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

DD's: 25 Years

[signature]
23/2/96.

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HM Treasury

Parliament Street
London SW1P 3AG
Telephone 01 270 4441

PS/Chancellor

I think it may be about time for a reminder from you on this! Just to assure you that it is in hand; you will recall this is public holiday time in Brussels. – M Schuman's birthday, M. Rond-Point's birthday etc etc – but I have asked David Bostock to follow it up as soon as possible
Susie Symes
10/5

Mr David Bostock
UKREP
Brussels

2 May 1989

Dear David

UKREP TELNO 1383 AND ABOLITION OF FISCAL FRONTIERS

1. UKREP Telno 1383 quotes Mme Scrivener as saying to the ESC on 27 April that 'if large outflows of capital took place, some member states would have to have recourse to safeguard clauses, in [sic] necessary contrary to EC law'.

2. Whilst the Commission presumably could not condone breaches of EC law there is that implication in the Commissioner's remarks. I should be most grateful if you could cast some light on what Mme Scrivener might have in mind; I should like to be able to pass this on to the Chancellor in good time for it to influence his thinking on the line to take at the informal meeting on 19-20 May.

3. Another odd element in Mme Scrivener's remarks is that of timing. She seems to be referring to ex post rather than ex ante action: only <u>after</u> any large outflow of capital - and hence presumably after the 1988 Directive had been implemented to the required timetable - might some member states 'have recourse to' measures that effectively clawed back their compliance with the Capital Movements Directive.

I am copying this letter to John Isaac (IR) and to Tim Lankester, Richard Allen, Nick Ilett and Mary Brown here.

Susie Symes

SUSIE SYMES

FROM: J M G TAYLOR
DATE: 3 MAY 1989

MR ILETT

cc Mr Wicks
Mr Lankester
Mr R I G Allen
Mr Odling-Smee

PARIS TEL NO 561: FRENCH REACTIONS TO GERMAN DECISION TO ABOLISH WITHHOLDING TAX

... The Chancellor has seen this telegram (attached).

2. He notes the comment that "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". He has commented that this is wishful thinking on a heroic scale.

J M G TAYLOR

023173
MDLIAN 7129

RESTRICTED
FM PARIS
TO ROUTINE FCO
TELNO 561
OF 281714Z APRIL 89
INFO OTHER EC POSTS

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. BEREGOVOY 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 THE 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. BEREGOVOY 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 AKE 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 BEHAVOUR 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.

023173
MDLIAN 7129

FERGUSSON

YYYY

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MAIN 188

.FRAME ECONOMIC

ECD (I)

ADDITIONAL 1

FRAME

NNNN

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC
5 May 1989

ECONOMIC SECRETARY

HARMONISATION: WITHHOLDING TAX

1. I am not sure whether you will yet have seen this note which UNICE (the EC equivalent of the CBI) have sent in to the Commission on the proposed withholding tax.

2. When talking to the CBI (as to the British Bankers' Association) we have urged them not just to talk to us, but to muster support from their European colleagues, and make their views known to the Commission direct. The outcome appears in the attached paper. As a position paper "setting out the views of European business and industry" it has a lot of good stuff in it, some of it pretty quotable. I have it in mind to ask the Commission formally to make copies available to the Ad Hoc Group, if they do not volunteer it themselves.

A J G ISAAC

---

cc Chancellor of the Exchequer*
Chief Secretary
Financial Secretary*
Paymaster General
Sir P Middleton
Mr Scholar
Mr Lankester
Mr Odling-Smee
Mr Ilett*
Mrs Brown
Mrs Chaplin

Mr Hewitt* (Bank of England)

Mr Bostock (UKREP Brussels)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Houghton
Mr Corlett
Mr Matheson
Mr Roberts
Mr Sullivan
Mr Cleave
Mr O'Connor
PS/IR

*With attachment

UNICE
Union des Confédérations de l'Industrie et des Employeurs d'Europe
Union of Industrial and Employers' Confederations of Europe

By fax -
G. Arpe
In. Rev.
Somerset

H.E. Sir David Hannay
Ambassador Extraordinary and
Plenipotentiary
Permanent Representative of
Great Britain & Northern Ireland
to the European Communities
Rond-Point Schuman, 6
B - 1040 Bruxelles

LE SECRETAIRE GÉNÉRAL

ZT/BV/hs/1.5.C.1

24 April 1989

Dear Sir,

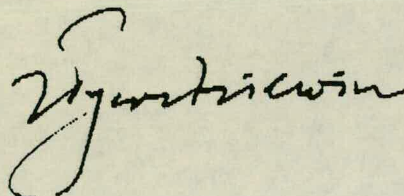
UNICE has noted the proposals submitted to the Council by the Commission concerning the fiscal measures intended to accompany the liberalisation of capital movements.

I have pleasure in enclosing a position setting out the views of European business and industry on this subject.

We would very much like to be kept abreast of the progress of Community work in this area, and are at your disposal should you consider that a discussion with our representatives would be useful.

Thank you for giving this letter your kind attention.

Yours faithfully,



Z. Tyszkiewicz

UNICE
Union des Confédérations de l'Industrie et des Employeurs d'Europe
Union of Industrial and Employers' Confederations of Europe

April 1989

Position paper on the draft directive on a common system of withholding tax on interest income.

According to the Commission's Global Communication, the draft directive on a common system of withholding tax on interest income is designed primarily to deal with the increased risk of tax evasion which is supposed to be a direct result of the final phase of the liberalisation of capital movements.

In UNICE's opinion, when looking for solutions, due attention should be given to the fact that this problem arises in a wider context than the Community's and that any measures to solve it must not result in a flight of capital towards certain countries that are not members of the EC. More generally speaking, the EC should avoid choosing a remedy which in the end could turn out to be more harmful than the illness it was meant to cure.(*)

After judging from this angle the draft directive on a common system of withholding tax on interest income, as recently submitted to the Council, UNICE had to arrive at the conclusion that the Commission's proposal is not satisfactory in that, firstly, it seems questionable at least whether this proposal would effectively prevent tax evasion, secondly, it appears to be damaging to the Community's function as a financial market place, thirdly, it would impose a considerable additional compliance burden on payors of interest, and, last but not least, increase costs for European business and industry. The proposed measures could turn out to be extremely detrimental to economic activity and not warranted by the liberalisation of the very few operations which are not yet free.

These points of criticism will be briefly analysed below.

a) Effectiveness

After the implementation of the directive, residents of the Community will still be free to invest their money outside the EC and, thereby, escape the EC withholding tax.

For various reasons, the level of the withholding tax should certainly not be higher than that proposed by the Commission. However, it seems realistic to note that such a level will not be fit to prevent mala fide EC residents from not declaring their interest income or to substantially reduce the budgetary loss for the Member States, resulting from tax evasion in this field.

(*) The CNPF considers that the free movement of capital makes a minimum level of harmonisation of tax on interest income necessary, in order to avoid the very real risk of delocalisation, which would seriously upset the functioning of the European market; it is in favour of a Community solution coordinating the national changes needed to forestall such risks.

b) Impact on the EC as a financial market place

The introduction of a European withholding tax will have a disturbing effect on the functioning of financial markets. These markets are becoming more and more interrelated due to the removal of restrictions and technical progress. Liberalisation of capital movements is not only a European, but a worldwide development. Therefore, any proposal regarding capital flows should take into account relations with the rest of the world. In a way, the Commission has done so by excluding recipients from non-EC countries from the scope of the tax. On the other hand, however, the Commission creates with its proposal a stimulus for EC residents to invest in countries outside the EC. This would have a direct negative effect on economic activity within the EC. Moreover, it would interfere with the policy of monetary authorities and reduce the role of the EC as a financial market place.

The possible "splitting" of capital markets as a result of tax-induced changes in investment patterns and its effects on interest rate differentials, should also be considered. Indeed, there is evidence to show that this happened in Germany following the introduction of a withholding tax in 1988. Investment patterns could be distorted if the proposed withholding tax on interest income is set at a significantly lower rate than for other types of investment such as, in particular, stockmarket and equity investment.

c) Practicability

A correct application of the proposed system would imply that the payor of interest is aware of :

- the nature of the loan;
- the country of residence of the payee (EC or third country? The payor required to obtain a certificate of residence for the payee?);
- the effect of any tax treaty in reducing or cancelling the withholding tax, or not doing so in particular cases;
- the capacity (private person or entrepreneur), in which the payee will receive the interest;
- the tax treatment of the interest in the country of residence of the payee (within or outside the scope of income or profits tax; if within the scope, still no tax because it constitutes commercial or industrial income of the recipient or is covered by a special scheme for private savings?)

It goes without saying that these requirements will result in a considerable additional administrative burden and its attendant costs for interest paying financial institutions and companies. In fact, to UNICE it seems hardly conceivable that the system as proposed by the Commission, would be workable in practice.

d) Costs for business and industry

Apart from the additional compliance costs mentioned above, European business and industry would be confronted with higher interest costs in the EC. To UNICE it appears likely that the introduction of a withholding tax would increase interest rates, not only in the Member States

which do not apply such a tax at present, but also in the Community as a whole (the scope of the existing withholding taxes on interest will actually be extended to interest from the other Member States; potential third country investors may become reluctant because of questions about residence, etc. which they will have to answer in future).

The recent German experience provides us with a small scale example of what could be expected in this respect (after the 10% withholding tax was announced by the German government, the differential vis-à-vis for example the Dutch long-term rates changed clearly in favour of the latter).

The fact that loan contracts often contain a so called "escalator clause" could result in further cost increases for business and industry as a consequence of the implementation of the proposal.

In this connection UNICE would like to know exactly what is the meaning of the concept "commercial and industrial income" in the exemption under art. 5(f) of the draft directive. Will interest payments on all loans to companies be covered by this exemption, and will the exemption apply regardless of whether or not the payor and payeee are affiliated companies?

UNICE realises that the Commission, when shaping its proposal, has tried to find the middle ground between a number of potentially conflicting objectives. The result, however, does not seem to be satisfying and UNICE wonders whether the Commission could given an economic appraisal of its proposal by identifying the consequences - in quantative terms - of its implementation taking into account :

- the compliance costs for the payors of interest;
- the cash-flow detriment to the recipient, who will incur tax about a year earlier than now and in some cases turn out not to owe tax on the interest (e.g. because of business losses);
- the incentive to lenders, whether resident in the EC or not, to lend to borrowers outside the EC in order to avoid the costs and/or complications caused by the directive;
- the higher interest payable on existing loans where the contract contains an escalator clause;
- the loss of financial business to the EC as a result of it going to financial centres outside the EC.

Furthermore, UNICE would appreciate it if the Commission could give a quantitative estimate of the distortion which might be caused if the proposed system of withholding tax is not implemented and the movement of capital is nevertheless liberalised?

Could the Commission also indicate in quantitative terms the amount of interest which would be affected by the proposed withholding tax and the amount of interest which would most likely be exempted from the tax?

---

chex.ps/jmt/100 **UNCLASSIFIED**

FROM: J M G TAYLOR
DATE: 8 May 1989

MR A J G ISAAC (Inland Revenue)

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
Mr Ilett
Mrs M Brown
Ms Symes
Mrs Chaplin
Mr Tyrie

Sir A Battishill - IR
PS/IR

Mr Unwin - C&E
PS/C&E

Mr Bostock (UKREP)

INFORMAL ECOFIN 19-20 MAY: TAXATION OF SAVINGS: LETTER FROM MADAME SCRIVENER

The Chancellor has seen Mme. Scrivener's letter of 28 April, suggesting a meeting between Commission officials and ourselves in advance of the informal ECOFIN. The Chancellor is well content with this proposal. You may like to liaise with Mr Lankester/Mr Bostock about dates.

J M G TAYLOR

ec2.ss/symes/10.5.1

FROM: SUSIE SYMES
DATE: 10 MAY 1989
EXTN: 4441

PS/CHANCELLOR

cc Mr Wicks - with attachment
Mr Lankester
Mr R I G Allen
Mr Ilett o/r

WITHHOLDING TAX: MME SCRIVENER'S SPEECH TO THE ECONOMIC AND SOCIAL COMMITTEE, 27 APRIL

The Chancellor noted Mme Scrivener's remark (UKREP Telno 1383) that 'if large outflows of capital took place, some member states would have to have recourse to safeguard clauses, [if] necessary contrary to EC law'.

2. I raised this with UKREP, and attach David Bostock's reply.

Susie Symes

SUSIE SYMES

Office of the United Kingdom Permanent Representative
to the European Community
Rond-Point Robert Schuman 6 1040 Brussels

Telephone 230.62.05

Miss S Symes
HM Treasury
LONDON

MUFAX

Your reference

Our reference

Date 10 May 1989

Dear Susie

WITHHOLDING TAX : MRS SCRIVENER'S SPEECH TO THE ECONOMIC AND SOCIAL COMMITTEE ON 27 APRIL

1. Thank you for your letter of 2 May.

2. I have spoken to Petite (Mrs Scrivener's deputy Chef de Cabinet), who seems to have had a large hand in drafting the speech summarised in UKRep tel no 1383, and put it to him that Mrs Scrivener's remarks reads suspiciously like an indication that the Commission might condone a breach of Community Law.

3. Petite denied that this was Mrs Scrivener's intention. Agreement on a withholding tax for other measures to reduce the risks of tax evasion, etc. was not a pre-condition for the liberalisation of capital movements. The Commission would have to react appropriately if any Member State failed to comply with its obligations under the 1988 Capital Movements Directive; the Commission would have "no sympathy" with any Member State which broke the provision of this Directive. (I am sure that "no sympathy" is an exaggeration). It was however a fact of life that for some Member States the liberalisation of capital movements would be easier if accompanying measures such as the withholding tax were approved. That was the point that Mrs Scrivener had been trying to get across.

4. Petite went on to say that he understood that the French Finance Ministry were cooking up new and onerous arrangements under which French residents would be required to declare to the authorities any movement of funds abroad. He implied that such restrictions might be less likely to be imposed if there were agreement on measures relating to the taxation of savings; and that the ideas being considered in Paris might be in breach of the Directive. (Comment: so far as I can see, it all depends on the small print; the Danish scheme is regarded as satisfactory).

5. I was less surprised than you by the implication in Mrs Scrivener's remarks that she was referring to ex post action. Mrs Scrivener talked about Member States' making use of safeguard clauses. The safeguard clauses in Article 73 of the Treaty and Article 3 of the Capital Movements Directive of June 1988 both seem to imply that safeguard action is taken after things have begun to go wrong.

Yours sincerely

David Bostock

D J Bostock

Yes. But my point was that the Capital Movements Directives would have to be fully implemented first, then - say - 'things go wrong', only then might safeguard clauses be called on.

Z

cc: T Lankester Esq, HMT)
R I G Allen Esq, ")
N J Ilett Esq, ")
Mrs M Brown, ") MUFAX
A J G Isaac Esq, IR)
M A Arthur Esq, FCO)
L Parker Esq, Cab Off)
M Jay Esq, British Embassy, Paris

typg.ul/ln/mg/ec1/2.10.5

BF

FROM **SUSIE SYMES (EC1)**
DATE **10 MAY 1989**
EXTN **4441**

PS/CHANCELLOR

cc Mr R I G Allen
Mrs M E Brown
Ms Young

UNICE

The Chancellor asked where UNICE is based - Brussels - and what organisations are affiliated. We have asked UKREP for more details on the 33 federations from 22 European countries who are currently members, and whether there are any looser affiliations.

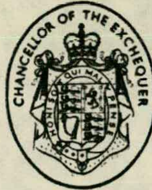
2. I am attaching a short descriptive paragraph from Vachers. UNICE are generally pro-harmonisation and pro-European, but within that framework take a relatively free-market approach. For example they have been helpful in supporting proposals on worker participation in the European Company Statute, but might be expected to take a rather more paternalistic (perhaps akin to a German Christian Democrat) approach to elements of a social charter.

Susie Symes

SUSIE SYMES

[illegible handwritten annotation]

Union of Industrial and Employers' Confederations of Europe (UNICE)
Rue Joseph II, 40/Bte 4 – B 1040 Bruxelles
Tel 237 65 11
Telex UNICE B 26013
Fax 231 14 45
Secretary-General Zygmunt Tyszkiewicz
UNICE is the official spokesman of the European business and industry world vis-à-vis the European Institutions.
UNICE's members are the central industrial and employers' confederations of Europe. 33 federations from 22 European countries are currently members of UNICE.
The aims of UNICE are to promote the common interests of its members to act as their European voice, and to ensure that the views of business and industry are taken fully into account by European legislators.
UNICE develops its work and position papers through 5 Main Policy Committees: Economic and Financial Affairs, External Relations, Company Affairs, Industrial Affairs, Social Affairs and several ad hoc experts' working groups.
UNICE maintains contacts also with several governmental and non governmental bodies such as EFTA, BIAC, OECD, I.C.C. and WIPO, and with the US and Japanese business organisations. It participates on behalf of Employers in various tripartite Committees, in the Standing Committee for Employment and in the Social Dialogue



FROM: J M G TAYLOR
DATE: 11 May 1989

MS S SYMES (EC1)

cc Mr Wicks
Mr Lankester
Mr R I G Allen
Mr Ilett

WITHHOLDING TAX: MME SCRIVENER'S SPEECH TO THE ECONOMIC AND SOCIAL COMMITTEE, 27 APRIL

The Chancellor was grateful for your note of 10 May.

J M G TAYLOR

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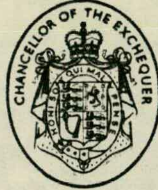


FROM: J M G TAYLOR
DATE: 11 May 1989

MR SYMES (EC1)

cc Mr R I G Allen
Mrs M Brown
Ms Young

UNICE

The Chancellor was grateful for your note of 10 May.

2. He looks forward to the further detailed information.

J M G TAYLOR

UNCLASSIFIED

ec2.ss/symes/12.5.2

UNCLASSIFIED

FROM: SUSIE SYMES (EC1)
DATE: 12 MAY 1989
X 4441

PS/CHANCELLOR

cc Mr R I G Allen
Mrs M E Brown
Ms Young

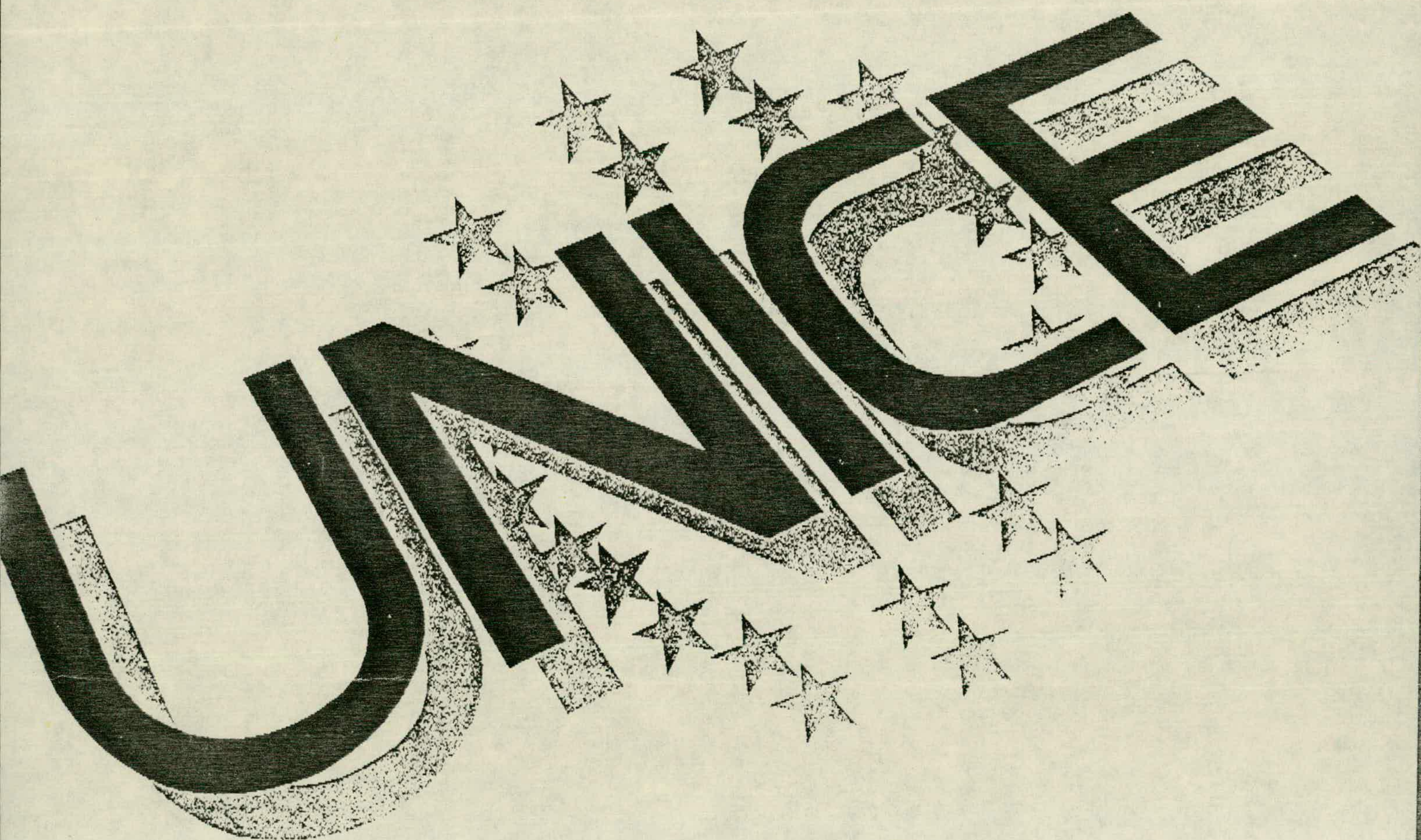
UNICE

I attach the further detailed information on UNICE that was promised in my note of 10 May.

Susie Symes

SUSIE SYMES

THE VOICE OF EUROPEAN BUSINESS AND INDUSTRY



Union of Industrial and Employers' Confederations of Europe

2

UNICE is

- the Union of Industrial and Employers' Confederations of Europe, created in 1958 and recognised as official spokesman for European business and industry vis-à-vis the European institutions
- composed of 33 member federations from 22 European countries (1.1.88) with a permanent Secretariat based in Brussels.

UNICE's purpose is

- to promote the common professional interests of the firms represented by its members
- to provide the framework within which member organisations can co-ordinate their European policies
- to ensure that European decision-makers take UNICE's policies and opinions fully into account.

UNICE's main activities are

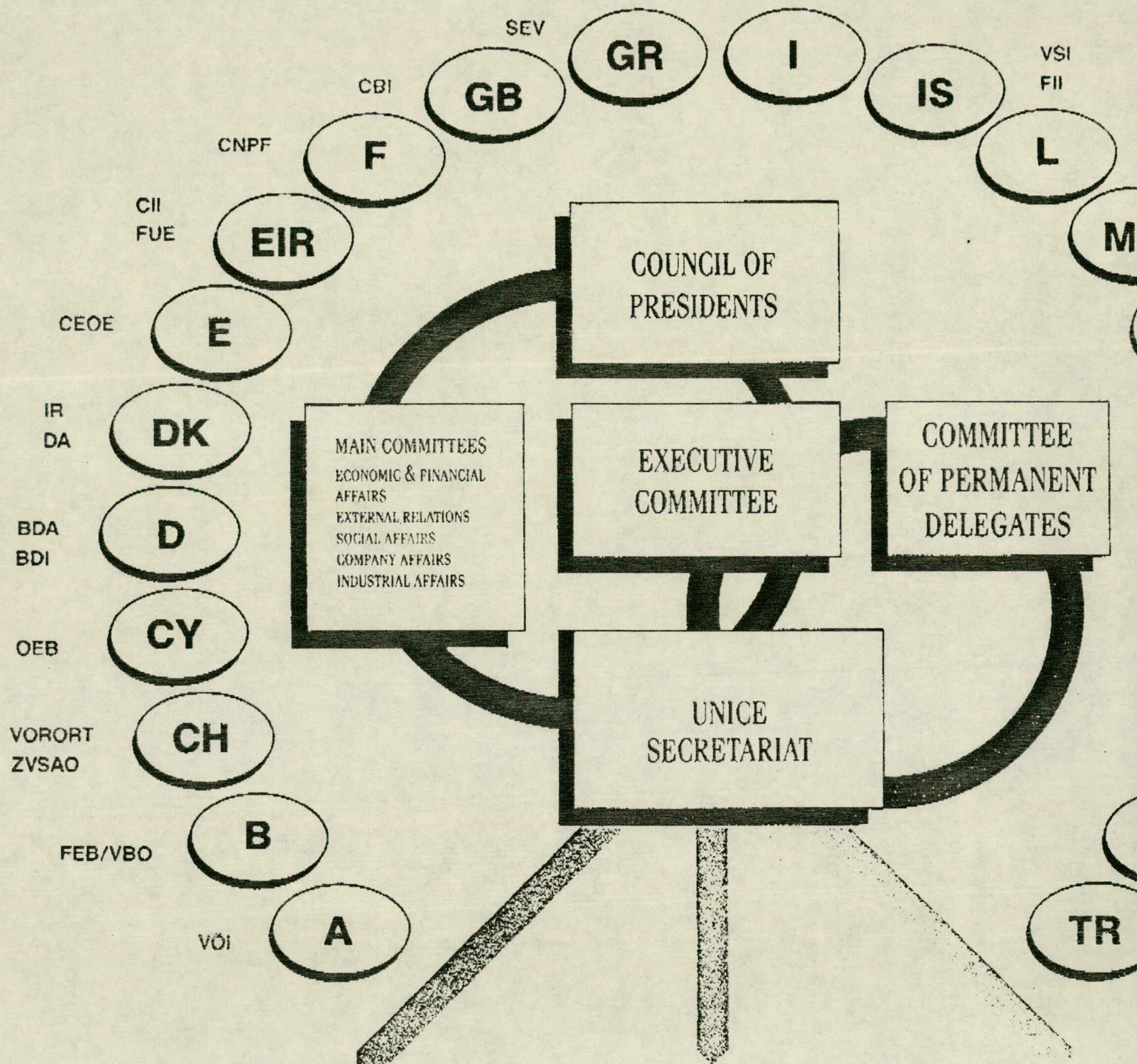
- to maintain effective contacts with all European institutions and, through these, to be well informed on matters of interest to members
- to organise members in committees and working groups whose task is to examine European policies or legislative proposals and to prepare UNICE opinions on these. UNICE not only reacts to events, it also initiates action by pressing the authorities to introduce new policies or legislation considered desirable by business and industry
- to promote and publicise UNICE policies and opinions at EC and national levels.

UNICE's main priorities are

- completion of the European Internal Market and development of the "European Economic Space" comprising the EC and EFTA countries
- creation of a more favourable climate for enterprise
- promotion of European technology, research and development
- strengthening of European economic and social cohesion
- development of the social dialogue between UNICE and the European Trade Union Confederation (ETUC)
- liberalisation of world trade, based on the principles of reciprocity and fair competition.

UNICE's principal contacts are

- **with European Institutions**
  - the European Commission, where regulations originate
  - the European Parliament and the Economic and Social Committee, which can influence legislation
  - the Council of Ministers, the final decision-maker.
- **with International Governmental Organisations**
  - whose work affects European business, such as the Council of Europe, the European Free Trade Association (EFTA), the European Committee for Standardisation (CEN), the European Patent Office (EPO), the European Conference of Ministers of Transport (ECMT), the United Nations Conference on Trade and Development (UNCTAD), the United Nations Industrial Development Organisation (UNIDO), the World Intellectual Property Organisation (WIPO), etc.
- **with International Non-Governmental Organisations**
  - including the International Organisation of Employers (IOE), the European Trade Union Confederation (ETUC), the Business and Industry Advisory Committee to the OECD (BIAC), the European Industrial Branch Federations (FEBIs), and international business organisations throughout the world, such as the International Chamber of Commerce, US business organisations, and the Keidanren (Japan Federation of Economic Organisations), etc.



REPRESENTATION:	LIAISON:	* OBSERVER:
EC INSTITUTIONS:	COUNCIL OF EUROPE	EFTA
EC COMMISSION	FEBIS	UNCTAD
COUNCIL OF MINISTERS	ETUC	UNIDO
EUROPEAN PARLIAMENT	BIAC	WIPO
ECONOMIC & SOCIAL COMMITTEE	IDE	EPO
ETC.	ICC	ETC.
	CEN/CENELEC	
	KEIDANREN	
	US BUSINESS ORGANISATIONS	
	ETC.	

* presumably meaning that UNICE has observer status at these organisations

IL

MFOI

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NAF
N

VNO
NCW
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Member Federations

A	Vereinigung Österreichischer Industrieller - VÖI	Austria
B	Fédération des Entreprises de Belgique - FEB Verbond van Belgische Ondernemingen - VBO	Belgium
CH	Vorort des Schweizerischen Handels- und Industrie Vereins - VORORT Zentralverband Schweizerischer Arbeitgeber Organisationen - ZVSAO	Switzerland
CY	Omospondia Ergodoton ke Viomichanon Kyprou - OEB	Cyprus
D	Bundesvereinigung der Deutschen Arbeitgeberverbände e.V. - BDA Bundesverband der Deutschen Industrie e.V. - BDI	Federal Republic of Germany
DK	Industrirådet - IR Dansk Arbejdsgiverforening - DA	Denmark
E	Confederación Española de Organizaciones Empresariales - CEOE	Spain
EIR	Confederation of Irish Industry - CII Federated Union of Employers - FUE	Ireland
F	Conseil National du Patronat Français - CNPF	France
GB	Confederation of British Industry - CBI	United Kingdom
GR	Syndesmos Ellinikon Viomichanion - SEV	Greece
I	Confederazione Generale dell'Industria Italiana - CONFINDUSTRIA	Italy
IS	Vinnuveitendasamband Íslands - VSI Félag Íslenskra Idnrekenda - FII	Iceland
L	Fédération des Industriels Luxembourgeois - FEDIL	Luxembourg
MW	The Malta Federation of Industries - MFOI	Malta
N	Norges Industriforbund - NI Norsk Arbeidsgiverforening - N.A.F.	Norway
NL	Verbond van Nederlandse Ondernemingen - VNO Nederlands Christelijk Werkgeversverbond - NCW	Netherlands
P	Associação Industrial Portuguesa - AIP Confederação da Indústria Portuguesa - CIP	Portugal
S	Sveriges Industriförbund - SI Svenska Arbetsgivareföreningen - SAF	Sweden
SF	Teollisuuden Keskusliitto - TKL Suomen Työnantajain Keskusliitto STK	Finland
SM	Associazione Nazionale dell'Industria Sammarinese - ANIS	San Marino
TR	Türkiye Işveren Sendikalari Konfederasyonu - TISK Türk Sanayicileri Ve Işadamlari Derneği - TÜSIAD	Turkey

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UNICE's organisation comprises

- the President and up to five Vice-Presidents, elected for two years, with the possibility of being re-elected once
- the Council of Presidents, made up of Presidents of the member federations, which lays down general policy and is the supreme authority
- the Executive Committee, consisting of Directors General of the member federations, which is the managing body
- the Committee of Permanent Delegates, made up of federation representatives mainly based in Brussels, which meets fortnightly with the Secretary General and ensures permanent liaison with the central federations
- the permanent Secretariat based in Brussels and headed by the Secretary General who is responsible for the day-to-day running of the association. The Secretariat, comprising some 26 people, is divided into departments which match the scope of the five main policy committees, and provide these with expert and administrative support. The public relations and information department ensures that UNICE's messages reach decision-makers, the media and the public
- five main policy committees made up of industrialists and experts from the federations. These committees monitor developments in their respective fields. They assist in formulating UNICE policy, suggest actions to be taken and implement the strategies adopted by the Executive Committee and Council of Presidents.

The **Economic and Financial Affairs Committee** deals with economic policy, monetary and fiscal matters, regional policy and the economic situation.

The **External Relations Committee** specialises in EC trade policy, relations with the USA, Japan and other developed countries, customs legislation, the GATT, and policy concerning the less-developed countries.

The scope of the **Social Affairs Committee** includes social policy, industrial relations, the social dialogue, the standing committee on employment, training, social security, health and safety, social charter and the Council of Europe.

The **Industrial Affairs Committee** covers energy, telecommunications, research and development, transport, the environment, small and medium-sized enterprises and public purchasing.

The **Company Affairs Committee** covers rules of competition, competition policy, company law, elimination of technical barriers to trade, industrial property (patents, licences, trademarks), consumer policy and marketing, civil and commercial law, multinational companies and insurance legislation.

- each main policy committee has created a number of working groups composed of experts. These groups prepare initial draft position papers which are then submitted through the main policy committee to the Executive Committee for approval.

Permanent Delegations in Brussels and contact addresses

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TR Türk Sanayicileri Ve Isadamlari Dernegi
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TR-Harbiye, Istanbul
Tel. 90-1/1401205

FROM: J M G TAYLOR
DATE: 16 May 1989

MS S SYMES (EC1)

cc **Mr R I G Allen**
Mrs M Brown
Ms Young

UNICE

The Chancellor was grateful for your note of 12 May.

J M G TAYLOR

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

From
John M M Banham
Director-General

16 May 1989

Our Ref. MW 09/25

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3AG

CH/EXCHEQUER
16 MAY 1989
17/5
Mr ISAAC-IR
PS/EST,
Mr WICKS
Mr LANKESTER
Mr COLWG-SMEE
Mr R.I.G. ALLEN,
Mr ILETT,
Mrs BROWN,
Ms SYMES

Dear Nigel,

European Commission - Withholding Tax Proposals

I am writing to let you know that UNICE, speaking for European business, has rejected the Commission's proposals for a new Community wide Withholding Tax. I enclose a copy of the UNICE position paper.

We fully support the stance taken by UNICE. We have consistently argued that the Commission's proposals are misguided and unnecessary and would inevitably result in increased costs for business as well as a loss of market share to financial centres outside the Community.

We hope that the UNICE paper and our own views will be of assistance to you in your contacts with the Commission and in the Council of Ministers.

If there is anything further that we can do to help you persuade the Commission to drop these proposals please do not hesitate to let me know.

I am writing in similar vein to Lord Young.

Yours,

John

John M M Banham

April 1989

Position paper on the draft directive on a common system of withholding tax on interest income.

According to the Commission's Global Communication, the draft directive on a common system of withholding tax on interest income is designed primarily to deal with the increased risk of tax evasion which is supposed to be a direct result of the final phase of the liberalisation of capital movements.

In UNICE's opinion, when looking for solutions, due attention should be given to the fact that this problem arises in a wider context than the Community's and that any measures to solve it must not result in a flight of capital towards certain countries that are not members of the EC. More generally speaking, the EC should avoid choosing a remedy which in the end could turn out to be more harmful than the illness it was meant to cure.(*)

After judging from this angle the draft directive on a common system of withholding tax on interest income, as recently submitted to the Council, UNICE had to arrive at the conclusion that the Commission's proposal is not satisfactory in that, firstly, it seems questionable at least whether this proposal would effectively prevent tax evasion, secondly, it appears to be damaging to the Community's function as a financial market place, thirdly, it would impose a considerable additional compliance burden on payors of interest, and, last but not least, increase costs for European business and industry. The proposed measures could turn out to be extremely detrimental to economic activity and not warranted by the liberalisation of the very few operations which are not yet free.

These points of criticism will be briefly analysed below.

a) Effectiveness

After the implementation of the directive, residents of the Community will still be free to invest their money outside the EC and, thereby, escape the EC withholding tax.

For various reasons, the level of the withholding tax should certainly not be higher than that proposed by the Commission. However, it seems realistic to note that such a level will not be fit to prevent mala fide EC residents from not declaring their interest income or to substantially reduce the budgetary loss for the Member States, resulting from tax evasion in this field.

(*) The CNPF considers that the free movement of capital makes a minimum level of harmonisation of tax on interest income necessary, in order to avoid the very real risk of delocalisation, which would seriously upset the functioning of the European market; it is in favour of a Community solution coordinating the national changes needed to forestall such risks.

RUE JOSEPH II 40 - Bte 4 - 1040 BRUXELLES - T.V.A. 536059612 - TÉL. 2376511 - TÉLÉFAX 2311445 - TÉLEX UNICE B 26013 - TÉLÉGR. UNINDUSEUROP

b) Impact on the EC as a financial market place

The introduction of a European withholding tax will have a disturbing effect on the functioning of financial markets. These markets are becoming more and more interrelated due to the removal of restrictions and technical progress. Liberalisation of capital movements is not only a European, but a worldwide development. Therefore, any proposal regarding capital flows should take into account relations with the rest of the world. In a way, the Commission has done so by excluding recipients from non-EC countries from the scope of the tax. On the other hand, however, the Commission creates with its proposal a stimulus for EC residents to invest in countries outside the EC. This would have a direct negative effect on economic activity within the EC. Moreover, it would interfere with the policy of monetary authorities and reduce the role of the EC as a financial market place.

The possible "splitting" of capital markets as a result of tax-induced changes in investment patterns and its effects on interest rate differentials, should also be considered. Indeed, there is evidence to show that this happened in Germany following the introduction of a withholding tax in 1988. Investment patterns could be distorted if the proposed withholding tax on interest income is set at a significantly lower rate than for other types of investment such as, in particular, stockmarket and equity investment.

c) Practicability

A correct application of the proposed system would imply that the payor of interest is aware of :

- the nature of the loan;
- the country of residence of the payee (EC or third country? The payor required to obtain a certificate of residence for the payee?);
- the effect of any tax treaty in reducing or cancelling the withholding tax, or not doing so in particular cases;
- the capacity (private person or entrepreneur), in which the payee will receive the interest;
- the tax treatment of the interest in the country of residence of the payee (within or outside the scope of income or profits tax; if within the scope, still no tax because it constitutes commercial or industrial income of the recipient or is covered by a special scheme for private savings?)

It goes without saying that these requirements will result in a considerable additional administrative burden and its attendant costs for interest paying financial institutions and companies. In fact, to UNICE it seems hardly conceivable that the system as proposed by the Commission, would be workable in practice.

d) Costs for business and industry

Apart from the additional compliance costs mentioned above, European business and industry would be confronted with higher interest costs in the EC. To UNICE it appears likely that the introduction of a withholding tax would increase interest rates, not only in the Member States

which do not apply such a tax at present, but also in the Community as a whole (the scope of the existing withholding taxes on interest will actually be extended to interest from the other Member States; potential third country investors may become reluctant because of questions about residence, etc. which they will have to answer in future).

The recent German experience provides us with a small scale example of what could be expected in this respect (after the 10% withholding tax was announced by the German government, the differential vis-à-vis for example the Dutch long-term rates changed clearly in favour of the latter).

The fact that loan contracts often contain a so called "escalator clause" could result in further cost increases for business and industry as a consequence of the implementation of the proposal.

In this connection UNICE would like to know exactly what is the meaning of the concept "commercial and industrial income" in the exemption under art. 5(f) of the draft directive. Will interest payments on all loans to companies be covered by this exemption, and will the exemption apply regardless of whether or not the payor and payeee are affiliated companies?

UNICE realises that the Commission, when shaping its proposal, has tried to find the middle ground between a number of potentially conflicting objectives. The result, however, does not seem to be satisfying and UNICE wonders whether the Commission could given an economic appraisal of its proposal by identifying the consequences - in quantative terms - of its implementation taking into account :

- the compliance costs for the payors of interest;
- the cash-flow detriment to the recipient, who will incur tax about a year earlier than now and in some cases turn out not to owe tax on the interest (e.g. because of business losses);
- the incentive to lenders, whether resident in the EC or not, to lend to borrowers outside the EC in order to avoid the costs and/or complications caused by the directive;
- the higher interest payable on existing loans where the contract contains an escalator clause;
- the loss of financial business to the EC as a result of it going to financial centres outside the EC.

Furthermore, UNICE would appreciate it if the Commission could give a quantitative estimate of the distortion which might be caused if the proposed system of withholding tax is not implemented and the movement of capital is nevertheless liberalised?

Could the Commission also indicate in quantitative terms the amount of interest which would be affected by the proposed withholding tax and the amount of interest which would most likely be exempted from the tax?

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC
17 May 1989

Ch/ Content?

CHANCELLOR OF THE EXCHEQUER

EUROPEAN COMMISSION - WITHHOLDING TAX PROPOSALS

You might care to reply on the following lines to Mr Banham's letter to you of 16 May.

behind

A J G ISAAC

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Wicks
Mr Scholar
Mr Lankester
Mr R I G Allen
Mr Odling-Smee
Mr Ilett
Mr Isaac
Mr Corlett
Mr O'Connor
PS/IR

EUROPEAN COMMISSION - WITHHOLDING TAX PROPOSALS

Thank you for your letter of 16 May and the copy which you sent me of the UNICE paper on the Commission's withholding tax proposals.

As it happens, I had already seen a copy of this very helpful and well-argued paper ~~through contacts in Brussels. Indeed, we have already~~ asked the Brussels authorities to make sure that a copy ~~is~~ drawn to the attention of my ~~colleagues~~ in the other European Community countries ~~concerned with the proposed withholding tax Directive.~~

As you will know from earlier discussions between the CBI and the Inland Revenue, it can be most helpful when industry makes its views known directly to the Community authorities in Brussels, to support and strengthen the arguments which we have been deploying - I am glad to think with some success - at the inter-Governmental level.

What is the Government's reaction to the Commission's revised ideas on tax approximation announced yesterday - including concessions on UK zero rates?

We welcome Commission's acceptance that its original proposals were non-starters, but regret its continuing desire for tax approximation. Also welcome fact that Commission's latest ideas appear to accept that zero rates can be retained. This is a major vindication of the UK's firm stance, but we shall need to study the small print of the Commission's new communication very carefully.

PRH Allen

HM Customs and Excise
New Kings Beam House
22 Upper Ground
London SE1 9PS

BACKGROUND NOTE

The Commission announced its revised proposals on tax approximation at a press conference yesterday (17 May). The text of the new communication is not yet available, but its main elements (as announced at the press conference) are:

- subject to certain conditions (unspecified) a limited number of VAT zero rates may be retained by Member States if they wish.

- The standard VAT rate band of 14 - 20% is replaced by a minimum rate (yet to be approved by the Commission); but a reduced rate band of 4 - 9% remains.

- Travellers' tax paid allowances to be progressively quadrupled by 1993 (not yet known if there are separate proposals for excise goods).

The Commission's new proposals will be discussed at ECOFIN this weekend; but with the text of the Commission communication unlikely to be available before the meeting our reaction must be provisional at this stage. Substantive discussion is more likely to occur at ECOFIN in June.

At yesterday's press conference, in reply to a question from the floor, Mme Scrivener apparently confirmed that the new proposals mean that the UK can keep its zero rates on food and children's clothes. This has been widely reported in the press and is clearly welcome. But the precise scope of what may eventually be agreed remains to be negotiated.

The Commission's revised ideas retain a requirement for some tax approximation: a minimum standard rate and a reduced rate band for VAT; and minimum rates or rate bands for excise duties. Under the UK's market-based approach such approximation is considered unnecessary.

chex.pj/jc/18.5.2

PWP

FROM: MRS JUDITH CHAPLIN
18th May 1989
x4359

CHANCELLOR

cc PS/Financial Secretary
Miss Hay FP

INDEPENDENT TAXATION

told JC 19/5.

The Prime Minister asked for a note on Independent Taxation in case she wished to mention it in her speech to the Conservative Women's Conference. Mary Hay supplied me with the attached note. Are you happy for me to send it to No 10?

JC

JUDITH CHAPLIN

INDEPENDENT TAXATION OF HUSBANDS AND WIVES

Independent taxation of husbands and wives will start in April 1990. With it we shall bring to an end the long standing and anachronistic system under which a married woman's income is treated as belonging to her husband for tax purposes.

The basic principle of the new system is that everyone - including husbands and wives - will be taxed completely independently on all their income, including earnings, savings and pensions. A married woman will in future be able to have complete privacy for her tax affairs. Her income will no longer be included on the tax return which her husband completes.

Married women of all ages will benefit from having their own personal allowance to set against their income from whatever source. In particular, a wife who has income from savings will be able to set her own allowance against it, instead of seeing it added to her husband's income and taxed as his.

And a great many married women pensions will pay less tax on their income. As well as being able to set their personal allowance against savings income, they will for the first time be able to set it against pensions they receive on the basis of their husband's National Insurance Contributions. As a result, more than 85 per cent of elderly married couples will see their tax bills go down.

In total over 3 million wives will pay less tax under Independent Taxation; and about 2½ million of these have incomes of less than £5,000.

The changes we are making will also remove the tax penalties on marriage which are inherent in the present system. They will get rid of discrimination against married people and the disadvantages which meant that a married couple could together be paying more tax than two single people.

[The introduction of Independent Taxation represents a fundamental change in our tax system; but the necessary preparatory work is already well in hand. Between now and April 1990, tax offices will be setting up independent records for married women, and transferring information to them from their husbands' records.]

[Tax offices can do most of this using the information they already have; but about a million more tax returns than usual have been sent out this year in order to gather the extra details that are needed. Most of the extra tax returns have gone to elderly married men, because their wives are among those who stand to benefit in particular from Independent Taxation.]

Independent Taxation demonstrates our commitment to giving all women a fair deal and recognising their role in our modern society.

cnex.ps/jmt2/25

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

22 May 1989

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Wicks
Mr Lankester
Mr Scholar
Mr R I G Allen
Mr Odling-Smee
Mr Ilett

Mr Isaac - IR
Mr Corlett - IR
Mr O'Connor - IR
PS/IR

John M M Banham Esq
Director-General
Confederation of British Industry
Centre Point
103 New Oxford Street
LONDON WC1A 1DU

Dear John

EUROPEAN COMMISSION - WITHHOLDING TAX PROPOSALS

Thank you for your letter of 16 May and the copy which you sent me of the UNICE paper on the Commission's withholding tax proposals, which I am determined to resist.

As it happens, I had already seen a copy of this very helpful and well-argued paper, and asked the Brussels authorities to make sure that a copy was drawn to the attention of my opposite numbers in the other European Community countries.

As you will know from earlier discussions between the CBI and the Inland Revenue, it can be most helpful when industry makes its views known directly to the Community authorities in Brussels, to support and strengthen the arguments which we have been deploying - I am glad to think with some success - at the inter-Governmental level.

Yours
Nigel

NIGEL LAWSON

David Curry 26/5/89.

HOUSE OF COMMONS
LONDON SW1A 0AA

ECONOMIC SECRETARY
REC'D 2? MAY 1989
FOR INFO
COPIES TO PS/CHX, PS/FST, PS/CST, PS/PMG, Mrs Chaplin, Mr Call, Mr Tyrie, Mr Gilhooly, Mr Michie, Mrs Brown, PS/C&E, Mr Wilmott, Mr Allen, Ms. D. Barrett.

Dear Peter,

I spoke to Christiane Scrivener in Strasbourg. She told me in private conversation that she wd have no difficulty with the UK's maintaining all its present 0 rates.

Later, in the Economic Committee she stated on the record:

"We envisage 0 rates for a limited range of products. It is the social aspect which counts. There is no question of extending it to other products and no question of other countries demanding 0 rates. What we keep is what exists when it has a social connotation."

Later, in response to questions, she said "Yes to 0 rates for products where it already exists but we will refuse all demands for addit. 0 rates. There is still a small question mark."

I asked her Cabinet aide, Françoise Le Bail (who is the wife of James Elles, MEP) to keep me informed of the legal services study of village halls in the light of the timetable for the Finance Bill.

I hope this helps,

Yours ever,

David

From:

Board of Academic Advisers

to the

Federal Ministry of Economic Affairs

Bonn, June 5, 1989

I assume you have seen this. Should we draw it to the Chancellor's attention? Please return. 16/10

To:

Dr. Helmut Haussmann,

Federal Minister of Economic Affairs

5300 Bonn 1

ANX D BOARD OF ECONOMIC ADVISERS

Dear Mr. Minister,

The Committee set up by the European Council for studying and proposing concrete steps leading towards economic and monetary union in Europe (Delors-Committee) has completed and submitted its report. This report presents many requirements and proposals to be considered before the ultimate objective can be obtained. To this extent, the Delors report and the positive acceptance it has received in many European countries should be welcomed. On the other hand, the Delors Committee has also adopted positions to which serious objections must be raised. A rash political adoption of the basic tenets of the Delors Committee's proposals means setting out on a problematic road. The Board of Academic Advisers wishes to comment briefly in this letter on a number of critical points in that report. Our remarks mainly refer to the stages preceding the economic and monetary union as well as to its eventual shape. Moreover, the Board of Academic Advisers wishes to draw attention to its Study entitled "A Monetary Order for the Single European Market" dated January 20/21, 1989.

1. For the period prior to the completion of the union, the Delors Committee wishes to propose a strategy whereby the EC Member States accept from the outset the irreversibility of their action and must all agree to keep the goal of parallel progress in economic and monetary integration in mind. The rejection of the socalled "crowning" theory - the idea that the monetary union would crown economic integration which has shown sufficient results - is not unjustified. However, the risks inherent in the proposed strategy must be contained. A premature decision to go beyond the point of no return would be too dangerous if it included the construction of new institutions

7/130

which we can only hope will provide satisfactory monetary stability and if at the same time it irrevocably dismantled the current proven ones. The Deutsche Bundesbank and its monetary constitution are achievements too valuable to allow their erosion and excessive reshaping before the prospects for the success of the economic and monetary union have been positively established. We deem particularly dangerous the risk that transitional arrangements ultimately become permanent ones, although they would represent a deterioration of conditions in comparison to the status quo, at least from the point of view of those countries that are especially committed to economic and monetary stability.

2. The basic guidance the Delors Committee offers for the road towards a monetary union is reflected by the idea that monetary policy in Europe should gradually become the responsibility of the European Community. Many of the procedures suggested for the two phases prior to the eventual monetary union in Europe serve this idea. With due respect to the difficulty of the task of providing the necessary guidance (for increasingly convergent economic policies) to the EC Member States in this period, the Board of Academic Advisers rejects this idea. The Community's monetary policy is being guided quite well by the Deutsche Bundesbank, a fact which has been acknowledged in the Delors Report. The hope for the future is that such - no less competent - guidance will come from a European Central Bank, which is to be eventually created. However, the approach suggested for the meantime, to increasingly leave such guidance de facto to coordinating EEC bodies, is contradictory. The Delors report proposes that during the second stage the ultimate responsibility be held by the national central banks, however under the guidance of coordinating bodies actual responsibility would tend to fall to them leaving the national banks' responsibilities a mere formality.

The new definition of the mandate and the institutional enlargement of the already existing European Council of Central Bank Governors by the three sub-committees as proposed by the Delors Committee is also problematic. This proposal would in fact give the Council a weight that is incompatible with the autonomy of national central banks that at present cannot be given up.

The largely undisputed insight that the conditions in the Community for a monetary union committed to stability have not yet been satisfied must be firmly borne in mind. At present, the Deutschmark is - for good reasons -

the anchor of the European Monetary System (EMS); monetary policy coordination is strongly effected by market forces. The asymmetrical adjustment mechanisms inherent in the EMS are largely responsible for its success. The Delors report proposes giving up this asymmetry at an appropriate moment in favour of a European Central Bank with power to act. This step should not be taken prematurely, nor even gradually. Currently, there is no substitute for the anchor function of the strongest of the large EMS currencies. Installing a community-wide monetary policy in place of the Deutschmark's anchor function would be tantamount to opting for a drag anchor. As long as many Community Member States have not exposed themselves to the test of running stability-oriented policies in an environment of completely free capital movements, there is no guarantee that the ex-ante coordination by European bodies will lead to a policy course that is sufficiently commited to stability. The fact that the proposed coordinating bodies are not to be formally given the final say in monetary policy before the end of the second stage, is not a justification for introducing this proposal either. The stages prior to a monetary union require the strengthening of coordination through market forces, rather than a rash substitution of them.

3. The Delors Committee proposes a federally shaped European central bank system whose decision-making body is to be independent and unambiguously committed to monetary stability. The independence of the decision-making body, however, requires the independence of each of its members. Since monetary policy is not an area for national compromises, the European central bank should not be organized on a federal or multilevel basis which is likely to provoke such compromises. Therefore, we should not allow the national representatives of the European decision-making body to be answerable in some form or another, possibly as central bank presidents, to their respective governments. (The Deutsche Bundesbank, with its Landeszentralbanken as regional administrative centres, is ultimately an example of a one-level central bank system as well.)

Since such independence has not been provided, at least not for the proposed second stage, and since an independent European Central Bank that does not have the last word in matters of monetary policy would not make sense either, the whole concept of a two-stage transition period leading to a monetary union is problematic. The proposal that the European central bank system grow on a step-by-step basis into its functions, while the

final responsibility for monetary policy action is to remain with the national bodies, may turn out to be a disastrous contradiction.

The aspects already mentioned in paragraphs 1 and 2 must be considered as well. There should, with respect to the new institutions, be a smooth and continuous period leading to monetary union. This period would initially bear the characteristics of economic policy coordination effected by market forces within the EMS. During this time, there should not be any mention of "formulating and enforcing a common monetary policy". The intra-Community monetary cooperation that already exists could increase considerably and become more binding in so far as the real convergence of economic policy towards stability is successful, and as the Delors Committee's recommendation to give greater autonomy to all central banks in Europe is acted upon. If possible, the central banks' legal responsibilities should be harmonized as well. A European Central Bank would be set up only at the end of this period. If its organizational structure is to be a federal one, complete independence of the participating national central banks would have to be ensured in advance.

4. The Delors Committee demands a "common exchange rate policy" vis-à-vis third countries. The basic tenets of this policy should be defined by community institutions in collaboration with the European central bank system. The latter should execute the agreed-upon policy. However, if there is a permanent exchange rate policy that is ultimately superimposed on monetary policy by EEC authorities, whose actions are guided by employment, growth and, possibly, foreign policy concerns, the outcome could be an impairment of the European Central Bank's independent policy towards monetary stability.

5. The Delors Committee's vision of a European economic and monetary union is based on the idea that, beyond monetary policy, effective ex-ante coordination between all areas of economic policy and all Member States is necessary. In spite of the welcomed acknowledgement of market forces, the Delors Committee's basic distrust of the coordinating force of the market and the help markets can provide in coordinating the national policies of the participating countries is ubiquitous throughout the whole Report. The value of proposals resulting from such distrust is highly questionable from the point of view of the market order and its constitution as well as from the area of impact analysis.

This applies to fiscal policy in particular. The Board of Academic Advisers deems it neither necessary nor desirable, first to institute to the extent proposed a binding ex-ante fiscal policy coordination based on majority voting among EC- Member States, and second to enforce coordination between fiscal and monetary policies of the member countries. A required ex-ante coordination of the Member States' fiscal policies, e.g. in the form of rules governing the upper limits for the budget deficits of individual Member States, is cause for concern, because it would mean intervening in powers that belong to the very core of national sovereignty.

It is certainly true that a considerable measure of economic and, especially, fiscal policy convergence is indispensable to an economic and monetary union, and also required for the transition to permanently fixed exchange rates or a single European currency. However, it is the results of the convergence that are important, not so much the measures taken to achieve them. Policy convergence may occur spontaneously, being brought about, as the case may be, by market forces. This outcome is to be expected when economic conditions, including monetary policy, are correct from the point of view of "Ordnungspolitik", i.e. the market order as a whole. As far as structural and regional policies are concerned, they must be pursued competitively through strict adherence by the individual nations to the rules of free competition. Above all, selective subsidies on a national basis should be strictly forbidden; here responsibility rests with the Community. The Board of Academic Advisers has already offered a detailed opposition to the hypothesis that an economic and monetary union per se would create additional demand for intra-Community transfers in its opinion "A Monetary Order for the Single European Market".

In its Report, the Delors Committee pays more attention than justified to the idea of permanent demand management, or "macroeconomic management". This reflects an emphasis on obsolete notions, rather than on the experience of the last decade. Here again the stipulated ex-ante coordination of Member States' general economic policies and the report's requirement of a common definition of monetary policy calls for opposition.

Monetary policy must be unambiguously committed to monetary stability and to objective money supply criteria. This principle is upheld in some parts of the Delors Report, but in other parts it receeds into the background behind macroeconomic management. At present, those EMS Member States which don't hold anchor currencies must subject their economic policies to the

constraints emanating from a monetary policy formulated by those countries with the strongest currencies, i.e. currently the policy of the Deutsche Bundesbank (as long as an exchange rate variation is not desired). Ex-ante coordination of economic and monetary policies by European authorities will mean that monetary policies must - time and again - be aligned with what is politically feasible for the system as a whole. Experience has taught us that this will not lead to stable money.

In this area basic general economic policy differences become visible. The Delors Committee does avoid extreme positions here. However, where it should give incentives and build in constraints for member states to do what is right in their own interests, it trusts too much in the proper functioning of new institutions, i.e., the new agencies which hopefully will identify and arrange policies for the good of all.

6. In summary, the Board of Academic Advisers deems the following actions necessary:

(1) The final responsibility and autonomy of the Deutsche Bundesbank for a monetary policy oriented towards stability must not be questioned, either directly or indirectly, before the end of the period resulting in a monetary union.

(2) The period leading to a monetary union should consist not of two, but of just one stage. A European Central Bank will be created only at the end of this period. For this simple reason, there is no need for an early commencement of negotiations to modify the Treaty as required by the Delors report.

(3) Monetary policy does not lend itself to the compromises which will occur in a federally shaped European central bank system. If this form is nonetheless chosen, the system - like that of the Deutsche Bundesbank - must ultimately be a de facto, single-level one; this means opinion-formation should be at a single level and there should be no dependent relationship from third parties at any level.

(4) Informal coordination of economic policies through market forces shall have priority over formal ex-ante coordination by European bodies. In monetary policy, too, new forms of a de facto binding coordination emerging in the period preceding monetary union can be considered only with strong

reservations. Every step in this direction must depend on how far actual convergence of economic policies towards stability has come and to what extent national central banks have achieved the level of independence necessary for monetary stability.

(5) Stability-oriented monetary policy must not be impaired by a "common exchange-rate policy ".

(6) The formal institutionalized coordination of general economic and fiscal policies proposed by the Delors Committee should be limited to the very modest level that is really indispensable to an economic and monetary union and constitutionally justifiable at the same time. The EC Member States require more, not less, fiscal policy autonomy than the federal states of the Federal Republic of Germany have at present.

(7) An economic and monetary union does not create an additional unavoidable demand for an European structural and regional policy; on the other hand, there is an increasing need to preclude state-caused distortions of competition. European structural and regional policies which compensate for errors in other policy areas, including wage-policy, are not only to be avoided, but are harmful with respect to incentives for preventing such policy errors as well.

Accept, Mr. Minister, the assurance of our highest consideration.

sgd. Prof. Dr. Christian Watrin	Prof. Dr. Olaf Sievert
Chairman	Vice-Chairman

Members of the Board of Academic Advisers to the Federal Ministry of Economics

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FROM: P JEFFERSON SMITH
DATE: 14 JUNE 1989

CHANCELLOR OF THE EXCHEQUER

TAX APPROXIMATION: PROSPECTS FOR 19 JUNE ECOFIN

1. I visited Brussels on Monday and Tuesday to discuss informally with Commission officials and members of cabinets likely prospects for progress on the tax approximation dossier. At the end of last week I also had a number of informal discussions with Constans, Mme Scrivener's Chief de Cabinet, in the margins of the conference we were both attending. This note sets out my assessment of how things might go at ECOFIN and thereafter.

2. The Commission want as little discussion as possible at ECOFIN, and the Presidency agree with this; but the Commission want to get out of ECOFIN as strong an endorsement as Member States can bring themselves to manage of Mme Scrivener's revised indirect tax proposals. Some in the Commission want yes or no answers to her propositions; but the realists, including her Cabinet, do not expect more than an endorsement of her

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communication as a basis for further work. They would not press for more because they do not want us or other Member States entering damaging reserves at this stage. But they hope for a strong commitment to progressing the work under the French Presidency. The idea was floated that it might be a task for the July ECOFIN to set a timetable; I think we could welcome this.

3. Forms of words for the conclusions of the 19 June ECOFIN are being discussed at COREPER in Luxemburg today. I think it is likely that a formula will emerge that you could endorse.

4. After that, the Commission envisage taking forward work on the technical aspects of their proposals. First would come travellers' allowances; I welcomed this, but pressed for the proposals to include increasing third country allowances, on which I got a "too difficult" answer. Then would come technical VAT and excise proposals. I found varying views on the speed with which the proposals might be developed and whether there would be informal discussion before formal proposals were tabled or not; DG XXI and the Scrivener Cabinet are not singing in tune with each other. But it looks as if we can expect to see proposals on travellers' allowances before the holidays, but VAT and excise machinery proposals probably not until after the holidays. On these machinery aspects, we have established very good bilateral links with Commission officials and are edging them in the direction of schemes which we would find satisfactory.

5. On zero rating, the position of Mme Scrivener's Cabinet is that they are prepared to do a lot to accommodate us, but they point out that they cannot subscribe to a proposition which would allow us to keep all our present zero ratings without any concessions on our part, and that other Member States would resent us getting away with the lot. But that is what they have to say at this stage, and it seems too early to lock horns on this issue.

6. In summary, I feel that consideration is continuing to go in the direction in which the UK has been pushing it and we can let

it continue under the momentum it now has. At ECOFIN on 19 June, I think the right line to go for is no discussion of the substantive issues but an endorsement of Mme Scrivener's proposals as a basis for further work and clear instructions to officials to pursue this. If the idea of setting a firm timetable is floated, I suggest you should support it. On the detail, I see no need to repeat the UK position (indeed it might be irritating to do so) but if you got the opportunity to plug the case for increases in travellers' allowances and that these should include third country allowances, that would be helpful.

P JEFFERSON SMITH

COMMISSION OF THE EUROPEAN COMMUNITIES

COM (89) 260 final

Brussels, 14 June 1989

COMPLETION OF THE INTERNAL MARKET AND APPROXIMATION OF INDIRECT TAXES

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND TO THE EUROPEAN PARLIAMENT

COMMN REVISED PRPS

COMMN REVISED PRPS.

COMPLETION OF THE INTERNAL MARKET AND APPROXIMATION OF INDIRECT TAXES

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND TO THE EUROPEAN PARLIAMENT

1. Following the Commission communication of 4 August 1987 and the accompanying proposals (COM(87) 320 to 328), a wide-ranging debate has taken place on ways and means of removing tax obstacles to the establishment of the internal market.

There have been discussions on several occasions within the Council (Economic and Financial Affairs) and, on the initiative of the Council and the Commission, a number of working parties have looked into the matter. Particular mention should be made here of the work of the Economic Policy Committee and, since the beginning of 1989, of the deliberations of two working parties, one on the clearing system, which completed its work in April 1989, and the other, whose work is still continuing, on the allocation of VAT rates to different product categories.

2. As to <u>objectives</u>, a broad consensus has emerged on the prime importance for the internal market of the reforms to be undertaken in the field of indirect taxation. This consensus was reflected earlier in the new wording of Article 99 of the Treaty that resulted from the Single European Act.

General agreement has also been reached on the two main aspects of any action to be taken by the Community:

- approximation of the VAT and excise duty rates applicable in Member States:

- removal of tax frontiers incompatible with a genuine single market.

In this context, the views expressed on the Commission's proposed system, which ensures that goods circulate <u>always bearing VAT</u>, have not called into question the major qualitative advance which the system represents in two respects:

- on the one hand, progress towards the achievement of a true internal market, since goods will circulate within that market under the same conditions as within a Member State;

- on the other hand, progress towards a fundamental elimination of one of the major causes of tax evasion,

notably that which stems from the existence of two separate but far from watertight channels for the movement of goods - depending on whether they are taxed or untaxed.

In these circumstances the Commission is entitled to consider that such a method of taxation is best adapted to the idea of an economic space without internal frontiers.

3. As to method, however, major disagreements still exist, adding to the difficulties facing the undertaking. Where VAT is concerned, the discussions under way must be energetically pursued in order to reach a consensus. As for excise duties, the Commission has already indicated that it will be presenting new proposals to increase the flexibility of the measures to be taken.

The purpose of this communication is to clarify the new guidelines agreed by the Commission in connection with the objectives proposed in 1987. In order to help bring about an agreement within the Council as speedily as possible, the essential aim is to adopt a pragmatic approach to the main problems and to the possible solutions.

This suggests the need for a threefold strategy: introduction at the earliest possible opportunity of a transitional phase for the approximation of indirect taxes that will last until the end of 1992; a new approach to the VAT clearing arrangements; and new proposals on excise duty rates.

I. Transitional phase

4. The abrupt transition, on 1 January 1993, from the present arrangements for VAT rates and excise duty amounts to a new system without internal frontiers is bound to be a source of disruption for economic agents and for the conduct of national economic policies. The introduction of a transitional period will be conducive to the effective entry into force of the reforms on the envisaged date, with the necessary adjustments being accommodated in the meantime.

Evidently, the bulk of the preparatory adjustments are a matter for individual Member States, due regard being had to their own priorities and to national circumstances. Such is the case with the convergence of VAT and excise duty rates, already under way or planned in a number of Member States.

In this context it is worth emphasizing that in its reflections on the necessary modifications to be made to its initial proposals, the Commission has attached particular importance to foreseeable budgetary consequences, and has favoured measures which reduce the importance of these consequences to the greatest possible extent.

However, it is essential that the definition at Community level of a transitonal period should be accompanied by steps to give practical shape to Member States' commitment to complete the internal market in the field of indirect taxation, especially as regards the approximation of VAT rates by the end of 1992.

5. This period would allow economic agents to prepare for the operational arrangements of the reform that would apply to them. It would also enable the introduction of certain procedural simplifications, so as to reinforce the preparatory nature of this transitional phase as a prelude to complete abolition of frontiers. In this context, proposals would be made to simplify Community transit procedures by abolishing the transit advice note.

6. Finally, in order to reinforce the process of market integration and the credibility of progress towards the single market as far as public opinion is concerned, the Commission proposes that this period should be marked by a gradual and substantial increase in travellers' allowances. Such an increase, which is being urged by Parliament, is entirely consistent with the prospect of a Peoples' Europe. Furthermore it ought to be attractive to the majority of economic operators:

- in foreshadowing the unlimited allowances and liberty of purchase, tax-paid, which will be the rule in the internal market from 1993;

- in accelerating the alignment of fiscal conditions, and in particular of VAT and excise rates, between the Member States.

To this end, the Commission intends to propose in three stages, beginning on 1 January 1990, 1 January 1991 and 1 January 1992 an increase of the order of:

- quadrupling the value of the VAT allowances;

- doubling the specific quantitative allowances for excisable products.

II. VAT

A. Approximation of rates

7. The Commission's proposal for two rate bands (4-9% for the reduced rate, and 14-20% for the standard rate) constitutes the basis for the discussions within the Council and the Parliament.

These discussions are concerned in particular with three matters: the width of the bands, which is often regarded as excessive and likely to bring about distortions of competition, notably in the case of the standard-rate band; the products to be charged with VAT at the reduced rate; and finally, the problem of zero-rated products.

Standard rate

8. An alternative to the rate band would be to replace it with a minimum rate applicable from 1 January 1993 without any upper limit being set for Member States insofar as the standard rate is concerned. Each Member State would choose a rate at least equal to the minimum rate, having regard not only to the national budgetary implications of its choice but also to the "competitive pressure" that would stem from the rates chosen by neighbouring Member States or by the Member States which were its main trading partners.

Such a minimum rate should make for a balanced sharing of the burden as between Member States with the highest VAT rates and the other Member States. This formula for a minimum rate is, therefore, simpler to apply than a rate band and takes better account of the autonomy and specific situation of each Member State.

9. It must also be acknowledged that, in the case of neighbouring Member States with widely differing rates and an important cross-frontier commercial traffic, it would be necessary to achieve a particularly close alignment of rates.

The Member States concerned could seek an agreement along these lines, in a form still to be determined. Their specific problem could thus be resolved without all the Member States being required to make an unnecessary effort.

Reduced rate

10. The Commission considers that the proposed band (4-9%) best meets the needs of the situation and that the essential task is to agree on the products to be taxed at the reduced rate relative to those chargeable at the standard rate. For the Commission, it is indispensable to reach agreement from the outset of the preparatory phase on the fact that a common structure based on two rates is the necessary condition for attaining a sufficient degree of alignment.

Zero-rated products(1)

11. Existing Community legislation has regarded the zero-rating of certain products in several Member States as not constituting VAT rates proper but rather as being temporary derogations from the general principles of VAT, derogations that are associated with the continuation of a transitional situation.

However, in its initial proposals, the Commission did not rule out the possibility of retaining zero-rating after 1992 in the form of derogations linked to a new transitional period.

Since there is a twofold need to reduce the present coverage of zero-rating and to take account of the social role assigned to VAT in some Member States, a relaxation of the Commission's position could be envisaged provided a number of conditions were met.

It would be necessary, in the framework of a final compromise, to authorize Member States who so wish, to maintain zero-rating for a very limited number of products currently subject to the reduced rate, provided this did not pose any risks of distortion of competition for the other Member States. Such a measure could only be envisaged by the Commission if the Council reached an agreement on the respective coverage of the standard rate and the reduced rate.

B. Differentiated approach

12. The main criticism levelled at the Commission's initial proposals concerned, on the one hand, the complicated and centralized nature of the clearing-house mechanism which is a potential source of budgetary conflict between Member States, and on the other hand, the risks of distortion of competition resulting, in so far as the purchases of final consumers are concerned, from rate differences which remain excessive for certain Member States. For private individuals the problem centres notably on mail order purchases and car purchases. For non-taxable institutional bodies and for exempt taxable persons the problem relates to their high-value purchases (for example, investment goods).

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(1) It is important to note that, unlike exemption which leaves the final consumer to bear input tax paid by the supplier, the zero rate involves the reimbursement of input tax, and consequently the product to which it applies is put into consumption totally untaxed, i.e. it is liable to no fiscal charge at all.

In order to help bring about an agreement within the Council, the Commission is suggesting in this communication a new approach whereby a number of transactions would be treated differently, at least while the rates are insufficiently aligned, and whereby a system of clearing or, rather, of refunds would be envisaged only for residual transactions between taxable persons.(2)

Mail-order (distance) selling

13. Most Member States have systems of selling by mail order, operated by large, specialised firms which base their activity on direct sales to final consumers and are also in direct contact with consumers in other Member States. It is important to avoid allowing differences in indirect taxation to become a source of distortion or of relocation of these enterprises.

The Commission is prepared to propose that for specialised operators, such sales should be taxed under the conditions applicable in the country of destination of the goods.

This system would not affect the principle under which any private individual can acquire goods, tax-paid, in the Member State of his choice.

Sales of cars

14. Sales of cars have often been cited as the typical example of transactions where distortions might arise due to disparities in tax rates that were considered to be excessive.

There is a possible technical solution which hinges on one of the characteristics specific to such items, viz. the fact that they are registered in the owner's country of residence. For VAT to be chargeable in the purchaser's country of residence, the place of supply would be defined as the place of registration. In such cases, the chargeable event would be the moment of registration.

In order to avoid any risk of tax evasion or arbitrary treatment, the conditions governing a change of residence would be those set out in existing Community legislation (Directive 83/183/EEC).

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(2)A taxable person is a physical or moral person carrying out economic activities liable to VAT.

Sales to institutional non-taxable persons and exempt taxable persons

15. It has also been pointed out that risks of distortion could arise from sales to such categories of "final consumers" as institutional non-taxable persons (bodies governed by public law and those treated as such) and exempt taxable persons (banks, insurance companies, etc.).

The purchases of these economic agents, and in particular their purchases of capital goods, in fact account for a considerable proportion of the sales of certain productive sectors. The danger of a shift of purchases from one country to another primarily for tax reasons, cannot therefore be ruled out, at least for purchases of considerable economic importance.

16. Here again, specific technical solutions can be found to counteract the potential consequences of rate differences in these special cases.

It could be stipulated, for example, that purchases in another Member State by these categories of operator should give rise, in the country in which these operators are established, to a self-supply procedure which would be taxable under the conditions applicable at the place of supply; or again that a differential tax should be instituted which would be equal to the difference between the VAT paid on purchase and the national VAT chargeable on similar goods or services.

These various solutions would help to reduce both the commercial and the budgetary risks to minimal proportions, while at the same time ensuring that the tax barriers to trade were removed.

It goes without saying that, over the long term, these specific arrangements would become progressively less necessary the more rates tended to converge.

Transactions of enterprises linked within the same group

17. One of the features of intra-Community trade is the considerable volume of trade between operators involved in the same industrial process, a significant proportion of which is carried out by enterprises within the same group. These enterprises offer a high degree of security because of the regularity of the flows of their transactions and the controls to which they are subject. This fact has already led a number of Member States, at national level, to suspend application of VAT to such transactions between linked companies, pursuant to Article 4(4)of the Sixth VAT Directive.

Subject to the necessary guarantees being provided, this possibility could usefully be extended to a portion of intra-Community trade. This arrangement should also be extended to associated small and medium-sized firms whose cross-frontier trade flows justify such action.

Intra-Community sales between approved members of a group woud take place without VAT being applied. The chargeability of the tax would be deferred to the moment of resale by one of the associated enterprises to a non-approved non-associated purchaser. Enterprises would be able to operate under this arwangement only on the basis of the prior and conditional authorization of the Member State in which they were established.

The treatment of other transactions between taxable persons

18. The measures described above would provide a pragmatic solution to the principal difficulties which have arisen in the process of abolishing fiscal frontiers.

On the one hand this would be achieved by introducing ad hoc provisions to reduce the risk of competitive distortions in the most significant cases; on the other hand it would be achieved by operating a system of VAT suspension on intra-Community sales between associated companies. As a result, the question of deciding what formula to adopt for the "residual" operations of taxable persons should be capable of being dealt with in a reasonably dispassionate manner.

19. One of the implications of the movement of products "inclusive of VAT" is a so-called clearing mechanism. Given that the aim is for all of the VAT revenue to continue to accrue to the country of final consumption, it is necessary for the exporting country to pass on to the importing country the proportion of VAT collected in respect of the cross-frontier transaction. It should be noted that this requirement exists independently both of the abolition of fiscal frontiers and of the approximation of rates and would continue to exist even if rates were to be unified.

Serious reservations have been expressed by national fiscal administrations concerning the mechanism proposed by the Commission: on the one hand, it would not offer all the necessary guarantees as to control and might therefore be a source of dispute between countries; on the other hand, it would imply an excessively centralized administration.

However, the measures suggested above, which would reduce the volume of residual transactions substantially, open the way for a new approach to this question.

In these circumstances, it would seem that a macroeconomic approach to the clearing operation, which would present appreciable operational advantages, could also become politically acceptable.

20. The resultant simplification would be very substantial both for firms and for the tax authorities, since the Member States' debits and credits would no longer be calculated on the basis of the VAT returns of taxable persons but on the basis of trade statistics.

The mechanism thus set up could be easily operated, since the method of calculating transfers would be no more complex than that used for the new own resources.

There would be no central clearing fund but only an accounting exercise designed to establish the surplus balances to be refunded.

This mechanism would in addition be efficient because it would solve at a stroke a number of controversial technical problems: the problem of distributing the surplus resulting from the transactions of non-taxable persons and exempt taxable persons would be solved naturally; similarly, the statistical base would ensure a regular flow of transfers.

It goes without saying that an essential condition of such a system would be the maintenance of a high quality statistical system in the Community, the principle of which has been proposed by the Commission(3).

III. Excise duties

21. The main criticism which the Commission has encountered here is that its initial 1987 proposal based on single rates per product for the whole Community lacks flexibility. More than in the case of VAT, the attempt at harmonization in this field highlights the continuing diversity of situation which persists in the Community.

In the case of the duties on tobacco and alcohol, this diversity is made all the more difficult to reduce due to the different circumstances of the Member States, according to whether they are producers or not. Finally, the degree to which public health requirements are reflected in the level of excise duties varies widely from one Member State to another.

---

(3)COM(88) 810 Final. Proposal for a regulation (EEC) of the Council, on the statistics for trade in goods between Member States.

As it has already indicated, the Commission considers that flexibility is necessary and that this flexibility can vary according to the product in question, but that it must in no case result in putting at risk the principle of abolishing fiscal frontiers.

A. Gradual approximation

22. The different arrangements proposed should be based on reference values, long-term targets which reflect the Community's determination to move towards greater integration. These could be defined on the basis of the single rates established in 1987.

In this matter the Commission is aware that the recent development of health policies and of the need to protect the environment, justifies higher long-term targets than was the case in 1987.

The flexibility would take the form of minimum rates or rate bands based on these targets, according to the products in question.

Alcohol and tobacco

23. The Commission will propose that differentiated minimum rates, which would vary according to the principal products, should be compulsory from the end of the transitional period, i.e. from 1 January 1993.

In fixing the minimum rates, particular attention will be paid to countries with low excises so as to ensure that the effort they have to make remains reasonable. The solution reached cannot take the form of frontier controls.

The existence of these minimum rates would not prevent those Member States which apply the highest duties on such products from progressively aligning their duties on the long-term reference values adopted for each category of product.

Mineral Oils

24. It is important to pay particular attention to the risks of competitive distortion which are greater in this area than for alcohol and tobacco and result from excessive divergences between the duties applied to the different oil products by the Member States. For this reason the Commission will propose that either single rates or rate bands should be applied to the different products in the mineral oils sector, without rejecting a priori the fixing

of minimum rates in certain circumstances. In making its choice the Commission will pay particular attention to the links existing with other sectoral policies (transport, energy, environment).

B. Rules governing movement

25. It is an established principle that frontier checks should also be abolished for excisable products.

Individuals should thus be able to buy such products where they see fit and to transport them freely, provided that commercial operations are not involved.

In order to facilitate intra-Community commercial operations and to guarantee that Member States are actually paid the duties due to them, proposals will have to be put forward concerning the conditions under which "interconnected" warehouses would function. These would enable operators to arrange for the movement of products while duties were suspended; duties would not become chargeable until the goods were definitively released from the warehouse procedure and put into consumption.

Finally, control measures will have to be implemented within Member States to prevent fraud based on the differences in duties between Member States, resulting from the flexible arrangements. These measures could take the form of tax stamps (bands, permits, etc.) guaranteeing that the appropriate duties had been paid in respect of the products marketed in a Member State.

Amended and supplementary proposals relating to excise duties are to be transmitted to the Council before August.

Conclusion

26. In order to ensure the success of the negotiations in progress on the crucial issue of tax frontiers, the Commission considers it necessary to make a number of suggestions and amendments to its proposals. These concern:

- the establishment of a transitonal convergence phase operational from now until the end of 1992, during which:

    - Member States will be given every incitement to accelerate the approximation of their rates of VAT and excises;

. procedural simplifications will be introduced in view of the final objective;

. freedom to buy, tax-paid, in another Member State, will be introduced progressively by means of a gradual but substantial raising of the travellers' allowances;

- the adoption, as an alternative to the standard VAT rate band, of a system involving only one minimum rate applicable from 1 January 1993 and, in this context, encouragement for the reaching of agreements between certain Member States designed to reduce further the divergences between their rates;

- the introduction of specific arrangements for certain clearly defined commercial operations

  . Mail order (distance) selling

  . Sales of cars

  . Sales to institutional non-taxable persons or to exempt taxable persons

  . definition of a system of VAT suspension for intra-Community sales between associated enterprises;

- for the remaining transactions, a new macro-economic approach to the mechanism for refunding VAT balances;

- amendments to the proposals relating to excise duties designed to give them the maximum possible flexibility compatible with the requirements of completing the internal market.

FROM: J M G TAYLOR
DATE: 19 JUNE 1989

MR JEFFERSON SMITH (C&E)

cc PS/Economic Secretary
Mr Unwin - C&E

TAX APPROXIMATION: PROSPECTS FOR 19 JUNE ECOFIN

The Chancellor was grateful for your note of 14 June.

J M G TAYLOR

IOD
Institute of Directors

From the Director General

PMG - 4 JUL 1989 - 4

1 JUL 1989
CX / CST / FST / EST
SIR P MIDDLETON
INFO SIR T BURNS
MR WICKS
MR ANSON
MR H.P. EVANS
MRS CHAPLIN
PS / IR
PS / C&E
MR ISAAC - I/R
MR JEFFERSON - SMITH C&E

78A/2

I shall be grateful for IR's assessment of proposals.

M. Jacques Delors
President of the Commission
Commission of the European Communities
rue de la Loi 200
1049 Brussels
Belgium

23 June 1989

Dear M. Delors,

Company Tax Harmonisation in the European Community

In my speeches this year on the European Community - most recently the speech I gave in Vienna on 12 June (copy enclosed) - I have been endeavouring to make the general point that some hard thinking is needed about priorities and institutional capabilities if the EC is to remain on the critical path for the completion of the Single European Market by 1993. This was at first portrayed by the media - as constructive criticism so often is - as a negative attitude by the IOD both to 1992 and the EC generally. It is now seen as more a statement of the obvious and I welcome the signs already emerging that the Commission and Member State governments are making, in the indirect taxation field at least, a more realistic appraisal of what is essential for 1993 and what must be done now to achieve those essentials by 1993.

The IOD believes a similar reappraisal is necessary regarding the corporate taxation harmonisation programme, where some useful (and some unnecessary) initiatives are belatedly making progress but where key problems from the **business** viewpoint have still to be addressed.

I, therefore, have pleasure in enclosing a paper written for the IOD by John Chown, which analyses the fiscal obstacles to companies operating on a Community-wide basis **which really matter in practice** and suggests how those obstacles might be removed. John Chown, an economist and internationally regarded tax practitioner, has for many years been a member of the IOD's Taxation Committee.

I hope you will find this a useful and positive contribution to the Commission's work in this field. I am copying this letter and the paper to your fellow Commissioners with economic and fiscal responsibilities and to the Finance Ministers of the Member States.

Yours sincerely

John Hoskyns

SIR JOHN HOSKYNS

cc Rt Hon Sir Geoffrey Howe QC MP, Rt Hon Lord Young of Graffham

COMPANY TAX HARMONISATION IN THE EUROPEAN COMMUNITY

by
John F Chown

IOD
Institute of Directors

INSTITUTE OF DIRECTORS

COMPANY TAX HARMONISATION IN THE EUROPEAN COMMUNITY

by JOHN F CHOWN

STATUS OF THIS PAPER

This paper is published by the Institute of Directors ("IOD") as a discussion paper. It has been discussed by the IOD's Taxation Committee which is in full agreement with the views expressed. The IOD and the author would welcome receiving any comments from readers. Enquiries should be addressed to the Policy Unit, IOD, 116 Pall Mall, SW1Y 5ED.

ABOUT THE AUTHOR

John Chown, a long-standing member of the IOD's Taxation Committee, is an economist and leading practitioner in the field of international corporate taxation. He is managing director of J F Chown & Company Limited, a founder Council member of the Institute for Fiscal Studies and a member of the Technical Committee of the Association of Corporate Treasurers.

ABOUT THE IOD

The Institute of Directors was incorporated by Royal Charter in 1906 and has a membership of over 37,000 individual company directors and business leaders (30,000 in the UK and 7,000 overseas). It has no corporate membership and no political affiliation.

Its main aims are:

* to provide an effective voice
  - to represent the interests of its members, and
  - to bring the experience of the business leader to bear on the conduct of public affairs for the common good;
* to encourage and help its members to improve their professional competence as business leaders.

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Preface by Sir John Hoskyns

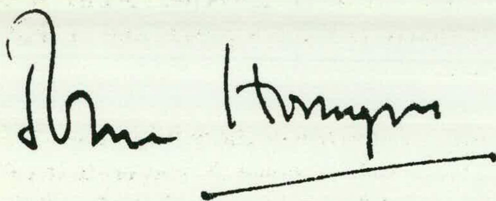
Director General of the Institute of Directors

The Institute of Directors fully supports the aim of completing the Single European Market by the start of 1993. Indeed, it is because we attach such importance to this aim that we have — most recently in our Manifesto for the European Parliament Election — been pressing for the European Commission, the Governments of the Member States and the European Parliament to concentrate their efforts on identifying, agreeing and implementing those measures which are truly *essential* to the completion of the single market.

In the last year there has been belated recognition that company taxation is generally more important than indirect taxes in determining where businesses locate in Europe and whether they can operate Community-wide.

But, in this field as in others, the specific problems which seem important from offices in Brussels or Whitehall are not always those which really affect businesses in practice. The linking of the subject politically with the "social dimension" and issues of employee involvement has further confused the picture.

This paper, based on the experiences of leading practitioners, identifies what are the real problems that matter to business and how they might be resolved. It is published as a discussion document to stimulate further debate throughout the EC and — it is hoped — action in time for Europe to be "open for business" in 1993.



June 1989

Sir John Hoskyns

Introduction and Summary

1. After years of neglect, company tax harmonisation is now back to the top of the agenda. Professional observers of European Community developments range in their views from the "united Europe at any price" enthusiasts to neo-Gaullist defenders of national sovereignty. Some of us, while generally favouring a move towards Europe without frontiers, would "be profoundly disappointed if the hard won and as yet incomplete restructuring of the UK economy . . . were to be overturned by a corporatist and dirigiste Community". The right way forward is surely not to fight a rearguard action, but to take a constructive and leading role in putting forward positive proposals for a united and truly free Europe.

2. Why do we want to harmonise company tax? The obvious reason is that we need to ensure that differences in tax systems do not distort company behaviour. This paper discusses three key aspects of this — "location", "administration" and "mergers". The last of these is perhaps the most important. Under present arrangements, "true" mergers resulting in parent companies with both their activities and their shareholders widely spread across several Community countries, are impossible. The Directives now tabled would not solve this problem. Joint ventures and other hybrid solutions are not a real substitute.

3. Tax professionals advising companies on their international strategies must work from a much broader perspective than tax law: hence any discussion about policies must look beyond the immediate terms of reference and take account of companies and securities legislation, monopolies and mergers and industrial policy generally. From this point of view the real problems, particularly those concerning cross-frontier mergers, seem very different from those which appear to be given priority in Brussels.

4. The various initiatives taken by the Commission to date contain some useful and detailed proposals but, even if they were implemented in full, they would not solve what are, from the point of view of the business community, the three key issues. The agenda has been set by those with a professional interest in tax *gathering*. The perspective of the tax *payer*, and of those concerned with broader economic issues, is quite different.

5. Appendix 2 gives a critical and historical, but mainly factual analysis of these initiatives. It is now a quarter of a century since the first proposals were made to harmonise EC corporate taxes, the Neumark report of 1962. This was followed by the van den Tempel report of 1971 and the current proposed Directive of 1975. The latter recommended an imputation system at rates between 45% and 55%. This recommendation was also included in the Convergence Report of 1980. This has now been supplemented by the "Base" Directive of 1988. The "three directives" tax package consists of those on mergers and on parent subsidiary relationships dating back to 1969, together with the 1976 one on arbitration.

Why Harmonise?

6. EC progress may have been diverted from the right track because the term "harmonisation" has been hi-jacked, by the unmusical, to mean "standardisation". Commission papers tend to concentrate on how to make tax systems more alike: this involves simple concepts well within the grasp of officials who may find it more difficult to deal with the subtler, but potentially more rewarding, steps needed to ensure peaceful co-existence between a healthy variety of national regimes. The concepts of "approximation" or "convergence" are generally taken to mean half-baked standardisation: this is not an answer to our criticism. (Musicians can play or sing in unison or in harmony: not, please not, *approximately* in unison!)

7. There are several good reasons for wanting to harmonise company taxes, some good and some bad. A desire for uniformity for its own sake is a *bad* reason.

8. Meanwhile this paper goes back to first principles, and discusses the three key practical problems facing companies engaged in cross-frontier activity within the EC.

   (a) How can we ensure that corporate decisions, notably on plant *location*, are not distorted by differences in tax rates, base and systems?

   (b) Second, how can we reduce the *administrative burden*, on small as well as large enterprises, of jurisdictional battles between different Revenue authorities?

   (c) Why are true trans-national *EC mergers* impossible? The appropriate solution here is to look at systems and structure, leaving "rates" and "base" to be taken care of by market forces.

9. Two further technical points, on interest deductions and capital gains tax, are discussed in Appendix 1. These come within the general scope of the "base" directive, but are not dealt with here.

Location–A Case for Approximation?

10. It is argued that unless a post "1992" free market in goods and capital is combined with fiscal approximation there will be a growing temptation, other things being equal, to supply the whole EC market from a low tax base, without the need for a *taxable presence* in a high tax country. This tactic is, it is said, even more likely to be pursued by third country parents. It does not even necessarily follow, under present arrangements, that the place where the taxable profit is incurred will be the place where manufacturing employment is created.

11. This argument has been overstated. A common market is perfectly compatible with differences in tax rates. In the United States, total company taxes (Federal and State) range from 34% in Arizona to 46% in New York City. In Canada, the present reform proposals (interrupted by the election) will continue the pattern of several different rates, ranging from 15.2% for a small, Canadian-controlled manufacturing company in Quebec to 45% for a large, non-manufacturing enterprise in Manitoba. Even within the broad category of "large manufacturing business" the range is from 28.9% to 40%. Swiss federal tax is 9.8%, and in some cantons that may be all that a company pays. In Zurich or Geneva the total burden can rise to 45%. These differentials do not distort competition, and if they were removed might cause an even greater concentration of activity in certain otherwise favoured locations.

12. The United Kingdom has taken the lead (closely followed by the United States) in lowering corporate tax rates. This initiative is likely to be followed by Germany and other EC countries, simply to maintain their competitive position. *A competitive, market-led move towards converging tax rates and systems is more likely to be effective than an imposed one.* Indeed, there is a serious danger that imposed harmonisation could effectively create a tax collectors' cartel, perpetuating high rates and antiquated structures.

13. Serious differences in tax rates and base between countries within a free market area are unlikely to persist for very long, except for valid economic reasons. Provided there is freedom of movement of people and capital as well as of goods, no Member State can afford to impose taxes at levels which drives away capital, creates unemployment and erodes the tax base itself. This is exactly what was suggested by Nigel Lawson in his proposal for a "market approach" to VAT harmonisation (24). [The numbers in brackets in this paper relate to the references which are listed in Appendix 4].

Tax Administration and Transfer Pricing

14. Another, more subtle but also more valid, argument in favour of approximation is the practical problem of transfer pricing policies. This affects both large companies and what should be the growing number of small companies making their first cross-border expansion. Where a company does business within more than one country the authorities of both (or all) will have a prima facie right to tax its activities. In principle this need not matter: existing bilateral double tax agreements are intended to define what can, and cannot, be taxed in each signatory State, and, where there is double taxation, to ensure that one country gives credit for taxes paid in another. The "parent-subsidiary" Directive would take this principle further. In practice, although these arrangements may give the right answer in the long run, there are serious administrative difficulties on the way to agreement. Cecchini (21) (page 32) states that this adds between 10% and 30% to the costs of the departments concerned.

15. Specifically, each tax authority will be looking for attempts to use transfer pricing or cost allocation as a means of shifting taxable profits in one jurisdiction to another. From the point of view of the tax-payer this activity is fair enough, or at least understandable, where it is a response to attempts by him to divert profits to offshore taxation havens. The difficulty is that it is used aggressively by national tax authorities even where tax rates on both sides of the border are more or less the same, and where the battle is really over who collects. This aggressive approach dates back to a 1962 US initiative, and may get worse following the 1988 US White Paper on transfer pricing policy. (25)

16. Transfer pricing policies practised in EC countries are inconsistent — so inconsistent that it has been suggested that a company doing business in every Member State has to be in an illegal situation somewhere, and that "Europe would grind to a halt if national legislation were fully applied." (6) This is, arguably, a case for some approximation of "base" rules. In the short run, the best way forward is an agreement between Revenue authorities to settle their own disputes in private. The taxpayer would make an interim settlement with Country A. This would be provisionally accepted by Country B on the basis that any subsequent adjustments could be agreed without involving the tax-payer. Some sort of consistency on "base" would be a great help.

17. Cecchini says:

> "These 'beggar my neighbour' attempts made by national tax authorities to maximise their share of a European company's tax liability have grave consequences . . . For example, the suspicion that transfer prices are being used to export profits from one tax jurisdiction to another makes it often difficult, according to the companies interviewed, for central R & D expenditure to be actually charged to subsidiaries. Indeed, they claimed that it was in fact easier for an independent firm to export items like software at its fair value than for affiliated companies to do so between themselves. There are more general problems too. Many companies cited the impossibility of reducing their tax liability by off-setting losses in one branch with profits in another as very costly to their operations."

18. As with tax *rates*, tax *bases* differ between Member countries for a number of reasons. These may be accidental or historical or may result from specific incentives (or, now less commonly, penalties) to encourage (or discourage) particular types of investment or other corporate activities. They may be designed to encourage investment in a particular and generally otherwise unfavoured part of a Member State, or (eg Ireland) to encourage investment in the State as a whole. Such tax incentives and differentials are an essential part of regional and industrial policy, and appear at first sight to be compatible with a market-led approach to harmonisation.

19. Differences of base may also result from the effects of inflation. No Member State yet imposes tax on a "monetary correction" or even "current cost accounting" basis, although the UK has cured some of the fiscal distortions of inflation by indexing capital gains. Unless and until all countries adopt a harmonised system taking account of inflation (or, until, unrealistically, inflation disappears), the tax base will be distorted both by the effects of inflation itself and by any national measures taken to mitigate these effects. The problem would be made even worse by foreign exchange movements particularly where these deviate from purchasing power parity. This aspect has not been addressed by the Commission papers.

European Mergers

20. The key problem concerns cross-border mergers. After a flurry of excitement in the early 1970s there have been few *genuine* mergers between EC companies although there have been many joint ventures and other compromise arrangements. Within a common market, genuine mergers should be as common across frontiers as within countries. It should be commonplace for a UK and a German company of equal size to merge. After the merger there should be a single parent with activities and shareholders spread between both countries.

21. There are no comparable obstacles to mergers between, for instance, New York and California based companies. One difference, of course, is that the California based shareholder in a California company would not lose any sleep over the prospect of exchanging his holding for shares in a New York company: many German shareholders however, would still regard UK shares as "foreign" and unfamiliar. Cultural patterns will change, but first we must get the legislation right.

22. Obviously, we must ask whether mergers are desirable. The evidence of recent history is unconvincing. This is a question of industrial policy and mergers policy. The tax system should (in principle) be neutral: at present it is not. A merger between companies in a single Member State is far more likely to limit competition than one across internal EC borders. Tax systems tend actively to encourage the first, but make the second difficult or impossible to implement.

23. Even if the EC "mergers" directive were implemented, it would remain impossible, without serious tax penalties, to create a company with its activities, and its shareholders, spread across the whole of the enlarged Common Market. Only the Americans, and increasingly the Japanese, can take a "European" view of expansion. Nestlé in Switzerland can build up a Europe-wide network of subsidiaries. There are tax reasons (apart from others) why Rowntree could not.

24. The reason is not hard to find, and can be stated simply:

    1. Mature publicly quoted companies will typically distribute about half of their profits to their shareholders as dividends. Indeed, public policy should encourage such distribution in the interests of efficient capital markets.

    2. Under the tax systems of many EC countries, including the United Kingdom and Germany and certainly under the imputation system recommended as the base for harmonisation within the EC, the total tax burden at company and shareholder level increases dramatically when the company passes the "prejudice point" — beyond which it cannot entirely service its dividends out of profits which have borne tax in its home country. (See Appendix 3 for an analysis of "prejudice".)

    3. It follows that, on present arrangements, such a company cannot really afford to diversify to the extent that its "foreign" profits are materially in excess of its domestic profits. So long as "domestic" in this context means "British" or "Dutch" rather than "community wide" we cannot really have true European companies. The domestic markets of even the larger members do not exceed 20% of the whole Community market. This point is one of particular concern to smaller countries such as the Netherlands. It is of no concern at all to American and other third country parents.

25. This problem is analysed in more technical detail in Appendix 3. The next section outlines an approach which would go a long way towards solving the problem within the framework of existing national tax systems.

Mergers–A Possible Solution

26. In 1982 Will Hopper (then an MEP and the European Democratic Group spokesman on Economic and Monetary Affairs) joined the present author in writing an article, "Company Tax Harmonisation in the European Economic Community" (13). This discussed the then current state of the dispute. We concluded:

    "1. We agree that "rates" and "base" are related but suggest that neither is the most urgent issue.

2. The medium term aim should be to ensure that even though member States do not standardize their tax systems they are made sufficiently compatible ("convergent" to use the Commission terminology) so that the distortion of international capital movements within the Community is kept to a minimum.

3. This is best achieved by agreeing national shares of the total tax taken from income and profit flows across internal EEC frontiers rather than relying on "mirror image" rates of withholding tax which, although apparently logical, can create a distorting effect . . .

The object should be to convert the 1975 draft into a comprehensive multilateral double tax arrangement within the EEC. This would be an excellent use of the powers taken by Parliament last year to amend draft legislation."

That analysis remains valid and has not been superseded by the very significant changes in company taxation in the UK and other individual member countries since.

27. We suggest, therefore, that member countries should agree on two points. First, that domestic tax systems be adapted to achieve a reasonable measure of both capital export and capital import neutrality, begging questions of definition, within the Community. The measures to be taken will vary from country to country and it may be necessary to modify the provisions of double tax agreements. An obstacle in the past has been the deceptive concept of "mirror image" withholding taxes. This has been a particular German worry. US negotiating attitudes have also been unhelpful.

28. Second, and this is the key point, it should be agreed that the total tax revenue (at corporate and shareholder level) from business profits should be divided as far as possible in an agreed ratio between the country of source of the income and the country of residence of the ultimate shareholder. The Chown/Hopper article suggested a ratio of ⅔:⅓, but this was an arbitrary figure.

29. It must also be agreed that third country intermediaries should neither collect tax on income passing through, nor be liable to refund tax they have not collected in the first place. Conceptually this leads us towards a multinational double tax agreement: whether this takes the form of a treaty or a Directive is a matter of politics and procedure rather than of technique.

30. The imputation system proposed, and generally accepted, as a basis for harmonisation is fully compatible with international harmonisation if, and only if, the following four conditions are met:

First, the imputation credit must be available to foreign as well as domestic portfolio investors. Both the UK and France already meet this test.

Second, although the imputation credit may be restricted (in the UK by denying the offset of ACT) where no domestic tax has been paid on the profits underlying the dividends, this restriction must not apply if the profits have been taxed in another Member State. This point particularly concerns the smaller countries. The "prejudice problem", in its various guises, now hits when distributions exceed domestic taxed profits, ie, where a group earns more than about half its profits outside its home base.

Third, the first two principles must operate in such a way as to give a fair and acceptable distribution of the total net revenue between the various states involved. This requires a "clearing house" procedure by which tax collected from subsidiary companies is refunded to the country of residence of the parents. (A "clearing house" for this purpose would be far simpler to operate, enforce and audit than that proposed by the Commission for VAT.)

Fourth, a harmonised European system must be compatible with the tax systems of non-member countries particularly the United States and Japan. Complete harmony with other systems may be impossible, but major distortions on inward and outward investment should be avoided.

31. It is surely essential that the UK in general, and the informed business community in particular, should now take the initiative by developing positive and constructive proposals. This is surely better than merely criticising proposals based on an inappropriate agenda.

32. Should one go even further? Should the UK take unilateral action to set up a "model" system? Technically, this would involve treating as eligible for ACT credit corporation tax borne not only in the UK but in other member States. The general anomalies of ACT, a campaign of the IOD's for seventeen years (26) have recently been given another airing by some major UK companies (27): any relief could now be associated with a positive international move. Unless other countries followed, there would be a net cost to the UK Revenue; the offsetting benefit would be that the UK could become, at least temporarily, the ideal location for independently quoted Community-wide holding companies. The UK already has the advantage of the largest market for equity capital in Europe, and the largest *outward looking* financial market in the world.

The "European Company" Proposals

33. Although not specifically on tax, the Brussels White Paper of 15th July 1988 on the European Company (9) gives a comprehensive overview of the related tax problems. Yet the lack of a uniform company code, or differences in national company law, has never been a real obstacle to cross-frontier mergers. There are many irritations, but none that cannot be sorted out, albeit at some expense, by competent company lawyers in the various jurisdictions putting their heads together. The United States does not have a Federal Companies Act and in the UK, England and Wales, Scotland and Northern Ireland have different companies legislation.

34. This is not the place for a detailed criticism of the White Paper. It is worth noting that the draftsmen seem unduly influenced by the "worker participation" concept and are seeking to find ways of associating this with more palatable proposals.

35. What tax advantage would the proposed European company have? Precious little, it seems. The White Paper accepts (page 21) that "the European company will be subject to the tax laws of the state in which it is domiciled". A European company with its headquarters in Germany would be subject to German tax on its world-wide income and to local tax in any other country in which it did business, subject to double tax relief. It would thus be no different from a German company and no useful purpose would be achieved. The sop offered is the right to offset losses in one country against profits in another. This offers little to anyone, and nothing to the UK.

Radical Approaches

36. This paper has suggested practical solutions to three "real" problems. These would leave present national tax structures broadly intact. Two more radical approaches have been examined briefly by the IOD's Taxation Committee. Neither appears to offer any easy short run solution, and neither has been considered in detail. Both are certainly worth a more considered examination.

37. First, one could move towards a "federal" tax system imposed in all Member States with a standard basis of assessment (and possibly a minimum basic rate of tax) which could still be modified by surcharges, reliefs and subsidies at national and local level. This, as in Germany, Switzerland, Canada and the United States, would leave scope for flexibility in rates and incentives at national or regional level. In concept this could start with a simple, broad base and low rates and could grow naturally into a main tax system. One problem is that the system would be alien to the laws of at least eleven (and politics being politics, probably twelve) national tax systems. Generations of case law and established practice cannot easily be overturned from one day to the next.

38. Second, it might be possible (within the EC) to reverse the "source" basis so that tax was collected in the country of residence of the final shareholder or at the level at which profits remained undistributed. This has the advantage of simplicity for intra EC investment, but would create problems with third country transactions. It would also have a major effect on how tax receipts were divided between Member States.

Conclusion

39. Twelve national tax systems each have their own history and body of precedents which cannot lightly be cast aside. Twelve nations have their own personalities, including very different attitudes to tax enforcement and compliance, different social objectives and different political structures. It is unrealistic to expect a unified EC tax system in less than one generation. Indeed, it has been argued that, in present circumstances, harmony of form could lead to disharmony of substance. The right question is not "How much uniformity can we enforce?". It is rather "How much diversity can be compatible with free capital movements?".

Appendix 1: Specific Comments on "Base"

1.1. This paper does not deal in detail with strengths and weaknesses of the individual proposed Directives, including that on "base". Apart from the two major issues discussed above there are two specific "base" questions which concern specialist practitioners and which are still not adequately dealt with by the proposed Directives. These concern corporate capital gains and interest on corporate borrowing, both obvious considerations in structuring international groups.

CAPITAL GAINS

1.2. The 1980 Convergence Report (15) does not mention the treatment of capital gains realised by a corporation. If a British or German company disposes of its substantial interest in a French company, any gain would be taxed under existing domestic law. UK capital gains are indexed for inflation: German gains are not, but the rate of inflation has not made the problem serious. High inflation Member States such as Italy and Spain have from time to time permitted their companies to write up assets to take account of inflation and to create a tax free reserve. If a Dutch company made a similar disposal it would not under the present law be taxed. If the 1975 proposal (11) were adopted with no change in the law on this point, there would obviously remain a material advantage in using the Netherlands as a jurisdiction for a holding company.

1.3. The 1969 mergers proposed Directive (7) deals with "deemed dispositions" but not the outright sale of a participation. Articles 13-19 of the "base" proposal (14) *do* deal with capital gains tax. If adopted, they would remove the Dutch advantage. However, there is *no* discussion on whether indexation would be permitted: if it is not, there could be a serious bias against high inflation countries as holding company locations.

DEBT INTEREST

1.4. Neither the Convergence Report (15) nor the "base" (14) draft mention the treatment of debt interest. Paragraphs 5 to 7 of the Introductory Memorandum to the 1975 proposal (11) stated specifically that "the Commission believes that in the long run it is better that the choice of means of financing should not depend on taxation considerations" and puts forward, as an advantage of the imputation system, that it was more neutral than the classical system as between loan and equity financing. The international aspects of this are not developed in either document.

1.5. One of the key decisions facing the international tax planner is where to borrow. Should the parent company raise debt and invest the money in a subsidiary, or should the subsidiary be encouraged to borrow locally? Apart possibly from questions of management control, this point is usually irrelevant as between a parent and its domestic subsidiaries and, in such a case, one would normally expect fund raising to be a head office function.

1.6. Within a fiscally harmonised Community there should be, from the company's point of view, nothing (except possibly for small variations in tax rate) to choose between borrowing as an obligation of a company in one country rather than of one in another. As the EC would be regarded effectively as a single "domestic" market, the most normal and effective financial arrangement would be for the head office to undertake at least all the longer term borrowing on behalf of the group.

1.7. At present, in an unharmonised Europe, the "where to borrow" decision is an important aspect of tax planning. A group of companies will not normally change physical investment or product sourcing decisions in reaction to small tax changes: it will, if well advised, react very quickly to adjust its funding structure.

1.8. This immediately raises a serious problem from the point of view of the Member States. Take the case of a UK parent with activities of roughly equal size in the United Kingdom itself and in France, and which earns 12 million ECU units pre-tax in each country. If it is entirely equity financed, the draft Directive ensures that the UK and France each tax the locally earned profits and also ensures that each country bears its due share of the cost of granting the imputation credit to shareholders, wherever those shareholders may live. If, however, the company decides to finance part of its operations by borrowing 10 million ECU at 10% at parent company level, the 1 million ECU interest charge would completely wipe out the UK tax liability, but would still leave the French Revenue with 500,000 ECU tax less (presumably the whole of) any imputation credit that was granted on the company's dividends. The problem, too, may require some form of "clearing house" arrangement.

Appendix 2: History of Initiatives Taken

(Author's note: I am indebted to Nicola Baker for considerable editorial and research help, particularly with this part of the paper.)

2.1. The task of seeking harmonised systems of corporate taxation within the European Economic Communities was not a primary objective of the founding fathers in 1957. Their concerns related solely to removing barriers to trade created by disparities in forms of indirect taxation. It was more than ten years after the formation of the EEC that the Commission produced its first proposals on the subject. The Treaty of Rome contains no obligation to harmonise direct taxes and therefore all Directives have been brought by the Commission under the legal aegis of the approximation of laws Article — Article 100 — which allows the Commission wide powers to issue directives to "approximate" any activities within the Member States which "directly affect the establishment or functioning of the common market" (1).

EARLY STAGES

2.2. The first document to address itself to the issue of tax harmonisation in the EEC was the Neumark Report "Tax Harmonisation in the European Economic Community" (1962). (2) This recommended a split rate system in the form then in use in Germany. The report also commented that the (pre 1965) UK system was then, in substance though not in form, substantially similar. France contemplated making such a change, but discovered that this would reduce the French revenue's share of the total tax taken from the profits of American investments in France (the "shadow effect") and in 1965 actually adopted an imputation system. In the same year the UK took a temporary backward step to full double taxation of companies and their shareholders. The system of "classical" corporation tax, introduced by Labour Chancellor James Callaghan was substantially criticised by the Conservative Opposition. (3)

2.3. The next initiative was by Van den Tempel, "Company Tax and Income Tax in the European Communities" (1971) (4), which made the last serious case for this so called "classical" system. At about this time, the newly elected UK Conservative Government set up a Parliamentary Select Committee (5), which recommended the adoption of an imputation system. Since this was implemented in 1972, most of the subsequent discussion on general systems has accepted the principle of the imputation system and has concentrated on the details.

THE THREE DIRECTIVES TAX PACKAGE

2.4. Meanwhile, three draft Directives, which are today still on the table unimplemented, addressed specific aspects of harmonisation. There are however clear indications that, after many years of delay, there may be action on all these in time for "1992". Two, published in January 1969 (*not* a misprint!) addressed parents and subsidiaries (6) and mergers (7) respectively. Another in 1976 proposed an arbitration procedure for dealing with transfer pricing disputes (8). These three are collectively referred to as the "three Directives tax package" in the Company Law White Paper, published in July 1988 (9) and it is the Commission's stated intention to continue to pursue adoption of all three as a package.

2.5. The "mergers" draft would extend roll over relief, loss carry forwards and other benefits into cross-frontier mergers within the EC. (The "capital duty" exemptions proposed have been implemented.) The "parent-subsidiary" draft proposes exemption from withholding tax in the member country of source and from corporate tax at parent level. (This would not solve the prejudice problem for the reasons discussed in the body of the paper, paragraphs 23 and 24.)

2.6. Despite favourable opinions from both the Economic and Social Committee and the European Parliament, followed by Commission amendments, the two 1969 proposals have still to find agreement in the Council. The Commission's amendments have failed to alleviate fears of certain Member States, in particular West Germany and the Netherlands, over the likely loss of tax revenues which might result if the companies took advantage of the tax changes proposed and moved their headquarters outside their territory.

2.7. Four final sticking points were identified in 1984 which have continued to prevent agreement, namely:

1) the problem raised in the framework of the "mergers" directive by the system of joint management applied in Germany;

2) the inclusion, in the scope of the same directive, of exchanges of shares;

3) the authorisation for Germany to continue to levy a withholding tax on dividends distributed to parent companies in other Member States;

4) the jurisdiction of the Court of Justice if the arbitration procedure for the elimination of double taxation is enacted by means of a convention between Member States, on the basis of Article 220 of the EEC Treaty.

2.8. The Commission has proposed a number of provisions to meet these stumbling blocks, namely, that German withholding tax should not exceed 10%; that Member States which at present apply a withholding tax on dividends paid out to Germany would reduce it in proportion to the reduction in German withholding tax. Any subsequent reduction in the difference between the two rates of tax charged by Germany would be matched by a proportionate reduction in the rates of these withholding taxes. In addition, the Commission has proposed that Greece should be allowed to retain a withholding tax on all dividend payments to parent companies situated in other Member States. Greece, alone among Member States, does not charge corporation tax on distributed profits. None of these proposals represent any difficulties for UK interests (10).

2.9. There has been little change until recently. It was hoped that the new German Government in 1987 would have signalled a change in attitude and given an opportunity to reach a compromise solution. In the meantime, the new Member States — Spain, Portugal and also Greece — were given more time to comment on the implication of the directives. Further delay has occurred while the new Commission, which took office in January 1989, has settled in but there are now signs of a real commitment to progress.

THE 1975 DRAFT DIRECTIVE

2.10. The European Commission's central harmonisation proposal concerning systems of company tax and of withholding tax on dividends was published on 1 August 1975 and came out in favour of an imputation system (11). It gave a range of rates for both corporation tax and the proportion of this to be granted as an imputation credit to shareholders.

2.11. Both the Budgets Committee and the Economic and Monetary Affairs Committee of the European Parliament presented favourable reports on the draft Directive. However, in the plenary session of December 1977, the Parliament rejected both reports. Some members thought the proposals had gone too far, others not far enough.

2.12. Mr Nyborg (Danish DEP) was appointed the new rapporteur for the Economic & Monetary Affairs Committee and produced an "interim" report on 2 May 1979 (12). The report made three main suggestions:

1. the Commission should abandon altogether its proposals for common rates for corporation tax and for tax credits on dividends and should restrict itself to laying down guidelines for the operation of the present systems. (Netherlands and Luxembourg could continue with no relief while Germany would continue with its 100% relief.)

2. the European Parliament should invite the Commission to produce a new set of proposals for a Council Decision for harmonising the tax base before considering the harmonisation of tax rates.

3. while the Commission were drawing up new proposals, the European Parliament would continue its examination of the Commission's present proposals.

2.13. The European Parliament passed a Resolution on 8 May 1979 on the basis of the Nyborg report. Effectively their Resolution refused to give a final opinion on the Commission's proposals until the Commission produced its proposals to harmonise the tax base: Parliament insisted that harmonisation of the rates of corporation tax and tax credits must take place in parallel with the gradual harmonisation of the systems for assessing companies' taxable profits.

2.14. This not unreasonable request (13) has now been met nine years later when, in early 1988, the Commission published its preliminary draft of a proposal to harmonise the tax base (14). This is discussed below.

COMPANY TAX HARMONISATION AND THE SINGLE EUROPEAN MARKET

2.15. During the intervening period, public attention concentrated more on the Commission's programme to harmonise VAT and other indirect taxes. Nevertheless, the Commission continued to make references to the importance it gave to the place of company tax harmonisation within the overall objective of creating a genuine common market in goods, capital and services.

2.16. The theme of its Convergence Report on tax systems, published in 1980 (15), that tax neutrality is essential to ensure that investment decisions are not determined by the tax environment "but are made, in response to economic considerations and guarantee the optimum utilisation of financial resources and production factors in the Community", has been repeated frequently in connection with the 1992 Programme for completing the internal market. [The Convergence Report of 1980 covered a wide range of direct and indirect taxes. Pages 62-71, on corporation tax, mainly summarised and discussed the 1975 proposals.]

2.17. Only the three Directives tax package is included in the timetable to complete the internal market by the end of 1992. The only other fleeting mention given to company taxation in Lord Cockfield's Internal Market White Paper (16) refers to the Commission's concern to maintain the competitive position of Community companies against non-EC firms, and states that there exists:

> "a widespread feeling in private enterprise in Europe that our fiscal environment for risk capital and for innovation compares badly with that of our major competitors."

(In fact the UK took the lead, in 1984, in reducing corporate tax rates. We were closely followed by the US but not, as yet, by Germany and Japan.)

2.18. It also stated the Commission's intention to publish a company taxation White Paper which would survey the existing proposals and highlight other areas for further action. This, they hoped, would emerge by the end of 1985; it has now been postponed indefinitely.

2.19. The Single European Act (17), passed in 1986 to introduce changes to the legislative procedure including qualified majority voting in the Council, is unlikely to have any positive effect on the decision-making process in taxation matters. Tax harmonisation Directives are expressly excluded from the qualified majority procedure and unanimity is still required. Moreover, nothing in the Single European Act negates the power of individual Members States to veto any decision affecting a vital national interest — the so-called Luxembourg "agreement". However, as Servaas van Thiel has pointed out in his article "The Single Act and Tax Harmonisation in the European Communities" (18), one of the new provisions in the Act which relates to research and technology does refer to the Commission's intention to remove fiscal as well as legal barriers in order to strengthen the scientific and technological basis of European industry by encouraging greater international competitiveness and co-operation between European enterprises.

WITHHOLDING TAX AND THE SMALLER INVESTOR

2.20. A further company tax proposal was published in 1978 (19). The first applied the effect of the 1975 imputation system proposals to the smaller shareholder investing in unit trusts and investment trusts, or collective investment institutions. The 1975 proposal specifically excluded dividends which a final beneficiary receives through an intermediary by limiting the granting of the tax credit to those recipients who are in principle liable to pay tax on dividends. Because, in the case of a collective investment institution, the body receiving the dividends and the person liable to tax are different entities, it was deemed necessary to draw up a separate proposal to transfer the right to set off withholding tax and to grant the tax credit to the final recipient.

CARRY-OVER OF LOSSES

2.21. Another proposal in 1984 (20) constituted the Commission's first step towards harmonising the tax *base* and set out a basis for resolving disparities in the tax treatment of the carry-over of losses. This, the Commission believed, could be agreed without waiting for the broader proposals to be published. It proposed to give companies the option to carry forward losses without a time limit but it imposed a limit of two years (subsequently amended at the request of the Parliament to three years) for the carry-back of losses for budgetary reasons, and only against non-distributed profits. Despite the Commission's high hopes, both these proposals remain unadopted.

TAX BASE PRELIMINARY DRAFT

2.22. The publication of the tax base preliminary Draft Directive in 1988 (14) has revived the company tax harmonisation debate within the Community. It did at first seem that this would share the fate of drafts going back for nearly 20 years. Recently, though, it has become clear that there is now to be a determined attempt to push through some, if not all, of these measures.

2.23. We are now seriously looking ahead to "1992", a "Europe without frontiers" (21). A business enterprise in the United Kingdom will be free to sell to customers in countries, with or without a real physical presence there, without let or hindrance. This, it is suggested, will encourage businesses to set up where tax rules are most favourable and this in turn will lead to a distortion of competition. Therefore, it is said, we must harmonise company tax rates and rules of computation.

2.24. In the explanatory memorandum to the tax base draft the Commission outlines its guiding objectives behind the proposals:

i) to achieve a greater degree of tax neutrality in the investment decision-making process of commercial operations;

ii) to prepare the way for a closer alignment of companies' tax burdens across the Community by establishing a more transparent and simpler tax environment as "an indispensable first step towards harmonising tax rates" and therefore allowing future tax legislation to be placed on more stable foundations. "In this way, it will be much easier for firms, especially small and medium-sized ones, to set up in other Member States";

iii) to improve the competitive position of European Community firms against non-member firms;

iv) to prevent Member States giving away incentives by way of the tax base, except in the form of tax credits and grants etc as permitted under the existing State aids measures (22).

2.25. The proposals cover rules of depreciation, capital gains and capital losses realised in the course of business on items forming part of fixed assets; provisions for liabilities and charges, stocks and deductible charges and expenditure, and provisions governing certain items forming part of fixed or current assets. The intention is to allow maximum business flexibility, and, as far as the UK is concerned, would do much to improve the tax system — with the exception of the proposed rules for directors' remuneration. In the view of the Institute of Directors' Taxation Committee, however, the draft shows every sign of being what it is — a preliminary document, and its provisions are unlikely to emerge in the same flexible form at the end of the legislative process.

COMPANY LAW

2.26. The Company Law White Paper (9) is critically analysed in the DTI/Department of Employment Consultative Document (23) and in the letter to Lord Young from the Director General of the Institute of Directors. It is wedded to the concept of "worker participation" and appears to be offering tax concessions to encourage the spread of this concept. To adapt Adam Smith in a different context, "few words need be wasted in persuading" the present UK Government on this point! We need only analyse the technical relevance of the tax aspects of the proposal.

2.27. The White Paper and other EC documents stress the impossibility of cross-frontier "mergers", using the term in its very narrow Continental sense. In Anglo-American usage a merger takes place where Company A and Company B come together so that after the event (whatever it is called) the shareholders of the two companies pool their assets and earnings into a single group. In practice this is usually achieved by Company A acquiring (for shares) if it is a true merger rather than an acquisition, the whole of the share capital of Company B or a new holding company acquiring the share capitals of both. Alternatively, there are arrangements under most systems of company law by which the assets of Company B can be made to vest into Company A with Company B disappearing as a corporate entity. This is a question of form rather than substance, and in the United Kingdom or United States it will be determined by professional advisers who would take into account tax and other factors, including the existence and possible behaviour of dissident minorities. It seldom, if ever, matters that a "merger" in this narrow sense cannot be consummated between companies in two countries.

2.28. Although differences in company law have never been a material problem in structuring cross-border transactions, care has usually to be given to avoid the unnecessary application of German worker participation rules. The concept may, for all we know, work well in Germany but would clearly be a disaster in the UK and many other countries. In at least one case involving a transnational holding company the major preoccupation determining structure was the need to avoid giving representatives of the trade unions of one country power to block international expansion, on the grounds that overseas investment is "exporting jobs". National trade unions are not the natural bedfellows of true international enterprise.

Appendix 3: The Prejudice Problem

3.1. In principle a credit system for dealing with international double taxation would normally result in the taxpayer paying, in total, the foreign tax rate or the domestic tax rate, whichever is higher. This raises one important question. If the domestic rate is 40% and the foreign rate is 50%, in what ways (if any) can the surplus 10 percentage points be used? The United Kingdom insists on a "slice by slice" computation. Other countries can be more flexible.

3.2. Subject to this complication, there are three main ways of taxing foreign source income:

— exemption (which may be "exemption with progression")

This solution has obvious practical advantages where the two countries have comparable tax rates. It is proposed by the Parent-Subsidiary Directive.

— credit with specific limitation (UK)

— credit with overall limitation (US historically: now modified).

3.3. None of these, including exemption, deals as such with the central "prejudice" problem, which arises from the interaction of the imputation credit (designed to relieve *domestic* double taxation) and the international tax credit (designed to relieve *international* double taxation). What happens if a dividend is paid out of profits which have mainly borne *foreign* tax and are therefore substantially relieved for domestic tax? There are two approaches.

(a) *Elimination of credit for foreign tax where imputation credit applies*

Some countries, notably the United Kingdom and France, take the view that they should only be required to credit tax paid to themselves and claw back or otherwise restrict the imputation credit to the extent to which it represents foreign tax paid. The UK "ACT" and French "precompte" procedures are designed to achieve this. The distribution of foreign earnings places a bar or restriction on the granting of a foreign tax credit.

(b) *Concurrent credit for foreign tax and imputation credit*

Other countries take the view that tax is tax, and that international fiscal neutrality requires them to afford the credit to their domestic taxpayers regardless of where the tax was originally paid. Countries which take this approach tend to be those which do not refund the imputation credit to pension funds and other tax-exempt investors. They are also, obviously, unwilling to grant imputation credit to foreign investors.

3.4. The disadvantage of (a) is that there is a serious element of double taxation where a domestic company with substantial international activities pays dividends not fully covered by *domestic* taxed profits. This is discussed below in the UK context. The disadvantage of (b) is that the countries concerned may be required to refund tax collected, not by them but by another government. It can be ruled out as a solution to EC harmonisation.

3.5. The imputation system was introduced in the UK in 1972. Profits were taxed at 52% (a rate which remained unchanged until 1984: it is now 35%) but dividends were eligible for an imputation credit at a rate equal to the basic rate of income tax. This was then 30%, but has been reduced, in stages, to 25%. *Distributed* profits thus suffered a "true" corporation tax of 31.43%, now reduced to 13.33%.

	Dec 1984	1988-89
Profits	100.00	100.00
Corporation Tax	(52.00)	(35.00)
	48.00	65.00
Imputation Credit	20.57	21.67
Grossed up Dividend	68.57	86.67
True CT	31.43%	13.33%
or, expressed differently		
Profits	100.00	100.00
Less True CT	(31.43)	(13.33)
	68.57	86.67
Less Income Tax 30%	(20.57)	
25%		(21.67)
Net After Tax (Basic rate)	48.00	65.00

3.6. The imputation system of taxing companies and shareholders reduced economic distortions at the *domestic* level, but increased or perpetuated them at the *international* level. Specifically, a new "prejudice" was created against UK-based companies investing abroad.

3.7. The internationally accepted principle of credit relief is that if a UK company has paid foreign tax through a branch or subsidiary abroad, the foreign tax should be allowed as a credit against UK tax. If the foreign tax rate was 52% (now 35%) no further UK tax is payable at *corporate* level.

3.8. Where dividends were paid out of such profits the position changed dramatically. Using current rates a UK company has to earn £115.375 of UK taxable profits to meet the net cost (£75) of a gross dividend of £100. If, however, the UK company has to pay dividends out of profits which had borne 35% tax abroad, the ACT becomes a real extra burden and the company has to earn *£153.85* gross — a third as much again — to service the same dividend rate.

3.9. There was a major and important concession built into the system. The "attribution" rules permit a company paying dividends to allocate its ACT *first* to profits which have borne UK tax and only then to slices of profit which have enjoyed a greater degree of credit relief and against which ACT cannot be fully offset. This is considerably more favourable than an averaging system. A company is only "prejudiced" if it cannot meet its dividends out of *UK* taxed profits.

NEUTRALITY

3.10. The first part of Table 1 shows the effect of prejudice on UK companies with different mixes of UK and foreign source income. Column A shows the normal case of a UK company earning all its profit in the UK, paying out half its profits. The tax charge is 35%. Column B shows the position of a company earning all its profits abroad, paying foreign tax at 35% and enjoying credit relief against *mainstream* UK tax. Because of unrelieved ACT, the total tax burden rises to 45.83%, and to 51.25% (Column C) in the unlikely case of full distribution. However Column D shows that the company can mix in well over half (56.67%) of foreign profits, on the half distribution assumption, before prejudice starts to bite. With this mix, a full distribution costs an extra 8.07% (Column E).

3.11. The second part of the table shows the position for Germany. The mechanism is different (restriction of distribution relief) but the substance is the same. These figures do assume full distribution — normally optimal under the German system. "Prejudice" can rise to 20% when the German company earns all its profits abroad, with no tax relief flowing through to shareholder level.

3.12. Harmonisation implies, amongst other things, that national tax systems should be as nearly as possible neutral as between domestic and foreign investment. Neutrality is relatively easy to define (but not always to achieve) when investment is into a country having comparable tax rates, but more ambiguous in other cases. With a neutral tax system the gross profit that would have to be earned to give a (for instance) UK resident shareholder a given net income, should be approximately the same whether the dividend is paid to the UK shareholders via:

(a) a UK company earning profits in the United Kingdom;

(b) a UK company earning profits in Germany; and

(c) a German company (in which the UK shareholder is a portfolio investor) earning profits in France.

This test is certainly *not* met today.

3.13. Table 2 shows the tax effect of merging a UK and a German company both of which had previously reached the limit of their "prejudice free" international expansion, and both of which were paying out about half their profits. There is a material "cost of merger" of 6% to 7% of profit which could in fact be reduced by modifying the structure. The figures are illustrative: a more sophisticated model shows that the results are very sensitive to foreign tax assumptions.

3.14. As suggested, the appropriate solution must, at EC level, be for the cost of refunding the imputation credit to be apportioned between the countries which collected mainstream tax in the first place. If this principle were generally adopted within the Commnity, it would substantially achieve neutrality. It might be possible to write a similar principle into double tax agreements with non-Member countries.

TABLE 1: PREJUDICE AND EC COMPANIES — EXAMPLES

Effect of Prejudice on UK Companies

For assumptions see text para 3.10

	A	B	C	D	E
UK Profits	100.00	0.00	0.00	43.30	43.30
Foreign Profits	0.00	100.00	100.00	56.70	56.70
Total	100.00	100.00	100.00	100.00	100.00
Foreign Tax	0.00	35.00	35.00	19.85	19.85
UK Tax	35.00	35.00	35.00	35.00	35.00
DTR	0.00	(35.00)	(35.00)	(19.85)	(19.85)
Unrelieved Tax	0.00	10.83	16.25	0.01	8.07
Total UK Tax	35.00	80.83	86.25	54.85	62.91
Total Tax	35.00	45.83	51.25	35.01	43.07
Net Dividend	32.50	32.50	48.75	32.50	56.68
ACT	10.83	10.83	16.25	10.83	18.89
Gross Dividend	43.33	43.33	65.00	43.33	75.57
Retention	32.50	21.67	0.00	32.49	0.25
Prejudice	0.00	10.83	16.25	0.01	8.07

Effect of Prejudice on German Companies

Full distribution assumed (para 3.11)
Foreign Tax Rate 50%

	A	B	C	D	E
German Profits	100.00	65.00	55.00	30.00	0.00
Foreign Profits	0.00	35.00	45.00	70.00	100.00
Total	100.00	100.00	100.00	100.00	100.00
Foreign Tax	0.00	17.50	22.50	35.00	50.00
German Tax	56.00	56.00	56.00	56.00	56.00
DTR	0.00	(17.50)	(22.50)	(35.00)	(50.00)
Distribution Relief	(20.00)	(20.00)	(11.00)	(6.00)	0.00
Net German Tax	36.00	18.50	22.50	15.00	6.00
Total Tax	36.00	36.00	45.00	50.00	56.00
Net Dividend	64.00	64.00	55.00	50.00	44.00
Gross Dividend	100.00	100.00	85.94	78.13	68.75
Retention	0.00	0.00	0.00	0.00	0.00
Prejudice	0.00	0.00	9.00	14.00	20.00

TABLE 2: EFFECT OF MERGING UK AND GERMAN COMPANIES

Assumptions:
Both companies at prejudice point
Net distribution by both (unmerged) companies equals retention
Net distribution by merged companies equals combined total for unmerged companies
All profits distributed from subsidiaries to parent

Tax Rates:		
	UK	35.00%
	Germany	56.00%
	Third Country ("Foreign")	56.00%
	UK basic rate (for ACT)	25.00%
	UK imputation rate	33.33%
	German imputation rate	56.25%
	German distribution rate	31.25%

	Unmerged Companies			Merged Companies Parent in	
	UK Co.	Ger Co.	Total	UK	Germany
UK Profits	43.00	0.00	43.00	43.00	43.00
German Profits	0.00	26.07	26.07	26.07	26.07
3rd Country Profits	57.00	73.93	130.93	130.93	130.93
Total Pretax Profits	100.00	100.00	200.00	200.00	200.00
UK Tax	35.00			70.00	
Double Tax Relief German	0.00			(9.13)	
Foreign	(19.95)			(45.82)	
Net UK Tax	15.05			15.05	
German Tax		56.00			112.00
Double Tax Relief UK		0.00			(15.05)
Foreign		(41.40)			(73.32)
Net German Tax		14.60			23.63
Foreign Tax UK		0.00			15.05
German	0.00			14.60	
Foreign	31.92	41.40		73.32	73.32
Cost of unrelieved ACT (UK)	0.00			6.78	
Distribution Relief (Germany)		(8.15)			(5.21)
Total Tax to Company	46.97	47.85	94.82	109.75	106.79
Net Dividend	26.51	26.07	52.58	52.58	52.58
"Imputation Credit"	8.84	14.67	23.50	17.53	29.58
Gross Dividend	35.35	40.74	76.09	70.11	82.16
Retention	26.52	26.07	52.59	37.67	40.63
Tax Increase (equals Retention Decrease) from Merger				14.93	11.96

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21) The European Challenge 1992. Paolo Cecchini with Michael Catinat and Aleus Jacquemin. English Edition by John Robinson, Wildwood House, 1988.
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25) A Study of Intercompany Pricing. Treasury Department and Internal Revenue Service. Discussion Draft. Washington DC, October 18, 1988.

26) The Tax Treatment of Overseas Income — What Should be Done. John Chown and Dr Barry Bracewell-Milnes, Institute of Directors, December 1980.

The point was also made in the Report from the Select Committee on Corporation Tax, HMSO, 20th October 1971. Evidence by Institute of Directors Taxation Committee (paras 745–809), by John Chown (paras 244–282) and by R. T. Esam (paras 283–345).

27) See for example the report in The Independent, 11th February 1989.

IOD

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FROM: J M G TAYLOR
DATE: 13 July 1989

MR ISAAC - IR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir Terence Burns
Mr Wicks
Mr Anson
Mr H P Evans
Mrs Chaplin
PS/IR
PS/C&E
Mr Jefferson Smith C&E

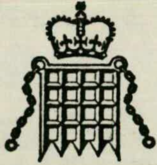
Jonathan
Mr Isaac intends to get something to us by the middle of next week
Tony 20/7

COMPANY TAX HARMONISATION IN THE EUROPEAN COMMUNITY: PAPER BY JOHN CHOWN

You should have seen a copy of this paper, which came under cover of Sir John Hoskyns' (IOD) letter of 23 June.

2. The Chancellor would welcome an assessment of the proposals contained in the paper. I should be most grateful if you could arrange for this to be prepared.

J M G TAYLOR



P Jefferson Smith
Deputy Chairman

Board Room
H M Customs and Excise
New King's Beam House
22 Upper Ground
London SE1 9PJ
Telephone: 01-382 5011

DATE: 20 July 1989

ECONOMIC SECRETARY

EUROPEAN COMMISSION'S REVISED PROPOSALS ON INDIRECT TAX

Attached is an Explanatory Memorandum covering the European Commission's revised proposal for indirect taxes in the Single Market. This requires your urgent signature, since the House of Lords Scrutiny Committee which will be considering the revised proposals meets on Monday 24 July. The Commons Committee meets on Wednesday 26 July.

2. I very much regret and apologise for this urgency. When Mme Scrivener published the Commission's revised thinking in May, the paper was circulated under cover of a personal letter from her to EC Finance Ministers. It was not until late June that we received it as an official European Community document. It was not immediately clear whether it was a depositable document because it did not contain formal proposals, and I regret that there was a delay here in coming to the view that it should be deposited. As a result of the delay this did not happen until 13 July.

3. These difficulties are compounded by the fact that the next meeting of the Scrutiny Committees are the last of this parliamentary session, and we consider it important that scrutiny is not delayed until after the recess.

4. The content of the Explanation Memorandum needs no explanation, as it concerns matters you are already familiar with. I attach a copy of the EM produced for the Commission's original proposals published in August 1987. I shall be away from London tomorrow; if you require further information I suggest your office contacts Mr Allen.

5. I would be grateful if you could return the EM when you have signed it, so that Customs can arrange for distribution.

P JEFFERSON SMITH

PS/Chancellor	CPS
PS/Chief Secretary	Mr Wilmott
PS/Financial Secretary	Mr Cockerell
PS/Paymaster General	Mr Kent
Mr R Culpin	Mr Allen
Mr J Gilhooly	Miss Linton
Mr R I G Allen	Mr Knox
Mr G Michie	Mr Oxenford
Mr M Call	Mr Norgrove UKREP

EM: Comm^n Revised Props.

6762/89
COM(89)260

EXPLANATORY MEMORANDUM ON A EUROPEAN COMMUNITY DOCUMENT

COMPLETION OF THE INTERNAL MARKET AND APPROXIMATION OF INDIRECT TAXES: COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND TO THE EUROPEAN PARLIAMENT

Submitted by H M Customs and Excise July 1989

SUBJECT MATTER

The Commission's 1985 White Paper "Completing the Internal Market" contained a detailed programme of action to achieve a single European market by the end of 1992. It envisaged that barriers to the movement of goods and persons would be abolished by changing the rules governing the VAT treatment of imports and exports; harmonising the coverage of VAT and excise duties; and bringing the rates of tax and duties closer together ("approximation").

In line with this the Commission put forward formal proposals in August 1987. It proposed approximation of VAT rates within two rate bands, a standard rate of between 14 and 20 percent and a reduced rate of 4 to 9 percent. It proposed that excise duties should be harmonised into rates calculated on the average of member states' existing rates (see COM(87)320 FINAL: 8199/87).

In order to ensure that after the abolition of fiscal frontiers member states received the revenues to which they were entitled, the Commission proposed a system for adjustment of VAT receipts through a central "clearing house". For excises the solution proposed was to channel trade between member states through linked bonded warehouses.

Acknowledging, however, after discussions with member states, that unanimous agreement on several aspects of its proposed measures was unlikely to be reached by the end of 1992, the Commission announced its revised thinking on 17 May 1989.

Under this revised approach a transitional phase could be introduced in the period up to 31 December 1992 in order to minimise disruption. For VAT the 14-20 percent rate band would be replaced by an as yet unspecified minimum rate; the proposal for the 4-9 percent band would remain unchanged. The Commission suggest that, to take account of the social role assigned to VAT in some Member States, it would be possible to maintain zero-rating for a very limited number of products currently assigned to the reduced rate, provided this did not pose any risk of distortion of competition for other Member States. Instead of harmonised excise rates, it is proposed that minimum rates - as yet unspecified - should apply to alcohol and tobacco, and either a single rate or rate bands (also unspecified) to mineral oils.

The VAT clearing house proposal is substantially revised. Special arrangements are envisaged, involving the retention of the destination principle, for mail order, car sales and supplies to the exempt sector. There would also be a suspension of VAT on cross-border transactions between businesses linked in groups. For the remaining trade between Member States, there would still be a need for a clearing system to attribute revenue, but this would be simply be based on macro-economic statistics.

For private individuals travelling between EC Member States the Commission proposes a four-fold increase in the value of VAT-paid allowances and a two-fold increase in the duty-paid allowances for exciseable products, these changes to be introduced in three stages up to 31 December 1992.

MINISTERIAL RESPONSIBILITY

The Chancellor of the Exchequer

LEGAL AND PROCEDURAL ISSUES

(i) Legal basis

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

(ii) Co-operation procedure

Not applicable

(iii) Voting procedure

Unanimity required

(iv) Impact on UK law

The objectives suggested in the communication cover matters which are at present governed, so far as excise duties are concerned, by the Customs and Excise Acts 1979. So far as value added tax is concerned these matters are governed both by Community legislation, primarily the Sixth VAT Directive 77/388/EEC (Council of 17 May 1977 O.J. No. L145 13.6.77. p1) but also by a limited number of other directives, and by United Kingdom law in the Value Added Tax Act 1983 and subordinate legislation made thereunder. If all the objectives were realised changes to United Kingdom primary and subordinate legislation would be necessary.

POLICY IMPLICATIONS

The Commission's proposals in many areas are unspecific. As a result it is not always possible to give a clear picture of the policy implications. The move away from both the fixed band for the standard rate of VAT and fixed rates for excise is welcome, as is the Commission's acceptance that certain zero rates may be retained on social grounds, though the list of items to be included is not indicated. But the Commission's long term aim remains the approximation of indirect tax rates, which the United Kingdom Government continues to believe to be unnecessary and inappropriate.

The revised approach to the clearing house represents a welcome move towards retaining the existing destination system which the UK favours (but for all intra-Community trade). But the system as proposed, which would involve both an origin and a destination principle, looks complex, and requires further clarification and discussion.

The proposals to increase duty and tax-paid allowances reflect UK policy.

FINANCIAL IMPLICATIONS

No calculations are possible on the financial implications of the objectives in this paper, as no specific rates are proposed.

TIMETABLE

The target date for implementation of the objectives in this document is 31 December 1992. Implementation is envisaged as being gradual up to that date.

PETER LILLEY
ECONOMIC SECRETARY TO THE TREASURY

CONFIDENTIAL

FROM: A J G ISAAC

A J G Isaac CB
Deputy Chairman

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27 July 1989

CHANCELLOR OF THE EXCHEQUER

COMPANY TAX HARMONISATION IN THE EUROPEAN COMMUNITY: PAPER BY MR JOHN CHOWN

1. You asked (Mr Taylors note of 13 July) for an assessment of the proposals in this paper by John Chown.

2. The final version of this paper includes some drafting changes, but the substance is very much the same as in earlier drafts which have been circulating widely since the Spring (and which some of us touched on at the IFS Oxford Conference last May).

3. The argument divides itself into three main themes (or two main themes and an intermezzo):-

---

cc		
	Chief Secretary	Chairman
	Financial Secretary	Mr Isaac
	Paymaster General	Mr Painter
	Economic Secretary	Mr Beighton
	Mr Middleton	Mr Houghton
	Mr Burns	Mr McGivern
	Mr Wicks	Mr Johns
	Mr Scholar	Mr Bush
	Mr Monck	Mr Calder
	Mr Anson	Mr Hunter
	Mr Culpin	Mr Keith
	Mr H P Evans	Mr Reed
	Mrs Chaplin	Mr Weeden
	PS/Customs & Excise	PS/IR
	Mr Jefferson Smith	

- first, too much time and attention in Brussels has been wasted on proposals for formal harmonisation of rates and bases of business taxes. (a) Formal harmonisation of this kind is not actually essential (it is only one of many differences in the environment with which businesses have to cope, when considering where to make their investments; in practice they generally manage); (b) it is exceedingly difficult to achieve in practice (given the differences in national tax systems, and national economic monetary and social priorities); and (c) it could actually be damaging in practice (it would create a "cartel", enabling national tax authorities to keep tax rates higher than would otherwise be possible in a competitive world economy).

- second there are, however, problems with transfer pricing activities by national Governments; in principle, national tax authorities are entitled to make sure that multi-nationals do not try to shift profits offshore, to some tax haven; however, international practice has now become too aggressive, led by the United States.

- third the immediate and major problem, however, is what John Chown has long called "ACT prejudice": the fact that, when profits or dividends cross national frontiers, they are liable to pay an additional slice of tax. This "prejudice" can and does exist quite independently of any additional tax charge arising from differences between national tax structures, basis and rates. It seriously impedes international mergers.

Harmonisation of CT base and rate

4. As John Chown explicitly acknowledges, the first theme is very closely in line with Ministers' policy. If I may say so, at the IFS Oxford Conference last May, I myself found most effective a variant of the "Cartel" argument, in persuading

private sector businessmen and advisers of the risks of harmonisation. Does anyone seriously believe that the business and other tax reforms achieved by the present Government would have been possible, if they had been conditional on unanimous agreement by France, Italy, Greece and 8 other EC Governments?

5. It is not entirely clear, whether John Chown accepts or disputes that harmonisation of structure on our imputation system (as distinct from harmonisation of tax rates and base) is necessary for his purposes. The implication, however, is that he does see harmonisation of structure as at least desirable, if not necessary. And if you accept his objective, there are indeed strong arguments pointing that way (see paras 19, 23 and 25 below).

Transfer pricing

6. On the general point of transfer pricing there is always going to be tension between multi-nationals and national tax authorities, over the amount of tax that the multinationals pay on their total operations, and where they pay it. I am not sure that many of us here share John Chown's perception that, on balance, the multi-national companies are suffering an unduly heavy overall tax bill on that account; but I am not sure that John Chown would expect us to. You will recall that part of the "French package" - which failed to win agreement at the recent ECOFIN - was an arbitration procedure to solve disagreements between national tax administrations within the Community.

7. Having said that, I do recognise John Chowns' particular perception, and share some of his anxiety, about the aggressive approach increasingly adopted in a number of tax areas by the United States administration. We are currently aware (for example) of potential pressures in "intangibles", international mergers, treaty shopping, Xerox and Lloyds of London. Sooner or later some of these matters may need to trouble Ministers

more seriously, perhaps in the context of amendments to or renegotiation of the double tax treaty with the United States. (Even in its present form this treaty reflects the Americans' pretty substantial negotiating weight). You have yourself just asked for advice on one of the current US proposals.

ACT

8. The issue here is one which has been at the top of John Chown's list of priorities for very many years. For example, some of us can remember that he was (in the Select Committee's own words) the "most assiduous" lobbyist of the Select Committee on Corporation Tax in 1971, making 5 separate oral or written submissions.

9. There is no doubt that the argument in John Chown's latest paper is part of a renewed campaign by the CBI, led by BP. I am told that Ministers may expect shortly a new demarche from the Chairman of BP.

10. As I have said, this is a debate which has been renewed (at intervals) since as far back as most of us care to remember. I will not attempt to run over the whole argument here. There is a convenient summary of the points, on both sides, in Chapter 14 of the 1982 Green Paper, and I attach at Annex A the relevant extract. Though some of the figures have naturally changed, the main points still hold good. I merely add here brief comments on three points which might be considered (to a greater or lesser extent) "new".

(i) - Surplus ACT

11. First, there is the increasing amount of surplus ACT: we now have an accumulated overhang of some £5bn, building up at an annual rate of between £½bn. and £3/4bn. Some of the lobbyists (though, to be fair, not the present John Chown paper) have argued that this result was never "intended" when

the imputation system was introduced. On the contrary, it in fact was the main point of dispute between the Government and the CBI, when the imputation system was being debated before the Parliamentary Select Committee in 1971. The Government then wished to ensure (and the CBI wished to prevent) precisely the result, that 'surplus ACT' should arise when a UK company pays dividends out of profits which have not borne UK tax.

The Select Committee accepted the Government's side of the argument, when they concluded that it was an "essential feature" of the imputation system, that ACT should act as a kind of "minimum tax".

12. The debate was renewed and the same line of argument led to the same conclusion at the time of the 1982 Green Paper. By that time the annual growth in surplus ACT had risen sharply to around £300 - £400m.

13. The amounts of tax, of course, have grown further since 1982* But that remains an argument that cuts both ways**. Whichever way one cuts the theoretical cake, it is clear that tax constraints have not in practice stopped the increasing spread of international business across frontiers. It must be assumed that tax considerations have probably helped to influence some individual companies' decisions - to discourage this overseas merger, or to encourage that other domestic

---

* This is at least partly because of a technical change to the legislation introduced in 1984 in response to pressure from industry. The change (in the order in which relief was given for ACT and DTR) both reduced industry's immediate tax burden and added to surplus ACT.

** In practice the amount of surplus ACT is sensitive to companies' own behaviour - with respect to, in particular, dividend payout ratios which are rising sharply but still have yet to return to 1960's levels, and the proportion of group income derived from the UK (which in an era of high acquisition/merger activity is entirely a matter of preference for any particular group). The "minimum" tax feature of ACT implies that those companies that successfully reduce UK taxable income to minimal levels by means of "tax planning" inevitably generate surplus ACT if they distribute profits to shareholders.

merger, for example, for a UK company to build up or acquire UK profits. Overall, however, the evidence before us suggests that any tax obstacles have usually been overridden by commercial factors; or companies have found ways round any tax obstacles (see for example the companion paper on PEGS); or perhaps that in practice (as discussed below) the channelling of profits and dividends across international frontiers can be (and is) used to attract tax benefits as well as tax penalties. Wherever the cause, business does in real life cross international frontiers increasingly often, on an increasingly large scale.

(ii) International competition

14. It is undoubtedly true that international competition for investment has been growing stronger, with Japanese, Australian and European multi-nationals running abreast of the familiar North American and British names. This year's budget measures (on unit trusts) illustrated the conclusion that national governments may find themselves under pressure to reduce effective tax rates, to match those of their competitors. And indeed Government policy on European harmonisation clearly implies that, up to a point, these competitive pressures can be healthy.

15. All that accepted, the question remains whether it is in the UK interest to match competition, or to go beyond that and seek to gain a lead. John Chown hints in his paper, and has argued explicitly in informal discussions, that this would be in the UK's interest: to make the UK an attractive place for foot loose multi-national companies, and thereby attract to this country additional employment, overseas earnings and profits and consequent tax offsets. The arguments for this would be powerful, if the option was costless and a multinational presence in the UK was an unqualified benefit: that is, if we were in a tax haven situation. In our present situation, however, the benefits have to be weighed against the facts that:

- there is the substantial amount of corporation tax (para 11 above) at issue from multinational companies under the present system; and further possible costs from behavioural changes.

- with modern information technology, we do not necessarily attract significant employment or market opportunities, if profits and dividends are channelled through (what may be) a UK brass plate company; just as we do not necessarily lose jobs and market opportunities, if profits and dividends are channelled through (what may be) a Luxembourg or Netherlands brass plate company. The form and substance of "headquarters" activity can and sometimes do go together. However, as quite a few practitioners emphasised at the IFS Oxford Conference, company groups are quite prepared, where they see advantage in that, (for example) to arrange for the group's activities to be co-ordinated through London, but dividends to be routed through the Netherlands.

- as I have said there are opportunities, which some companies now exploit, to reduce the UK tax take by channelling international activities through a UK "headquarters" office. Annex B gives three simple and familiar examples.

(iii) The European single market

16. Very briefly, John Chown is saying that (whether or not we recognise the case for any formal harmonisation of CT rates or base) we should at least recognise for tax purposes the existence of a European single market; and (so the argument runs) this means that:

- if we allow UK corporation tax paid by a UK company to be imputed as a credit against the UK income tax due on dividends of a UK shareholder, then:

a. we should similarly allow French (or some other EC) tax paid by a UK company, or its subsidiary, to be imputed as a credit against the UK income tax of a UK shareholder and

b. we should allow UK (or EC) corporation tax paid by UK company or a subsidiary to be imputed and paid as a credit against the French (or other EC) income tax liability of a French (or other EC) shareholder.

17. This argument, as such, is framed in terms of a European single market. The paper does not argue the case whether, if the principle was conceded for Europe, it could be restricted to Europe. My guess is that, in practice, John Chown and the CBI would almost certainly argue that similar treatment should be accorded to international flows of profits and dividends much more generally. Indeed there is a hint of that, towards the end of the paper (see para 21 and 22 below).

18. The new "European" argument is essentially a presentational or debating one. It is encouraged by the way that the same amount of money is (under an imputation system) "regarded at one stage as corporation tax paid by the company, and at the next stage as income tax paid by the shareholder". (official evidence to the 1971 Select Committee.) It therefore invites the line of argument that within a single market we should treat French Corporation tax in the same way as UK Corporation Tax.

But the point of substance is still the familiar point from 1965 and before. Should national tax authorities in future - as they have not as a rule up to now - credit or repay to their domestic income tax payers some or all of the corporation tax paid to overseas tax authorities by a company earning profits overseas?

19. And it remains the fact that, even in Europe, corporate tax structure, rates and base have not been harmonised - so that Dutch (or Italian) Corporation Tax is not on all fours with UK tax. Thus, one result of letting other EC countries' corporation tax run against a UK shareholder's income tax liabilities, would be that, as things now stand

- not only would we get no income tax from a UK resident taxpayer with a possibly big investment income, enjoying all the benefits and protection of the UK's public services,

- but also we could find ourselves treating a UK investor in (eg) a UK holding company with a Dutch subsidiary better than the Dutch themselves treat a Dutch shareholder in the same Dutch company. (The mind boggles at the implications if a UK top company was then interposed between the Dutch company and its Dutch shareholders, and the UK was asked to pay tax credit on dividends paid to the Netherlands).

John Chown's approach

20. John Chown suggests three broad principles derived from his analysis.

- domestic tax systems should be adapted to achieve a reasonable measure of Capital Export and Import Neutrality

- total tax revenue (at corporate and shareholder level) from business profits should be divided as far as possible in an agreed ratio (perhaps 2:1), between the country of source of the income, and the country of residence of the shareholder;

- third country intermediaries should neither collect tax on income passing through, nor be liable to refund tax they have not collected in the first place.

21. Based on these principles, John Chown identifies four necessary conditions, if the European Community is to harmonise on an imputation system of tax:

i. tax credit should be paid to foreign as to domestic portfolio investors;

ii. French (or other European Community) corporation tax should be allowed to cover ACT on dividends paid by a UK company out of overseas profits and vice versa in other countries.

iii. there should be an international clearing house, to sort out the financial consequences of (i) and (ii) above.

iv. the harmonised European system must be compatible with the tax systems of non member countries, particularly the United States and Japan.

It would be a matter of "politics and procedure rather than of technique," how far all this was achieved through the form of an international treaty and double tax negotiations, or through a European Community Directive.

Assessment

22. John Chown's condition (iv) is familiar and persuasive. Indeed, it is a point which we ourselves have argued strongly in the EC harmonisation debate, that the Community cannot and must not try to isolate itself from the competitive world outside.

23. John Chown's "condition" (iii) appears to be derived from his second "principle" in paragraph 20 above, and I come back ~~with~~ to it in para 25 below. In essence, he seems to be conceding that, even if the UK and other European Governments accept the main thrust of his argument, and even within a European single market, national tax authorities in the UK and elsewhere cannot be expected to sign a blank cheque (see para 19 above):-

- not only to give up all domestic income tax, but also to "repay" tax where necessary on income received from abroad by their domestic income tax payers; or

- by paying tax credit to overseas shareholders, to give up most or all of the corporation tax liability on profits earned by companies in their domestic economy.

24. The crux is John Chown's points at 21(i) and (ii). These remain very much in line with the case which he has argued over the last 20 years or so. The big question is whether there have been 'new'developments, including the acceptance of the European Single Market and the continuing growth of international business, that have changed the balance to such an extent that Ministers should seriously consider the economic and practical implications of reversing policy. I have to say that we here are not persuaded.

25. We are of course at your disposal if you see this as a policy area which should have high priority for future work. If so, a lot more research work is needed on (inter alia) the practical implications of a change in policy. In brief outline, at this stage

- Payment of tax credit (21(i) presents no great practical or structural (as distinct from policy and financial) problems. We already allow tax credit to be paid under double tax agreements in many circumstances (at a cost of £450m). Recently we have taken a fairly rigorous policy, granting payment only when it appears to be to the UK's direct advantage in the context of a bilateral negotiation, with a full reciprocal benefit from the other country.

- Allowing overseas company tax to shelter domestic shareholders' income tax would go to the heart of the imputation system and could present much more serious practical problems. Countries with a classical corporation tax (USA, Netherlands, Luxembourg) avoid the problem altogether. Some with a two - rate system (Germany) compromise by effectively refusing payment of tax credit and/or imposing a withholding tax on dividends. Under an imputation system, the options include a German style compromise, or (with all its beaurocracy) an international clearing house such as that recommended (here) by John Chown and (elsewhere) by the European Commission. Either option is formidable. Either, even after the domestic UK issues had been settled, would be likely to require long detailed negotiations with our European partners, and outside, notably with the United States. As I have noted, harmonisation of structure might be a prerequisite to any multilateral arrangements with Europe.

C.L.C.J.

INTERACTION OF SURPLUS RELIEFS AND DOUBLE TAX RELIEF

EXTRACT FROM THE GREEN PAPER ON CORPORATION TAX OF JANUARY 1982 (CMND 8456)

14.23 A further radical proposal has been put forward, which would in effect institutionalise and make more generally available the kind of arrangements discussed in paragraph 14.22. This is that a "market" should be created in which companies with surplus current tax reliefs or allowances could sell them to other companies with surplus taxable capacity. The Exchequer cost of creating a "market" of this kind could be very substantial. Surplus tax losses currently arising at £5 billion a year at a tax rate of 52 per cent would be equivalent to tax of some £2 billion or more. And there could be scope for arrangements, particularly within groups of companies, which might in practice bring the total Exchequer cost very close to the total mainstream corporation tax yield of some £3 billion.[1]

C. INTERACTION OF SURPLUS RELIEFS AND DOUBLE TAXATION RELIEF

Allowing double taxation relief against ACT

14.24 A company which pays tax abroad on income derived from a foreign source can, in appropriate circumstances, set that tax against any UK corporation tax liability on that income. This set off is made after all UK tax reliefs and set offs and the relief (double taxation relief) is intended to ensure that the same income in the hands of the company is not taxed twice, both abroad and in the UK. As with the losses and reliefs discussed in paragraph 14.6 above, double taxation relief cannot be used to shelter a company's liability to advance corporation tax, or to claim a refund of advance corporation tax.

14.25 This rule—and the arguments in paragraphs 14.27 to 14.42 below whether double taxation relief should be used to cover ACT—were perhaps the single item most intensely discussed in oral and written representations before the Select Committee on Corporation Tax in 1971 reached the conclusion reported in paragraph 14.14 above, and the debate has continued.

14.26 It is tentatively estimated that the ex-ante cost of permitting double taxation relief to cover ACT might be in the region of £m150.

Distinguishing between domestic reliefs and double taxation relief

14.27 If losses and domestic tax reliefs were generally available for set off against ACT it would presumably follow that double taxation relief should be similarly available. But the question arises whether it would be defensible to distinguish double taxation relief from domestic reliefs for this purpose, so that *double taxation* relief would be made allowable against ACT even if the present rule remained that *domestic* tax reliefs were not allowable against ACT.

14.28 On the one hand, it is argued that in the case of double taxation relief (by contrast with the domestic reliefs) the company has (usually) paid tax on income in its hands, even if the tax was paid to a foreign revenue authority, and not to the UK Inland Revenue; and it is argued that this distinguishes the two cases. On the other hand, it is argued that, if the principle can be conceded—of allowing the company's tax relief to run against ACT—then the arguments for encouraging investment in the UK, for example in a development area, are at least as great as the arguments for encouraging overseas investment.

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[1] In the nature of changes of the kind discussed in this section, it is not possible to present their implications for the rate of corporation tax on a revenue-neutral basis.

14.29 It is argued that any discrimination of this kind would be particularly difficult to defend, to the extent that the double taxation relief is attributable to "tax spared"[1] in the other country. In these cases the company will have paid corporation tax neither overseas nor in the UK; and the case cannot be distinguished from that of the tax-exhausted domestic company on the grounds argued in the previous paragraph.

Distinguishing between tax credit and tax repaid

14.30 If double taxation relief were allowed against ACT it would follow that the relief would run through to the shareholder to the extent that the company's tax was imputed to him; in other words, it would frank the shareholder's tax credit.

14.31 As a corollary of this, a preliminary question would arise, whether, as in the pre-1965 system, shareholders who were liable at less than the basic rate[2] on their dividends should have their repayments restricted to the "net UK rate" borne on them.

14.32 The main arguments against a "net UK rate" have been that:—

a. it is difficult to justify the different treatment of shareholders liable at the basic rate or above and shareholders liable at less than the basic rate. For the first category the double taxation relief would frank part or all of the tax credit and hence of the basic rate liability. For the shareholder liable at less than the basic rate, repayment would be restricted to the "net UK rate". It has been said that there is no logical basis for applying different criteria as between forgoing tax from one taxpayer and repaying tax to another;

b. the pre-1965 arrangements were complicated and expensive to administer;

c. their reintroduction would inevitably disturb the stock markets as pension funds and other exempt bodies would tend to shift out of companies affected by the "net UK rate" arrangements and into companies in which they could continue to claim payment of tax credit in respect of their dividends; and

d. as compared with pre-1965 there would additionally be the problem of restricting tax credit to non-resident shareholders entitled to it, in many cases under double taxation agreements.

The general question

14.33 The arguments for and against allowing double taxation relief against ACT may be related to the answer given to the more general question, how far

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[1] A number of countries—notably developing countries—provide tax holidays for certain enterprises specifically to promote industrial and commercial development etc. (If in these cases the UK double tax relief were limited to the tax actually paid, the "sparing" of overseas tax would simply result in a corresponding increase in the UK tax chargeable.) Under the terms of a double taxation agreement (DTA), the UK can extend credit relief to tax which has been "spared" overseas. Some 25 of the UK's DTAs currently contain a provision to this effect.

[2] eg where the shareholder is exempt or where (after tax reliefs and allowances) tax is not payable by the shareholder or is payable on only part of the dividend.

the tax system should be neutral in the treatment of income derived at home or from overseas, and how should neutrality be defined in these circumstances?

14.34 It would be beyond the ambit of this Green Paper to consider in any detail the relative economic merits of investment at home and overseas. Relevant factors include the rates of return available, the impact on domestic activity and exports, and the effect if any on the exchange rate. Whether or not overseas investment has any initial impact on the exchange rate depends on how it is financed; in the longer run the stream of overseas income from the investment will be a further factor. Similarly, the effect on exports may depend on the circumstances; but in general firms will be most likely to invest abroad where such investment complements rather than replaces UK exports, or where the investment opportunities would otherwise be taken up by firms from other countries.

i. The return to the shareholder:

14.35 Some comparisons look first to the post-tax return to the individual shareholder. On this basis they compare (for example) the position under the present system of a UK shareholder liable at the basic rate of income tax in two alternative situations where the shareholder invests:—

a. in a UK company with domestic income.

b. in a UK company with income derived from a foreign source, where tax has been charged by the overseas country at the same rate (52 per cent) as UK corporation tax.

The position will then be as follows:

		(a)		(b)
Gross pre-tax income		100		143
Foreign CT		—		—74.4
UK income		100		68.6
UK corporation tax				
at 52%	—52		—74.4	
less ACT set-off	+20.6		+20.6	
mainstream CT		—31.4		−53.8
less DTR		—		+53.8[1]
ACT		—20.6		—20.6
Cash dividend		48		48

In other words, the company with overseas income needs to earn almost half as much again (143 as compared with 100) in order to provide the UK shareholder with the same cash dividend of 48. If this is the correct basis of comparison, it will—if other things are equal—be more profitable for the individual to finance investment at home, rather than overseas.

[1] Up to full amount of mainstream CT payable.

ii. The return to the country as a whole:

14.36 Others have argued[1] that the comparison should be made in terms of the financial return to the country as a whole (which, even narrowly defined, would include the sum of the dividend to the individual shareholder plus the tax paid to the Exchequer) rather than the return to the individual shareholder (that is, his post-tax dividend alone). Thus,

— the shareholder's dividend of 48 in case a. above is part of a total UK return of 100 (48 dividend plus 52 UK corporation tax); but

— the shareholder's dividend of 48 in case b. above is part of a total UK return of only 69 (48 dividend plus 21 ACT); and so

— a pre UK tax income from overseas of 69 will provide the same return to the individual shareholder as domestic income of 100.

14.37 The present tax treatment can thus make it in the individual shareholder's (post UK tax) interest to invest overseas, even if an alternative investment in the UK would yield a higher (pre UK tax) return. On this basis, it has been argued that, if one looks at the UK economy as a whole, insofar as the present system gives credit for foreign corporation tax directly against UK corporation tax liability (rather than merely allowing the foreign tax as a cost incurred in earning profit) it is already favourable to overseas investment.

14.38 It has also been argued that to go further and give relief to the UK shareholder for tax paid, for example, by a United States company in the United States would be to treat the UK shareholder more favourably than a US shareholder in the same company, and indeed would be more favourable than to give the UK company an outright exemption from UK tax on income earned abroad.

iii. Comparison with other countries' rules:

14.39 A third approach has been in terms of a comparison between the treatment by this country of investment overseas and by other countries of investment in the UK.

14.40 On this line of approach, the present system is even-handed, in that under a network of double taxation arrangements, or by unilateral arrangements, other countries either give credit against their company taxes (on the UK pattern) for income earned and subjected to corporation tax in the UK, or exempt such income from tax. (To the extent that relief is given for "tax spared" there is a departure from neutrality in favour of investment abroad. The USA does not give credit for tax spared, precisely because it wishes to preserve neutrality in this sense.)

14.41 Other major countries do not in general allow relief for a foreign tax paid by a resident company to shelter the personal income tax liability of the shareholder. In countries such as the United States, this is precluded by the formal separation of company and personal taxation under a classical system. In

[1] See for example, the Memorandum of Dissent from the Royal Commission on the Taxation of Profits and Income, Cmd 9474, June 1955.

France and Germany it is prevented by the "précompte" or by the Ausschüttungsbelastung which (as in the case of French or German profits sheltered by domestic tax reliefs, and as in the case of ACT in the UK) ensure that sufficient tax is actually paid to the French or German authorities to frank the shareholders' tax credits. The position for the individual French or German shareholder is therefore broadly analogous to that for the UK shareholder at paragraph 14.35 above.

14.42 In France, under the provisions of French double taxation agreements the foreign withholding tax may be set off against the "précompte" levied if dividends received from a subsidiary and effectively exempted from tax are deemed to be distributed. Of the 8 major countries which it has been estimated together account for just over 90 per cent[1] of the stock of international direct investment, only Canada as a general rule allows tax paid by a resident company in a foreign country to shelter the domestic shareholder's personal tax liability; and Canada does not allow repayment of tax to exempt shareholders in such circumstances.

D. OTHER CHANGES TO LIMIT THE "OVERHANG"

14.43 The possibilities discussed in paragraphs 14.6 to 14.42 above have been of changes which would enable companies to make greater or more immediate use of surplus tax reliefs.

14.44 A contrasting approach would be to ensure that "surplus" relief was not given in the first place—for example, by restricting tax reliefs so as not to exceed the provisions made in company accounts. Parts II and III above (some alternative tax systems; and effects of inflation) discuss certain possibilities in this direction. In principle, a change of this kind would be likely to affect not only the current £5 billion per annum surplus of unused allowances, but also leasing and similar arrangements of the kind discussed in paragraph 14.22 above.

14.45 Even if it were not wished to reduce the level of reliefs and allowances currently being generated, the question would arise whether something should be done to limit the rate at which the accumulated surplus of unused losses continues to increase, from its present level of £30 billion.

14.46 The main arguments for such an approach might be:

a. many individual businesses' tax liabilities may for the foreseeable future be determined by tax losses originating many years in the past, and the distribution of the tax burden between companies—and for that matter between the business sector and the personal sector—may come to bear increasingly little relationship to current taxable capacity; and hence

b. the "overhang" of unused losses in the corporate sector as a whole may unreasonably depress the yield of corporation tax, when company profits recover, thus restricting the Government's room for manoeuvre in reducing tax or interest rates for the benefit of the economy generally.

[1]Source: United Nations Centre on Transnational Corporations.

ANNEX B

Multi-national businesses:the real world

1. It is self-evident that the theoretical costs, attached to streams of income crossing national frontiers, have not in practice stopped the steady growth of multi-national businesses over the past few decades, so that very few, if any, major manufacturing or other industrial companies are now structured on an independent national basis, or could readily be restructured to confine them within a single tax administration. In some cases, no doubt, this is because multi-national companies have been able to exploit commercial advantages (eg the brand names of Ford or Coca Cola, or worldwide economies of scale) that have more than outweighed any fiscal disadvantages. At the same time, however, the growth of tax planning will on occasion have shifted the balance very significantly. In particular multi-national companies have employed a variety of (more or less legitimate) devices - as well of course as more direct bargaining with Governments over the choice of physical location of real investment - to get the most favourable (not the least favourable) fiscal treatment on offer by any relevant national administration.

2. Familiar examples might include:

- transfer pricing, to ensure that as much as possible of the profits earned by the enterprise as a whole is recorded in the accounts of a business in a low tax country and as little profit as possible - or possibly a loss - is recorded in the accounts of a business in a high tax country.

- debt shifting, to ensure that interest on borrowings is routed through the books of a business where there would otherwise be taxable profits, even though the money is borrowed to finance the earnings of overseas profits which will never be included or taxed in that country.

- treaty shopping: for example profits earned in a country which does not (eg) pay tax credit on dividends to the United States may be routed through a UK head company, so that the dividends to the US shareholders attract payment of UK tax credit and ACT set off to reduce mainstream corporation tax otherwise payable on UK profits. This illustrates the fact that where there are taxable UK profits, a multinational group may have a tax incentive to attract a liability to ACT, in order to gain payment of tax credit.

chex.ps/jmt/45 **CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 3 August 1989

MR A J G ISAAC - Inland Revenue

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks

Mr Anson
Mr H P Evans
Mrs Chaplin

Mr Unwin - C&E
PS/C&E

Sir A Battishill - IR
Mr Painter - IR
Mr Beighton - IR
Mr Houghton - IR
Mr McGivern - IR
Mr Johns - IR
Mr Bush - IR
Mr Calder - IR
PS/IR

COMPANY TAX HARMONISATION IN THE EUROPEAN COMMUNITY: PAPER BY MR JOHN CHOWN

The Chancellor was most grateful for your note of 27 July, which he thought a lucid and persuasive analysis.

J M G TAYLOR

CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 3 August 1989

MR CULPIN (FP)

COMPANY TAX HARMONISATION IN THE EUROPEAN COMMUNITY: PAPER BY MR JOHN CHOWN

The Chancellor has seen Mr Isaac's note of 27 July (and I have minuted out his thanks).

2. The Chancellor would be interested in any comments you might have, especially on the balance of advantage discussed in Mr Isaac's paragraph 15 (ie whether it is in the UK interest to match competition, or to go beyond that and seek to gain a lead).

J M G TAYLOR

BRITISH EMBASSY

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R L Turner Esq
ECD(I)
FCO

Your reference

Our reference

Date

21 August 1989

ECONOMIC AND MONETARY UNION

1. I attach a translation of the paper released by the Federal Economics Ministry (our telno 798).

2. Reporting of the paper in the media was limited and generally concentrated on its criticism of the Delors Report. The financial daily, Handelsblatt, described it as a study which was intended to close the gap on monetary union on which the Delors Report was very vague. The newspaper went on to highlight the main points of the paper, including the call for more study of the level of cooperation and the rejection of new institutions.

3. The only other substantive report I picked up was in the General Anzeiger, a Bonn-based newspaper with a small but influential readership. Its report followed the lines of that in Handelsblatt but an editorial alongside said that given the traditional social market leanings of the Economics Ministry, it was not surprising that the "Haussmann Report" should criticise Delors. The editorial continued that the central point of the criticism was directed towards attempts by Brussels to initiate policies which crossed national interests of member states. In the view of the Bonn Government, budgetary decisions should remain the responsibility of national parliaments.

E Jenkinson

cc: I Polin Esq, HM Treasury
I Tower Esq, Bank of England

Translation

Federal Ministry for Economic Affairs

Paper on Economic and Monetary Union

I

At the European Council meeting in Madrid on 26/27 June 1989, the EC Member States reaffirmed their determination to achieve Economic and Monetary Union in a step-by-step approach. In the Council's opinion, the Delors Report constitutes a good basis for the work ahead. Among other things, the Council expressly emphasises that, while establishing the EMU, consideration must be given to the parallelism of economic policy and monetary policy aspects.

This reaffirms the fact that there are close and indissoluble links between the economic and monetary policy aspects. Whereas ideas about the practical and institutional form of monetary union are already relatively far advanced, the conception of economic union and related economic policy requirements still needs further analysis and the formulation of concrete conclusions.

II

The Delors Report, which also stresses the need for parallelism and equilibrium between economic and monetary union, sets out the following on the subject of economic union:

1. Four basic elements are stated as the principle features of economic union (para 25):

   - the single market with free movement of persons, goods, services and capital;
   - competition policy and other measures aimed at strengthening market mechanisms;

- common policies aimed at structural adjustment and regional development;
- co-ordination of macro-economic policies, including binding rules for budgetary policy.

2. In defining specific rules and agreements governing an economic union, two considerations play a central role:

   - economic union must be based on the same market economy principles which also underlie the economic order of its member countries;
   - an appropriate balance must be ensured between the economic and monetary components if the union is to be viable.

3. In order to create an economic and monetary union the single market should be complemented by activities in three inter-related areas (paras 27 ff):

   - competition policy - conducted at Community level - must operate in such a way that private or public economic agents do not impede access to markets or distort market operations.
   - EC regional and structural policies are necessary in order to promote an optimum allocation of resources and to spread welfare gains throughout the Community.
   - With regard to macro-economic policy an appropriate definition is required of the role which the Community has to play in promoting price stability and economic growth through the coordination of economic policies.

4. The following steps are proposed for achieving economic union (para 50 ff):

Stage 1:

- removal of physical, technical and fiscal barriers and strengthening of Community competition policy.
- implementation of the reform of the structural funds and doubling of their resources.
- revision of the 1974 Council Decision on economic convergence in order to strengthen economic and fiscal policy coordination.

Stage 2:

- review of the results of the single market programme.
- evaluation of structural and regional policy with a possible increase in resources and strengthening of Community programmes for investment in research and infrastructure.
- strengthening of the procedures introduced with the revision of the 1974 Decision on convergence (creating key objectives for stable growth, setting rules relating to the size and financing of budget deficits).

Stage 3:

- possible further expansion of structural and regional policy.
- binding rules in the macro-economic field with directly enforceable decisions by the Council of Ministers (constraints on national budgets, supplementation of structural transfers, application of terms and conditions to Community structural policies and Community loans).
- restructuring of Community's role in international economic policy cooperation.

III

5. The establishment of an EMU requires a large degree of parallelism between economic and monetary policy measures without rigid rules having to be laid down.

The European Council in Madrid expressly confirmed that consideration must be given to this parallelism. This does not mean absolute parallelism at all times. Sometimes there will be faster progress in the monetary sector, other times in the field of economic policy convergence. Concrete steps must therefore take account of past experience and the current state of integration. This applies in particular during the transition to a new stage. There should then be a review of whether and where there is a need to catch up and the corresponding measures introduced.

Such a principle of 'advancing and pursuing competition', which obviates the need for a rigid sequence of decisions on the path to EMU, is an essential component of a dynamic process of integration. At the same time, this is a renunciation of the so-called "crowning theory", whereby only the fully functional integration of the markets, the solution of all harmonisation problems and general convergence would enable the EMU to be concluded with a Monetary Union and the establishment of a European Central Bank.

6. A decisive feature of developments towards economic union and its lasting existence is basic agreement on the market economy structure of the different areas of the economic regulative framework and improved convergence in the macro-economic objectives of growth, employment and foreign trade balance with stable prices. This requires greater coordination of economic policies. It must be ensured in particular that the economic policy measures of the individual countries fit into a consistent overall Community policy, as far as possible during the first stage.

7. The market-economy orientation of economic union envisaged in the Delors Report (para 25) requires more specific details in the individual policy areas.

- The single market with the free movement of persons, goods, services and capital is decisive for the transition to European economic union. Its completion must therefore be given the greatest priority. It is particularly important that the agreement reached at the Council of Economic and Finance Ministers in June 1988 on the complete liberalisation of the capital market in summer 1990 should be implemented and a solution found to the question of harmonising indirect taxes. The more progress is achieved on the path to economic and monetary union, the greater the effect of the single market will be.

- It is vital to reaffirm the competition principle laid down in the Treaty of Rome. Competition must be regarded and ensured as the central guiding and co-ordinating mechanism in an economic union. It must not be subordinated to industrial or regional policy aspects. Economic relations within the union must be characterised by freedom of movement and competition, not by the principle of compulsory harmonisation or state-imposed constraints on industrial activities. It is important to utilize competition as a crucial decentralised control instrument also in hitherto largely regulated sectors (e.g. agriculture, energy, insurance, banking). Particularly from an economic policy point of view it must be made clear that competition is by far the most efficient control mechanism and that it must not be undermined by interventionist policies aimed at achieving national objectives. It must therefore be

ensured that national industrial, research and structural policies - as far as they can be pursued in the individual states or at Community level - are in accord with the principle of competition. In general, it would also be useful to speed up the removal of subsidies and further supplement the criterion of the distortion of competition in intra-Community trade which is already laid down in the Treaty of Rome (e.g. distortion of allocation)

- In accordance with the Delors Report a single EC monetary policy, which is to be entrusted to an independent European Central Bank, should be committed to the objective of price stability. The use of monetary policy to support the other objectives of economic policy should only be considered to the extent that this does not damage stability. The idea of the policy of the Central Bank System being guided by non-global (e.g. regional or structural policy) objectives should be ruled out. The proposal in the Delors Report (para 32) that public sector deficits should not be financed through central bank loans is to be welcomed.

- Common trade policy in an economic union must work towards open external frontiers. Various instruments still used today to influence trade through state intervention (e.g. market allocation, self-restraint agreements, state negotiated prices and quotas) are not compatible with the strengthening of market mechanisms recommended in the Delors Report. It is important to convince our partners that open markets create the greatest benefits for everyone concerned.

- As far as financial policy is concerned, it must be assumed that the Community budget is still limited

in size and therefore cannot be employed for macro-economic control measures. Only when political union is achieved will the central Community budget gradually attain greater importance, although this means that its structure will probably also change. One point which is very problematical and should therefore be rejected is the call in the Delors Report (para 59) for "discretionary changes in Community resources to influence the overall policy stance in the Community".

8. However, the necessary degree of coordination in the field of financial and budgetary policies still require closer study. Compulsory central constraints on national budget and deficit planning are neither necessary nor feasible in the transitional period or the final stage of EMU. Arguments against this are the sovereignty of the national parliaments, the federal character of the Community and the current state of political union. More efficient consultation and coordination procedures are what is required, also in the field of budgetary policy. The objective must be the broadest possible consensus on the targets and measures to be pursued.

9. But coordination cannot be based on average Community statistics. The average budget deficit (as a percentage of GNP) of all EC Member States, for example, is not a suitable indicator. We need further analyses of the criteria for assessing the size and structure of national budget deficits and the extent to which this provides information on the necessary degree of adjustment (e.g. different states of development in individual Member States, consideration of expenditure structure, where there can be a fundamental difference between whether a budget deficit has occurred primarily due to national expenditure on productive infrastructure investment or as a result of consumer expenditure; consideration of differing demographic developments in individual Member States).

An essential basis for a more efficient financial policy and for steps towards greater convergence would be the early realisation of the Delors Report's call for an end to the practice of the monetary financing of national budget deficits.

10. According to the Delors Report, objective indicators should play a major role (cf para 30). The use of such indicators as an analytical aid to the regular review of the economic position is certainly a helpful instrument. But its statistical shortcomings mean that it cannot by itself produce any binding guideline for economic policy measures. In particular, it should not lead to any automatic action on the part of economic policy.

11. No new economic policy institutions are required at Community level to co-ordinate economic policies. It is rather a question of making better use of existing institutions. Co-ordination of individual national economic policies at Community level means above all that the Council of Economic and Finance Ministers are taking a closer interest in this task than before, after thorough preparation by the existing bodies. The proposal in the Delors Report (para 51) to revise the 1974 Council Decision on convergence may improve the co-ordination of economic and financial policies. But in the final analysis, the essential factor is the political will to tackle the task of co-ordination. Unfortunately, this will has often been lacking in the past.

12. It is encouraging to note that the Delors Report is based on the principle of subsidiarity: "An essential element in defining the appropriate balance of power within the Community would be adherence to the principle of subsidiarity according to which the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels" (para 20).

In the opinion of the Federal Economic Ministry's Economic Advisory Council, the competitive path to European integration requires only a very limited number of central co-ordinating bodies or formal (i.e. binding) co-ordination of national conduct at Community level (cf. Economic Advisory Council Report on the European Monetary System, p. 21). The Advisory Council considers "a considerable degree of convergence of general economic policy - especially budgetary policy - is essential in an Economic and Monetary Union, even a pre-requisite for the final transition to absolutely fixed exchange rates or a single European currency". We agree that it is more a question of the convergence of results than the convergence of measures, although this convergence may also occur spontaneously under the correct framework conditions, which also include the currency system. But the chances of such convergence with an *ex ante* co-ordination of economic policies is likely to be markedly higher. In any case, the positive experience which the Federal Republic has enjoyed with co-ordination in the Fiscal Planning and Economic Policy Councils or between the Länder Economics Minister shows that this is a more likely way to achieve co-ordinated behaviour of the parties involved. At the very least, it facilitated this process.

13. Actual convergence in individual policy areas and the policy measures to be taken still differ greatly in detail. To give just two examples:

- A comparatively large degree of convergence has been achieved among a majority of Member States in the fight against inflation (cf. table 1). However, price trends have been drifting apart again recently. The objective of price stability must remain the yardstick for efficient co-ordination.

- Considerable progress towards convergence is required in the field of financial policy. The large budget deficits of several Member States constitute a danger to stability and monetary policy, threaten to provoke destabilising movements of capital and increases in interest rates which will hinder investment and growth and are also incompatible with long-term exchange rate stability. A lasting reduction of budget deficits would seem to be an urgent requirement in several countries (cf. table 2).

14. It is important to achieve basic agreement on fundamental regulative ideas concerning the role of the State e.g. on the shaping of the national debt in conformity with stability, the restriction of State activities to its real tasks and the role of public institutions.

15. In co-ordinating financial policy it must be remembered that harmonisation of indirect taxes also restricts national fiscal sovereignty. On the other hand, the harmonisation of most direct taxes is neither envisaged nor necessary. Nevertheless, one must expect competition between individual locations within the economic union which will automatically produce a certain degree of approximation.

16. As flexible exchange rates disappear, it must be ensured that structural change is controlled primarily by market economy adjustment mechanisms and not by state intervention. This path offers the greatest opportunity to create dynamic economic processes, growth and thus also jobs. The Delors Report is correct when it states (cf. para 29) that an economic and monetary union must promote a structural policy which helps the poorer regions to catch up. Since the interest of many countries is

focussed on state transfers, connections need to be clarified. The Delors Report, which recommends an increase in resources for Community regional and structural policies to narrow disparities and promote a balanced development in the Community, seems to considerably over-estimate the quantitative contribution of state transfers towards solving such problems.

17. Regional and structural disparities must be reduced primarily by an increase in productivity, a corresponding mobility of production factors and attractive location conditions for investment. Harmonisation by "competition of economic policies" in individual regions is clearly preferable to compulsory harmonisation by state bodies. In the final analysis, state transfers can only ever be an accompanying measure. They cannot by any means correct mistakes in efforts to make locations more attractive, e.g. excessive pay increases.

The Economic Advisory Council also states in its report on the European Monetary System (p. 27) that a monetary union in itself creates no additional requirement for intra-European transfers. Where financial transfers are granted, they should (and here the Delors Report concurs, para 29) be linked to conditions which prompt the receiving countries to step up their adjustment efforts and should be invested in economically useful projects (e.g. infrastructure, industrial conversion measures).

In view of the existing disparities, it is therefore necessary to strengthen the market-related incentive mechanisms and utilise existing location advantages rather than attempting to level things out by artificial means such as pay and investment subsidies. It is therefore also necessary, for example, to underline the significance

of differing pay levels, taking account of differing levels of productivity, and to make use of opportunities for more flexible working regulations. The training and further training of employees must everywhere meet the standards of a modern industrial and service-based society. The contribution of private capital movements towards solving regional disparities is likely to be incomparably greater in such cases than that of state transfers. However, this requires an economic policy in the countries concerned which has a positive influence on the investment climate and returns on capital investment (e.g. also by showing restraint in of wages policy and additional social benefits).

18. Harmonisation of social standards (which is not dealt with in detail in the Delors Report) must take account of the different stages of development in the individual Member States and the interdependence of economic and social policies. The harmonisation of social standards at the highest level would remove the existing competition advantages of the less developed regions. As a consequence, economic activities would concentrate even more on those regions which were already more efficient. Capital investment would move predominantly into these more efficient regions, whilst jobs would be lost in the less developed regions. This does not rule out the possibility that harmonisation should be sought under social policy aspects for certain sectors (e.g. in the case of such fundamental social rights for employees as the freedom of association, the prohibition of child labour, protective legislation for working mothers, health and safety at work etc) or that additional measures should be taken for the social security of migrant workers.

19. An economic and monetary union can only function if it is accepted by a majority of citizens, also with regard to their economic and social variety and differences. Particularly where there is not such a high degree of mobility as in the USA, correspondingly greater regional differences must be accepted. (Even in the USA, per capita income in Connecticut in 1987 was twice as high as in Mississippi $ 17,784, and $ 8,868 respectively). The attractiveness of locations will finally decide on whether - as is desirable - capital flows to people in regions which are economically and socially under-developed.

20. According to political and economic logic there is a natural progression from Economic and Monetary Union to Political Union, in which a higher degree of commitment would also be conceivable for national policies. Above all, the rights of EC and national parliaments would have to be fundamentally reorganised. The precise shape of Political Union cannot yet be outlined. But it should be clear from the outset that it is a path in three stages which leads from the internal market via Economic and Monetary Union to Political Union.

Annex

Selected EC statistics

Table 1

Inflation rates (weighted average of the deflator of private consumption)

	1985	1986	1987	1988	1989*	1990*
B-NL-L-DK-F-D-IRL	3.8	1.1	1.7	1.9	3	2 3/4
I-UK-E	7.5	5.8	4.5	5.0	6 1/4	6
P-GR	19.0	18.1	13.1	11.6	13 1/2	12
Community	5.9	3.8	3.4	3.6	4 3/4	4 1/2

Table 2

National financial surplus / deficit (in % of GDP)

	1986	1987	1988	1989*	1990*
B	- 8.8	- 7.0	- 6.5	- 6 1/4	- 6 1/4
DK	3.1	1.8	0.4	1/2	1 1/4
D	- 1.3	- 1.8	- 2.0	- 1/4	- 1
GR	- 10.8	- 10.0	- 14.3	- 14 1/2	- 14 1/4
E	- 5.7	- 3.6	- 3.2	- 3	- 2 3/4
F	- 2.9	- 2.5	- 1.6	- 1 3/4	- 1 3/4
IRL	- 11.0	- 8.9	- 3.4	- 4 1/2	- 4 1/4
I	- 11.4	- 10.5	- 10.6	- 10 1/4	- 11
L	6.0	5.2	- 2.6	2 1/2	2 1/2
NL	- 5.9	- 6.2	- 5.0	- 4 1/2	- 4 3/4
P	- 7.8	- 6.9	- 6.6	- 6 1/4	- 6 1/4
UK	- 2.4	- 1.4	0.8	1 3/4	1 3/4
EC	- 4.8	- 4.2	- 3.6	- 3	- 3 1/4
USA	- 4.4	- 2.3	- 1.8	- 1 3/4	- 1 3/4
Japan	- 1.1	- 0.3	0.5	1/2	1/2

* EC Commission forecasts

DJS

MR CULPIN IS WORKING ON THIS

AT MOMENT BUT COULD GIVE

NO DELIVERY TIME/DATE.

TONY 2/9

Tony 4027 BF 4/9 ~~X 4419~~

Pls chase Mr Culpin's office,

Duncan. We will be

getting something by friday

"So say FP".

Tony