means of registering all traders importing or exporting products liable to MCAs from or to other Member States. For goods not in free circulation, it will not be possible to verify movements at frontiers. The principle would be that the trader and the administration which had originally admitted the goods into the Community would be responsible for the duty payable until they obtained an acquittance from the administration of another Member State or export from the Community.
- (b) prohibitions and restrictions. Where goods were prohibited or restricted within a Member State and subject to controls including licencing or seizure within that State, it will be permissible to maintain parallel controls consistent with the Treaty on such goods entering or leaving the Member State's jurisdiction;
- (c) trade statistics. Member States should be allowed to obtain returns of goods traded with other Member States by whatever method is most effective and least burdensome to businesses. These could include periodic surveys on a sample basis and regular returns, using electronic data transmission, by importers and exporters.

Convergence

19. Frontierless controls as outlined above represent a radical change which will present many difficulties for Member States. The major step is likely to be abandonment of the principle that all imports are brought under a form of official supervision or control. Yet this is the key step which must be taken if there is

to be a Internal Market without fiscal frontiers. The Member States must adapt their existing systems to move towards this goal. Some may be able to adjust unilaterally in many respects, as the United Kingdom will be doing. In many cases new Community instruments must be devised. It must be an early aim of the Commission and Council to develop these instruments. To a substantial extent, they will be needed whatever solution if any is found to the problems of divergent tax rates. This work must be advanced without delay if the many technical changes required can be in place before the end of 1992.



FROM: J M G TAYLOR
DATE: 28 February 1989

bf. 673

MR LANKESTER

cc Mr Odling-Smee
Mr R I G Allen
Mr Ilett
Ms Symes

TAX ON SAVINGS

The Chancellor was grateful for sight of Sir D Hannay's note of 22 February recording his meeting with the Netherlands Permanent Representative.

2. The Chancellor thinks he must get a personal message to Ruding. I should be grateful for advice.

JMG

J M G TAYLOR

From: T P Lankester
Date: 28 February 1989

CHANCELLOR

*OK. I will
ask Wicks &
New have a
word with
him*

*Wicks
Appo.
cc*

*Ch. Do you want to write in
these terms - or leave it
for a word at interim mee?*

Mr Wicks
Mr Odling-Smee
Mr Ilett
Mr R I G Allen
Ms Symes

TAX ON SAVINGS

*df
1/3*

You saw the note from Sir David Hannay reporting that Ruding seemed to be under the impression that at some stage we might compromise on the withholding tax proposal. You said you would like to send Ruding a personal message.

2. So far, we have made it clear that we are totally opposed to the Commission's proposals, but we have been careful not to say that we will definitely veto any proposal that may eventually emerge. For it is just conceivable that at the end of the day the current proposal will be so watered down as to be something that we could live with - for example, if there were to be a European-wide withholding tax on similar lines in terms of coverage and limits to our composite rate. While we might want to veto even such a limited proposal on the grounds of fiscal sovereignty, we might also decide it was worth going along with if it would buy us something useful in some other area - such as emu.

3. So it is a little difficult to give Ruding the unequivocal assurance that he seems to be looking for. Not a great deal is going to happen between now and the end of March on this issue - there is a further meeting of the ad hoc group of officials on 9 and 10 March following which the Spanish Presidency will prepare a report (presumably showing widely divergent views)

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

through COREPER for ECOFIN on April 17. Rather than send Ruding a message, I would be inclined to advise that you have a word with him in the margins of the Interim Committee in early April.

4. However, if you do wish to send him a message now, I attach a draft - though this stops short of giving him the commitment that he seems to be looking for.

R

T P LANKESTER

DRAFT LETTER FOR THE CHANCELLOR TO SEND TO:

ONNO RUDING
Minister of Finance
Netherlands

I understand from reports I have seen from our Permanent Representative in Brussels that you may be under the impression that our position on the Commission's proposals on taxation of savings is wavering.

I am not sure how this impression has arisen. However, if it has, I want to assure you that we are totally and unequivocally opposed to the proposals. As Peter Lilley and I have both made clear, they are unnecessary, they are likely to be ineffective and they would - if implemented - do great damage to the financial markets of Europe. As your officials will know, my own officials have spelled out in some detail what our objections are in the ad hoc group which is looking into this subject.

I understand that you too are opposed to the proposals, I hope that we and our respective officials can work together in countering the Commission's ambitions in this area.



Inland Revenue

Business Tax Division
Somerset House

*V. Sahajack - 1.7.86
But I am - 10
puzzled how
Commission's proposals
could work in France
as much as UK
when French
is more of 1/2
share of 60%
total tax
upward on UK CT.*

FROM: E McGIVERN
DATE: 28 FEBRUARY 1989

Financial Secretary

EC HARMONISATION: GROUP OF SIX WORKING PARTY

1. Mr Houghton, Miss Reid and I attended the first meeting in The Hague on 23 and 24 February of the Group of Six Working Party on the Harmonisation of the Business Tax Base. You will recall that the Working Party was set up at the meeting in June of last year of the main Group of Six. The background is set out in the attached extract (paragraphs 13 and 14) of Mr Painter's and my submissions of 10 June.

2. The meeting went well from the UK's point of view. The main conclusion reached was that there was no need for a Directive on the harmonisation of the business tax base.

PS

- cc Chancellor of the Exchequer
- Chief Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Sir G Littler
- Mr Byatt
- Mr Lankester
- Mr Scholar
- Mr Culpin
- Mr R I G Allen
- Mr Gilhooly
- Mr Ford
- Mrs Chaplin
- Mr Tyrie
- Mr Unwin (C/E)
- Mr Jefferson Smith (C/E)

- Chairman
- Mr Isaac
- Mr Painter
- Mr Houghton
- Mr Pitts
- Mr Calder
- Mr Cleave
- Mr Corlett
- Mr Johns
- Mr Deacon
- Mr Fitzpatrick
- Mr Nield
- Mr Cayley
- Mr Shepherd
- Mr Keith
- Mr Elliott
- Mr Weeden
- Miss Brand PS/IR

3. The Working Party quickly agreed the terms of reference which the UK had drafted - on the lines of paragraph 13 of the extract - and proceeded to explore (in no great detail) the major features of each of the six countries' business tax bases to identify the major differences between them. The Netherlands, as Chairman of the Working Party, undertook to summarise the more important differences and to report these to the meeting of the main Group of Six in June next. It was recognised in discussion that it would be difficult to demonstrate that differences necessarily led to distortions in investment decisions; and that a major difference in one particular aspect of the tax base could be more than offset by other differences, eg in tax rates or structure. The Working Party did not pursue the question and we understand that the summary report will not attempt to reach a view on it.

4. The following were the main points to emerge in discussion:-

- (i) The business tax base in Germany, Netherlands and Luxemburg is based substantially on the profits shown in the commercial accounts and is therefore, for the most part, already fairly close to the base set out in the Commission's preliminary draft proposals (which they have of course taken away for further consideration following the June 1988 meeting with Heads of Tax Administrations from the 12 Member States). For these countries - and subject to what is said below about the cost to the German fisc - adoption of the Commission's preliminary proposals would not require major changes in their systems.
- (ii) Significant changes would be necessary in the case of France, the United Kingdom and probably also in the case of Belgium, although to a much lesser extent.

- (iii) The United Kingdom, Luxemburg and Belgium saw no need for a draft directive on the Business Tax base. In particular, we argued that the United Kingdom was firmly of the view that market forces of themselves would be sufficient to bring about any necessary degree of convergence of business tax systems, particularly within the liberalised Single Market post-1992.
- (iv) France, Germany and the Netherlands remained in favour of some degree of harmonisation, otherwise - as France and The Netherlands argued - investment within, and into, the Community would move to the country with the lowest level of taxation. But France did not at present attach a high priority to harmonisation of the tax base: they saw the need for action on VAT and a withholding tax on savings as much more important.
- (v) Cost - The Chairman asked whether countries could give any indication of the likely Exchequer cost of implementing the Commission's proposals as they stood. France said that (allowing for uncertainties) the proposals would cost them something between one half and one third of the CT yield.* Belgium could give no figures but undertook to see if they could do a costing. The German delegate said that he had not seen any figures but had been told that the Budgetary cost would be "important". Both Luxemburg and Netherlands did not think that the amounts would be

* Per OECD, the 1987 yield was FF120 billion (£11 billion). The comparable OECD figure for the UK yield of CT was £16.2 billion. The French CT yield is also smaller as a percentage of total tax (5.1% compared with 10.5% in UK) and of GDP (2.3% compared with 4.0% in UK).

significant. For the United Kingdom we said that it was difficult to put a precise figure on the cost, but it could amount to many hundreds of millions of pounds, possibly substantially in excess of £1 billion pounds. (As we explained in our submission to Ministers of 23 May, we can only guess at the cost of the Commission's proposals and the figures we gave then were very speculative, ie a possible long term extra cost of £3 billion plus an impact cost which might be as high as £1 billion. But in view of the very uncertain nature of these figures, we thought it best to keep our response in fairly general terms).

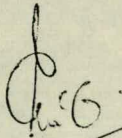
- (vi) Germany suggested that the Working Party should examine the scope for "silent harmonisation". Under this approach, officials would look at particular areas or "fields" of the business tax systems to see whether a common approach or convergence might be possible eg on the basis of generally acceptable accountancy principles for depreciation allowances. This would be a fairly long term objective and, unlike the Commission's proposals, would be entirely voluntary.

Conclusion

5. In summing up the meeting, the Chairman said -

- (1) the Working Party was agreed that there was no need for a Directive on the harmonisation of the business tax base; but
- (2) an alternative possibility would be some form of "silent harmonisation" which might lead to some voluntary measure of convergence, although there was no consensus within the Working Party in support of this.

6. We were surprised, if pleasantly so, by the Chairman's concluding remarks. We had not expected that, after only one meeting, the Netherlands and Germany would be prepared to agree to a Working Party report which concluded that it saw no need for a Directive in this area. It was clear from the outset that the Netherlands were anxious to report quickly to the main Group of Six and that they were not therefore attempting any detailed analysis of the major differences in each countries' tax systems or whether these were likely to cause distortions which would not be removed or modified by the operation of market forces post-1992. It may well be, however, that the main Group will insist on some further work being done, possibly on the German idea of "silent harmonisation" as a voluntary and long term objective. When we see how things develop over the next few months, we will come back to you for approval on a "line to take" at the main June meeting.



E MCGIVERN

structuring their tax regimes to attract foreign investment and thought further work was necessary in this area. They might then support a draft Directive.

10. Belgium was also concerned about the budgetary implications of the proposals, but said they had not yet had an opportunity to take the views of their new Ministers. (In the margins of the meeting, the Belgium delegate told me that he believed his Ministers would agree that some form of centrally imposed harmonisation was necessary for the development of the single market).

11. Luxemburg doubted the competence of the Commission to prepare a Directive on business tax harmonisation and may well challenge the proposals on this basis at Tuesday's meeting, although they got no support from other delegations of the Six.

12. So it seems certain that the Commission are likely to win support from other members of the Group, at least in principle, for some form of draft Directive which would then be sent to the Council and the Parliament, leading, at a fairly early stage, to a detailed examination of the draft by representatives of the Commission and Member States.

Group of Six working party

13. Germany and the Netherlands both pressed for a Group of Six working party to be set up to examine the Commission's draft in detail with a view to identifying possible compromise harmonisation proposals which would meet the objections of Group of Six members. We resisted and questioned the need for this, emphasising again that it had not yet been established that across-the-board, centrally imposed harmonisation was necessary. But other members of the Group made it plain that they were in favour of having a working party. We judged therefore that there was a real risk that the Group would undertake the kind of detailed technical examination of the

Commission's proposals which the UK regards as inappropriate, possibly with a view to producing a draft compromise Directive. In that event the UK would either have to join in or have no influence on the Group's further work and, more important, the likely outcome. We reluctantly agreed therefore that, subject to taking the views of UK Ministers, we would participate in a working party provided that its first task would be to consider -

- i. the need for a draft Directive on harmonising the tax base;
- ii. why it was considered that any specific aspects of existing tax regimes which were thought to be distortionary would not be removed or sufficiently modified by the operation of market forces within the single market; and
- iii. the detailed justification for any alternative proposals which Group of Six countries might put forward within the working party

and that the Group should only then take stock of whether further work would be justified. (Since the decision to set up the working party was taken in The Hague, the Dutch will assume the Chairmanship.)

14. We agreed to circulate a draft of the terms of reference on the above lines. We will of course keep Ministers informed of developments.

The Greek presidency

15. We understand from the ~~Embassy~~ in Athens (TELNO. 208) that progress on the proposed Directives on ~~direct~~ taxation "is not judged either desirable or attainable". If they hold ~~to~~



FROM: J M G TAYLOR
DATE: 2 March 1989

pmf

bp 30/3

MR LANKESTER

cc Mr Wicks
Mr Odling-Smee
Mr Ilett
Mr R I G Allen
Ms Symes

Alex
To note

TAX ON SAVINGS

The Chancellor was grateful for your note of 28 February.

X

2. He would not write at this stage, but will have a word with Mr Ruding in Washington in April, as you suggest.

JTG

J M G TAYLOR

RESTRICTED



FROM: J M G TAYLOR

DATE: 6 March 1989

16/3
~~2/3~~

6/2/89

PS/FINANCIAL SECRETARY

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Wicks
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr R I G Allen
Mr Gilhooly
Mr Ford
Mrs Chaplin
Mr Tyrie

Mr Unwin - C&E
Mr Jefferson Smith - C&E

Sir A Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Houghton - IR
Mr McGivern - IR
PS/IR

EC HARMONISATION: GROUP OF SIX WORKING PARTY

The Chancellor was interested to see Mr McGivern's note of 28 February, recording the first meeting in the Hague on 23/24 February of the Group of Six. He has commented that the outcome - that there was no need for a Directive on the harmonisation of the business tax base - was very satisfactory.

2. He is a little puzzled, however, about why the Commission's proposals could cost France five times as much as they would cost the UK, when French Corporation Tax is roughly half the share of both total tax and GDP represented by UK Corporation Tax.

A handwritten signature, likely of J M G Taylor, consisting of a stylized 'J' and 'T'.

J M G TAYLOR



Inland Revenue

Business Tax Division
Somerset House

FROM: E MCGIVERN
DATE: 10 MARCH 1989

PS/Financial Secretary

EC HARMONISATION: GROUP OF SIX WORKING PARTY

1. The Chancellor was puzzled why the Commission's proposals should be so much more expensive for France compared with the United Kingdom - Mr Taylor's minute of 6 March.

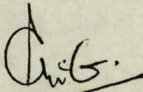
2. The cost to the UK is very uncertain - not least of all because of the uncertainty surrounding some of the Commission's proposals - but it would clearly be very substantial. Our best guesstimate when we looked at this last year, was that there could be a possible long term cost of £3 billion per annum plus an impact cost of £1 billion. As I mentioned in my earlier note, because of the uncertainty about the figures (and to avoid giving the impression that the United Kingdom's stand on centrally imposed harmonisation

cc	Chancellor of the Exchequer	Chairman
	Chief Secretary	Mr Isaac
	Paymaster General	Mr Painter
	Economic Secretary	Mr Houghton
	Sir P Middleton	Mr Pitts
	Sir G Littler	Mr Calder
	Mr Byatt	Mr Cleave
	Mr Lankester	Mr Corlett
	Mr Scholar	Mr Johns
	Mr Culpin	Mr Deacon
	Mr R I G Allen	Mr Fitzpatrick
	Mr Gilhooly	Mr Nield
	Mr Ford	Mr Cayley
	Mrs Chaplin	Mr Shepherd
	Mr Tyrie	Mr Keith
	Mr Unwin (C/E)	Mr Elliott
	Mr Jefferson Smith (C/E)	Mr Weeden
		Miss Brand PS/IR

was governed solely by the size of the potential budgetary cost), we replied in fairly general terms which undoubtedly under-played the possible actual amounts at stake.

3. But we too were puzzled by the French estimate. Even on the basis of a UK cost - at 1988 income and price levels - of £3 billion to £4 billion (ie around 20%-25% of the 1987 OECD figure for the UK yield of CT), the French figures of one third to one half still look very high. The French delegate said that the main components of the cost were the more generous Commission rules for depreciation, the roll over of capital gains and the extension of tax relief for provisions.

4. When we see what eventually emerges from the Commission on the proposed harmonisation of the tax base, we shall need to look again at the possible costs. The main Group of Six is likely to return to the point at their meeting next June and we may therefore need to be more forthcoming about the UK budgetary implications, although we would want to clear our line with Ministers beforehand.



E MCGIVERN



Ch. I do not think Mr Isaac's proposal UK wide - Annex A - makes enough of the "privacy" point, i.e. that some (e.g. Middle Eastern) investors would so object to the necessary invasion of their privacy by a w/h tax - that matter has low its rate, how big its exemptions etc. - that they would be driven offshore. It may be that Mr I did not make much of this at the meetings, + if so, so be it - but if he did, it's worth mentioning.

FROM: A J G ISAAC

13 March 1989

ECONOMIC SECRETARY

A EUROPEAN TAX SYSTEM: DRAFT DIRECTIVE ON WITHHOLDING TAX

*AS
B
1/3*

*telegram m
this in tels.
(shar)*

1. Mrs Brown, Mr O'Connor and I duly attended the meeting of the Ad Hoc Group in Brussels on 9 and 10 March, to continue our debate (without significant progress) on the draft Directive on a withholding tax on interest.

2. The next step will be for the Spanish chairman of the Ad Hoc Group (Borrell) to report to COREPER on the way to ECOFIN on 17 April. In anticipation, the Spanish chairman pencilled in our diaries dates for further meetings of the Ad Hoc Group on 28 April and 12 May.

3. The Spanish chairman and the Council Secretariat started with the clear ambition of focusing both the debate and the eventual report from the Ad Hoc Group on "technical" matters (how a withholding tax might best be implemented), rather than on "substance" (whether a withholding tax should be introduced).

- cc Chancellor of the Exchequer
- Chief Secretary
- Financial Secretary
- Paymaster General
- Sir P Middleton
- Sir T Burns
- Mr Scholar
- Mr Lankester
- Mr Ilett
- Mrs Brown
- Mrs Chaplin
- Mr Tyrie
- Mr Call

- Sir A Battishill
- Mr Isaac
- Mr Painter
- Mr Beighton
- Mr Corlett
- Mr McGivern
- Mr Houghton
- Mr Bush
- Mr O'Connor
- Mr Bryce
- Mr Sullivan
- Mr Shepherd
- Mr Reed
- PS/IR

*Agree.
Richard's m-1
to analysis
he rather
bring home*

Under pressure from (in particular) us and the Dutch, both inside and outside the formal meetings, the chairman promised that the report would present a balanced view of the debates, bringing out the fundamental objections which a number of countries had expressed, and the serious practical consequences which they saw emerging. But the chairman refused a request from the Germans to show us all a draft of the report (and admittedly, the time between now and COREPER is pretty short). It remains to be seen how far he will report what we all said, rather than what he would have liked to have heard.

4. In this context, the Spanish chairman offered, in the closing session of the meetings, an opportunity for national delegations to send in a short (two- or at most three-page) summary of their views, so that the Council Secretariat might reflect them fairly in drafting his report. He asked that any such notes should reach him within 5 days. I said that I would probably wish to take advantage of this opportunity, and indeed might ask for my note to be annexed to his report.

So the draft is, inevitably 3 1/2 pages long!

5. I attach at Annex A a copy of a draft note for this purpose, which reflects very closely what I myself said during the closing "overview" session. I apologise for troubling you with this at the high point of the Budget debates. But I should be most grateful if you could let me know as soon as possible whether you are content

(a) that I should send in this note to the Council Secretariat in Brussels, as a fair summary - subject to any amendments you might wish to make - of the UK's position; and

(b) whether you would wish me to ask for it to be annexed to the chairman's report, if he cannot find room to reproduce its substance in the body of his own report.

6. This is the only immediate item for action at this stage. I attach at Annex B a few general points emerging from the three days' debate in the Ad Hoc Group, this month and last. At this stage, however, these are very much by way of general background and information. But I hope they help to explain the balance of my draft note - recording the UK's "fundamental" objections to the draft Directive, and then concentrating on its unacceptable practical implications. (Paragraph 11 of the draft is directed to answer a particular criticism raised by the Commission at the end of the overview session - though I had in fact anticipated it in my first substantial intervention on 20 February.)

CJG

A J G ISAAC

PROPOSAL FOR A COUNCIL DIRECTIVE ON A COMMON SYSTEM OF
WITHHOLDING TAX ON INTEREST INCOME

DISCUSSION IN THE AD HOC HIGH LEVEL GROUP ON THE TAXATION OF
SAVINGS: NOTE BY THE UNITED KINGDOM DELEGATION.

1. At the ECOFIN in February, UK Ministers expressed certain fundamental objections to the proposed draft Directive for a common system of withholding tax on interest income. In particular, Mr Lilley described the draft Directive as unnecessary, ineffective and damaging.

2. In discussions in the Ad Hoc Group, the UK delegation entered a general reserve on the draft Directive. Consistently with the objectives of the Ad Hoc Group, we then focused our comments explicitly on the practical reasons why the United Kingdom believed that the draft Directive would be ineffective in achieving its purpose and damaging to Community interests.

INEFFECTIVE IN COMBATING FRAUD

3. As we understood it, the draft Directive was founded on the proposition that liberalisation of capital movements within the Community (or the removal of exchange controls) would stimulate investors in one Community country (let us say, for the sake of example, France) to place their money in financial markets in other Community countries (for example, the UK) in order to evade French withholding tax or reporting requirements. There is room for more than one view, whether that fear is well founded. If it is well founded - if the French investor will have a fiscal inducement to put his money in London - then he will have an equal opportunity and inducement to put his money in Switzerland, Liechtenstein, Panama or a host of other third country financial centres. The United Kingdom delegation noted that this analysis had not been questioned during any of the discussions of the Ad

Hoc Group so far. It followed that either the liberalisation of capital movements created no real new problem (as Mr Lilley had suggested at ECOFIN) or the draft Directive on the withholding tax offered no real solution.

4. In addition, nothing in the draft Directive, or suggested in discussions in the Ad Hoc Group, would effectively prevent money transferred by a Community investor to a third country financial market subsequently being channelled back from that third country to the Community.

DAMAGE TO THE ECONOMY OF THE COMMUNITY

5. In the course of the Ad Hoc Group's discussions, the UK made a number of substantive points on all major articles of the draft Directive. It is not necessary to list them in detail in this brief summary note. But it is necessary to emphasise that they are not merely "theoretical" but of real importance in the practical world of business and finance and in the United Kingdom's right to conclude international agreements with other sovereign states.

6. In this brief summary note, the United Kingdom delegation concentrates on three themes which recurred in its comments throughout the three days of discussion.

7. First, Madame Scrivener highlighted in her address to the Ad Hoc Group the need to avoid damage to major European financial markets. The United Kingdom delegation expressed its concern in this context with particular reference to: payments of interest to companies and other commercial concerns; short-term deposits; the wholesale markets; a variety of negotiable instruments; Eurobonds; payments of interest to third countries. In a number (though not all) of these areas the draft Directive recognised in principle the need for an exemption, but further work was needed on their scope.

8. The risk, identified by the UK delegation, was that imposition of withholding tax in these areas, or onerous reporting requirements, could drive major international business offshore.

9. A number of delegations drew attention to an additional (or in some cases alternative) risk, which arose where an industrial or commercial borrower within the Community wished to borrow in the international markets, for investment in the Community; and was not able in one way or another to "go offshore" (the Ad Hoc Group identified the problem of existing debt instruments as a special case of that general problem). It was recognised that in many cases the rate of debt interest would in practice be grossed up to compensate the lender for the cost of withholding tax. Thus, the practical result in these cases would be that a withholding tax would have no impact on the post-tax income of lenders seeking to evade tax (it would increase the post-tax income of the lender who declared his income for tax), and it would increase the cost of borrowing for industrial and commercial businesses within the Community.

10. Third, Madame Scrivener had emphasised in her address the need to avoid excessive bureaucratic costs. The United Kingdom delegation had seen this need as applying both to administrative costs within Government and international institutions and to compliance costs for industry, commerce and the financial markets.

11. To sum up, the UK delegation had emphasised from the outset that - even leaving aside any question of international principle - as a matter of practical cost-effective administration, the case for deduction of tax at source from any form of income had to be judged pragmatically, on its facts: what it would yield by way of revenue or other benefits; what it would cost by way of administrative burden and possible economic distortion. On this basis, the UK domestic system withheld tax at source from (for example) employment income and interest on certain retail deposits with banks and building societies, where

the balance of advantage lay plainly in favour of a withholding tax. By contrast, the UK perceived the withholding tax proposed in the draft Directive as having wholly perverse effects. Those who gained from such a tax would be third country financial markets, and to some extent those investing in such markets. Those who lost would be Community financial markets, and industrial and commercial borrowers within the Community.

SOME POINTS ARISING FROM THE BRUSSELS DISCUSSIONS ON THE
WITHHOLDING TAX DIRECTIVE

(a) In an address which she gave to the Ad Hoc Group over lunch, Mme Scrivener again sought to present the UK position in terms of "theory" or "dogma" - again describing the UK position in terms of direct and indirect tax indiscriminately. This allowed her to present Luxembourg as the only country having difficulties of "substance" with the withholding tax Directive.

(b) Perhaps consistently with this, I encountered in the corridors a good deal of hope (from the proponents of the withholding tax) and a good deal of anxiety (from in particular the Dutch) that, when it came to the point, Ministers would not support the clear line I had been taking. In a particular example, the Council Secretariat (Pini) urged me not to press for the chairman's report to include anything about the damaging consequences of the draft Directive - because that would "embarrass" British Ministers, if they wished to concede on the political question in Committee.

(c) In response, I repeated that UK Ministers saw fundamental objections to the draft Directive, and would not understand it, if the report from the Ad Hoc Group did not draw attention to those objections. Leaving aside any wider political aspects, the UK saw hard practical reasons why the present draft Directive could cause unacceptable damage to Community financial markets, while still failing to deliver its supposed policy objectives.

(d) As the meetings wore on - and possibly encouraged by the fact that our position did not shift - the Dutch came increasingly boldly out of their closet in opposition to the

draft Directive. A number of other countries expressed reservations about details, though continuing to support the draft Directive "in principle".

(e) On the details, the Commission displayed their usual rigidity. However, it was noticeable that the French, in particular, did not argue for the details of the Directive with the verve and enthusiasm that one would have expected if they had really believed in what they are proposing. This may be consistent with the theory that they are seeking something more in the nature of a political gesture, rather than action of substance.

(f) Again, perhaps consistently with this, the Belgians took me aside on the final day to ask me if I could identify the specific amendments needed to the draft Directive, to make it acceptable to the UK: to exclude wholesale markets, short-term money, Eurobonds etc etc. If I could (so my Belgian colleagues said) the Belgians would immediately table an amendment in those terms. I said that I had identified in debate a number of important areas where the UK considered the draft Directive to be unclear, misguided, or likely to produce unacceptable consequences. That was as far as officials could go at the "technical" level. It must be for Ministers to form a political view of the Directive, judged as a whole on its facts, and in relation to their view about how the Community should develop.



FROM: J M G TAYLOR

DATE: 17 March 1989

JMG

PS/ECONOMIC SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Lankester
Mr Ilett
Mrs Brown
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
Mr Isaac IR
Mr Painter IR
Mr Beighton IR
Mr Corlett IR
Mr McGivern IR
Mr Houghton IR
Mr Bush IR
Mr O'Connor IR
PS/IR

A EUROPEAN TAX SYSTEM: DRAFT DIRECTIVE ON WITHHOLDING TAX

The Chancellor has seen Mr Isaac's note of 13 March.

2. He suggests that the draft note could make a little more of the "privacy" point ie that some investors would so object to the necessary invasion of their privacy by a withholding tax - no matter how low its rate and how large its exemptions - that they would be driven off shore. He suggests that paragraph 8 might be amplified in this respect.

JMG

J M G TAYLOR

67. 25/4



FROM: J M G TAYLOR

DATE: 4 April 1989

~~19/4~~
~~19/4~~

PS/CUSTOMS & EXCISE

cc PS/Economic Secretary
Mr Lankester
Mr Scholar
Mr R I G Allen
Mr Culpin
Mr Tyrie

19/4

Jonathan
Thanks
C+E say that
We should have something
on this early next week.
TD 19/4
Tom
Plc chm.
JS

Mr Jefferson Smith - C&E
Mr P R H Allen - C&E

INDIRECT TAX HARMONISATION: ARTICLE IN "WALL STREET JOURNAL"

... The Chancellor has seen the attached article in a recent edition of the Wall Street Journal.

2. He has commented that it is worth noting the authorship of this article. Mr Boss' approach and conclusions have much in common with our own analysis. There are, however, some differences - notably Mr Boss' view that abolishing tax borders without harmonising taxes would mean that the origin principle would take over from the destination principle. The Chancellor would be grateful for a note on this point.

JS

J M G TAYLOR

The Flaw in Europe's Tax Strategy 6

By ALFRED BOSS

KIEL, West Germany—Many politicians as well as economists feel that the creation of a common market within the European Community and the abolition of tax borders have to be accompanied by tax harmonization. In their view more similarity of the rates of indirect taxes—i.e. value added taxes and taxes on the consumption of specific goods like tobacco—is necessary. The EC institutions have been busy preparing measures along these lines of reasoning. Nevertheless, it is doubtful, whether harmonization is necessary as a precondition for a common European market.

The value added tax systems prevailing in all member countries are characterized by the destination principle—i.e. exports are tax exempt, whereas imports are taxed at the domestic value added tax rate. In such a system, tax borders are necessary to ensure that domestic consumption is taxed at national VAT rates. As a result national private consumption expenditures are taxed; investment expenditures normally are tax free. The national tax revenues depend upon the country's consumption expenditures. The same principles are applied to excise taxes on such items as tobacco, coffee, wine, beer, and oil.

Within the common value added tax system, the tax rates differ among the EC countries. The rates are relatively high in Denmark, Ireland, Belgium and France, but relatively low in the Federal Republic of Germany, Britain and Luxembourg. As to specific excise taxes there are also differences between national rates.

The EC Proposals

In 1987, the Commission of the EC proposed a number of measures that should be introduced while abolishing the tax borders with the EC. The proposals include the:

- introduction of a two-rate value added system—general rates of 14% to 20% and reduced rates of 4% to 9%—in all EC member countries;
- introduction of a "clearing-system" that would guarantee that tax revenues are distributed to member countries according to their national consumption expenditures and;
- harmonization of the rates of specific excise taxes.

The West German government shares the EC Commission's view that some kind of tax harmonization is necessary as a result of the abolishment of tax borders.

According to the Commission, harmonization of indirect taxes is a precondition for a common market because these taxes are a component of prices for goods and services. Abolishing the tax borders without narrowing the differences between tax rates would

mean major price differences and thus changes in the flows of goods between EC countries.

Is the view of the EC Commission correct? The answer can be found by analyzing what would happen were tax borders abolished without harmonizing taxes.

This would mean that the origin principle instead of the destination principle would become effective; the origin principle is characterized by the fact that the net value added is taxed in that country in which economic activities occur, i.e. in which net value is added. Consequently, countries with low VAT rates would realize higher exports; their goods and services would

The European Commission's plan for harmonizing value added tax rates is unnecessary for a single market—and inefficient, to boot.

become cheaper for foreigners as a result of the elimination of the tax borders because the prices would only include the low "origin" VAT rate, but not—as in the system prevailing—high foreign "destination" VAT rates. At the same time in low VAT rate countries imports would decrease because goods from abroad would remain taxed by the high tax rates prevailing there.

But this would not yet be the final outcome. Higher exports and lower imports of low rate countries and the opposite effects in high VAT rate countries would induce exchange rate changes. Countries with low VAT rates would realize an appreciation of their currency, while high rate countries' currencies would depreciate. Thus, the relative competitive positions would not change despite differences in the average level of VAT rates.

What is the conclusion? Harmonization of average VAT rates within the EC is not necessary as a precondition for abolishing tax borders. There would be no adverse effects on trade because the exchange rates would adjust in such a way that different levels of VAT rates would be compensated. As to the European Monetary System, however, when tax borders are abolished without adjusting or harmonizing the national VAT rates, exchange rates within the EMS would have to be allowed to float—at least for some months to allow for necessary adjustment.

Apart from the differences in the average value added tax rates there are differences as to the rate structure. Some countries have high tax rates for "luxury" goods, many countries tax food or energy at a relatively low rate or even not at all. If tax borders are abolished, producers in low rate countries would benefit, others would lose market shares; the adjustment exchange rates would only eliminate differences in the average tax rate levels. But this would only be the first round effect. National governments would adjust their tax rates. Why?

The Effects of Adjustment

High rate countries would—as a result of the origin principle—lose tax revenues; they would reduce their rates in order to get more revenues. Low rate countries probably would increase their rates; this would be possible because of the higher demand for these countries' products. The outcome would be "harmonization" as a result of competitive forces. The same kind of process would start because of national differences in the special excise tax rates. What does this mean? Harmonization is unnecessary not only for the VAT rate structure but also for rates of excise taxes.

It is important to realize that the specific VAT or excise tax rates would approach each other at a level that is below the average now prevailing in the EC countries and proposed by the EC Commission for all countries. Competitive forces would guarantee this by means of the consumers' decisions vis-a-vis price differentials induced by different specific tax rates. Lower overall tax revenues in the EC countries on average probably would induce lower government expenditures, at least in the relation to gross domestic product. Harmonizing rates according to the ideas of the EC Commission would mean the contrary: higher tax rates and more government power as a result of a cartel solution.

Tax rate harmonization is not necessary as a precondition for realizing the Common Market within the EC, and it is not desirable from the viewpoint of economic efficiency. As to direct taxes, international capital mobility is a strong impediment for an autonomous national tax policy. Harmonizing the rates of direct taxes would reduce competitive pressures on national governments and would reduce efficiency. Fortunately, forces in the EC have not yet taken to the idea of overhauling the entire direct taxation system.

Mr. Boss is director of the finance department at the Kiel Institute of World Economics.

The Flaw in Europe's Tax Strategy 6

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The West German government shares the EC Commission's view that some kind of tax harmonization is necessary as a result of the abolishment of tax borders.

According to the Commission, harmonization of indirect taxes is a precondition for a common market because these taxes are a component of prices for goods and services. Abolishing the tax borders without narrowing the differences between tax rates would

mean major price differences and thus changes in the flows of goods between EC countries.

Is the view of the EC Commission correct? The answer can be found by analyzing what would happen were tax borders abolished without harmonizing taxes.

This would mean that the origin principle instead of the destination principle would become effective; the origin principle is characterized by the fact that the net value added is taxed in that country in which economic activities occur, i.e. in which net value is added. Consequently, countries with low VAT rates would realize higher exports; their goods and services would

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But this would not yet be the final outcome. Higher exports and lower imports of low rate countries and the opposite effects in high VAT rate countries would induce exchange rate changes. Countries with low VAT rates would realize an appreciation of their currency, while high rate countries' currencies would depreciate. Thus, the relative competitive positions would not change despite differences in the average level of VAT rates.

What is the conclusion? Harmonization of average VAT rates within the EC is not necessary as a precondition for abolishing tax borders. There would be no adverse effects on trade because the exchange rates would adjust in such a way that different levels of VAT rates would be compensated. As to the European Monetary System, however, when tax borders are abolished without adjusting or harmonizing the national VAT rates, exchange rates within the EMS would have to be allowed to float—at least for some months to allow for necessary adjustment.

Apart from the differences in the average value added tax rates there are differences as to the rate structure. Some countries have high tax rates for "luxury" goods, many countries tax food or energy at a relatively low rate or even not at all. If tax borders are abolished, producers in low rate countries would benefit, others would lose market shares; the adjustment exchange rates would only eliminate differences in the average tax rate levels. But this would only be the first round effect. National governments would adjust their tax rates. Why?

The Effects of Adjustment

High rate countries would—as a result of the origin principle—lose tax revenues; they would reduce their rates in order to get more revenues. Low rate countries probably would increase their rates; this would be possible because of the higher demand for these countries' products. The outcome would be "harmonization" as a result of competitive forces. The same kind of process would start because of national differences in the special excise tax rates. What does this mean? Harmonization is unnecessary not only for the VAT rate structure but also for rates of excise taxes.

It is important to realize that the specific VAT or excise tax rates would approach each other at a level that is below the average now prevailing in the EC countries and proposed by the EC Commission for all countries. Competitive forces would guarantee this by means of the consumers' decisions vis-a-vis price differentials induced by different specific tax rates. Lower overall tax revenues in the EC countries on average probably would induce lower government expenditures, at least in the relation to gross domestic product. Harmonizing rates according to the ideas of the EC Commission would mean the contrary: higher tax rates and more government power as a result of a cartel solution.

Tax rate harmonization is not necessary as a precondition for realizing the Common Market within the EC, and it is not desirable from the viewpoint of economic efficiency. As to direct taxes, international capital mobility is a strong impediment for an autonomous national tax policy. Harmonizing the rates of direct taxes would reduce competitive pressures on national governments and would reduce efficiency. Fortunately, forces in the EC have not yet taken to the idea of overhauling the entire direct taxation system.

Mr. Boss is director of the finance department at the Kiel Institute of World Economics.

*MS source.
Much in common with new
own analysis, but some differences
(esp X). A note, p. 11.*



FROM: J M G TAYLOR

DATE: 7 April 1989

MR JEFFERSON SMITH - C&E

cc PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr R I G Allen
Mrs M Brown
Mr Tyrrie

Mr Unwin - C&E

Mr P R H Allen - C&E

INDIRECT TAX APPROXIMATION

... The Chancellor has seen UKREP TelNo.1005 (attached). He has noted inter alia Madame Scrivener's comments that "the Commission was prepared to discuss the width of the proposed VAT rate bands", and that "a minimum/normal rate (and a maximum lower rate) was a possible solution". The Chancellor wonders whether a "maximum lower rate" would not enable us to have a lower rate of zero. He would be grateful for advice.

A handwritten signature in dark ink, appearing to be 'JMG' or similar initials.

J M G TAYLOR

RESTRICTED
FM UKREP BRUSSELS
TO IMMEDIATE FCO
TELNO 1100
OF 062130Z APRIL 89
INFO PRIORITY EUROPEAN COMMUNITY POSTS

FRAME ECONOMIC

MY TELNO 1005
COREPER (AMBASSADORS), 6 APRIL
ABOLITION OF FISCAL FRONTIERS

SUMMARY

1. MRS SCRIVENER SOUNDS THE DEATH KNELL OF THE CLEARING HOUSE, INDICATES COMMISSION FLEXIBILITY ON VAT SYSTEM AND ZERO RATES, ACCEPTS IMPOSSIBILITY OF EXCISE RATE HARMONISATION AND NEED FOR TAX STAMPS FOR TOBACCO AND ALCOHOL PRODUCTS. PRESIDENCY TO REPORT STATE OF PLAY TO ECOFIN, FURTHER COREPER DISCUSSION AFTER 17 APRIL, INVOLVING UK, FRENCH AND BELGIAN PAPERS.

DETAIL

2. MRS SCRIVENER (COMMISSIONER RESPONSIBLE FOR TAX) SET OUT TO COREPER TODAY HER VIEWS ON THE MAIN ASPECTS OF THE INDIRECT TAX DOSSIER. SHE SPOKE INFORMALLY (IE. WITHOUT A FORMAL DECISION OF THE COMMISSION AS A WHOLE), BUT HER REMARKS CLEARLY INDICATED THE EXTENT TO WHICH THOSE CONCERNED IN THE COMMISSION HAVE COME TO REALISE OVER THE LAST FEW MONTHS THAT ITS ORIGINAL PROPOSALS WILL NOT PASS AND THAT SERIOUS THOUGHT MUST BE GIVEN TO THE ALTERNATIVE APPROACHES TO THE ABOLITION OF FISCAL FRONTIERS ELABORATED BY THE UNITED KINGDOM AND OTHER DELEGATIONS.

3. MRS SCRIVENER DEALT IN TURN WITH THE CLEARING HOUSE AND VAT SYSTEM, VAT RATES AND EXCISES.

VAT SYSTEM AND CLEARING HOUSE

4. MRS SCRIVENER SAID THAT THE COMMISSION'S IDEAS REMAINED ON THE COUNCIL'S TABLE. THE CLEARING HOUSE PLAYED A CENTRAL ROLE AND WAS TO BE FURTHER EXAMINED IN A COMMISSION WORKING GROUP ON 14 APRIL. THE COMMISSION WOULD RECONSIDER THIS ASPECT OF ITS PROPOSALS IN ABOUT A MONTH. IT WAS AT THAT MOMENT THAT ANY CHANGES OF DIRECTION WOULD BE DECIDED UPON. IT WAS HOWEVER CLEAR THAT THE CLEARING HOUSE HAD MANY OPPONENTS AND ONLY ONE SUPPORTER, GERMANY. SHE WAS PREPARED TO CONSIDER ANY CONSTRUCTIVE SOLUTION OR SUGGESTION: THE COMMISSION WAS

CONSIDERING THE IDEAS PUT FORWARD BY THE UK AND FRANCE. ANY SOLUTION MUST AVOID OVER CENTRALISATION AND EXCESS BUREAUCRACY. IT MUST BE SIMPLE AND CLEAR AND MUST BE PUT INTO PLACE QUICKLY TO ALLOW THE OTHER ISSUE OF FISCAL FRONTIERS AT THE END OF 1992. IT MUST INVOLVE THE ABOLITION OF ALL FISCAL CONTROLS AT INTRA-COMMUNITY FRONTIERS AND THE HARMONISATION OF VAT RATES.

VAT RATES

5. LEAVING ASIDE THE QUESTIONS OF PRINCIPLE RAISED BY THE UK AND LUXEMBOURG, VAT RATE APPROXIMATION RAISED TWO PROBLEMS: BUDGETARY COSTS FOR SOME MEMBER STATES AND THE ARRANGEMENTS FOR APPROXIMATION. THE MOST FRUITFUL WAY FORWARD MIGHT BE TO CONSIDER VAT RATES PRODUCT BY PRODUCT. THE COMMISSION WAS PREPARED TO DISCUSS THE WIDTH OF THE PROPOSED VAT RATE BANDS. A MINIMUM/NORMAL RATE (AND A MAXIMUM LOWER RATE) WAS A POSSIBLE SOLUTION.

6. THE COMMISSION WAS CONSCIOUS OF THE POLITICAL AND SOCIAL PROBLEMS WHICH WOULD BE INVOLVED IN ABOLISHING CERTAIN ZERO RATES IN THE UNITED KINGDOM. SHE WAS PREPARED TO FIND A SOLUTION THOUGH THE ONLY SOLUTION POSSIBLE APPEARED TO BE A DEROGATION (THE CIRCULATED VERSION OF HER SPEAKING NOTE IS UNCLEAR ON THIS POINT).

EXCISES

7. THE COMMISSION'S PROPOSALS FOR A SINGLE EXCISE RATE FOR EACH PROJECT WERE ACCEPTABLE NEITHER TO THE COUNCIL NOR THE PARLIAMENT. THE COMMISSION'S PROPOSALS MUST BE MADE MORE FLEXIBLE AND, FOR TOBACCO AND ALCOHOL, HEALTH CONSIDERATIONS MUST BE TAKEN INTO ACCOUNT. THE COMMISSION WAS STUDYING VARIOUS POSSIBILITIES. DIFFERENT CONSIDERATIONS APPLIED IN THE CASE OF TOBACCO AND ALCOHOL ON ONE HAND AND MINERAL OILS ON THE OTHER. RATE APPROXIMATION WAS PROBABLY NECESSARY FOR MINERAL OILS, WHERE LARGE RATE DIFFERENCES COULD AFFECT COMPETITION WITHIN THE COMMUNITY. FOR TOBACCO AND ALCOHOL, ACCOUNT MUST BE TAKEN OF REGIONAL DISPARITIES WITHIN THE COMMUNITY, PERHAPS BY MEANS OF RATE BANDS OR MINIMUM RATES. TO GUARD AGAINST TAX EVASION IN THE ABSENCE OF FRONTIER CONTROLS AND HARMONISED RATES, THERE SEEMED TO BE NO OTHER SOLUTION THAN TAX STAMPS OR 'BANDEROLLES'.

COREPER REACTIONS

8. THERE WAS A GENERAL WELCOME FOR THE FLEXIBLE AND REALISTIC APPROACH SHOWN BY MRS SCRIVENER. MOST AMBASSADORS ALSO REHEARSED BRIEFLY THE VIEWS EXPRESSED AT OUR BRAIN-STORMING SESSION ON 22 MARCH (TUR). THE MAIN OTHER CONTRIBUTIONS WERE AS FOLLOWS:
(A) WESTENDORP STRESSED THE NEED FOR THE COMMISSION RAPIDLY TO BRING

FORWARD ITS PROPOSAL ON LINKED BONDED WAREHOUSES, WHICH WOULD BE AN ESSENTIAL ELEMENT IN THE ARRANGEMENTS FINALLY AGREED.

(B) NIEMAN (NETHERLANDS) SAID THAT THE DUTCH ADMINISTRATION HAD BEEN VERY INTERESTED IN ELEMENTS IN OUR TECHNICAL PAPER.

(C) DE SCHOUTHEETE (BELGIUM) ADDUCED PRESIDENT DELORS' FAVOURITE DOCTRINE OF SUBSIDIARITY IN FAVOUR OF SETTING ONLY MINIMUM VAT RATES: THE COMMUNITY NEEDED TO SET MINIMUM RATES TO AVOID BEGGAR MY NEIGHBOUR FISCAL POLICIES BUT INDIVIDUAL MEMBER STATES SHOULD BE LEFT FREE TO DECIDE HOW FAR ABOVE THE MINIMA TO PITCH THEIR TAX RATES.

(D) CAMPBELL (IRELAND) HINTED HEAVILY THAT THE COMMISSION SHOULD CONSIDER PROPOSING COMPENSATION TO MEMBER STATES LIKE IRELAND TO WHOM TAX APPROXIMATION WOULD INVOLVE HEAVY REVENUE LOSSES.

9. I WELCOMED THE FLEXIBILITY WHICH MRS SCRIVENER HAD SHOWN ON THE VAT CORRECTION SYSTEM. WE ACCEPTED THAT THE OBJECTIVE MUST BE TO REMOVE FISCAL FRONTIER CONTROLS. WE THOUGHT THIS WAS BEST DONE BY AMALGAMATING CONTROLS ON INTRA-COMMUNITY TRADE WITH NORMAL INTERNAL VAT CHECKS. MRS SCRIVENER WAS QUITE RIGHT TO SAY THAT DECISIONS MUST BE TAKEN SOON IF THE TIMETABLE IN THE TREATY WERE TO BE EFFECTED. WE WERE SIMILARLY GRATEFUL FOR MRS SCRIVENER'S FLEXIBILITY ON ZERO RATES, A FUNDAMENTAL COMPONENT OF BRITISH SOCIAL AND FISCAL POLICY. THEIR RETENTION WOULD NOT LEAD TO A SIGNIFICANT DISTORTION OF COMPETITION THEY WOULD NOT ENDANGER ANY SUCCESSFUL COMPLETION OF THE INTERNAL MARKET: IT WOULD BE BEST TO AVOID THEOLOGICAL ISSUES SUCH AS WHETHER THEY WOULD BE REGARDED AS DEROGATIONS OR TEMPORARY. WE REMAINED UNCONVINCED OF THE CASE FOR VAT BANDS OR MINIMUM RATES. THE COMMUNITY COULD OPERATE PERFECTLY WELL WITHOUT LEGISLATION OF THIS SORT. AS FOR EXCISES, MRS SCRIVENER WAS AGAIN RIGHT TO RECOGNISE THE NEED FOR FLEXIBILITY AND THE IMPORTANCE OF HEALTH POLICY, BUT ON DOUBTFUL GROUND IN SUGGESTING THAT THERE MIGHT BE A CASE FOR SOME APPROXIMATION. OVERALL, IT WAS CLEAR THAT THIS DOSSIER WAS NOW ON THE MOVE: THE UK WOULD WORK HARD IN THE COMING MONTHS TO CONTRIBUTE TO REACHING AN AGREEMENT.

PROCEDURE

10. WESTENDORP SAID THAT THE PRESIDENCY WOULD REPORT TO THE 17 APRIL ECOFIN ON THE STATE OF WORK AND MAKE (UNSPECIFIED) PROCEDURAL SUGGESTIONS. MEANWHILE, THOSE DELEGATIONS WHO HAD PRODUCED PAPERS ON THE ABOLITION OF FISCAL FRONTIERS SHOULD CIRCULATE THEM TO COREPER TO PERMIT FURTHER DISCUSSION AFTER THE COUNCIL. LOUET (FRANCE), DE SCHOUTHEETE AND I SAID WE WOULD DO SO.

11. TEXT OF MRS SCRIVENER'S SPEAKING NOTE BY HAND OF WILMOTT

RESTRICTED



H.M. CUSTOMS AND EXCISE
DEPARTMENTAL PLANNING UNIT
NEW KING'S BEAM HOUSE, 22 UPPER GROUND
LONDON SG1 9PJ

01-620 1313 Ext 5023

FROM: P R H ALLEN
DEPARTMENTAL PLANNING UNIT

DATE: 7 April 1989

*Ch. content for pp. 5
be circ'd under enclosed
cover note?*

2/4 Cont.

CHANCELLOR

INDIRECT TAXATION IN THE SINGLE MARKET: DEVELOPMENTS AT COREPER

I understand that the Chairman briefed you yesterday on Mme Scrivener's address to Coreper, in which she outlined some extremely welcome changes in her thinking, notably in relation to the VAT clearing house and harmonisation of excise duties. This note considers two questions (a) public presentation and (b) a Presidency request to submit to Coreper papers on how fiscal frontiers should be removed.

(a) Public Presentation

2. Proceedings at Coreper are confidential, which of course rules out public quotation of what is said at Coreper meetings. Moreover, Madame Scrivener made it clear that she was speaking informally - in other words, her remarks have yet to be built into an official Commission position. Mr Knudsen of the Commission,

Circulation: PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Mr Scholar
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Bush
Mr Lankester
Mr R I G Allen
Mr Culpin
Mr Gilhooly
Mr Gieve
Ms Symes
Mr Michie
Mr Isaac IR

CPS
Mr Jefferson Smith
Mr Wilmott
Mr Knox
Mr Oxenford
Mr Norgrove UKREP

who is speaking at the IFS conference, was at pains to underline this point in conversation with Mr Jefferson Smith: early publicity of unofficial remarks at a confidential meeting would be regarded as both unworthy and unhelpful.

3. Things are obviously moving in the UK's direction at present. But it is equally clear that matters are at a very sensitive stage. Most important, it is crucial that in the weeks ahead Mme Scrivener should be able to carry the rest of the Commission with her, so that the sort of flexibility shown at Coreper becomes embodied in the official Commission position. That has not yet happened.

4. We would therefore advise very strongly against publicising Madame Scrivener's remarks at this stage. Sir David Hannay has also confirmed that he would advise against premature publicity. To do so would not only contravene the rules of Coreper, it would also risk stifling the infant at birth. To jump the gun just as things are beginning to move decisively our way could prove very counter productive indeed.

5. That said, the opportunity for publicity should not be long delayed; we expect reasonably early public clarification of the Commission's position. When that happens, we can be ready with our response.

(b) Submission of a paper to Coreper

6. The other development at Coreper was a request by the Presidency for Member States to submit written views on the way ahead as regards tax approximation and fiscal frontiers. These would be discussed at a forthcoming Coreper meeting as a first step in the consideration of alternative approaches. This was, at least in part, an offer for the UK and France formally to circulate their "technical" papers to Coreper.

7. The UK view is, of course, well established; but we welcome the opportunity to provide the Customs technical paper as a contribution to discussions, together with an introductory explanatory note. In this note we have aimed to maintain the technical status of the Customs paper in line with what was said in your note of 22 February to the Prime Minister. The attached draft has already been cleared at official level by FCO, Treasury, Cabinet Office and UKREP, and, as it reflects agreed policy, we see no need for it to be cleared with your colleagues. We need to submit the paper early next week and I would be most grateful for early confirmation that you are content for us to proceed on this basis.

RA.

P R H ALLEN

**INDIRECT TAXATION IN THE SINGLE MARKET: UNITED KINGDOM VIEWS ON
THE STEPS NECESSARY FOR PROGRESS**

1. The United Kingdom's views on indirect taxation and the removal of fiscal barriers have already been explained in two papers. First, in September 1988, the Chancellor of the Exchequer sent to his Community colleagues a paper explaining why the United Kingdom considers centrally-determined tax approximation to be unnecessary for the completion of the single market; and outlining an alternative, practical approach to the frontiers question. Second, in March this year, the Chairman of HM Customs and Excise sent to his Community colleagues an informal technical paper which, basing itself on the concepts introduced by the Chancellor, described a possible mechanism by which fiscal frontier controls between member states could be abolished. This paper, which is offered as a starting point in discussions, is attached.

2. The essential features of the UK position are as follows:
 - i) Centrally-determined tax approximation is unnecessary for the completion of the single market. Moreover, discussions to date have demonstrated that tax approximation, combined with an origin system for VAT and a clearing mechanism, does not offer the prospect of the removal of fiscal frontiers by 1 January 1993.

 - ii) Urgent discussions are required to identify and agree

mechanisms by which fiscal frontier controls can be removed within an acceptable timescale.

3. The attached technical paper describes such a mechanism. Its main elements are:

- i) Retention of the destination principle for VAT, which does not distort competition and which does not require a clearing mechanism.
- ii) For freight, no fiscal checks at frontiers. Controls to be based on existing domestic arrangements (using audit-type checks of traders' accounts), with VAT-registered traders accounting for supplies from other Member States as part of their normal VAT procedures.
- iii) Similar arrangements, building on domestic procedures, to apply to goods subject to excise duties - but with additional measures reflecting the generally wider variations in duty levels, such as accompanying documentation or identification of duty payment by fiscal stamps or banderoles.
- iv) For individual travellers, no limits on tax-paid purchases (to be brought about by progressive increases in the allowances). Duty paid allowances for alcohol and tobacco should be increased, but it may not be possible to abolish them entirely on health grounds.

4. These ideas are intended as a constructive contribution to the emerging debate within the Community about the most effective way to remove fiscal frontier controls. We recognise that member states have varying needs and difficulties; and that other ideas have been and will be put forward. We look forward to discussions which lead quickly to a solution acceptable to all.



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PLEASE NOTE EMBARGO

NOT FOR PUBLICATION, BROADCAST OR USE
ON CLUB TAPES BEFORE 20.00 HOURS (BST)
ON 7 APRIL, 1989

7 April 1989

DISPELLING MYTHS ABOUT UK APPROACH TO FISCAL FRONTIER CHECKS POST - 1992

Speaking in Oxford at an Institute for Fiscal Studies conference on the single market, the Paymaster General, the Rt Hon Peter Brooke, today clarified the United Kingdom's position on the question of controls at EC frontiers post - 1992.

Mr Brooke said one myth to be dispelled was that the UK wanted to retain existing tax-related frontier checks on goods and people crossing frontiers within the EC. That simply wasn't true. The UK believed that fiscal frontier checks can be abolished and that this should be done without recourse to the European Commission's proposals for the harmonisation or approximation of VAT and excise duties. The twin themes of the UK approach were the avoidance of over-regulation and the need to concentrate on practical, achievable solutions.

Mr Brooke explained:

"there may well be some misunderstanding because of the UK's insistence on retaining preventive frontier controls. We have made it clear that the UK cannot remove existing frontier controls against terrorism and arms and drug smuggling until the Community's external frontier provides us with protection that is at least as effective. But the retention of preventive controls at UK frontiers does not mean that we intend Customs staff to carry out fiscal checks".

Mr Brooke pointed out that the Commission's proposals did not offer a realistic way forward:-

"Centrally imposed tax approximation is inappropriate. Tax structures in different member states reflect differing economies and differing social and political priorities. These cannot suddenly be "averaged"; the results would almost certainly be unsuitable for individual members states and would be extremely difficult to change once agreed."

Mr Brooke said that Customs and Excise had drawn up technical proposals aimed at abolishing fiscal frontier controls without centrally-dictated tax harmonisation. Their initial findings, which had been sent to customs administrations in other member states and to Commission officials, demonstrated that such an approach was technically feasible. The only exceptions would be for alcohol and tobacco, where health considerations meant that some checks might continue to be necessary.

Mr Brooke said:-

"We hope that other member states will look at our technical proposals in an open spirit. They are not a rigid blueprint, but are intended as a contribution to the debate. Our concern is to open up discussions in Brussels so that the Community concentrates on practical and achievable measures to obtain the objectives of the Single Market. Already we see a clear indication that others accept the need for a fundamental rethink of the initial approach."

Press Office
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Parliament Street
LONDON SW1 3AG

34/89

NOTE TO EDITORS

The Chancellor of the Exchequer set out his ideas for an alternative, market-based approach to indirect taxation in the single market in a paper which he sent to his EC colleagues in September 1988 (See Press Notice 74/88, 8 September 1988). Basing themselves on this general approach, Customs and Excise have developed practical proposals which would remove fiscal controls at frontiers within the EC without the need for the harmonisation or approximation of indirect tax rates. A paper outlining these proposals has been sent to other EC customs administrations and to Commission officials.

2. The Customs approach maintains the existing system whereby exports are relieved of tax (the "destination system"). Goods from the EC would pass straight through UK points of entry without stopping except for preventive checks for drugs etc. VAT-registered traders would account for supplies made to or received from other EC countries as part of their normal VAT accounting and payment procedures.

3. Customs checks would be similar to the audit-type checks of traders' accounts currently carried out in relation to domestic activities. Similar arrangements would apply to traders importing or exporting goods subject to excise duties.

4. Because the Customs approach retains the existing "destination system", it removes the need for the complex and bureaucratic "clearing house" arrangement which is a central feature of the Commission's proposals.

5. Private individuals travelling from other EC countries would be allowed to bring in unlimited quantities of goods bought VAT-paid. This would also apply for goods subject to the excise duties on hydrocarbon oils (eg petrol). However, health considerations mean it would be inappropriate to allow unlimited imports of alcohol or tobacco from other member states, where duty rates are often far lower than in the UK. The Customs paper suggests that some limits on personal allowances for these goods might have to be retained, albeit at a higher level than at present.

6. Customs and Excise officials are engaged in a series of bilateral discussions with their opposite numbers in other member states. UK ministers and officials will explain the UK approach at Community meetings.



FROM: J M G TAYLOR
DATE: 10 April 1989

pmf

MR P R H ALLEN

- cc PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Lankester
Mr Scholar
Mr R I G Allen
Mr Culpin
Mr Gilhooly
Mr Gieve
Ms Symes
Mr Michie
Mr Bush
Mrs Chaplin
Mr Tyrie
Mr Call
- Mr Isaac - IR
- Mr Unwin - C&E
Mr Jefferson Smith - C&E
Mr Wilmott - C&E
- Mr Norgrove - UKREP

pmf

INDIRECT TAXATION IN THE SINGLE MARKET: DEVELOPMENTS AT COREPER

The Chancellor was grateful for your note of 7 April. He is content for the UK paper to be circulated under the proposed cover note.

J

J M G TAYLOR



Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

Handwritten notes:
 1. Make OK.
 2. Set 2 querr - Annex 2
 3. Annex 2

Handwritten note:
 Ch. I am not attaching previous pp., in the interests of brevity. Agree with Mr I's concl. (which seems sensible) that at this stage we stick to the first option: fundamental objections of principle, practical difficulties; but not closing off explicitly all future options? 28. 10/4

FROM: A J G ISAAC
10 April 1989

CHANCELLOR OF THE EXCHEQUER

WITHHOLDING TAX ON SAVINGS: ECOFIN DISCUSSION ON 17 APRIL

1. As you know, EcoFin on 17 April will be considering (inter alia) a report from the Chairman of the Ad Hoc Group on Taxation of Savings, discussing the two draft directives on withholding tax and mutual assistance.

DISCUSSIONS IN THE AD HOC GROUP

2. I do not think that I need to trouble you again in this note with the details. Briefly, the Spanish Chairman's report - though (as we predicted) it tends to exaggerate the degree of support for the Commission's proposals - conveys the three essential messages:

cc Chief Secretary
 Financial Secretary
 Economic Secretary
 Paymaster General
 Sir P Middleton
 Sir T Burns
 Mr Scholar
 Mr Lankester
 Mr Odling Smee
 Mr Ilett
 Mrs Brown
 Mrs Chaplin
 Mr Tyrie

Sir A Battishill
 Mr Isaac
 Mr Painter
 Mr Beighton
 Mr Corlett
 Mr Houghton
 Mr McGivern
 Mr Bush
 Mr O'Connor
 Mr Sullivan
 Mr Weeden
 PS/IR

Mr Bostock (UKREP Brussels)

- The Ad Hoc Group has discussed the details expressly without prejudice to the general reserve which Ministers have entered on both the withholding tax directive and the mutual assistance directive.
- The UK, Netherlands and Luxembourg delegations have expressed fundamental objections to the withholding tax directive.
- We and most other delegations have also registered a large number of technical points, affecting virtually every Article of the draft withholding tax directive, where we see greater or lesser practical difficulties.

The Chairman's report will be before EcoFin, together (we understand) with a copy of the note summarising the UK's views, in the form approved by you before Easter.

3. In the Ad Hoc Group, so far, we have been careful to take up a position which leaves you every possible flexibility. That is:

(a) We have put on record that Ministers have "fundamental objections" to the proposed directive; and

(b) we have (as I have said) drawn attention to a number of detailed aspects where the directive would be misguided, ineffective, or cause unacceptable damage to Community financial markets;

(c) we have been careful not to respond to suggestions that we name the conditions (if any) on which Ministers would be prepared to go along with a revised draft directive. We have said that the question whether or not to proceed with any directive must be for political decision by Ministers in the light of all the relevant factors.

OPTIONS FOR 17 APRIL

4. Against this background you will wish to consider what

course to take at the meeting on 17 April; and what "steer" the Council should give to further work (if any).

5. Consistently with everything that officials have said so far, you could oppose the draft directive - concentrating on the damage that the present draft would cause - whilst dismissing as "hypothetical" any question whether the UK could go along with some "acceptably" revised compromise, if at some future point this seemed to be expedient as part of a broader political package (the first option). Or you could register a UK determination to veto any idea of any directive on withholding tax, however radically it might be revised to meet our "technical" points (the second option). Or you could indicate a willingness to accept fairly specific compromise proposals, if the directive were revised to remove its most damaging features (the third option).

The first option

6. One approach would be to follow much the same approach as officials have done so far in the Ad Hoc Group. That is, to indicate fundamental objections of principle, to indicate practical difficulties, but not explicitly to close off all future options. For what it is worth, I (and I think the official Treasury) see attractions in holding this line for the time being. Sooner or later, we may come under pressure on the question at 3(c) above. For the time being, however, it is still possible to brush this question aside as hypothetical - something that cannot sensibly be answered until much more work has been done by officials. I do not think that anything has yet happened which may force UK Ministers to put many of your cards on the table yet, if you do not wish to do so for your own reasons.

7. Consistently with this option, officials would presumably continue to play a full part in the promised (threatened) further meetings of the Ad Hoc Group.

8. The other two options entail developing a more or less open response to the question at 3(c), in one sense or the other.

The second option

9. A second approach might thus move in the direction of a firm declaration in EcoFin, to the effect that there are no possible conditions under which the UK would accept a withholding tax directive - even if the directive were revised so as to impose effectively no new burdens on British financial institutions or UK administration.

10. The main argument for this approach is perhaps that, if the Council of Ministers ever adopted a directive in this area - even if its original form was "acceptable" to UK interests - the point of principle would have been accepted; and we should come under subsequent pressure to tighten up the directive, stop up alleged "loopholes", and of course to accept other EC directives for harmonising other parts of the direct tax system. A firm and clear UK veto at this stage could cut off this threat (and incidentally release us from the need to put more resources into future meetings of the Ad Hoc Group).

11. In earlier discussion,^{*} however, you have indicated to us (although not publicly) that you might in due course be prepared to accept some compromise withholding tax directive, revised to minimise any cost to London as an international financial centre, if that became expedient in the context of some future wider

* By the same token, you earlier agreed that the UK could accept the draft directives on mergers and on parent/subsidiaries - the heart of the so-called "French package" - provided that these were amended to ensure that they represented no practical threat to the UK interests, and in particular that we secured a satisfactory definition of "withholding tax" (Mr Taylor's note of 11 November 1988). With your agreement, officials have not sought to argue that a Community directive in the field of direct taxation is necessarily unacceptable per se.

package negotiated with the French. On the face of it, this "second option" would inhibit or rule out that future flexibility.

12. In its nature, an approach of this kind would be likely to be seen as aggressively non-"Communautaire" by other Community countries. Whereas now we have a good deal of quiet and some open support on the withholding tax directive, we should be likely to find ourselves politically isolated. Given that it is far from certain yet whether an "acceptable" directive is in fact negotiable (paragraph 15), you may think it premature to volunteer so controversial an answer to a question which may never arise.

The third option

13. Finally, if only for completeness, there is a third possible approach which would entail the UK moving in the direction of indicating that you would be prepared at least to consider a directive on withholding tax, provided the thing could be revised to minimise any cost to London - for example provided it did not do much more than require us to extend to other Community residents something equivalent to our present withholding tax (composite rate tax) on bank and building society deposits by UK residents - and of course to retain our present withholding tax (basic rate) on many gilts and corporate bonds - in a way that did not impose any undue compliance burden on the UK markets or on our own administration. In effect, our price for reaching an agreement would be for the directive to reflect (at a minimum) all the points and concerns we have raised, or will need to raise, at the Ministerial and official meetings and in our written submissions.

14. The advantages and disadvantages of this approach are very much the reverse of those in the second approach.

Possibility of an acceptable compromise

15. In weighing up the options it may be helpful to take a first speculative look at the possibility of negotiating a compromise - that is, a directive revised so as to be acceptable to UK banking and other financial interests, and not to impose unacceptable costs on the UK's administration. Some of the broad implications of some possible options are discussed in the annex. For what it is worth, my judgment at the moment is that, if Ministers were prepared to accept a compromise, something towards the more acceptable end of the outcomes in the annex would possibly be negotiable. I say "possibly". It would be silly to promise certainty. As we expected, the Ad Hoc Group exposed many technical weaknesses in the Commission's present draft, and wide differences of policy between national delegations. Much turns on whether the French would in the last resort be prepared to accept a gesture falling well short of their ambitions, if the alternative is no agreement at all. And I have to say that the French (and the Commission) might not find it very easy to live with the fairly narrow terms on which we could even extend composite rate to EC residents. Having said that, however, I myself would rate the chances at this stage as probably a little (but only a little) better than even of getting agreement on a directive the present terms of which would not cause major practical difficulties to the UK. For example, we have already had feelers from both the Belgians (virtually asking us to name our price) and the Danes.

16. But, though we can of course veto any directive that does not meet our needs, there remains the risk that other countries would seek to raise the price of agreement against us, if ever we indicated that we were in principle willing to negotiate. One obvious possibility is pressure to raise the present CRT threshold of £50,000, taking us closer to the "wholesale" dimension. And beyond that there remains the risk, already discussed, that, once a directive existed - even if in an "acceptable" original shape - we should be exposed to subsequent pressures to tighten it up and extend it.

CONCLUSION

17. EcoFin on 17 April will discuss the report from the Spanish Chairman of the Ad Hoc Group, and I imagine the Council will be asked to give some general "steer" to the Group's future work. Sooner or later, the UK may come under serious pressure to say whether there are any terms on which we could accept a withholding tax directive. Subject, however, to any unexpected late developments in Coreper or elsewhere, officials do not think that we have reached that point yet. Our recommendation is that it remains possible to maintain the line that the UK has taken in the earlier Council and Ad Hoc Group, and on balance we see this - the first option - as the most attractive course at this stage.

18. This note has been seen in draft by ^{as the Annex drafted by} Treasury officials.

C. J. E. R.

A J G ISAAC

WITHHOLDING TAX: RANGE OF POSSIBLE OUTCOMES

1. Existing UK System

- Characteristics: - existing UK system
- Advantages: - no changes to Revenue or banks' systems;
- no concession of principle in this area; full flexibility for the future.
- Disadvantages: - loss of bargaining counter; some political cost in "communautaire" sense.

2. Commission proposal sanitised to meet UK system - (ie CRT system extended on Community-wide basis).

- Characteristics: - Commission proposal amended as follows.
- deposits above £50,000 - £100,000. CRT ceiling exempt.
 - non-residence of the Community certifiable by depositor or his agent;
 - short-term deposits (less than 7 days), money market instruments, deep discounts exempted;
 - no compulsory refunds with member States accepting that the provision for nil rates in our double taxation treaties no longer applies to deposit interest;
 - tax to be paid to host state;
 - sensible timetable for introduction (ie 1991 or 1992).
- Advantages: - wholesale markets protected;
- political brownie points in Community context;
- What? ??* - possibility of something worth having in exchange.
- Disadvantages - cost to banks of systems changes;
- banks need to ask whether UK, Community or third country resident;

*push
not under
below CRT
CRT*

1

- loss of deposits from some EC and maybe third country residents, given extra formalities, uncertainties etc;
- so many more holes in proposal that its proponents might think it no longer worthwhile;
- if the provisions of our treaties with most member States are to remain as at present, we should have to refund the tax on receipt of valid claims.

3. Commission proposal amended in UK direction

Characteristics: - Commission proposal amended to include some exemptions in 2 above but not all.

Advantages: - might command a higher price in terms of quid pro quo.

Disadvantages: - depends on content. A very high CRT cut-off would discourage third country investors and push UK and EC deposits offshore, eg to the Channel Islands. *or further*
Strict requirements to check the status of depositors or to ensure that a non-Community resident was not acting on behalf of or as nominee for a Community resident would be strongly resisted by banks. Even a simple certification procedure accepted at face value would add to costs. Any suggestion of including depositors other than individuals would involve further complications. Nevertheless such provisions would arguably do less harm than insistence that the tax treatment of money market instruments, deep discounts etc should depend on the tax and/or residential status of the beneficial owner, which would seriously damage the financial markets, raise costs to their users etc.

4. Present Commission proposal

Characteristics: - present proposals.

Advantages: - maybe better quid pro quo.

Disadvantages: - substantial loss of political face: extra costs to banks, significant damage to financial markets, higher costs to users etc.

5. Tougher Commission proposals

Characteristics: - present proposals minus eurobond exemption and with unhelpful clarification of ambiguities, eg duty of banks to identify beneficial owners, modalities for taxing deep discounts, general move towards French principle of using regulation to direct savings into instruments convenient to the taxman.

Advantages: - maybe better quid pro quo.

Disadvantages: - as 4 but worse, notably through loss of eurobond market to third countries. Immediate serious disruption to eurobond market with losses to investors and issuers.

Comment on acceptability

From the point of view of the costs to the financial system and the Inland Revenue, 2 is probably acceptable; 4 and 5 are not. Whether something in between was acceptable or not would depend on exactly how it was defined and, of course, on what concessions might be obtained in return.



Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

*Thanks
Enclosure*

FROM: A J G ISAAC
11 April 1989

CHANCELLOR OF THE EXCHEQUER

OXFORD CONFERENCE: 7 AND 8 APRIL: HARMONISATION

1. As you know, Mr Jefferson Smith and I both spoke (on lines approved by Ministers) at last weekend's Oxford Conference on Harmonisation of the Direct and Indirect Taxes within the European Community. This note reports our joint assessment.
2. As a whole, the Conference went rather well. So far as we can judge, our contributions were well received. More important, we found - and were able to develop - a good deal of support for the Government's line, that the best approach to the European Single Market is in general likely to be through freeing market forces, rather than through formal harmonisation of tax rules.
3. In particular, the application of these principles to indirect taxation, set out in the Paymaster General's speech, met with approval. More generally, there was a good deal of

PN behind

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Lankester
Mr Culpin
Mr Odling-Smee
Mr Ilett
Mrs Chaplin
Mr Ritchie
Mr Jefferson Smith
(Customs)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Houghton
Mr McGivern
Mr Corlett
Mr Bryce
Mr Keith
Mr O'Connor
PS/IR

acceptance of our point that tax cannot be considered in isolation from the wider fiscal, economic, social and political environment; and that the European Community cannot prosper in isolation from wider world markets.

4. Inevitably, some (including of course the Commission spokesman) ran the academic argument that formal harmonisation was essential to prevent distortion of capital movements. But perhaps the most encouraging thing from the Conference was that, whilst at the beginning others who challenged this view felt that they were being "controversial", by the end of the two days the market approach commanded very significant support and may even perhaps have become the majority view.

5. Indeed, a participant from the CBI told us that the discussions at the Conference had caused him to change his view and he no longer believes that something like the Commission's proposals were probably necessary. Indeed in the light of discussions, he thought they could be positively damaging to European economies.

DIRECT TAXES

6. On the direct taxes, two points of detail and one more substantial point are perhaps worth picking out.

7. First, the more detailed points.

- The Commission spokesman set out a pretty ambitious programme for harmonisation directives by 1992. More realistically, however, he seemed to put top priority on the draft directives on mergers and parent/subsidiaries, where most of the technical problems have now been ironed out.
- A number of people at the Conference expressed more or less anxiety about the withholding tax directive, and

the short timetable (June this year) set for decision. I explained the UK position on familiar lines.

8. The main problem of substance arose on relief for double taxation. As expected, even those who supported the market approach generally tended to argue that imputation relief (tax credits) should apply to dividends paid not just out of UK profits, but also out of profits earned abroad. Otherwise, the tax system would continue to discriminate in favour of domestic investment, as opposed to investment elsewhere in the Community. Within this debate, differences of emphasis emerged on whether

- if relief were given, it should be confined to Europe, or extend worldwide;
- the UK should give relief unilaterally, or should any movement depend on reciprocity with other countries (given that no other major country credits foreign corporation tax against the income tax liability of its own domestic taxpayers);
- the cost of such relief should be borne by the country of source (where corporation tax was charged) or the country of residence of the shareholder (where income tax was charged);
- the advantages of the change would outweigh the costs (and implicit increase in the CT rate). One group argued that market forces could only work properly if the tax credit were to be paid to non-resident shareholders; and indeed that if this was done, market forces would then be enough to secure whatever degree of tax convergence was necessary for the operation of the Single Market.

In the margins of the Conference there was a good deal of talk about some recent arrangements seeking to get round the "ACT prejudice" problem through stapled stock and similar devices. We

shall be reporting separately on some recent developments in this field when we have completed some research which we have under way.

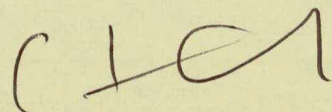
INDIRECT TAXES

9. Debate on indirect taxes was generally less detailed, and on the Customs and Excise technical proposals, less well informed. This is because most of those attending were fiscal experts, many of them well versed in the legal and economic aspects of indirect taxation, but less expert on the detailed machinery. But there was a general welcome for our anti-regulatory approach and our initiatives in promoting the alternatives to harmonisation. No-one quarrelled with Mr Jefferson Smith's analysis, based on the history of the last thirty years, that the Cockfield approach was leading to a dead end.

10. On the Customs technical approach, there were two reservations worth noting:

- If we move fiscal controls inland while keeping preventive controls at the border, the total compliance burden must not be greater than it is now.
- Customs effectiveness in relation to drugs must not be weakened.

11. Mr Jefferson Smith made it clear that both are points which the Government takes very seriously, and expressed vigorously our determination to keep the preventive controls which protect our society.



A J G ISAAC



FROM: J M G TAYLOR

DATE: 11 April 1989

MR ISAAC - INLAND REVENUE

6/14/89

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Lankester
Mr Odling-Smee
Mr Ilett
Mrs Brown
Ms Symes
Mrs Chaplin
Mr Tyrie

Mr Bostock
(UKREP Brussels)

Sir A Battishill
PS/IR

WITHHOLDING TAX ON SAVINGS: ECOFIN DISCUSSION ON 17 APRIL

The Chancellor was grateful for your note of 10 April. He agrees with your recommendation that he should stick to the "first option" at ECOFIN on 17 April - ie that he should indicate fundamental objections of principle to the Commission's proposals and that we also see practical difficulties; but that he should not close off explicitly all future options. He would be grateful if briefing could be prepared (in the usual format) on this basis.

2. The Chancellor had two comments on the second outcome described in the annex (Commission proposal sanitised to meet UK system). First, he wondered what was in mind as the "something worth having in exchange" (described as the third advantage of this outcome). Second, he noted that the second disadvantage was



that banks would need to ask whether depositors were UK, Community or third country residents. He presumes that this would only be the case if the depositors were below the CRT ceiling. I should be grateful for advice on these points.

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

J M G TAYLOR



CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

My thanks. Re X, I was concerned we were ~~not~~ compliance with UK Savings (this) but with the monthly sum of £1000. I declare that I need not be ~~at~~ all that ~~troubled~~ at stage.

FROM: A J G ISAAC
12 April 1989

CHANCELLOR OF THE EXCHEQUER

WITHHOLDING TAX ON SAVINGS: ECOFIN DISCUSSION ON 17 APRIL

1. I am grateful for your Private Secretary's note of 11 April.
2. We have set in hand accordingly briefing in the usual form on
 - (a) withholding tax and
 - (b) mutual assistance.
3. I have discussed with official Treasury (Mr Ilett) your first question in paragraph 2 ("something worth having in exchange"). They are letting you have an answer direct.
4. Your second question was about the compliance burden on UK banks needing to ask whether depositors were UK, Community or

X |

cc Chief Secretary
 Financial Secretary
 Paymaster General
 Economic Secretary
 Sir P Middleton
 Mr Scholar
 Mr Lankester
 Mr Culpin
 Mr Odling-Smee
 Mr Ilett
 Mrs Chaplin
 Mr Ritchie

Sir A Battishill
 Mr Isaac
 Mr Painter
 Mr Houghton
 Mr McGivern
 Mr Corlett
 Mr Bryce
 Mr Keith
 Mr O'Connor
 PS/IR

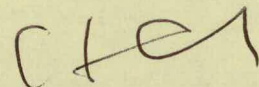
Mr Deacon

Mr Jefferson Smith
(Customs)

third country residents. You asked whether this compliance burden would arise only in the case where depositors were below the CRT ceiling. The short answer is "yes, provided that they have a switch into time deposits, or CDs. (There is of course no CRT ceiling or other deposits.)

5. Out of (I hope not excessive) caution, I should perhaps add that this greatly - even crucially - reduces the problem; but I think the banks would say that it does not remove it altogether. First, there would still be a lot of people and large sums of money at issue (I said in my earlier note that one single clearing bank in the UK is believed to have deposits from EC individuals totalling some £350 million; a chunk of this could come within the CRT ceiling and some of this business would be lost to the UK accordingly). Second, the banks would say that they would be even less able to test the credibility of a statement that a depositor was, or was not, a resident of another EC member State, than at present they are able to test the credibility of a statement that a depositor is or is not a UK resident. (Each member country has its own rules, differing significantly at the margin. The UK clearing bank may have at least a fair idea of the general thrust of the UK rules - even if it has no information on the actual circumstances of the individual depositor. It may not have quite the same clear view even of the rules in France, Luxembourg, Portugal and Italy.)

6. By the same token, if the time ever comes when you want us to move into negotiating mode, I think that both the banks and we (for our own administrative reasons) might well want to explore the possibility of widening somewhat the conditions (as compared with those suggested in the present draft directive) under which interest could continue to be paid gross to EC residents. One possibility might be to link this with the Danish proposal (under which the national authorities of the country in which the depositor is resident could require him to authorise the bank holding his deposit to disclose his financial affairs). But we do not need to trouble you with this for the time being.





FROM: J M G TAYLOR
DATE: 13 April 1989

MR ISAAC - Inland Revenue

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Lankester
Mr Culpin
Mr Odling-Smee
Mr Ilett
Mr Ritchie
Mrs Chaplin

Mr Jefferson Smith - C&E

Sir A Battishill - IR
PS/IR

WITHHOLDING TAX ON SAVINGS: ECOFIN DISCUSSION ON 17 APRIL

The Chancellor was most grateful for your note of 12 April.

2. He has commented that his principal concern, with the requirement that banks would need to ask whether depositors were UK, Community or third country residents, is not the compliance burden on the banks - though that is a factor - but the unwillingness of the depositor to declare himself. But he agrees that, as you say, all that need not be thrashed out at this stage.

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

J M G TAYLOR

FROM: N J ILETT (FIM2)

DATE: 13 APRIL 1989

EXT: 5549

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Lankester
Mr Odling-Smee
Mr Peretz
Mrs Brown
Ms Symes
Mrs Chaplin
Mr Tyrie

Sir A Battishill (IR)
Mr Isaac IR
PS/IR

Mr Unwin C&E
PS/C&E

Mr Bostock UKREP
Brussels

Marks

WITHHOLDING TAX : ECOFIN DISCUSSION ON 17 APRIL

Mr Taylor's minute of 11 April asks what was in mind as the "something worth having in exchange", which was listed in the Annex to Mr Isaac's submission of 10 April as a possible advantage should the UK accept the Commission proposal sanitised to meet the UK system.

2. I had two general thoughts in mind; a concession by the Commission/French in the indirect tax area, or just possibly something on the monetary front. These are very vague at this stage; just the idea that if we make a concession on something which other people appear to want very badly we should do our best to get something in exchange.

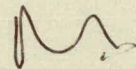
3. Mme Scrivener has herself floated the idea of a package covering both the withholding tax and VAT, as I have already reported. That might also fit French priorities. Whether we need a bargaining counter on indirect tax, or could buy much with this

CONFIDENTIAL

particular counter, would of course depend on timing and other circumstances. It is conceivable that we would not have any opportunity to use a bargaining counter even if we were prepared to do so.

4. On the monetary front, there are some who believe that a concession on the withholding tax could buy some easing of French pressures for EMU, either some movement towards our position on concrete points yet to emerge or, possibly more likely, an understanding that pressure on us would be relaxed for a time. At this stage this is even woollier than the prospect of a deal on indirect tax.

5. The Inland Revenue have responded separately on your second question.



N J ILETT



FROM: J M G TAYLOR
DATE: 14 APRIL 1989

A large, stylized handwritten signature in dark ink, likely belonging to J M G Taylor.

MR ISAAC IR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Lankester
Mr Culpin
Mr Odling-Smee
Mr Ilett
Mrs Chaplin
Mr Ritchie

Mr Jefferson Smith
(Customs)

Sir A Battishill IR
Mr Painter IR
Mr Houghton IR
Mr McGivern IR
Mr Corlett IR
PS/IR

OXFORD CONFERENCE: 7 AND 8 APRIL: HARMONISATION

The Chancellor was grateful for your note of 11 April. He shares your view that the responses of participants at this Conference to our views seem encouraging.

A smaller handwritten signature in dark ink, likely belonging to J M G Taylor.

J M G TAYLOR



FROM: J M G TAYLOR
DATE: 14 APRIL 1989

A large, stylized handwritten signature in the top right corner of the page.

MR ILETT (FIM2)

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Lankester
Mr Odling-Smee
Mr Peretz
Mrs Brown
Ms Symes
Mrs Chaplin
Mr Tyrie

Sir A Battishill (IR)
Mr Isaac IR
PS/IR

Mr Unwin C&E
PS/C&E

Mr Bostock UKREP
Brussels

WITHHOLDING TAX: ECOFIN DISCUSSION ON 17 APRIL

The Chancellor was grateful for your note of 13 April.

Handwritten initials, possibly 'JMGT', in the bottom right area of the page.

J M G TAYLOR

M. Allan - 12/2

[Handwritten scribble]

MORNING PRESS

INTERNATIONAL MONETARY FUND FRIDAY, April 14/89 DA EXTERNAL RELATIONS DEPARTMENT

U.S. FEBRUARY TRADE DEFICIT \$10.5B AFTER \$8.7B IN JANUARY. AP-DJ reported from Washington that the U.S. February trade deficit was \$10.5B after \$8.68B in January (revised from \$9.49B originally estimated). The U.S. producer price index rose 0.4% in March after 1% in February.

DOLLAR DRIFTS AFTER TRADE, PRICE FIGURES. News agencies reported that the U.S. dollar drifted in cautious exchange markets, after the announcement of a higher U.S. February trade deficit and lower March wholesale price inflation. Dealers said the figures were much in line with expectations. Exchange rates: German mark 1.8750 (1.8720), yen 132.45 (132.80), sterling \$1.6935 (1.6965), French franc 6.3425, Swiss franc 1.6530, and Canadian dollar 84.09c. Gold fell \$1.70 to \$388.50. The SDR was \$1.29657 (1.29815).

U.S. BUDGET NEGOTIATORS REACH TENTATIVE AGREEMENT ON \$30B DEFICIT CUT. AP-DJ reported from Washington that U.S. Administration and Congressional negotiators reached tentative agreement on nearly \$30B of budget deficit cuts, that minimally meets next year's legal targets while putting off tough choices until later. A White House meeting is scheduled for today so President George Bush and Congressional leaders can review and announce the compromise. The fiscal 1990 deficit would be cut to about \$99.2B from an estimated \$163B in the current fiscal year, meeting the \$100B legal requirement. About half the reduction would come from a combination of increased revenues, sources said. Details remain to be worked out.

MURAYAMA SAYS PACE OF TRADE IMBALANCE REDUCTION HAS SLOWED. Kyodo reported from Tokyo that Japanese Finance Minister Tatsuo Murayama told newsmen he is concerned with a 4% rise in Japan's fiscal 1988 trade surplus, acknowledged that the pace of correcting trade imbalances has slowed, and added that major industrial countries seem more concerned about fighting inflationary pressures than correcting these imbalances. He cited Germany as an example. WSJ, pA11, said Japan's March trade surplus with the U.S. rose sharply, despite a decline in the overall surplus. Economists said the overall contraction belied the fundamental pattern in Japan's trade, and that the overall surplus is likely to resume its growth.

GERMAN CABINET RESHUFFLE OVERSHADOWED BY FRESH CONFUSION. Ldn Fin Times, p1, said in a Bonn report that a German Cabinet reshuffle designed to stem a tide of setbacks to the ruling center/right coalition and to improve handling of controversial defense and immigration issues was immediately overshadowed by fresh confusions over key aspects of tax and nuclear energy policies. Chancellor Helmut Kohl's decision to change the Defense, Finance and Interior Ministers plus five other less important portfolios was the most important reshaping of the Government since it took office in Oct 1982. NYT, pA10, said the scope and content of the changes were evidence of the seriousness of Kohl's plight, which has sparked talk on whether he can survive in office through next year's national elections. Many of the shifted ministers were those worse scarred in the political flareups of the last year, including public dissatisfaction with military policies, new taxes, the influx of foreigners and the Government's mishandling of disclosures of German participation in building a Libyan chemical plant. There was no immediate indication of how the changes will affect policies. Kohl said he will address policy in a major speech to Parliament April 27. WSJ, pA11, said the reshuffle may do little to reverse Kohl's sagging fortunes. Some of his supporters said Kohl has done further damage to himself by repudiating his own policies. The removal of Gerhard Stoltenberg as Finance Minister may mark a retreat from the austere process of budget consolidation begun in 1982, which was at times harshly criticized by the U.S. and European countries.

*What does know
of lawyer's
views?*

IMF HEAD WARNS AGAINST INFLATION IMPACT ON CHINESE REFORM. Xinhua reported from Beijing that visiting IMF Managing Director Michel Camdessus warned in a speech against the derailing of China's reforms by inflation, a concern, he said, which is shared by China's leaders who are fully committed to the ongoing reforms. Top priority to controlling inflation is surely the right decision. Transformation of China's economy from total direct control to indirect market control is a complex and time-consuming process which cannot be expected always to proceed smoothly. China's system of double exchange rates is only temporary, although it has been an efficient tool in balancing external trade. China is committed to the gradual replacement of this system with a unified exchange rate, which the IMF supports, he added.

IMF CHIEF SAYS CHINA MUST ACHIEVE REFORMS. Int Herald Trib, April 10, p13, reported from Washington that IMF Managing Director Michel Camdessus said in an interview before leaving for talks with high-level Chinese officials in Beijing that it is essential that China succeed in its bid for market-oriented economic reforms. The IMF does not see its job to turn the Chinese into good capitalists, saying the IMF is not a school of capitalism. But at this particularly burning juncture in China's drive for reform, the IMF is intensifying its dialogue with the Chinese authorities to see with them how to regain control of the situation. China's problem is how to move to an open price system without the checks and balances of a market economy and how the central bank can tackle the over-liquidity of the economy in the transitional period, the same problem as in countries like Hungary and Yugoslavia. All centrally-planned economies are looking to the Chinese experience and if China succeeds, another great part of humanity would benefit from its experience.

LI DENIES PARTY CHIEF ZHAO RESIGNATION RUMORS. Reuters reported from Beijing that Chinese Prime Minister Li Peng denied rumors that Communist Party chief Zhao Ziyang would be forced to resign following criticism of the economic reforms he championed. Zhao told a news conference that reports of factions within the party leadership and of major differences between himself and Zhao are not true.

FROM BRITEMB WTON

04/16/89 05:03 P. 2

ARGENTINA UNIFIES EXCHANGE RATE, TAXES EXPORTS: CITES ECONOMIC EMERGENCY. EFE/AP-DJ reported from Buenos Aires that Argentine Economy Minister Juan Carlos Pugliese announced a unification of exchange rates from Monday, taxes on exports and a 14% rise in prices for government services in an effort to curtail inflation, lower interest rates and shore up the austral. He said in a TV speech that Argentina faces an economic emergency. Observers said the Government had resisted a unified exchange rate (the free market rate was 59 australes to the dollar, the official rate 20) for fear of igniting inflation. But exporters have refused to sell dollars to the Central Bank at less than the free market rate. Commerce Secretary Jorge Todesca said the Government will not freeze prices or wages, but will apply the full force of the law on price increases above government guidelines. dpa reported that Pugliese called in an earlier speech for a political solution to the debt crisis in Latin America.

SALINAS SAYS \$3.6B IMF LOAN WILL HELP RESTORE MEXICO'S ECONOMY. AP-DJ reported from Guadalajara that Mexican President Carlos Salinas de Gortari told businessmen that a \$3.65B IMF loan will help Mexico get back on track after years of economic crisis. The agreement with the IMF is that of a sovereign country. It is a solution that gets to the bottom of a very damaging problem in Mexico. The loan will be used to bolster Mexico's foreign reserves and spur economic development. About one third will be used to support debt-reduction proposals to creditor banks.

PEREZ SAYS VENEZUELA'S PROGRAM COULD FAIL WITHOUT DEBT PLAN. Reuters reported from Caracas that Venezuelan President Carlos Andres Perez told state governors that the country's economic austerity program could fail unless ways are found to ease payments on \$32B of foreign debt. The austerity plan, designed to help Venezuela get an IMF loan, is the only way to right the economy. Venezuela accepts the serious responsibility for correcting the errors of its economy, he said, adding that the international agencies are not at all concerned about the brutal extraction of payments on foreign debt. This contradiction is what caused the failure of adjustment plans in Brazil, Argentina and Mexico and could cause a failure in Venezuela, he said.

BRAZIL RAISES WAGES FOR FIRST TIME SINCE JANUARY FREEZE. AP-DJ reported from Brasilia that Brazil raised wages by 11.74% to 13.58%, the first increases since a mid-January wage-price freeze. Union leaders had demanded 49% increases. Business leaders promised to absorb the wage increases without raising prices. Labor Minister Dorothea Werneck said wages will be readjusted quarterly, while prices for several basic goods will continue to rise under a loosening up of the price freeze. The agency noted that Finance Minister Mailson da Nobrega told Congress this week that the Government is studying a possible new indexing of the economy.

DEBT, ENVIRONMENT SEEN HIGH ON AGENDA OF PARIS G7 MEETING. Kyodo reported from Tokyo that a senior Japanese Finance Ministry official said Vice Finance Minister Toyoo Gyohen told Prime Minister Noboru Takeshita that LDC debt and environmental protection will be high on the agenda of July's annual G7 leaders meeting in Paris. This was confirmed at a preparatory meeting in Venezuela, following IMF/IBRD spring meetings in Washington. Takeshita told Gyohen to expedite the study of steps to implement an LDC debt relief plan proposed by U.S. Treasury Secretary Nicholas Brady.

U.S. BANK REGULATORS NOTE DECLINING BANK ENGAGEMENT TO DEBTOR LDCs. Neue Zuercher Zeitung, April 13, p20, reported from Washington that a report from the U.S. FRB, FDIC and Comptroller of the Currency to Congress said U.S. banks have sharply reduced their commitments to heavily-indebted LDCs since 1982, although the levels remain very high for nine major banks. In 1988, 22 major international banks reduced their claims on countries with BOP difficulties by \$9B, either through selling in the secondary market or through debt/equity swaps, while they extended \$2.2B in new credits. Bank claims on this group were \$76B at the end of September, down 25% from the start of the debt crisis in 1982. Claims of nine major money market banks fell only 13% to \$55B. Claims of 13 other major banks fell 40% to \$12B and of all other banks by 50% to \$9B.

INDIA RULES OUT IMF LOAN FOR THIS YEAR. Ldn Fin Times, April 13, p6, reported from New Delhi that Indian Finance Minister S.B. Chavan said on his return from IMF/IBRD spring meetings in Washington that he does not think an IMF loan will be required this year. But he left open the question of borrowing next year, saying the decision will be studied afresh then.

U.S. TO PRESS TO AID POLAND, WITH CONDITIONS; MEETING IMF GOALS MAJOR PROBLEM. WSJ, pA10, reported from Washington that the U.S. plans to press for an international aid effort for Poland, dependent on further economic reforms in the country. A package of more than \$1B would involve U.S. tariff relief and investment help, international loans and loan reschedulings from the IBRD, IMF and Paris Club. The toughest test for Poland will be meeting the IMF's strict economic reform standards.

U.S. MOVES TO LIMIT PLO MEMBERSHIP OF UN AGENCIES. WP, pA22, reported from Washington a U.S. diplomatic campaign to block a PLO bid for full membership of the WHO and other UN affiliates and agencies. U.S. officials said the State Dept has told a number of allies that the U.S. is firmly opposed to current PLO efforts to gain wider recognition for its self-proclaimed Palestinian state, already recognized by 91 nations. The paper said it seems doubtful the U.S. can block the PLO bid for WHO membership at its annual meeting May 8, since a simple majority can decide.

ROMANIA SAYS FOREIGN DEBTS PAID THROUGH AUSTERITY PROGRAM. WP, pA21.

GATT SEEKS TO STRENGTHEN DISPUTES POLICY. NYT, pD16.

UNCLASSIFIED

FROM: SUSIE SYMES (EC1)
DATE: 14 April 1989
Ext: 4441

CHANCELLOR

cc PS/Economic Secretary
Mr Wicks
Mr Lankester
Mr Odling-Smee
Mr R I G Allen
Mrs M E Brown
Mr Ilett
Mr Gieve

*US/MS. What I need
to statements for
Waigel in the press,
before no cabinet,
has to be done it
when no
withholding tax
contains
its*

DR WAIGEL AND THE FRG WITHHOLDING TAX

You asked for useful statements by Dr Waigel on the withholding tax. We have not found much, as he has been careful not to be drawn. But the Bonn Embassy (Eric Jenkinson) has supplied the attached, fairly useful, collection of (translated) recent comments made in the last two or three days by leading politicians including Waigel.

2. Sir David Hannay has suggested that you could mention at your press conference that anyone who had doubts about the effects of the German withholding tax should take a look at the state of the Frankfurt Stock Exchange on Thursday and Friday this week (13, 14 April). You will have seen the report in today's FT, attached for ease of reference. I am not sure this is such a powerful example; after all the markets would ~~not~~ react to any fairly unexpected change of Finance Minister.

Susie Symes
SUSIE SYMES

UNCLASSIFIED

Kohl:

Correctness of Quellensteuer would be examined within general round of reassessment of policies

We have spoken about Quellensteuer and will continue to do so

Wants to clear up Quellensteuer question before Government Declaration on 27 April

Press reports that Waigel had insisted on abolition of Quellensteuer before agreeing to join Cabinet were "pure invention"

Quellensteuer will be a subject for discussion in cabinet over the next two weeks

Waigel:

In first interview following nomination described Quellensteuer as "irritant" but declined to commit himself further

Denies that abolition of Quellensteuer was condition to joining Cabinet

Lambsdorff:

Nobody is considering lifting Quellensteuer until a later date, not to mention abolishing it. -But it needs to be examined whether it can be made administratively more simple. The bureaucratic burden, above all of the small investor, is too great. There is no alternative to Quellensteuer, other than some form of control system which nobody in the FRG wants. Of course the introduction of Quellensteuer has triggered capital movements but not all capital exports are attributable to Quellensteuer. The money which is flowing into Luxemburg belongs to "ordinary people" who misunderstand the Quellensteuer and believe their savings will be now be taxed again. The FRG with its massive current account surplus needs a corresponding level of capital exports.

OTHERS**Hasselmann**
(CDU Nieder-
sachsen)

Postpone introduction until after completion of Single Market 1993

Röller
(Dresdner)

It would be very pleasing if something were to move on Quellensteuer

Kohl:

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OTHERS

Hasselmann
(CDU Nieder-
sachsen)

Postpone introduction until after completion of Single Market 1993

Röllner
(Dresdner)

It would be very pleasing if something were to move on Quellensteuer

EUROPEAN NEWS

Kohl picks little known Bavarian for Finance Minister
Waigel thrust into the limelight

By Andrew Fisher in Frankfurt

CHANCELLOR Helmut Kohl has turned south for his new Finance Minister, choosing Theo Waigel, a pipe-smoking, bushy-eyebrowed Bavarian, to replace Gerhard Stoltenberg, the cool, silvery-haired northern whose reputation has slid rapidly over the past year or so.

Although Mr Waigel (49) is virtually unknown in the financial community, his appointment caused considerable confusion and activity in markets yesterday. The reason was the withholding tax (*Quellensteuer*), a levy strongly criticised by the Bundesbank and others when Mr Stoltenberg introduced it and which led to heavy outflows of investment funds last year.

In the belief that Mr Waigel would try to draw the teeth of this tax, the D-Mark strengthened and share prices initially moved briskly ahead. Prices of domestic bonds, subject to the new 10 per cent tax on interest, firmed, while those of foreign D-Mark loans, which are exempt from it, slipped. However, Mr Kohl later described the idea that Mr Waigel had made changes in the tax a condition of his cabinet entry as "pure invention."

It is true, though, that the Christian Social Union (CSU), of which Mr Waigel became head after Mr Franz Josef Strauss's death last year, has opposed the tax. But while officials said yesterday that it



Chancellor Helmut Kohl and his spokesman, Mr Friedhelm Ost, announce government changes to the press. Mr Ost was one of those who lost his job

could be simplified, any decision to scrap or emasculate it would clearly mark an even further loss of face for the centre-right coalition of Mr Kohl, for whom the cabinet reshuffle is an attempt to recover status in the eyes of increasingly sceptical voters.

As for Mr Waigel, he will have to establish a profile quickly both at home and abroad. He must also develop a close relationship with the Bundesbank, whose association with Mr Stoltenberg was generally fruitful, despite strong differences over the new tax and other issues.

Ironically, the Bundesbank yesterday reaffirmed its opposition to the withholding tax in its annual report, noting that it had not only led to heavy out-

flows last year, but also contributed to a sharp drop in foreign long-term holdings in West Germany. Mr Karl Otto Pöhl, its president, has made no secret of his opposition to the tax.

Since he is one of the best known West German personalities on the world financial stage, it will be important for Mr Waigel to try to approach this status. For someone whose experience has been almost entirely domestic - a lawyer, he has served in the Bavarian Finance Ministry - this will be a hard task. For all his faults of judgment, Mr Stoltenberg was a leading figure on the international monetary scene.

● The new government is as follows:

Swiss rates rise on worries about franc

By William Dullforce in Geneva

THE SWISS National Bank yesterday raised its discount and Lombard rates, after bankers and economists had begun to voice growing concern about the depreciation of the Swiss franc. From today the discount rate increases from 4 to 4½ per cent; the Lombard by 1 point to 7 per cent.

The bank said its move emphasised its determination to continue "a stability-oriented policy". It signalled a tighter monetary policy last December, when it set a 2 per cent target for the growth in the monetary base (M0) in 1989.

However, signs of overheating and some acceleration in inflation stimulated worries about price stability. In March the consumer price index hit an annual growth rate of 2.3 per cent and forecasters have been talking of a rise of 3 per cent or more this year. The index rose by only 1.9 per cent in 1988 and 1.4 per cent in 1987.

During the first quarter the franc fell by 10 per cent against the dollar and by 3.4 per cent against the D-Mark.

Acceleration of the trend this week led the Union Bank of Switzerland to describe the franc as "a crippled currency" and to criticise the national bank for not following its state-ment of intent with action.

The national bank feared the



FROM: J M G TAYLOR

DATE: 18 April 1989

17/5

MS SYMES - EC1

cc PS/Economic Secretary
Mr Wicks
Mr Lankester
Mr Odling-Smee
Mr R I G Allen
Mrs M Brown
Mr Ilett
Mr Gieve

DR WAIGEL AND THE FRG WITHHOLDING TAX

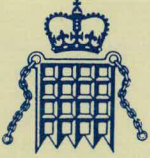
Thank you for your note of 14 April to the Chancellor.

2. The Chancellor would also be grateful for statements made by Waigel on the FRG withholding tax in the past, ie before the Cabinet reshuffle, and when the withholding tax controversy was at its height.

3. The Chancellor has also asked about what we know of Waigel's economic views.

4. Perhaps you could liaise with Mr Jenkinson on these points.

J M G TAYLOR



H.M. CUSTOMS AND EXCISE
DEPARTMENTAL PLANNING UNIT
NEW KING'S BEAM HOUSE, 22 UPPER GROUND
LONDON SG1 9PJ
01-620 1313

Pages 1-4
(X)

Taylor's note
to
8000
to
Allen

[Handwritten signature]

FROM: P R H ALLEN
Departmental Planning Unit

DATE: 21 APRIL 1989

CHANCELLOR

INDIRECT TAX HARMONISATION: ARTICLE IN WALL STREET JOURNAL

You asked (Mr Taylor's note of 4 April) for a note on Mr Boss' comment in the above article that abolishing tax borders without harmonising taxes would mean that the origin principle would take over from the destination principle.

2. The analysis would seem to stem from a very theoretical interpretation of what would be required to abolish fiscal frontiers. Under the destination system, as set out in our technical proposals, exports are differentiated from domestic supplies because they are zero-rated. So, in theory, a fiscal frontier remains. Under the origin system, there is no difference between cross-border transactions and domestic ones - outputs are taxable, VAT registered traders make input tax deductions in both cases. There is no fiscal frontier.

3. In practice, the difference between the two systems is more theoretical than real. Under the UK approach, there would be no declaration or checks at the frontier; control would be on the basis of audit-type checking at trader's premises on similar lines

Circulation: Paymaster General
Economic Secretary
Mr Wicks
Mr Scholar
Mr Lankester
Mr Culpin
Mr R I G Allen
Mr Gilhooly
Ms Symes
Mr Tyrie
Mr Call

CPS
Mr Jefferson Smith
Mr Wilmott
Mr Nash
Mr Cockerell
Mr Knox
Mr Vernon
Mr Oxenford

to existing domestic controls. Physical fiscal frontiers are thus abolished. We should carry out the same procedures under an origin system. (This is not necessarily true for all destination system controls. The system proposed by the French would involve controls of a different nature - albeit away from the frontier - on cross border transactions and on domestic ones).

4. The recent Belgian proposals, which we have now examined in more detail, do indeed attempt to get round the theoretical problems of a destination system. They do this by moving the responsibility for paying VAT from the supplier to the purchaser. Thus in practice, under their approach, suppliers would supply goods VAT free (whether exporting or for internal transactions) and a VAT-registered trader would charge himself the VAT and then deduct it. The VAT would be paid only at the retail stage. Since this effectively would convert VAT to a retail sales tax, we imagine that its theoretical virtues will be outweighed for most Member States by the practical effects of its transformation of the VAT system.

5. It may well be, however, that Mr Boss has merely decided to consider the effect of the Commission's approach without tax approximation. This would, in effect, represent "market forces" carried to their logical extreme. Such a situation has been described in the past as the "Irish solution". All fiscal controls on imports would be removed and both traders and private individuals would be free to purchase tax paid wherever they wished. In practice, of course, this would tend to mean that they shopped wherever tax rates were lowest.

6. The main problem with the "Irish solution" is, of course, that it would be quite unacceptable to the majority of Member States, because of the problems caused by revenue losses and distortion of trade. Further likely effects would be exchange rate adjustments and a general forcing down of tax rates across the Community.

7. We have no argument with the economic analysis in the remainder of the article.

RA.

pmj



FROM: S M A JAMES
DATE: 24 April 1989

PS/CHANCELLOR

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Sir P Middleton
Mr Lankester
Mr Odling-Smee
Mr Culpin
Mr R I G Allen
Mrs M E Brown
Mr Gieve
Mr Pickford
Mr Ilett
Mr Gilhooly
Mr Bush
Mr Michie
Mrs Chaplin
Mr Tyrie
Mr Call

John PS/BST
*Ch: Content for BT
to see Mr Colchester?*
[Red signature]
24/4

PS/C&E
Mr Jefferson-Smith - C&E
Mr Nash - C&E
Mr Hammond - C&E
Mr P R H Allen - C&E
Mr Rogers - C&E

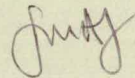
PS/IR
Mr Isaac - IR

ECONOMIST BRIEFING ON TAX APPROXIMATION

Customs and Excise have been approached by Nicholas Colchester of the Economist ^{and abroad} to provide briefing for an article to be published on Friday 28 April on tax and 1992. Customs believe there are political angles which would best be covered by a Treasury Minister with officials providing support, and briefing Mr Colchester on the technicalities. The Economic Secretary is willing to see the Economist if the Chancellor is content for him to do so, and providing IDT foresee no difficulties.

2. The Economist have provided an outline of issues they wish to cover (attached). This includes withholding tax (as well as indirect tax approximation and frontier controls) and would therefore involve the Revenue and Treasury as well as Customs.

3. The interview would need to take place tomorrow or Wednesday morning at the latest to meet Mr Colchester's deadline for this Friday's publication.



S M A JAMES
PRIVATE SECRETARY

839-2029 ATTN SHEILA JAMES

For the attention of Hugh Rogers

Could the interview be arranged for this afternoon or sometime tomorrow, Tuesday? Wednesday would be too late.)

Outline of request for briefing with well-informed official in the Treasury or Customs and Excise about Tax and 1992.

~~At this time, tax remains one of the most important difficulties~~ facing the ideal of the free flow of goods across European frontiers. But after three years of deadlock--partly caused by the style and convictions of Lord Cockfield, partly by national sensitivities, not least in Britain--pragmatic compromises are beginning to appear.

- a) Brussels seems to be prepared to be more flexible on its VAT bands, possibly restricting them to minima and setting those minima at zero for goods in which substantial cross-border leakage is not likely. Does Whitehall share this impression? Would it do the trick?
- b) Brussels seems prepared to scrap its excise harmonisation and allow countries to charge what duties they like. This would be made consistent with open frontiers by the ~~introduction of tax bands/stamps (?)~~ and a tougher anti-bootlegging regime, rather on the American pattern, where commercial flows of wrongly-taxed goods are illegal but a blind-eye is turned to private flows. Does Whitehall share this impression? Could the blind eye be turned?
- c) Brussels still clings, though not so dogmatically, to its clearing house system with no zero rating on cross border flows of goods. Britain still wants zero rating but seems to have conceded a bit here, placing less emphasis on taxpaid allowances and sounding more determined that tax related formalities be eliminated. Clarification please.
- d) Wouldn't it be realistic to aim for a clear divide between checks at borders for economic, health and social reasons, which should be scrapped, and those for criminal reasons--drugs, firearms, rabid dogs, sentex--which should specifically be continued, at borders and elsewhere, when grounds for suspicion exist? At the moment an unrealistic best is being made the enemy of the economic good. No?
- e) Where do matters stand on the withholding tax argument, which threatens the appearance of a truly open financial community?

Yours sincerely

Nicholas Colchester.

Sheila
He spoke.
H. ROGERS
865-5470

www.dia.ic.gov.uk



FROM: J M G TAYLOR
DATE: 25 April 1989

A handwritten signature in the top right corner of the page.

MR P R H ALLEN

cc PS/Paymaster General
PS/Economic Secretary
Mr Wicks
Mr Scholar
Mr Lankester
Mr Culpin
Mr R I G Allen
Mr Gilhooly
Ms Symes
Mr Tyrie
Mr Call

Mr Unwin - C&E
Mr Jefferson Smith - C&E
Mr Wilmott - C&E

INDIRECT TAX HARMONISATION: ARTICLE IN WALL STREET JOURNAL

The Chancellor was grateful for your note of 21 April.

Handwritten initials, possibly 'JMG', in the center of the page.

J M G TAYLOR

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[Mr. Gynns pointing]

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asked how at no time
how long?*

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MY TELNO 443 AND TELECON SHEINWALD/BROUCHER: WITHHOLDING TAX

SUMMARY

1. FEDERAL FINANCE MINISTRY CONFIRM THAT GERMAN POSITION ON AN EC WITHHOLDING TAX IS UNDER REVIEW. HOWEVER, KOHL'S GOVERNMENT STATEMENT REPRESENTS THE SUM OF THEIR THINKING SO FAR.

DETAIL

2. MY TELNO 457 REPORTS KOHL'S STATEMENT THAT THE GERMANS WILL SEEK AN ARRANGEMENT FOR TAXING INTEREST ON SAVINGS ACCEPTABLE TO ALL PARTNERS AND CONSISTENT WITH THE AIMS OF THE INTERNAL MARKET. PIESKE (UNDER SECRETARY FEDERAL FINANCE MINISTRY) TOLD BROUCHER BEFORE THE CHANCELLOR'S STATEMENT WAS DELIVERED THAT THIS SENTENCE HAD BEEN DRAFTED WITH GREAT CARE. HE SAID THAT THERE WOULD ALSO BE A SECOND SENTENCE TO THE EFFECT THAT GERMANY WOULD MAINTAIN THE PRINCIPLE OF BANKING SECRECY. HOWEVER THIS SENTENCE WAS DROPPED FROM KOHL'S STATEMENT AS DELIVERED. THIS LENDS CREDIBILITY TO A REPORT IN ONE GERMAN NEWSPAPER YESTERDAY (NOT PICKED UP MORE WIDELY) WHICH SUGGESTED THAT AN INTERMINISTERIAL WORKING GROUP WAS CONSIDERING SOME RELAXATION OF BANKING SECRECY IN GERMANY. THE NEWSPAPER REPORT PRESENTED THIS IN THE CONTEXT OF THE FIGHT AGAINST ORGANISED CRIME, BUT IT COULD ALSO OF COURSE HAVE IMPLICATIONS FOR THE GERMAN POSITION ON THE SECOND BANKING DIRECTIVE.

COMMENT.

3. THE WITHHOLDING TAX WAS WITHDRAWN FOR DOMESTIC REASONS. WE BELIEVE THE GERMANS REGARD THE EC IMPLICATIONS AS SECONDARY, BUT THEY ARE AWARE THAT THEY WILL NOW COME UNDER PRESSURE FROM THE FRENCH AND KOHL'S CAREFUL FORMULATION SEEKS TO FORESTALL CRITICISM FROM THAT QUARTER. WAIGEL APPEARS TO BELIEVE (MY TELNO 443) THAT HE CAN SATISFY THE FRENCH BY MAINTAINING A TAX ON SAVINGS, BUT ONE COLLECTED RETROSPECTIVELY AND NOT WITHHELD AT SOURCE. HOWEVER, IN PRACTICE A TAX OF THIS KIND WILL BE NO MORE EFFECTIVE NOW THAN IT WAS BEFORE, UNLESS IT IS BACKED UP BY A SUBSTANTIVE DILUTION OF BANKING SECRECY. MOREOVER, MUTUAL ASSISTANCE WITHIN THE EC TO

IDENTIFY TAX DODGERS WOULD END AT THE COMMUNITY BORDERS AND, THEREFORE, WOULD LIKE, THE WITHHOLDING TAX, TEND TO DRIVE SAVINGS OFF SHORE. WE THINK THE GERMANS, AND PARTICULARLY WAIGEL, WILL NOW BE MORE DISPOSED TO RESIST THE PROPOSAL FOR A COMMUNITY-WIDE WITHHOLDING TAX, BUT MUCH DEPENDS ON HOW HARD THE FRENCH PUSH THEM. KOHL APPEARS TO BELIEVE THAT HE HAS AN OBLIGATION TO MITTERAND ON THE TAX ISSUE AND SOME REDUCTIONS OF BANKING SECRECY COULD BE SEEN AS AN ACCEPTABLE SOP.

FCO PLEASE ADVANCE TO KERR, ARTHUR(ECD(I), PS/CHANCELLOR OF THE EXCHEQUER, MS SYMES (HM TREASURY), ARROWSMITH (BANK OF ENGLAND)

MALLABY

YYYY

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MR RATFORD

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*At X, we really
cannot have a
Commission app-ly
customary studies
of EC law. or do
I miss-just?
Sr. J. Han-*

FRAME ECONOMIC
WITHHOLDING TAX AND ABOLITION OF FISCAL FRONTIERS:
MRS SCRIVENER AT THE ESC : 27 APRIL

SUMMARY

1. WITHHOLDING TAX. HINT THAT SOME MEMBER STATES MIGHT DELAY LIBERALISATION OF CAPITAL MOVEMENTS AND TRY TO INVOKE SAFEGUARD CLAUSE IF NO AGREEMENT ON COMMISSION'S PROPOSALS.

2. FISCAL FRONTIERS. HINTS OF CONTINUING COMMISSION INTEREST IN A SIMPLIFIED CLEARING HOUSE, MINIMUM EXCISE RATES AND PERHAPS ZONES FOR TOBACCO AND ALCOHOL, BANDS FOR MINERAL OILS. NEED FOR PERMANENT SOLUTION TO UK ZERO RATES.

DETAIL

3. MRS SCRIVENER ADRESSED THE PLENARY SESSION OF THE ECONOMIC AND SOCIAL COMMITTEE THIS MORNING ON THE TAXATION OF SAVINGS AND THE ABOLITION OF FISCAL FRONTIERS. IN LARGE PART SHE SPOKE ON STANDARD LINES BUT IN ONE OR TWO RESPECTS WENT FURTHER THAN IN PREVIOUS COMMENTS TO THE EP, COUNCIL AND COREPER.

X | 4. ON THE TAXATION OF SAVINGS, MRS SCRIVENER SAID THAT FAILURE TO AGREE ON THE COMMISSION'S PROPOSALS WOULD PUT AT RISK THE LIBERALISATION OF CAPITAL MOVEMENTS. 'IF LARGE OUTFLOWS OF CAPITAL TOOK PLACE, SOME MEMBER STATES WOULD HAVE TO HAVE RECOURSE TO SAFEGUARD CLAUSES, IN NECESSARY CONTRARY TO EC LAW'. (COMMENT: THIS APPEARS TO BE THE FIRST PUBLIC SUGGESTION BY ANY MEMBER OF THE COMMISSION THAT FAILURE TO AGREE ON THE WITHHOLDING TAX MIGHT LEAD SOME MEMBER STATES NOT TO COMPLY WITH THEIR OBLIGATIONS UNDER THE 1988 CAPITAL MOVEMENTS DIRECTIVE. THERE IS OF COURSE NO LEGAL LINK BETWEEN THE TWO MATTERS.)

5. ON INDIRECT TAX MRS SCRIVENER AGAIN DECLARED HERSELF A PRAGMATIST, SAID THAT SHE WOULD SOON PRESENT TO THE COMMISSION A DRAFT COMMUNICATION TO THE COUNCIL ON INDIRECT TAX AS A WHOLE, AND REFERRED TO HER INTENTION TO ADDRESS THE 20 MAY INFORMAL MEETING OF FINANCE MINISTERS AND THE EUROPEAN PARLIAMENT (22 MAY). THE WORDS

SHE USED HOWEVER SUGGESTED A CONTINUED HANKERING AFTER SOME SORT OF CLEARING HOUSE ('I HAVE ASKED FOR VARIOUS POSSIBILITIES OF SIMPLYFING THE CLEARING MECHANISM TO BE STUDIED, FOR EXAMPLE BY LIMITING SIGNIFICANTLY THE SUMS WHICH WOULD PASS THROUGH IT'). AS FOR EXCISES, THE COMMISSION WAS MOVING TOWARDS MINIMUM RATES FOR ALCOHOL AND TOBACCO (INTER ALIA FOR HEALTH REASONS) AND BANDS FOR MINERAL OILS.

6. IN REPLY TO QUESTIONS MRS SCRIVENER MADE IT CLEAR THAT THE COMMISSION HAD NOT FINALLY DECIDED ON WHAT FORM VAT RATES APPROXIMATION SHOULD TAKE. SHE AGREED WITH HANCOCK (UK, EMPLOYERS GROUP) THAT A PERMANENT SOLUTION WOULD HAVE TO BE FOUND FOR THE UK ON ZERO RATING. SHE HINTED AT THE POSSIBILITY OF A TRADE OFF: COULD THE UK ADOPT A MORE FLEXIBLE STANCE ELSEWHERE? ON EXCISE DUTIES, SHE ALLUDED TO THE POSSIBILITY OF REGIONAL ZONES WHICH AT LEAST REDUCED EXCESSIVE DISTORTION.

7. TEXT OF MRS SCRIVENER'S SPEECH BY BAG TO ALLE (CUSTOMS AND EXCISE), O'CONNER (INLAND REVENUE) AND ILETT (HMT).

HANNAY

YYYY

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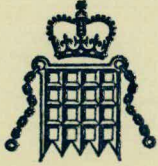
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Board Room
H M Customs and Excise
New King's Beam House
22 Upper Ground
London SE1 9PJ
Telephone: 01-620 1313

FAX Copy gone to Chex.

FROM : THE CHAIRMAN

DATE : 28 April 1989

CHANCELLOR OF THE EXCHEQUER

SINGLE MARKET: DUTCH POSITION

I understand you will be seeing Onno Ruding tomorrow at Chequers. You may therefore like to know that I had some very constructive discussions with my opposite number, Anton Schoemaker, earlier this week in the Hague. He has responsibility for both direct and indirect taxation and is very much in the lead on single market and tax harmonisation issues.

2. Although the formal position of the Dutch hitherto has been a general endorsement of the Commission proposals on tax approximation, in fact there is now an encouraging identity between us. They support the general thrust of our technical proposals, though they see a need for more controls through exchanges of information between member states, which we could support. These would not be systematic and would in no way resemble the French proposals which, like us, they regard as too onerous and bureaucratic.

cc
Economic Secretary
Sir Peter Middleton
Mr Wicks
Mr Lankester
Mr Culpin
Mr R I G Allen
Mr Call
Mr Lavelle (Cabinet Office)
Sir D Hannay (UKREP)

Mr Jefferson Smith
Mr Nash
Mr Wilmott
Mr P R H Allen
Mr Knox
Mr Oxenford

RESTRICTED

3. While they still want some approximation of VAT they appear to have softened their line to look for narrower solutions to specific problems of cross-border shopping, particularly with their neighbour and main trading partner Germany. The Dutch have recently reduced their standard rate to 18.5% and are looking to Germany to move up to 16%. Apparently Stoltenberg was amenable to this (it would also help the Danes), but he has moved on and they do not know if Waigel will follow this line. Nevertheless, these bi-lateral negotiations, probably spurred on by the Schengen developments, are very encouraging and support your market forces approach.

4. The Dutch are opposed to the continuation of zero rates, principally (or so they claim) because they do not want any domestic pressure to introduce them in the Netherlands. I pointed out that there would be no increased pressure provided there was no centrally-imposed tax approximation, to which we remained strongly opposed. In practice I believe they could probably accept them if a suitable formula could be found.

5. On excises, they have fewer concerns than we do and do not believe a more restrictive regime for commercial transactions is necessary. All the main excise traders are registered for VAT and a satisfactory VAT control system is all they consider necessary. However there would still be a need for spot checks on people. They explained that the Schengen agreement only called for the abolition of police checks at the frontier (immigration, security, drugs, etc) and reductions in other areas.

6. On the collection of statistics they are as aghast as we are at the outrageously burdensome Luxembourg proposals and agree with our approach to use 1992 as an opportunity to rationalise intra-EC statistical requirements to meet essential governmental needs, and to look very critically at trade demands on a cost-effective basis. They could accept a system of collecting the majority of

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detailed statistics from the minority of (the largest) traders, almost as a by-product of their accounting systems - an approach that is gaining ground in several member states - and agreed that the link between the movement of goods and the collection of data had to be severed.

7. Finally, I was encouraged that they did not take exception or express strong opposition to our intentions on preventive controls at our frontiers for drugs, firearms, etc, although they obviously do not share our concerns. I explained that, despite our determination to maintain the level of effectiveness of these checks, we were working hard to make them lighter and more selective for the legitimate trader and traveller.

Conclusions

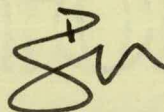
8. I think the Dutch are moving in the right direction and are potentially valuable allies. Certainly the common ground between us is greater than our differences. If, therefore, the opportunity arises tomorrow, I think it would be useful if you could tackle Ruding on one or two of the fundamental issues and in particular seek to establish common cause on our broad approach:

- (i) We need to establish a system that will accommodate our zero rates;
- (ii) we must dissuade him from trying to pursue compulsory harmonisation: tax rates should be left to each member state to decide in the light of social and economic considerations and particular problems such as serious distortions of trade which can be solved bilaterally with goodwill on both sides;
- (iii) get him to agree that there are alternatives that meet the objectives of the Single European Act without great

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upheavals and loss of flexibility (the UK approach is one possibility, there may be others). Excise is a problem area but no-one has an ideal solution and its significance should not be exaggerated;

(iv) agree that we should concert our tactics at a high official level on our approach to the informal ECOFIN in May and follow-up action thereafter (Schoemaker was keen to do this).



J B UNWIN

RESTRICTED
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*See X: Cresson's Turkey
 on the lower side.*

FRAME ECONOMIC
 FRENCH REACTIONS TO GERMAN DECISION TO ABOLISH WITHHOLDING TAX

SUMMARY

1. A ROUGHISH PATCH IN FRANCO-GERMAN RELATIONS. MME CRESSON ISSUES DECLARATION TICKING OFF THE GERMANS. BEREGOVY MORE PHLEGMATIC. MME SCRIVENER PUTS ON A BRAVE FACE.

DETAIL

2. THE GERMAN DECISION TO ABOLISH ITS 10 PERCENT WITHHOLDING TAX HAS LED TO GNASHING OF TEETH IN PARIS. THE NEWSPAPERS HAVE PRESENTED IT AS A BLOW TO EUROPE AND A SLIGHT TO THE FRENCH. COMMENT FOCUSSES ON A LIKELY SHIFT IN THE LINE UP OF OPINION ON THE EC WITHHOLDING TAX AND ON THE WAY FRANCE MAY NOW BE ISOLATED. A LEADER IN THE TRIBUNE DE L'EXPANSION SAYS THAT FRANCE SHOULD HAVE KNOWN WHAT IT WAS DOING WHEN IT SIGNED THE SEA, WHICH PROVIDES FOR THE LIBERALISATION OF CAPITAL MOVEMENTS WITHOUT PRIOR TAX HARMONISATION.

3. MME CRESSON TOOK THE SLIGHTLY UNUSUAL STEP OF ISSUING A STATEMENT ON 26 APRIL (WHEN NEWS OF THE LIKELY GERMAN DECISION FILTERED THROUGH) RECALLING HOW AT THE RECENT FRANCO-GERMAN SUMMIT THE FRENCH HAD RECEIVED ASSURANCES THAT THE GERMANS ENTIRELY ACCEPTED THE POLITICAL LINK BETWEEN HARMONISING THE TAXATION OF SAVINGS AND THE FREE MOVEMENT OF CAPITAL AND THAT THEY HAD NO WISH TO MAKE THE EC NEGOTIATIONS MORE DIFFICULT AND WERE CONSIDERING CHANGES TO THE TAX ONLY FOR SMALL SAVERS. MME CRESSON WENT ON TO SAY IT WAS TOO SOON TO SAY WHAT THE GERMAN SHIFT WOULD MEAN FOR THE LIBERALISATION OF CAPITAL MOVEMENTS, BUT THE LINK WITH TAX HARMONISATION WOULD BE MAINTAINED. SHE CONTINUED QUOTE I WOULD LIKE HOWEVER TO MENTION A DEEPER CONCERN, WHICH IS THAT THE SINGLE MARKET WILL NOT BE BUILT IF EACH COUNTRY LETS ITS OWN PURELY NATIONAL INTERESTS PREVAIL UNQUOTE. SHE CONCLUDED BY DRAWING ATTENTION TO THE MAJOR EFFORTS THE FRENCH HAD BEEN MAKING AND HOW THEIR PARTNERS - STARTING WITH THE ONE SO OFTER IN THE LEAD IN THE BATTLE FOR EUROPE - MUST DO THEIR BIT TOO.

4. BEREGOVY CONFINED HIMSELF TO SAYING HE WAS DISAPPOINTED, BUT NOT

WORRIED, BY THE GERMAN DECISION, AND DREW ATTENTION TO THE RECENT AGREEMENT TO SET UP UNIT TRUST CAPITALISATION FUNDS (REPORTED TO HM TREASURY) AS A STEP FORWARD IN FRENCH SAVINGS TAX REFORM. TRESOR SOURCES HAVE BEEN QUOTED AS SAYING THAT IN ANY CASE THE COMMISSION PROPOSAL WAS FULL OF HOLES AND WOULD NOT HAVE WORKED VERY WELL, THAT THE IMPORTANT THING WAS TO LIGHTEN FRENCH TAXES AND THAT FURTHER PROGRESS IN CUTS IN FRENCH BOND AND INSURANCE TAXATION WOULD HELP.

5. MME SCRIVENER FOR HER PART HAS GIVEN AN INTERVIEW MAKING THE BEST OF THE GERMAN DECISION, POINTING OUT HOW KOHL HAS SAID HE WILL STILL CONTINUE TO WORK FOR AN EC COMPROMISE ACCEPTABLE TO THE TWELVE, AND HOW IT WAS VERY SATISFACTORY THAT KOHL, IN DECLARATION, HAD REAFFIRMED HIS EUROPEAN COMMITMENT. SHE AGREED THAT THE RECENT FRENCH MOVE ON THE TAXATION OF UNIT TRUSTS WAS A STEP IN THE RIGHT DIRECTION, AND CONFIRMED THAT THE COMMISSION WAS CONSIDERING A GLOBAL COMPROMISE EMBRACING ALL TAX ISSUES, VAT INCLUDED.

COMMENT

6. THIS DECISION, ADDED TO GERMAN BEHAVIOUR OVER SNF, AND LAST WEEK'S UNEXPECTED HIKE IN INTEREST RATES BY THE BUNDESBANK, HAS SORELY TRIED FRENCH PATIENCE WITH THE GERMANS. THE FRENCH ARE IRRITATED THAT THESE DECISIONS CAME DURING OR JUST AFTER A FRANCO-GERMAN SUMMIT THE MAIN PURPOSE OF WHICH IS TO DEMONSTRATE SOLIDARITY. WHEN I SAW DE LAROSIERE TODAY AND ASKED HIM ABOUT THIS HE SAID THAT THE INTEREST RATE EPISODE HAD LED ONE OR TWO PEOPLE TO TAKE THE SHORT TERM VIEW THAT IT SHOWED HOW YOU COULD NOT TRUST EUROPEAN MONETARY QUESTIONS TO THE CENTRAL BANKERS. BUT THE LONGER TERM VIEW, WHICH HE THOUGHT WAS RIGHT, WAS THAT A CENTRAL BODY FOR DETERMINING MONETARY ARRANGEMENTS AS SKETCHED OUT IN THE DELORS REPORT WOULD ACTUALLY ALLOW BETTER ADVANCE CONSULTATION AND COORDINATION ON MONETARY ISSUES WITH THE GERMANS, LIMITING THE IDIOSYNCRATIC BEHAVIOUR OF THE LAENDER BANKS, SO THAT DECISIONS HITHERTO TAKEN FOR PURELY INTERNAL REASONS WOULD INSTEAD BE CONSIDERED IN THEIR WIDER EUROPEAN AND INTERNATIONAL CONTEXT.

7. THE FRENCH ARE USED TO UPS AND DOWNS IN THE RELATIONSHIP AND THESE IRRITATIONS WILL NOT DIMINISH THE NEED TO CONTINUE WORKING CLOSELY WITH THE GERMANS. INDEED THE WEAKER THE GERMANS APPEAR ON E/W SECURITY ISSUES THE MORE THE FRENCH MAY FEEL THEY HAVE TO WORK HARD TO BIND THEM IN. AT THE STRATEGIC LEVEL, HOWEVER, FOR MITTERRAND GERMAN 'UNRELIABILITY' MAY WELL INCREASE THE SENSE OF THE NEED FOR BALANCING BRITISH INVOLVEMENT, AND COULD THUS DECREASE THE ATTRACTIONS OF VARIABLE-SPEED EUROPE TYPE OF THINKING.

FERGUSSON

YYYY

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COMMISSION
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CHRISTIANE SCRIVENER
COMMISSAIRE

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CH/EXCHEQUER	
REC.	- 5 MAY 1989
ACTION	MR. A.J.G. TEAOC
COPIES TO	PS/CST, PS/FST PS/AMB, PS/EST SIR P. Middleton SIR T. Burns MR Scholar MR Lankester MR Collingsmee MR Peretz MR Ilett MRs Brown Ms Symon MRs Chaplin Mr Payne SIR A. Buttshall I.R. PS/IR

28th April 1989

Ch / Seems unobjectionable - indeed possibly helpful.

Dear Mr Lawson, MR Unwin C+E PS/C+E
MR Bostock UKREP

As you know, the informal ECO/FIN on 19/20 May will be the occasion for continuing the negotiations on a number of the Commission's proposals on both direct and indirect taxation.

One of the items of the agenda will be taxation of savings, including the Commission's proposal for a minimum withholding tax. I would like to assure myself before the ECO/FIN meeting that the Commission has the fullest possible understanding of the reasons for the United Kingdom's position on withholding tax and in particular for the various technical problems, which your officials have raised in the Ad hoc Group.

The purpose of this letter is accordingly to propose that, in advance of the 19/20 May ECO/FIN, there should be a bilateral discussion at senior level between my services and your officials, who are most closely concerned with this dossier. I would be ready to send a small team to London for this purpose, consisting of Emmanuel Constans, my Chef de Cabinet, Jolly Dixon from the President's Cabinet and Geoffrey Fitchew (DG XV). I should be grateful if you could arrange for your officials to meet with them. We will get in touch with Mr Bostock in the United Kingdom Permanent Representation to arrange a mutually convenient date.

Yours sincerely,

Ch. Scrivener

The Rt Honourable Nigel Lawson, M.P.,
Chancellor of the Exchequer,
11, Downing Street,
London SW1.