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PO CH/NL/0494. Pt. E.

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

DD's: 25 Year

23/2/96.

PO CH/NL/0494. Pt. E.

1. JT

2 PUF

FROM: N L WICKS
DATE: 12 SEPTEMBER 1989
Ext : 4369

PRINCIPAL PRIVATE SECRETARY

cc PMG
FST
Sir P Middleton
Sir T Burns
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Peretz
Mr Riley
Mrs M E Brown
Miss O'Mara (MG1)
Mrs Chaplin (CX)
Mr Tyrie (FST)

Mr Isaac ) - IR
Mr Houghton)
Mr Jefferson Smith - C&E

Mr Kerr - FCO
Mr Hadley - Cab Off

Sir D Hannay - UKRep

**BREAKFAST DISCUSSION WITH MME SCRIVENER ON SUNDAY 10 SEPTEMBER**

I attach a note of the discussion on taxation of savings and indirect tax that the Chancellor had with the Commissioner during the Informal ECOFIN Council.

DISC^N W MME SCRIVENER 10/9

N.L.W.

N L WICKS

**NOTE OF A DISCUSSION OVER BREAKFAST AT HOTEL DU CAP EDEN ROC, ANTIBES DURING THE INFORMAL ECOFIN COUNCIL ON SUNDAY 10 SEPTEMBER BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND COMMISSIONER SCRIVENER**

Those present:

| | |
|---|---|
| Chancellor | Mme Scrivener |
| Mr Wicks | M Constans (Chef de Cabinet) |

Taxation of Savings

After initial courtesies, the Chancellor of the Exchequer said that it was well known that the UK did not regard a withholding tax as a necessary accompaniment to the liberalisation of capital movements. There was no evidence that tax fraud had increased since exchange controls were abolished in the UK in 1979. He would study the questions circulated by Commissioner Scrivener at the Informal ECOFIN. He hoped to accept as much as he could, provided that the Commission would agree to drop their proposal for a Community-wide withholding tax. Mme Scrivener replied that the Commission wanted agreement as quickly as possible. She then handed over a further "non-paper" outlining the Commission's approach to taxation matters, a copy of which is attached. She asked that someone from London should be in touch with M Constans to discuss these issues. The Chancellor said that he would ask senior officials in Customs & Excise and the Inland Revenue to speak to M Constans. [Mr Houghton (Inland Revenue) and Mr Jefferson Smith (Customs & Excise) have already been asked to be in touch with M Constans.]

2. After quickly reading the Commission's non-paper, the Chancellor said that the UK were not at all keen on Commission involvement in the direct taxation of companies. On the questions raised in the note circulated to ECOFIN, one at least (question 3) regarding judicial co-operation was not his responsibility within the UK Government. He would ensure that that question was drawn to the attention of the competent department so that the Commission could be given a reply. He repeated that he would try to accept as much as possible if the Commission could undertake to

formally withdraw the proposal for a withholding tax. That prompted M Constans to say that formal withdrawal could create a problem. The Chancellor said that it was an important point of principle, though in practice the Commission could always retable the proposal if they thought circumstances so required. Mme Scrivener said that if the Commission were to withdraw the proposal, the time to do it would be at the last possible moment when there was virtually complete agreement on the other issues. She would consider the matter further.

3. The Chancellor noted that while the UK were sympathetic to co-operation between national tax authorities to combat fraud, some of the Commission's proposals seemed to require the enactment of new legislation. That was a matter for each country, not for the Community. A particularly important point of principle for the UK was that nothing should be required which provided an excuse for retaining some of the old exchange control machinery. Mme Scrivener said that the Commission strongly agreed.

Indirect Taxation

4. Mme Scrivener said that the Commission sought a global accord covering all outstanding issues in the indirect taxation dossier, including VAT rates, problems of compensation and excise duties. The Commission still believed that a minimum range was a good idea and asked for the Chancellor's views on the fourchette concept under consideration in the ad hoc group. The Chancellor responded that there were obvious attractions to some member states in a minimum rate of, say, 14 per cent. Mme Scrivener then asked the Chancellor whether he was a priori opposed to a 14 per cent minimum rate. The Chancellor responded that that was a possibility; a minimum rate system was preferable to a range.

5. The Chancellor then said that the key issue for the UK was the retention of our zero rate system. Mme Scrivener replied that a derogation was one possibility. The Chancellor said that a temporary derogation would not meet our point; there were unbreakable pledges on zero rates in the UK. Mme Scrivener said that she understood this. But this would no doubt have to be one

of the points for bargaining in the end. She could not give commitments. Her objective was to bring about an alignment of tax rates over time. The Chancellor reminded her that the United Kingdom was not the only country with zero rates. Mme Scrivener responded that that was a factor which helped her. She agreed with the Chancellor's comments that the UK zero rate had minimal trade effects. The Chancellor then said that while the Commission might have the objective of the ultimate harmonisation of tax rates, that was not an objective which the UK could share. The Commission's indirect taxation proposals were an intensely political subject in the UK Government and it would, of course, be necessary to seek the agreement of his colleagues, including the Prime Minister, for the UK's final position. He commended the work of the ad hoc group and the useful French proposals which, in his view, appeared to provide the only basis for any consensus, if there was going to be consensus. Mme Scrivener agreed.

6. On excise rates, Mme Scrivener said that it looked as if there would have to be a minimum rate system. The Chancellor said that that looked to be the only possible way forward and he reminded the Commissioner of the consequences for UK health policy of the issue. M Constans noted that countries with no excise duty on wine would find problems even with a minimum rate. The Chancellor reminded him of the UK's reaction, set out in the 1984 Budget, to the infraction case concerning duties on wine and beer. The increase in travellers' allowances was important in the context of the minimum rate. Mme Scrivener responded that she attached importance to an increase in the travellers' allowances because that was an issue which the ordinary man in the street understood as a result of his foreign holidays.

7. Mme Scrivener then emphasised that the abolition of fiscal frontiers and the adoption of the destination principle would require the establishment of interior controls to prevent fraud. The Chancellor undertook to look at proposals which the Commission would put forward. Obviously there needed to be checks against fraud, but they should be implemented in a way which avoided putting burdens on the taxpayer greater than the burdens which had been abolished through the abolition of frontier controls. The

position of small businesses needed particular attention. Mme Scrivener expressed agreement. In her view the only disadvantage of the destination principle was the point referred to by the Chancellor. M Constans said that the Benelux countries, with their customs unions, were already tackling these problems. The Chancellor thought it would be interesting to see how they tackled fraud.

NON-PAPER

Subject: Taxation: second half of 1989

1. Taxation of savings

At its meeting in Madrid, the European Council asked the Council to increase its efforts to find a satisfactory solution to the problem of the taxation of savings with a view to agreement being reached before 1 July 1990.

If a solution is to be implemented by the time full liberalisation of capital movements comes into force on 1 July 1990, it would be desirable for the Council (Economic and Financial Affairs) to reach agreement by the end of 1989.

The Commission stands by the proposals it presented last February, although most Member States are opposed to the introduction of a general withholding tax.

As an accompaniment to these proposals, the Commission suggests (informal discussion paper of 6 July 1989) five ways of reinforcing cooperation in the taxe sphere:

- measures to prompt taxpayers to declare income from savings;

- reinforcement of mutual assistance;

- increased cooperation between courts;

- monitoring of capital movements;

- international cooperation.

2. Approximation of indirect taxation

At its meeting in Madrid, the European Council welcomed the fact that detailed discussions had begun on the basis of the new approaches proposed by the Commission and in the light of the Member States' suggestions and gave the Council (Economic and Financial Affairs) a clear mandate and a precise deadline: to reach agreement on the broad lines of a solution before the end of 1989.

Following its communication of last May (officially dated 14 June 1989), the Commission has already tabled two formal proposals (abolition of the transit advice note and gradual increase in travellers' allowances between 1990 and 1992).

On the French Presidency's initiative and in agreement with the Commission, a high-level working party held two meetings in July. It will meet again in September and will report to the Council (Economic and Financial Affairs) on 9 October.

It should be possible for the Council's discussions on 9 October to cover draft conclusions drawn up by the French Presidency setting out the main lines of a comprehensive solution:

- objectives underlying approximation of VAT rates (minimum rate, band, etc.);

- differentiated treatment of certain major categories of transactions (mail-order selling, sales of cars, etc.);

- clearing system or some other system;

- guidelines on excise duties;

- transitional period up to 31 December 1992 (particularly travellers' allowances);

3. Direct taxation of companies

a) Measures to facilitate cooperation between companies from different Member States

The three proposals for Directives involved here (mergers/ divisions and contributions of assets; parent companies and their subsidiaries; arbitration procedure) were not adopted at the Council meeting (Economic and Financial Affairs) in Luxembourg in June despite the efforts of the Spanish Presidency and the Commission. Their adoption on the basis of the compromise put forward by the Spanish Presidency was prevented at the last moment by a difficulty raised by Germany and the Netherlands concerning the Directive relating to parent companies and their subsidiaries.

While this compromise still has the support of the Commission, it is essential for agreement to be reached at the earliest possible opportunity. Failing that, the Commission might consider separate adoption of the different proposals. The proposal relating to mergers, divisions and contributions of assets is the most urgent.

-

b) Introduction of group taxation

The proposed Statute for a European Company contains a tax provision which permits a company to set against its profits losses incurred by its establishments in other Member States.

In addition to the European Company, the Commission is tackling the general problem of the offsetting of the profits and losses of groups, including those of subsidiaries.

Documents are being drawn up in preparation for consultations planned for the autumn (representative associations and Member States), the intention being that the Commission will be able to table a proposal before the end of the year.

CONFIDENTIAL


P Jefferson Smith
*Deputy Chairman*

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Ch,
It seems a good idea to have a discussion as at 'X'. Any comments in the meantime on this proposed approach?

15/9 SW

Thanks. This seems rather sensible approach. Re para 5, considerable difficulties with (i) & (v). But fix a mtg (as suggested). LS

FROM: P JEFFERSON SMITH

DATE: 15 SEPTEMBER 1989

CHANCELLOR

**INDIRECT TAXATION IN THE SINGLE MARKET : NEGOTIATING STRATEGY**

The discussions at the informal ECOFIN in Antibes and in the Ad Hoc Group and Financial Questions Group will all feed into what is likely to be a substantive discussion of the indirect taxation dossier at ECOFIN on 9 October. There is a reasonable chance that the Presidency report will concentrate on technical issues, as largely discussed in the Ad Hoc Group, and it will be in our interests to promote this. However, discussions will undoubtedly include the more sensitive issues of tax rates and rate structures. We felt you might find it helpful if we set out our initial views on a possible negotiating strategy for the October ECOFIN and the following months. If you found it helpful, we could perhaps discuss these matters between the pre-ECOFIN Coreper in the last week of September and 9 October. X

JEFFERSON SMITH → CHIEF 15/9

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| cc | | | |
|---|---|---|---|
| cc | Chief Secretary | CPS | Sir D Hannay UKREP |
| | Paymaster General | Mr Nash | Mr Hadley Cab Off |
| | Financial Secretary | Mr Wilmott | Mr Kerr FCO |
| | Economic Secretary | Ms Seammen | |
| | Sir P Middleton | Mr P R H Allen | |
| | Mr Wicks | Mr Cockerell | |
| | Mr Scholar | Mr Trevett | |
| | Mr Evans | Mr Savins | |
| | Mr R I G Allen | Mr Brown | |
| | Mr Culpin | Mr Kent | |
| | Mrs M Brown | Mr Gaw | |
| | Mr W White | Mr Knox | |
| | Mrs Chaplin | Mr Railton | |
| | Mr Tyrie | | |

**The current position**

and formally published in June, as attached.

2. Mme Scrivener's revised proposals (announced in May) have provided the basis for considerable movement on technical issues, but there has been little discussion on the tax rate and rate structure proposals - not least because the Commission have yet to announce their proposals on excise duty rates. By the time of the October ECOFIN the position is likely to be as follows:-

i. The Commission are prepared to accept that the UK can retain at least some zero rates. This is unlikely to be supported by all Member States. There has been no discussion of what zero rates would be covered by the rather vague formulation in Mme Scrivener's revised proposals. We have deliberately adopted a low profile approach.

ii. The Commission's more flexible proposals on minimum rates have made little headway. On VAT, Member States seem generally to prefer rate bands: the minimum rate proposal faces the strong risk of being removed from the menu unless it gets more determined support from the Commission and serious backing from at least a couple of Member States.

iii. On the other hand, the prospect of agreement on tax approximation seems just about as far away as ever. On VAT, Member States have differing views on what should be the level and range of the standard rate band; on the reduced rate band, there is broad agreement but not unanimity on the core items, but considerable differences on what else might be included. The prospective minimum rates for excise will not solve the problems either for those Member States with very high rates or for those with extremely low or nil rates.

iv. However, there is a real possibility that Member States can agree to the broad lines of technical measures that would remove fiscal frontiers, following the useful discussions in the Ad Hoc Group. This will involve retaining the destination principle for commercial transactions and also using it for certain transactions involving individuals (mail order, purchases of vehicles) and for the exempt commercial sector. For the Commission and some Member States to accept the destination principle, it will probably have to be dressed up as "temporary". The main outstanding problem will be the restrictions which Member States feel necessary for travellers' allowances.

**Key policy priorities**

3. We understand the Government's key policy priorities to be as follows:-

i. Retention of most, if not all, current UK zero ratings.

ii. No centrally-agreed approximation of VAT or excise duty rates.

iii. Radical liberalisation of travellers' allowances, subject to retention of quantitative limits (admittedly at higher levels than at present) on alcohol and tobacco.

We note the Chancellor's comment (Mr Sparkes' note of 8 September) that the revenue cost of removing these limits might be only about £40 million more than the cost of limited allowances. However, the estimates for unlimited purchases are very uncertain and depend critically on behavioural effects. If people were to react as they did in 1982 - when beer imports rocketted before we put on quantitative limits - either the revenue effects could be substantially higher with consequential major damage to UK businesses, or there would be a substantial resource cost in preventing abuse.

iv. Implementation of frontierless procedures on 1.1.93, imposing the minimum of burdens on UK business and with the lowest possible use of administrative resources.

**Possible elements in an eventual package**

4. In order to achieve these key objectives, it will be necessary to keep the technical issues separate from tax rate and rate structure questions. The more

we can achieve agreement on the former (where key policy priorities are not involved), the less we should need to make difficult concessions on the latter. But, of course, it will be in the interests of the Commission and some Member States to preserve the link between these issues. In any case, pressure is likely to build up eventually for an agreement covering tax rates and rate structures. It is, therefore, worth considering where concessions may be sought, not least to ensure that our interim negotiating strategy does not cut across what we might agree to as part of a final package.

5. So far as we can identify them now, the areas where, despite the great political sensitivities, we might have to accept more or less unpalatable concessions as part of a final package are as follows:-

i. Give up some currently zero rated items.

ii. Minimum VAT standard rate (no higher than 15%).

iii. Minimum rates of excise duties.

iv. A notional distinction between genuine travellers' purchases and quasi-commercial transactions for VAT and excise duties, which would provide limits on travellers' purchases (at a fairly high level). Perhaps more likely would be a derogation (under our control) allowing us to retain such limits.

v. Commitment to non-divergence of excise rates, which might be a condition of retaining travellers' allowances.

vi. Something along the lines of the latest French technical proposals, although they are likely to involve higher business compliance costs and higher administrative costs than under the UK approach.

**Strategy and timing**

6. If this analysis is right, we should seek an early agreement on the technical issues. This would have a double benefit. First, it should require no concessions involving key policy objectives. Second, a Community agreement

on technical systems which remove fiscal frontiers increases the strength of our contention that tax approximation is unnecessary (and, of course, reduces the strength of the counter-argument). Of course, others will see the implications and will be attempting to preserve the link.

7. If this view is plausible, this would reinforce your policy of playing the tax rate and rate structure issues long. It also meets the need to reach early agreement on the broad lines of the technical measures required to remove fiscal frontiers, in order to deliver the important political prize of frontierless Europe in 1993. The longer agreement is delayed, and the more we have to rush the change, the greater the resource cost and short term dislocation.

8. We are not sure how far the French Presidency (or other Member States or the Commission) will try to link progress on the technical issues with that on tax rates and rate structure. The main area where it may be difficult to disentangle the two is in relation to cross-border purchases by individuals, where many Member States consider that the only way to achieve the removal of fiscal frontiers is through tax approximation. It would be very unfortunate if problems in this area meant that the technical discussions stalled, after such considerable progress in the Ad Hoc Group.

9. The other timing problem relates to minimum rates. There is a distinct risk - certainly as far as VAT is concerned - that they will no longer be on offer unless we indicate continued support for the concept. You told Mme Scrivener at Antibes that minimum rates were a "possibility", and the message may have to be reinforced. On the other hand, we are of course well aware of the Prime Minister's concern that, particularly if offered too soon, minimum rates could be at the top of a slippery slope towards tax approximation/harmonisation.

**Implications for tactics at October ECOFIN**

10. We consider that the most fruitful approach would be to press for agreement on those issues where the Ad Hoc Group have reached unanimity - the destination system for commercial transactions, for vehicles, mail order and

supplies to the exempt sector. We could also press for the Ad Hoc Group to take forward its considerations, especially on excises and on developing its work on technical systems. We could also ask for full Commission participation in this work, in preparation for the necessary EC legislation that will emerge from it.

11. On cross-border purchases by individuals, we feel that the best course might be to argue in favour of early liberalisation, but with a safeguard to distinguish genuine travellers' purchases from quasi-commercial transactions. With something in place along those lines, and with special arrangements proposed for mail order and purchases of vehicles, we could reasonably continue to argue that tax approximation was unnecessary; and the scope for cross-border shoppers taking advantage of different tax rates considerably reduced. Indeed, given that the Cecchini report suggested that tax rate differences account for only about 25% of price differences, we could legitimately question whether tax differentials would have any continuing significance in influencing EC consumers choice.

P JEFFERSON SMITH

15 September 1989

chex.jp/jmt2/72 **CONFIDENTIAL** BF 19/9

FROM: J M G TAYLOR
DATE: 18 SEPTEMBER 1989

MR JEFFERSON SMITH (C&E)

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr Scholar
Mr H P Evans
Mr R I G Allen
Mr Culpin
Mrs M Brown
Mr W White
Mrs Chaplin
Mr Tyrie

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

Sir D Hannay - UKREP

Mr Hadley - Cabinet Office

Mr Kerr - FCO

JM GET → JEFFERSON SMITH 18/9

**INDIRECT TAXATION IN THE SINGLE MARKET: NEGOTIATING STRATEGY**

The Chancellor was grateful for your note of 15 September.

2. He thinks that your proposed negotiating approach is a sensible one. He has commented, however, that as far as the 'unpalatable concessions' are concerned he sees considerable difficulty with the possibility of giving up some currently zero-rated items, and with a commitment to non-divergence of excise rates.

3. He agrees that it would be sensible to hold a meeting on this between the pre-Ecofin coreper in the last week of September, and 9 October. This office will arrange.

J M G TAYLOR

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Chancellor

FROM: J B UNWIN
DATE: 20 SEPTEMBER 1989

UNWIN → CH/EX 20/9

**INDIRECT TAXATION IN THE SINGLE MARKET: NEGOTIATING STRATEGY**

As a brief postscript to Peter Jefferson Smith's minute of 15 September, you may like to know that I was able to have a word with Sir Leon Brittan, Madame Scrivener and M. Constans (Madame Scrivener's Chef de Cabinet) during a visit to Brussels for a Heads of Customs meeting earlier this week.

2. On VAT approximation, Leon Brittan made it clear that he regards a minimum rate as the only feasible way forward and I am sure he will argue for keeping this on the table. Constans also gave the impression that they will keep this alive and I encouraged him to think in terms of a general agreement at ECOFIN next month on the VAT issues on which the Ad Hoc Group had made such good progress, and to remit further detailed work both in this area and on the excise (on which we now need new Commission proposals) to the Group. Madame Scrivener also seemed to be thinking in these terms, and there were signs that, although some face savers may be necessary, she is abandoning any serious struggle against retention of the destination principle.

3. For the rest, at the officials' meeting we discussed a range of issues relating to the future organisation of Customs services and frontier controls in the post 1992 world, and are generally in the middle of the pack.

J B UNWIN

---

cc Paymaster General
Economic Secretary
Mr Wicks
Mr R I G Allen
Mrs Chaplin
Mrs Strachan
Mr Jefferson Smith
Mr P G Wilmott
Mr P R H Allen

b7 4/10

FROM: J M G TAYLOR
DATE: 22 SEPTEMBER 1989

JMGT → UNWIN 22/9

MR J B UNWIN - C&E

cc PS/Paymaster General
PS/Economic Secretary
Mr Wicks
Mr R I G Allen
Mrs Chaplin

Mrs Strachan - C&E
Mr Jefferson Smith - C&E
Mr Wilmott - C&E
Mr P R H Allen - C&E

**INDIRECT TAXATION IN THE SINGLE MARKET: NEGOTIATING STRATEGY**

The Chancellor was grateful for your note of 20 September.

J M G TAYLOR

B.F 4/5 for meeting folder

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P Jefferson Smith
*Deputy Chairman*

JEFFERSON SMITH → CH/EX 3/10

FROM: P JEFFERSON SMITH
DATE: 3 October 1989

CHANCELLOR

**INDIRECT TAXATION IN THE SINGLE MARKET: NEGOTIATING STRATEGY**

You have called a meeting to discuss this on 5 October. I thought you might find it helpful as an aid to discussion of the main issues for ECOFIN if you had a copy of our draft ECOFIN briefing. A copy is attached. I suggest that we might concentrate on the "UK objectives" and "General line to take" sections. top-flagged

2. There are a couple of other points, relevant to ECOFIN, which I ought to draw to your attention:-

(i) In order to reach agreement on a technical system, we are likely to have to accept something on the lines of the French proposals for checking of intra-Community transactions, which would impose higher business compliance costs and administrative costs for us than the pure UK "zero option" proposals. We will be negotiating hard to minimise these costs; but to the extent that we have to go some way to meet the French and those administrations which sympathise with them, there will be a resource burden to be paid for.

Note at back of folder (see ¶¶6-7 of that)

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| Circulation: | | |
|---|---|---|
| | Paymaster General | CPS |
| FST | Economic Secretary | Mr Nash |
| | Sir P Middleton | Mr Wilmott |
| | Mr Wicks | Ms Seammen |
| | Mr H P Evans | Mr Allen |
| | Mr Scholar | Mr Cockerell |
| | Mr R I G Allen | Mr Trevett |
| | Mr Culpin | Mr Savins |
| | Mrs M Brown | Mr Brown |
| | Mrs Chaplin | Mr Knox |
| | Mr Tyrie | Mr Railton |
| | Mr Isaac (IR) | Miss Leech |

(ii) The Paymaster General asked us to try and negotiate a distinction between genuinely private and "quasi-commercial" cross-border transactions for alcohol and tobacco (to avoid the need for a derogation to enable us to retain - admittedly substantially increased - travellers' allowances for these goods). This is going well: but the same sort of logic also applies to VAT, and while we see no need for continuing allowances for VAT-paid goods, other Member States do. As part of a deal on travellers' allowances, we may have to modify our position that there should be no limits for VAT, to meet the concerns of Continental States which would face serious distortions.

3. A final issue which you might wish to discuss concerns possible developments after ECOFIN. Sir David Hannay considers that the French Presidency will want a serious discussion about rates and rate structure before the end of their Presidency (Strasbourg Council or December ECOFIN). Whether this might be tied to a deal about technical issues is not clear. He feels that there may be some advantage in stitching together a deal under the French Presidency because of the dubious capabilities of the two following Presidencies, Ireland and Italy. At any rate, he has suggested that we should take stock later in the Autumn (we suggest early November) to consider what the possibilities (if any) are of a deal.

P JEFFERSON SMITH

DRAFT ECOFIN BRIEFING

## UK OBJECTIVES

To press for ECOFIN to endorse issues on which the Ad Hoc Group national delegations have reached unanimity - the destination system for commercial transactions, vehicles, mail order and supplies to the exempt sector - and ensure that the progress made on these technical issues is maintained and not tied to the more difficult problems of rates and rate structures. To also press for the Ad Hoc Group to take forward its considerations, especially on excises and develop its work on technical systems.

+ [illegible]?

GENERAL LINE TO TAKE

1. Welcome effect of Commission's revised proposals in providing basis for considerable progress achieved in Ad Hoc Group. Welcome positive approach of Ad Hoc Group.

2. Commend work of the Ad Hoc Group in reaching agreement on general principles of administrative procedures for VAT. Welcome agreement in Ad Hoc Group on various technical aspects - retention of destination system for VAT on intra-EC commercial trade, treatment of mail order, private importations of vehicles and sales to exempt bodies.

? // 3. Ad Hoc Group should be asked to consider, in more detail, technical measures for removing fiscal frontiers; reporting back to November ECOFIN. Although VAT must be progressed, excise should not be allowed to lag behind. Also take account of need to maintain accurate intra-Community trade statistics. Essential that broad outline of post-1992 procedures agreed by end of 1989.

4. UK still regards enforced tax approximation as unnecessary and inappropriate. Must retain ability to apply zero rates.

5. UK committed to removal of fiscal frontiers, but in a way that does not impose additional burdens on business.

6. Any new system will need to distinguish between genuine cross-border purchases by individuals for their own consumption and what are, in effect, commercial or quasi-commercial transactions.

We need a package to consider

## LINE TO TAKE ON DETAILED POINTS

### 1. Need for tax approximation

Neither necessary nor appropriate. Tax structures reflect national preferences built up over many years. Individual member states should be free to adjust fiscal structures in the face of changing circumstances.

### 2. Zero rates to be retained for a limited number of products.

UK Government view remains that it wants to retain its existing right to zero rates. Require further clarification on Commission's criteria for zero rates.

### 3. Minimum rate to be set for VAT standard rate

Centrally dictated tax approximation is neither necessary nor appropriate.

[Note: It is possible that the recent speech by Sir Leon Brittan, urging the UK to give a lead by coming out strongly in favour of minimum rates for VAT, will be used to try and put us on the spot.The preferred response would be to say nothing; but if that proves impossible, we suggest that the line to take should be:

Centrally dictated tax approximation (whether a system of rate bands or minimum rates) neither necessary nor appropriate. Accept that minimum rates approach is the lesser of two evils.]

### 4. Reduced rate band of 4-9 per cent

UK sees no reason for setting a minimum rate for standard rate. But even more puzzled to know why idea of both maximum and minimum retained for reduced rate - or indeed why necessary to specify reduced rate at all.

Uk would not wish to be in position of needing to apply more than one positive rate of VAT.

### 5. Reduced rate should be optional

Member states should be free to decide to charge a standard rate for goods or services subject to a reduced rate in another member state. Clearly will need to give careful consideration to implications of such a decision - not least the loss of revenue to low tax states.

### 6. Separation of technical proposals from rate/rate structure proposals

UK view is that systems can and should be devised to operate in conditions where tax rates have not been harmonised. The various proposals made by Ad Hoc Group substantially reduce potential for tax-induced distortions of trade.

## 7. Controls and compliance/administration costs

Accept the need for continuing controls against fraud when fiscal frontiers removed. However, new control systems should not impose additional burdens on business or extra bureaucracy. The vast majority of smaller businesses account for a very small proportion (about 10%) of intra-Community trade. They must only be subjected to the simplest administrative requirements.

## 8. Control and monitoring suggestions in the Ad Hoc Group report

Prepared to accept as the basis for further discussion of a new control system. However, will need to consider details fully - and take special account of the need to provide simple and selective arrangements.

## 9. Distinction between private and commercial transactions

Essential to avoid fraud. Possible use of residual spot checks at the frontier not inconsistent with Single European Act.

## 10. Statistics and small traders

Collection of intra-EC trade statistics needs to be considered with fiscal systems for monitoring this trade.

## 11. Excise duty rates

Look forward to receiving Commission's proposals on excises and hope they take account of vastly differing rates in member states.

Still do not see need for approximation and minimum rates set too low will create significant problems for member states with very high rates.

## 12. Quadruple VAT-paid travellers' allowances and double excise paid allowances in three stages (1 Jan. 1990, 1991 and 1992).

UK supports proposal in recent draft directive - though would prefer to do it in one go. Hope all can now agree to support this proposal. Stress importance of maintaining value or volume limits to distinguish between private and quasi-commercial transactions.

## 13. Duty free allowances

Sympathy for Commission's logic, but maintain neutral line on future of duty free.

## 14. VAT clearing mechanism

Discussions in Ad Hoc Group have lead to agreement on destination principle for commercial traffic and other specified transactions. Clearing house involved administrative complexities and could not guarantee security of national revenues.

PRESENT POSITION

VAT

1. Acknowledging that unanimous agreement on its original proposals was unlikely before the end of 1992, on 17 May 1989 the Commission announced its revised thinking. The essential features of this are:

i) The 14-20 per cent rate band originally proposed to be replaced by a minimum rate, as yet unspecified. The reduced rate band of 4-9 per cent to remain unchanged.

ii) Acceptance that zero rates may be retained on a limited number of unspecified items, subject to certain conditions; however, they still see the need for some measure of tax approximation.

iii) The retention of the destination system for some EC traffic. Remaining EC trade to move to an origin system and to be subject to a clearing mechanism based on macro-economic trade statistics.

2. The Ad Hoc Group of officials set up to examine the Commission's revised proposals has, to date, met on three occasions to discuss VAT. Considerable progress has been made in discussions on the technical aspects, but there has been little progress in discussions on rates and rate structures.

3. There has been general agreement from member states' delegations that:

i) The destination principle should apply on all trade between taxable persons within the EC, thus removing the need for a clearing house mechanism.

ii) The destination principle should also apply to certain transactions concerning individuals (specifically, mail order and purchases of vehicles) and all intra-EC trade by non-registered institutions and exempt or partly exempt bodies.

iii) There will be a need for enhanced mutual assistance between tax authorities.

iv) There may be a case for linking traders' VAT and statistical returns, by way of periodic recapitulative returns from traders, which could be used for cross-checking.

v) The goods themselves would continue to be accompanied by commercial documentation, the content of which has yet to be established.

4. Although the Commission are now prepared to accept that the UK can retain some zero rates, there has been no discussion on what zero rates would be covered by the rather vague formulation in the Commission's revised proposals.

5. The Commission's more flexible proposals on minimum rates have made little headway. Member states seem generally to prefer rate bands; the minimum rate proposal faces the strong risk of being removed from the menu unless it gets more determined support from the Commission and serious backing from at least a couple of member states. In a speech in Cardiff on 29 September, Sir Leon Brittan is quoted in "The Times" (attached) as calling on the Government "to give a lead by coming out strongly in favour of a system of minimum VAT rates".

6. The prospect of agreement on tax approximation seems as distant as ever. Member states have differing views on what should be the level and range of the standard rate band; on the reduced rate band, there is broad agreement but not unanimity on the core items, but considerable differences on what else should be included.

7. The Presidency report on the proceedings of the Ad Hoc Group, to be put to ECOFIN on 9 October, largely endorses the agreement reached among member states' delegations, but contains frequent references to tax approximation. This is obviously contrary to the UK view. The French Presidency appears to have gone some way to meet UK concerns, but have made no reference to zero rates. This is clearly unacceptable.

8. The report also mentions the desirability of a joint VAT and statistical return. The UK view remains that collection of intra-EC trade statistics should be discussed in conjuction with fiscal systems i.e. in the Ad Hoc Group, and it is too early to express a preference for any particular system.

THE TIMES

# Brittan in call for VAT harmony

From Our Correspondent
Brussels

Sir Leon Brittan, the European Commissioner, has called on the Government to throw its weight behind European Community plans for harmonizing VAT rates.

The latest compromise proposal, put forward in June by Mme Christiane Scrivener, the Tax Commissioner, calls for a lower VAT band of 4 per cent to 9 per cent, which would apply to certain necessities in the 12 EC countries.

But, because of criticism by a number of members, the Commission dropped its original plan for an upper VAT band, and instead has proposed that a simple minimum be set as a basic rate.

Members would then be able to set whatever maximum rate they chose.

This, the Commission argues, will be the most effective means of harmonizing VAT rates, as market forces would bring them into line.

Sir Leon, the Commissioner responsible for financial affairs, said that the level for the minimum VAT rate "remains a matter for discussion, but it would certainly not be higher than the current 15 per cent VAT rate in the UK."

He added: "There would be no risk of UK taxes having to rise."

Sir Leon also claims that it would not affect the current status of zero rating which the UK applies to necessities such as food and children's clothes.

This is despite the EC Commission has made it clear that, after harmonization, zero ratings will be extremely limited, and would possibly be allowed only on a temporary basis.

EC finance ministers will be examining the VAT scheme in Luxembourg on October 9. Sir Leon has called on the Government to "give a lead by coming out strongly in favour of a system of minimum VAT rates."

Sir Leon was speaking in Cardiff at the launch of a European Partnership scheme for Welsh companies. This means that the Commission will be helping Welsh businesses enter into commercial agreements with companies in EC member countries.

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## EXCISES

1. Discussions on excises are lagging much further behind. There has, to date, been only one meeting of the Ad Hoc Group on excises; however, this was much more positive than expected. Discussions concerned systems not rates or rate structures.

2. The Commission have promised an early "working paper" on rates and rate structures, however, it appears likely that any proposed minimum rate will be well below UK levels and is unlikely to be acceptable to the Danes or the Irish.

3. A majority of member states supported the UK proposition that a distinction needs to be drawn, based on quantative limits, between "commercial" traffic and private individuals crossing frontiers. At the UK's request, this is also reflected in the Presidency report on VAT to ECOFIN.

4. A majority, including the UK, also favour the movement of commercial traffic under a duty-suspension system between approved operators e.g. bonded warehouses. The UK view, that warehouses should be subject to conditions to be set by each member state, was also well received. However, some member states, and the Commission, argued that to deny the possibility of commercial cross-border purchases of duty-paid goods would run counter to the intentions of the Single Market. Because of the administrative complexities and scope for evasion the UK are opposed to this view.

VAT: FRENCH NOTE

**ABOLITION OF FISCAL FRONTIERS: VAT FRENCH "NOTE TECHNIQUE" JUNE 1989**

1. VAT cross-border transactions should be subject to the destination system for VAT registered traders and exempt bodies.

2. Individuals should pay VAT under the origin system except for mail order and vehicles.

(i) Mail order: destination system should apply to avoid economic distortion. The simplest system would be to register mail order companies in countries where supplies will be made. This could be subject to a threshold.

(ii) Vehicles: companies cars, boats, motor-bikes and aircraft. Destination system, linked to payment of vehicle registration tax*, would apply.

3. Controls by tax authorities would be on the basis of periodic declaration schedules by registered traders. Invoices, etc covering cross-border transactions would have to be retained by the importer for checking by the tax authorities as necessary. Checking by the authorities could cover only a sample of transactions. The modalities of exchanges of information (and cross-checking) between Member States should be examined by their technical experts and should be adaptable to the circumstances of each Member State.

4. Exempt bodies would have to be subjected to the same regime as registered traders.

5. Exactly what the periodic VAT declarations should contain would need to be discussed by technical experts. In general, the

* immatriculation

FRENCH VAT PROPOSALS

French proposals go for a simplification of the INTRASTAT proposals (draft Regulation 18.2.89). The periodic declaration schedule for VAT purposes would also cover statistical requirements. 2 systems could be used - fewer details for small traders (eg. with an import or export turnover of less than 1 million ecus p.a) and a fuller declaration schedule for larger businesses - though even in the latter case, it might be possible to use sample enquiries for more details (statistical?) material.

6. This seems to suggest a period entry type system (simplified for small traders) for both VAT and statistical purposes. The information could be used for national as well as cross-frontier checks. As the Chancellor said about the Commission's zero rate proposals, the devil may be in the detail. We need to get an early view of how much information the French envisage being required for each cross-frontier transaction in the periodic schedule.

TECHNICAL NOTE
FROM THE FRENCH DELEGATION

On 17 April 1989 France sent the Commission and the Member States a note (FISC 57) proposing a transitional solution regarding the abolition of fiscal frontiers with respect to VAT.

The note arose from discussions, and from an initial document circulated informally in January 1989.

Many delegations have asked for further particulars; there has also been criticism of the way the proposed system would be implemented. Bearing in mind these queries and criticisms, the French delegation would like to go into more detail, and to simplify its initial proposal.

(1) The French proposal is fully in line with Commission work on the cost of fiscal frontiers in internal Community trade, and the need to abolish all the formalities which obstruct the development of that trade. During work on the CECCHINI report, the cost to business of such formalities was calculated at ECU 7 500 million, i.e. 1,5% of the value of intra-Community trade, with the cost of waiting at fiscal frontiers alone being estimated at from ECU 415 to 830 million. Fiscal frontiers are also an obstacle preventing many companies from embarking on intra-Community trade.

These are the costs and the obstacles which must be removed. In view of these considerations, careful attention should be paid to the constraints that businesses will be subject to after 1992.

(2) When fiscal frontiers have been abolished, undertakings will still have to declare sales and purchases of goods within the Community. An exhaustive declaration is provided for in the INTRASTAT system, which is the subject of the draft Regulation published in OJ No C 41 of 18 February 1989.

This declaration will involve costs and constraints for business. Maximum use should be made of the declaration, which will be required whatever the scenario. Constraints should also be reduced to the absolute minimum.

(3) The VAT problem can be much simplified. To avoid the difficulties of a clearing mechanism, the system of zero-rating exports and charging tax on imports would be maintained for taxable bodies and non-taxable institutional bodies.

For private individuals, tax would be payable at the place of purchase, with some adjustments for

- distance selling
- purchases of registered vehicles (note No 1).

(4) Authorities must simply be able to ascertain that VAT has actually been paid on goods moving within the Community. It would suffice if they were able to check by an appropriate exchange of information that where a consignment had been exempted from VAT, the tax had indeed been paid at the time of import.

It is therefore proposed that prior checks on goods, which are cumbersome and costly for business, should be replaced by an exchange of information between administrations that would take place outside the undertaking, after the event.

Note No 2 sets out possible procedures for this exchange of information.

(5) Declaration constraints should also be reduced to the absolute minimum.

It is proposed to set up a simplified system below a certain trade threshold. All Community undertakings would thus be able to enter into intra-Community trade without discourgaging constraints.

Note No 3 sets out the detailed procedures for this simplification of declaration requirements.

(6) The reduction in costs for business could thus be considerable.

Initial calculations using France as an example show that the burden on undertakings could be less than with the INTRASTAT system, and, as far as taxation is concerned, on a level with domestic VAT arrangements. The encouragement to small businesses to enter into intra-Community trade without further ado would be a major achievement for the Community.

Note No 4 gives preliminary information on this point.

# NOTE No 1

## TAX RULES

In order to avoid situations in which fiscal neutrality is not kept up, leading to relocation and deflection of trade, France thinks it necessary to provide for certain adjustments.

I. PURCHASES BY PRIVATE INDIVIDUALS

A. Distance selling

In the case of undertakings which sell directly and deliver over long distances, the rate of the country of consumption should apply wherever the vendor is established.

The simplest system might be for undertakings engaged in this type of business [1] to register for tax purposes in the State of destination of the goods. A threshold would have to be determined to make small transactions easier.

(1) or parties liable to account for VAT designated by them.

B. Sale of registered vehicles

Purchases of cars, boats, motorcycles and planes are transactions frequently carried out by private individuals, at a relatively high unit cost.

For this reason, as long as VAT rates were not unified, these transactions would give rise to major relocation and distort competition rules.

For non-registered vehicles, the chargeable event for VAT would remain delivery or import. For vehicles which are already registered, and are acquired by private individuals in another Member State, tax would not be payable until the vehicle was re-registered. The tax paid would take the residual VAT into account.

II. PURCHASES BY BODIES NOT LIABLE FOR TAX

Since these bodies cannot deduct tax invoiced to them, where large sums are involved, the rate of the country of destination will have to apply in order not to distort competition.

In order to be neutral as against both purchasers and vendors, it seems that the simplest system would be to apply the same arrangements to non-taxpayers as to taxpayers for all purchases of goods and services in another Member State: they would therefore have to pay VAT on their purchases at the rate of the country of consumption.

## NOTE No 2

### EXCHANGE OF INFORMATION

I. When border controls have been abolished, in line with the Single Act, it will no longer be possible to check on VAT payment as at present, by comparing goods and declarations, this being the customs system applicable to foreign trade.

In the main, such checking will be done by regular inspections in undertakings.

However, to be sure that VAT exemption on export is followed by VAT payment on import, it would seem necessary to organize exchanges of information between Member States' administrations.

Organized systematically, these exchanges of information would prevent investigations into the accounts of an undertaking in one Member State leading to operations in several other undertakings in other Member States, following requests for administrative assistance. These operations would be a source of excessive constraints on business.

II. Rules for the application of this information exchange would have to be jointly defined.

(1) The first system envisaged by France was as follows:

- dispatching and importing undertakings would regularly send the appropriate authorities in their own countries a list summarizing the movements of goods they had engaged in;

- a document issued by the dispatching undertaking would accompany the goods; the importing undertaking would send the document to its authority; that authority would send it back to the authority of the dispatcher, which would check that all the goods declared for export, and thus exempted from VAT, had indeed been declared in another Member State.

Compared with the present system, this system of exhaustive cross-checking would allow savings of roughly 60% in the amount of data processed by administrations.

Some partners thought it too cumbersome.

(2) France is now proposing to simplify the arrangements.

Cross-checking could be done by exchanging and comparing computerized files compiled from the summary declarations. The forms accompanying the goods would not longer need to be sent to the authorities and returned to the country of dispatch, and so these flows of paper would be done away with. The consignee would merely keep the accompanying document, in support of its accounts.

(3) A further simplification may be envisaged: cross-checking would no longer be carried out on all movements, but only on a sample of them. This procedure would be similar to some internal VAT monitoring systems, which are based largely on sampling.

(4) The detailed procedures for this exchange of information would need to be carefully examined by experts from the different Member States, as they would need to be suited to the particular situation in each Member State, particularly as regards administrative organization and computerization.

The important thing is that, whatever procedures are chosen, business would not be subject to greater constraints than with the domestic VAT system and the INTRASTAT statistical system proposed by the Commission.

NOTE No 3

DECLARATION REQUIREMENTS

(1) France is proposing a careful review of declaration requirements, to make them as simple as possible. The French proposal goes farther towards simplification than the INTRASTAT draft, which involves making domestic VAT declarations more complicated. Under the French proposal, information would be sent only once; this would be enough to fulfil fiscal and statistical requirements. Domestic arrangements would remain unchanged. Two avenues of simplification would be explored:

- a simplified declaration for small traders;

- collecting some information from larger traders by sampling.

(2) At present, intra-Community trade is mainly conducted by a small number of large traders. Conversely, a large number of smaller traders together account for only a small fraction of intra-Community trade. Percentages probably vary depending on the Member State. To quote the French example: 97% of exports and 95% of imports are carried out by roughly 20 000 undertakings; 100 000 undertakings carry out the remainder: 3% of exports and 5% of imports.

(3) There could therefore be two different systems of declaration:

. a highly simplified declaration for small traders; these might be, for example, undertakings whose import or export turnover was less than ECU 1 million, or those which had not carried out transactions worth more than ECU 150 000 in the previous year;

. a fuller declaration, for larger traders.

Moreover, in this last case it might be possible for structural data currently gathered in all statements to be gathered by inquiries in a sample of undertakings only. This would simplify these undertakings' declarations too.

(4) Laying dwn the content of the summary declarations will require detailed discussions between national and Commission experts, to meet each country's needs.

## FICHE No 4

### COST REDUCTIONS FOR UNDERTAKINGS AND ADMINISTRATIONS

(1) Undertakings would be in an entirely new situation.

No more time would be spent waiting for formalities. Waiting at borders would be abolished; sending goods to customs offices, or waiting for customs inspections at undertakings, as has to be done under some existing procedures, would likewise be abolished. The whole cost of waiting would be avoided.

(2) In the case of France, 35,8 million documents would be done away with:

- 6 million import declarations;
- 5,2 million export declarations;
- 6,9 million transit declarations on entry;
- 5 million transit declarations on exit;
- 5,8 million simplified declarations;
- 6,9 million frontier transit notes.

Doing away with these documents would reduce the burden on business and on national administrations very considerably.

(3) The remaining cost to undertakings would be comprised of only two factors:

- issue of a document to accompany the goods;
- issue of a summary declaration.

The accompanying document would be a copy of an internal company document: dispatch note, invoice, etc. There would only be very low duplication costs. In any case, in accompanying document seems to be necessary in practice, whatever system is chosen. The requirement exists at present in domestic systems.

As with the INTRASTAT system, provision is made for a summry declaraltion, but it would be less onerous.

For business, the cost of the proposed system, whatever the detailed procedures, would be less than the combined costs of domestic VAT arrangements and the INTRASTAT system proposed by the Commission.

(4) The residual burden on administrations, stemming from intra-Community trade, would be the reception and processing of summary statements for statistical and fiscal purposes.

Statistical processing is necessary under all systems. Fiscal processing is a matter for the Member States.

Under the initial French proposal, the authorities were to process the documents accompanying the goods (approximately 16 million in the case of France). The reduction in work was thus 60%.

Under this proposal, the amount of work involved in processing the summary declarations for the purposes of fiscal cross-checking depends on how exhaustive the checks are to be.

Taking partial cross-checking on movements of goods, the amount of data to be processed would fall considerably; for example, for France, a cross-checking rate of 5% would make the number of crosschecks fall to 1 million. Even if the reduction in the administrative burden was not proportional to these figures, the cost of the system for the Member States would be close to that of the domestic VAT system aggregated with the cost of the INTRASTAT system.

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NOTE FOR THE RECORD

cc: PS/Chancellor

Relevant to today's afternoon's discussion.

Ch/ This has, of course, been extensively leaked (cf. the Press reports I sent over earlier). The draft conclusions have, now been circulated, too.

CC: J O Kerr Esq, CMG, FCO
D Hadley Esq, Cabinet Of
N Wicks Esq, HMT
R I G Allen Esq, HMT
R Culpin Esq, HMT
P Jefferson Smith Esq, H

COMMISSION MEETING ON 4 OCTOBER: INDIRECT TAXATION

1. The Secretary General of the Commission (who had been the only official present and whose confidence must be therefore carefully respected) told me that almost the whole of today's Commission meeting, morning and afternoon, had been given up to the discussion of the line that Madame Scrivener should take at the 9 October ECOFIN. The discussion had been emotional confrontational and pretty disastrous for Madame Scrivener who had, over recent months, ignored all the signs that opinion was building up against her in the Commission as being too flexible by half.

2. Williamson said that it had rapidly become apparent that there was no conceivable way of getting a majority for the policy Madame Scrivener was propounding, namely outright acceptance of the consensus now reached in the Ad Hoc Group. There had been much unpleasantness along the way with suggestions that Madam Scrivener should be replaced by Delors in the Council discussion as not being capable of being trusted to take a sufficiently tough line. Strangely enough Mr Millan seems to have been one of the principal assailants although what he knows about fiscal policy and what his interest in attacking Madame Scrivener is, neither I nor the Secretary General can divine.

3. After many hours of discussion it apparently however began to dawn upon the assailants that for the Commission to go to the Council and reject a report unanimously agreed by the member

states was not likely to be very profitable. The debate then swung back into attempts to find some middle course. It was agreed therefore that the Commission line at the Council should be to express mildly welcoming interest in some of the conclusions of the group, to pose some critical questions about the favoured system's propensity to fraud and the burdens imposed on business and to try to ensure that nothing was settled definitively at this stage and that all was pushed off to a final package. Delors and Madame Scrivener were tasked to produce a speaking note to that effect.

4. In all the excitement ideas of setting a date for a switchover from destination to origin went straight out of the window and that is not part of the Commission's position.

5. Williamson said he had subsequently spoken to Vidal (President of Coreper) to bring him up to date with the situation which, all things considered, was a good deal less disastrous than the tenor of the Commission's debate would have suggested was likely.

6. Meanwhile we have received from the French Presidency in strict confidence the attached copy of the draft conclusions which they are thinking of putting to the Council. We are proposing to reply on the following lines:

> [Warmly] applaud Presidency on [excellent] draft. It would be a great pity if the UK was forced to do anything other than support it on Monday but:
>
> (i) paragraph 2 is unacceptable to us in its implication that centrally determined tax approximation is an agreed objective. Ideally we would want a paragraph that recognised that total elimination of limits on travellers' purchases is impossible with the present diversity of tax rates but that it should nevertheless be possible to eliminate systematic

controls on travellers provided that some (fairly generous) quantitative limits are maintained in order to distinguish between the genuinely personal and the quasi-commercial. The Group would then be invited to consider what these limits should be. [A fallback position which we might have to concede at the Council on Monday would be to delete the second sentence of paragraph 2, relegate the rest to an unnumbered paragraph at the end of the piece and remit the question in more general terms for further study in the Group]; and

(ii) we would have strong objections to elevating the problem of "budgetary consequences" in the final paragraph to the same level as the implementation of the VAT system and the question of excise duties. We would prefer either that mention of these consequences was left for those concerned (eg. Denmark and Ireland) to argue for themselves; or that they were referred to in a separate issue at the foot of the page.

Comment

7. It seems to me that if we can get the French draft conclusions into the shape we want, it would still be strongly in our interest to get them adopted at the Council on 9 October. We will press the French Presidency in that sense. From what Williamson said it does not seem to me impossible that Madame Scrivener will in fact go along with conclusions of this sort, perhaps with the addition of some language about a final package in the last paragraph.

pp.

D H A HANNAY

CONFIDENTIAL

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DRAFT

CONSEIL ECOFIN
du 9 octobre 1989

Abolition des frontières fiscales

Projet de relevé de conclusions

Après avoir examiné le rapport fait par la présidence du Groupe ad hoc, conformément au mandat donné par le Conseil le 19 juin 1989, le Conseil a arrêté les orientations suivantes.

L'instauration d'un système de taxation dans le pays d'origine, tel que l'a proposé la Commission, suppose que soient remplies des conditions qui ne peuvent pas être satisfaites avant le 1er janvier 1993. Aussi, afin de réaliser la suppression effective des frontières à cette date, pour les entreprises et pour les particuliers, tout en respectant la neutralité économique du système commun de taxe sur la valeur ajoutée, le Conseil estime nécessaire de continuer, à titre provisoire, à prélever la T.V.A. et les accises dans l'Etat de consommation.

Les premières orientations de la solution envisagée pour le 1er janvier 1993 en matière de T.V.A. sont les suivantes :

1 - Les opérations réalisées par les assujettis et les organismes exonérés ou non assujettis, seront taxées dans le pays de destination au taux et conditions de ce pays.

2 - La suppression des limitations aux achats des voyageurs accompagnée d'un rapprochement des taux permettra d'instaurer la liberté de circulation et d'achat des particuliers en écartant les risques de distorsions de concurrence trop importantes.

Le niveau et l'amplitude des variations des taux devront être déterminés.

3 - Les achats de véhicules immatriculés et les achats à distance des particuliers seront soumis à la T.V.A. dans le pays de destination et au taux de ce pays afin d'assurer la neutralité du système commun de T.V.A..

4 - Les obligations des entreprises seront simplifiées : toutes les formalités liées au passage des frontières seront supprimées. Seule subsistera l'obligation fiscale de déclarer les transactions commerciales intra-communautaires, qui permettra d'assurer également le suivi statistique des échanges.

5 - Le suivi administratif et le contrôle des opérations seront assurés par un renforcement de la coopération administrative et des échanges d'informations entre Etats membres en matière de T.V.A..

Le groupe ad hoc est chargé de poursuivre l'examen des modalités d'application de ce dispositif et des questions relatives aux accises et aux conséquences budgétaires. Il devra soumettre des propositions détaillées au Conseil ECOFIN du 13 novembre.

HM CUSTOMS AND EXCISE
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1992

[illegible]

**FROM: P R H ALLEN**
**SINGLE MARKET UNIT**

**DATE: 4 OCTOBER 1989**

**PS/PAYMASTER GENERAL**

**INDIRECT TAXATION IN THE SINGLE MARKET: NEGOTIATING STRATEGY**

The Paymaster General asked for some clarification of the effects on VAT of the approach set out in Mr Jefferson Smith's minute of 3 October.

2. At present travellers from other EC countries may bring back up to £250 worth of goods which they have bought VAT-paid in another Member State. The UK has argued for an early increase to £1000 with removal of any limit after 1992: i.e. private individuals could buy for their own consumption any amount of goods bought VAT-paid in another Member State. Mme Scrivener's revised proposals announced in May would increase the limit to £1000 on 1.1.1992 in three stages. This has been resisted by some Member States who, unlike us, would expect substantial revenue losses through the additional scope for cross-border shopping.

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cc PS/Chancellor
PS/Financial Secretary
PS/Economic Secretary
Mr Wicks
Mr R I G Allen
Mrs Brown
Mrs Chaplin
Mr Tyrie
CPS
Mr Jefferson Smith
Mr Cockerell
Mr Brown
Mr Knox
Mr Railton

3. What the effect would be of having a value limit for VAT-paid cross-border transactions to distinguish genuinely private importations from those which were in effect commercial would depend to a great extent on the level at which the limit were set. A high limit of, say, £2000 to £5000 (which is the sort of level we should be aiming at) would be scarcely different in either revenue or control terms from having no value limits. Revenue estimates in this area are fairly speculative because of shortage of data: our assumptions are that we might lose or gain small amounts (+ or - £5m - the benefits of our relatively low 15% rate could be particularly affected by exchange rate fluctuations). Controls would be extremely light, very selective spot checks.

4. A lower level - of £1000 or under - is likely to be supported by a number of Member States. We would certainly want to resist going below £1000. Although below that level the effects on revenue would differ little from that at a higher level (other than reducing the potential gains or losses slightly), the implications for our controls would be unwelcome. Although it might not mean that we needed a large number of additional posts, we would probably require some. Also we would have to operate less unobtrusively than we would like in post-"1992" circumstances.

5. We doubt whether most people who want to be able to buy goods VAT-paid in another Member State are likely to be greatly affected by the exact level of a limit over £1000, especially as Member States have agreed to treat vehicles under a separate regime, which would mean that they would have to pay the tax in the country where the vehicle was registered and used. On the other hand, the lower the limit, the less easy it would be to justify it as being consistent with the Single European Act.

6. I hope this covers what the Paymaster General wanted.

RA.

Richard Allen

(Not in Press cuttings)

THE GUARDIAN
Thursday October 5 1989

Community states fall out over plan to harmonise rates

# Tax row threatens EC single market

**John Palmer in Brussels**

ONE of the pillars of the 1992 single European market appeared to be crumbling last night as prospects receded of an agreement to harmonise VAT and excise duties among the 12 Community governments.

The European Commission fears that the scheme, favoured by national government tax experts, could push back the date for the abolition of tax barriers to the single EC market well past the 1992 deadline.

As members of the commission discussed the crisis in the indirect taxation strategy behind closed doors here yesterday there were reports that harmonisation might have to be put back to 1995 or later.

The Commissioner for Tax Policy, Mrs Christiane Scrivener, complained that national governments were putting at risk the goal of scrapping border controls in the single market by their approach to the issue of VAT harmonisation.

The commission's plans to bring VAT and customs duty rates into line with each other throughout the 12 EC countries were among the most ambitious and controversial in the entire 1992 programme.

The original commission plan — which called for a VAT band of 4 to 9 per cent, a single rate for most excise duties and a complex clearing house to ensure that VAT payments ended up in the country where the goods were consumed — was proposed by the former British Conservative cabinet minister, Lord Cockfield.

Following bitter exchanges between ministers and Lord Cockfield, Mrs Thatcher declined to renominate him to the commission in 1988 and his place was taken by Sir Leon Brittan. British ministers may take wry satisfaction from the latest impasse of the entire EC indirect tax strategy, and see it as evidence supporting their case for free market forces to be allowed to determine indirect tax rates in the single EC market.

From the beginning the British Government insisted that it would not agree to abandon VAT zero-rating on sensitive items, such as food and children's clothes. Although the commission earlier this summer conceded Britain's demand to keep VAT zero rates, the mood has grown more pessimistic as a result of the objections of other governments to detailed aspects of the tax plan.

Other countries, such as Ireland, Denmark, France and Greece, have objected to the loss of tax revenue involved in having to reduce their relatively high VAT rates to a new Community norm. They fear the abolition of border tax controls could result in a massive increase of cross-border shopping in countries with lower VAT and duty rates.

In an attempt to get round these complex national tax difficulties, experts have suggested that for an initial period the exporting countries should carry the responsibility for collecting the VAT. But this is a proposal the commission fears could, in practice, lead to the maintenance of border tax controls and thus eliminate a major cost-cutting factor justifying the single market project.

The looming crisis in the Community's tax plan will be discussed by EC finance ministers in Luxembourg on Monday. There is bound to be concern that failure to agree a comprehensive scheme for approximating indirect tax rates could undermine the credibility of the whole 1992 project.

"There is no point in disguising the danger that our timetable for abolishing tax frontiers is now at risk," one commission official said yesterday. "It may be possible to press ahead with the overall strategy of scrapping all frontier and border controls by 1992, but this could be fatally undermined if there is not an agreed way on how to handle VAT and excise duty payments."

# Brussels heads for clash with governments over VAT

By **David Buchan** in Brussels

THE EUROPEAN Commission yesterday opted for confrontation in the increasingly tense battle with EC governments over how to levy indirect taxes in a frontier-free Community.

In the face of a plan drawn up by finance ministry officials of the Twelve to stick to their present practice of taking value added tax off exports and re-imposing it on imports – even after 1992 – Mrs Christiane Scrivener, the EC tax commissioner, horrified many of her Brussels colleagues by proposing that the current system stay until the end of 1995.

She was overruled by the rest of the 17-member Commission, who argued that they should not give any ground on the 1992 deadline for the removal of all intra-EC border checks, including fiscal controls.

The Commission decided that Mrs Scrivener should confront finance ministers at their meeting next Monday and ask how they intend to deal with the increased tax fraud and bureaucratic red tape which Brussels believes will be the upshot of the governments' preferred solution.

The new clash centres on Brussels' proposal for VAT to be levied among states just as it is within an individual country. This would involve levying it at every stage of production across the Community. By this means the Commission aims to do away with the chief fiscal rationale of border controls, which is to check that zero-rated exports do not fraudulently re-enter the home market.

The particular objection of all countries, bar West Germany, is to the Commission's further plan to reapportion VAT receipts so that the cash remains, as at present, in the coffers of the country of sale. Instead, the report by officials of the Twelve opts to replace controls at borders with controls at both the point of export and import and a cross-check between the two to stem fraud. This will place more paperwork on EC traders, not less, the Commission objects.

In the eyes of some of her colleagues, Mrs Scrivener runs the risk of proving too flexible to EC governments' demands. She counters that there is no point forcing a plan on EC governments, whose unanimous approval is needed.

FINANCIAL TIMES THURSDAY OCTOBER 5 1989

5\10\89.

<u>Alternative to Paragraph 2 of draft conclusions</u>

"2. Limits on purchases by travellers will be removed, subject to safeguards to ensure that commercial transactions bear tax in the country of destination."

Mov. [illegible]

# MINISTERE DE L'ECONOMIE, DES FINANCES ET DU BUDGET

--==ooOoo==--

PARIS, LE 05 octobre 1989

*TELECOPIE :* 19.44.1.83.920.29

**EXPEDITEUR :** M. Guillaume HANNEZO - CONSEILLER TECHNIQUE AU CABINET DE M. BEREGOVOY, MINISTRE DE L'ECONOMIE, DES FINANCES ET DU BUDGET

**DESTINATAIRE :** Mr LAWSON
Chancelier de l'Echiquier
de Grande-Bretagne

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SUITE ET FIN DU DOCUMENT TRANSMIS CE MATIN

ECOFIN COUNCIL

on 9 October 1989
Abolition of fiscal frontiers

Draft conclusions

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1. Transactions carried out by taxable persons and exempt or non-taxable bodies will be taxed in the country of destination at the rates and under the conditions applying in that country.

2. Removing limits on purchases by travellers along with an approximation of rates will make it possible to introduce freedom of movement and purchase by individuals while averting excessive risks of distortions of competition.

   The level and extent of variations in rates will have to be determined.

NO

3. Purchases of registered vehicles and distance purchasing by individuals will be subject to VAT in the country of destination and at that country's rate, in order to ensure the neutrality of the common system of VAT.

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Supprimer

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TAGUNG DES ECOFIN-RATES AM 9. OKTOBER 1989

Beseitigung der Steuergrenzen

Entwurf der Schlussfolgerungen

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5. Hinsichtlich der Mehrwertsteuer werden die verwaltungsmässige Bearbeitung sowie die Kontrolle der Geschäftsvorgänge durch eine verstärkte Zusammenarbeit der Verwaltung und durch einen erweiterten Informationsaustausch zwischen den Mitgliedstaaten gewährleistet.

Die Ad-hoc-Gruppe ist beauftragt, die Durchführungsbestimmungen für diese Regelung sowie die Fragen, die die Verbrauchsteuern und die Auswirkungen auf den Haushalt betreffen, weiterzuprüfen. Sie muss dem ECOFIN-Rat am 13. November entsprechende Gesamtvorschläge unterbreiten.

# MINISTERE DE L'ECONOMIE, DES FINANCES ET DU BUDGET

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CAB/27

*Le Ministre d'Etat,*
*Ministre de l'Economie, des Finances*
*et du Budget*

Paris, le 5 octobre 1989

CC: PS/C+E (by FAX)
(Pse. distribute immediately to Mr Varin, Mr Jefferson Smith, Mr Wilmott, Mr PRH Allen, Ms Leech)

FST; PMG; EST
Mr Wicks; Mr HP Evans;
Mr Scholar; Mr RIG Allen;
Mr Culpin; Mrs Brown; Mrs Chaplin,
Mr Tyrie.

Ch

You will want to discuss at this afternoon's meeting. Mr Jefferson Smith's first reaction is that only "2" (at 'X') is likely to cause us any difficulty

5/10

Mon Cher Collègue,

En vue du Conseil des Ministres de l'Economie et des Finances du 9 octobre, je vous prie de trouver, ci-joint, un projet de relevé de conclusions. Les traductions dans les langues de travail suivent.

Ce projet de relevé de conclusions est ambitieux. Mais il me paraît nécessaire de progresser rapidement, si nous voulons tenir le calendrier qui nous a été fixé par le conseil européen de Madrid.

Je vous prie d'agréer, Mon Cher Collègue, l'expression de mes meilleurs sentiments.

P Bérégovoy

Pierre BÉRÉGOVOY

Monsieur Nigel LAWSON
Chancelier de l'Echiquier
Parliament Street
LONDON SWIP 3 AG

# CONSEIL ECOFIN

## du 9 octobre 1989

## Abolition des frontières fiscales

## Projet de relevé de conclusions

Après avoir examiné le rapport fait par la présidence du Groupe ad hoc, conformément au mandat donné par le Conseil le 19 juin 1989, le Conseil a arrêté les orientations suivantes.

L'instauration d'un système de taxation dans le pays d'origine, tel que l'a proposé la Commission suppose que soient remplies des conditions qui ne peuvent pas être satisfaites avant le 1er janvier 1993. Aussi, afin de réaliser la suppression effective des frontières à cette date, pour les entreprises et pour les particuliers, tout en respectant la neutralité économique du système commun de taxe sur la valeur ajoutée, le Conseil estime nécessaire de continuer, à titre transitoire, à prélever la T.V.A. et les accises dans l'Etat de consommation.

Les premières orientations de la solution envisagée pour le 1er janvier 1993 en matière de T.V.A. sont les suivantes :

1 - les opérations réalisées par les assujettis et les organismes exonérés ou non assujettis, seront taxées dans le pays de destination au taux et conditions de ce pays ;

2 - la suppression des limitations aux achats des voyageurs accompagnée d'un rapprochement des taux permettra d'instaurer la liberté de circulation et d'achat des particuliers en écartant les risques de distorsions de concurrence trop importantes.

Le niveau et l'amplitude des variations des taux devront être déterminés ;

3 - les achats de véhicules immatriculés et les achats à distance des particuliers seront soumis à la T.V.A. dans le pays de destination et au taux de ce pays afin d'assurer la neutralité du système commun de T.V.A. ;

4 - les obligations des entreprises seront simplifiées : toutes les formalités liées au passage des frontières seront supprimées. Seule subsistera l'obligation fiscale de déclarer à posteriori les transactions commerciales intra-communautaires, qui permettra d'assurer également le suivi statistique des échanges ;

5 - le suivi administratif et le contrôle des opérations seront assurés par un renforcement de la coopération administrative et des échanges d'informations entre Etats membres en matière de T.V.A.

Le groupe ad hoc est chargé de poursuivre l'examen des modalités d'application de ce dispositif et des questions relatives aux accises et aux conséquences budgétaires. Il devra soumettre des propositions d'ensemble au Conseil ECOFIN du 13 novembre.

# MINISTERE DE L'ECONOMIE, DES FINANCES ET DU BUDGET

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PMP

**NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM, HM TREASURY AT 5.30 PM ON 5 OCTOBER 1989**

Present:

Chancellor
Financial Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr R I G Allen
Mr Culpin
Mr W White
Mrs Chaplin
Mr Tyrie

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

.................................................................

**INDIRECT TAXATION IN THE SINGLE MARKET: NEGOTIATING STRATEGY**

Papers: Mr Jefferson Smith's note of 3 October; M Bérégovoy's letter of 5 October and enclosed draft conclusions.

The Chancellor invited the meeting to consider first the draft conclusions circulated by M Bérégovoy on behalf of the French Presidency.

2. In discussion, it was agreed that the draft conclusions were generally acceptable, subject to two points. First, in the second paragraph of the conclusions the reference to 'for a transitional period' was unwelcome. A better phrase would be 'on a provisional basis'. Second, the reference in item 2 of the numbered paragraphs to 'approximation' was unacceptable.

3. It was agreed that, while the first of these points might be conceded in the context of a satisfactory bargain elsewhere, the second was a sticking point. If it were not possible to amend the

phrase substantively, our dissension would need to be recorded in the conclusions, or (preferably) the conclusion would have to be attributed only to most member states.

4. The meeting considered which alternative texts might be acceptable. It was agreed that a conclusion that 'removing limits on purchases by travellers will make it possible to introduce freedom of movement and purchase by individuals, subject to safeguards to ensure that transactions of a commercial character bear tax in the country of destination' would be acceptable.

5. It was agreed that the Chancellor should reply to M Bérégovoy and register our difficulties with these two points (this letter has since been drafted and signed, and the Financial Secretary will hand it to Bérégovoy before the discussion).

6. The meeting considered briefly the points in Mr Jefferson Smith's note of 3 October. The Chancellor said we might need to make some modest concession on the lines of the French proposals for checking of intra Community transactions, in order to reach an agreement. Fraud was a weakness with the destination principle, which the Commission could be expected to point up. Any concession should, however, be kept to a minimum. Likewise, we might need to modify our position that there should be no limits for VAT to meet the concerns of Continental states which would face serious distortions, as part of a deal on travellers' allowances.

7. The Chancellor said that the idea of a substantive discussion of this subject at the November Ecofin was unattractive, since that meeting would already have a very full agenda. More generally, we would need to see how the shape of the whole package emerged before expressing a final position on it (though the technical elements could be separated from the rest).

8. The meeting considered the 'objectives', 'line to take', and 'detailed points' enclosed with Mr Jefferson Smith's note, and a number of drafting points were made. These would be taken into account in the final briefing.

J M G TAYLOR
6 October 1989

Distribution:

Those present
Mr Wicks

RESTRICTED

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

Thanks. An excellent paper. (What nationality is the author?)

Ch/ This is the note which JBU mentioned at the meeting today. JF 5/10

Chancellor

FROM: J B UNWIN
DATE: 5 October 1989

**THE ECONOMICS OF INDIRECT TAXATION HARMONISATION**

You may care to glance at the fascinating document attached which has come into our hands by a somewhat devious route.

2. It is an internal memorandum by DGII-B of the Commission summarising the main economic arguments relating to the various proposals for indirect tax harmonisation and abolition of fiscal frontiers. It starts with Cockfield, and moves on to the current French Presidency proposals.

3. As you will see, the main conclusions are closely in accord with those on which our own position has rested. Significant points that emerge, for example, include:

- while the psychological impact of abolishing frontier controls should not be overlooked, the actual resource saving is 'hardly of macro-economic significance';

---

cc Paymaster General
Financial Secretary
Economic Secretary
Mr Wicks
Mr Allen
Mr Culpin
Mr Jefferson Smith
Mr Wilmott
Mr Allen
Mr Vernon

- there is no major macro-economic difference between the origin or destination principle for charging VAT;

- mandatory harmonisation carries the risk of introducing greater rigidity in tax structures at a time when 'the pursuit of the best tax structure relies upon a process of continuous experimentation by independent governments';

- differences in state sales tax rates in the USA have not destroyed the credibility of the internal market there and 'are unlikely to do so in the EC either'.

4. The only serious counter-argument against the current destination principle based proposals is the risk of fraud. As you know, this is one of the issues under close scrutiny in the ad hoc group, where we are seeking to strike a reasonable balance between adequate safeguards and avoiding an excessive burden on both ourselves and on industry.

5. Although we are not, at the moment, in a position to make any overt use of this paper, it is most encouraging to see these arguments being deployed within the Commission. All the more reason to stick to our guns.

J B UNWIN

07.09.89 /II/0493

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels
ME/MJO/cm

Copy, PRHA
LR.

Directorate-General II
for Economic and Financial Affairs

II-B

# INDIRECT TAXATION AND COMPLETION OF THE INTERNAL MARKET.

1. Introduction
2. The Economic Case for Suppressing Fiscal Frontiers
3. The Economic Consequences of Indirect Tax Convergence on the Public Finances of Member States
4. The Destination Principle Favoured by the French Presidency

Annex 1. Cockfield, Scrivener and French Presidency proposals

Annex 2. Macroeconomic impacts of the Scrivener proposals

Annex 3. Origin and destination principles for the VAT

Annex 4. The Fraud Risk with the Destination principle

Table 1. Value added Taxes

Table 2. Excises

Provisional address: Rue de la Loi 200 • B-1049 Brussels - Belgium - Telephone direct line 23 Telephone exchange 235 11 11
Telex COMEU B 21877 Telegraphic address COMEUR Brussels

36/10

# INDIRECT TAXATION AND COMPLETION OF THE INTERNAL MARKET

## 1. Introduction

This note summarises the main economic arguments relevant at the present stage of the negotiations: i.e. given the draft conclusions of the French presidency of the ad hoc group of the Council, and against the background of the successive Cockfield and Scrivener proposals (see Annex 1).

The main economic issue is: how to optimise the combination of (A) gains from suppressing fiscal frontiers with (B) freedom to structure and reform national taxes according to decentralised preferences.

There are robust arguments to the effect that both (A) and (B) are of great economic as well as political importance.

The Cockfield proposals failed to gain sufficient support, it seems, because they went too far in favour of A at the expense of B.

The Scrivener proposals can be defended as a serious compromise, or reconciliation of A and B to a high degree.

The French presidency proposals contains a technical switch from the origin to the destination principle, together with (we suppose) maintenance of the Scrivener proposals for the rates of VAT and excises. A question is whether this proposal changes the economic costs and benefits in relation to the Commission's origin-based proposal.

Before evaluating these last proposals, let us recall the main arguments concerning both A and B separately.

## 2. The Economic Case for Suppressing Fiscal Frontiers (A).

The economic case for suppressing fiscal frontiers relies upon a minor and major argument:

- minor argument: this concerns eliminating the resource cost to companies and public administrations of frontier checks and delays. The Cecchini report showed the total cost of such delays (for fiscal and other reasons) to be around 10 billion ECU per annum, or 0.2% of GDP, or 2% of the cost of intra-EC trade.

As we have often said!

This sum, while not completely trivial, is hardly of macroeconomic significance.

It has also been contested, in the sense that this estimate may understate the cost of internal accounting calculations of

.../...

companies that would remain. It is hardly worthwhile to argue about this very secondary point.

It is important however, to argue that those opponents of the Commission's proposals who point to these small- savings are ignoring the major argument.

- major argument: this concerns the psychological or expectational impact of suppressing border controls on the attitudes of people, companies and governments, and thence on the strategic behaviour of the private sector.

While this is of course a somewhat subjective matter, all that we have seen and learned since the Cecchini report (which quantified the large gains from inducing "integrated" rather than "segmented" market behaviour of companies) confirms its importance.

Independent and distinguished tax economists heard at conferences these days (e.g. Professor Sinn of Munich, Professor Cnossen of Rotterdam, Professor Kay of London) confidently support the argument that "... the effect of having borders physically open for business and persons is of incalculable importance in the formation of the strategic perceptions of the private sector. This is one of the hallmarks of the United States' internal market compared to the EC at the moment. The open frontier also signals the irreversible commitment of national governments to frontier disarmament ..."

Industrial organisation economists give greater rigour to this argument by characterising different types of more or less competitive and integrated (versus segmented) modes of market behaviour. The practical use of this work is that it is also becoming possible to quantify the economic gains to be obtained by inducing companies to switch their behaviour from one mode to another. The Cecchini report exploited this work. This is how it was possible to justify the assertion that more than half of the 4 to 6% of GDP total potential gains would come from inducing more competitive and integrated strategic behaviour. To get these gains relies above all on the long-term credibility of the commitment to open markets: there is no clearer signal of this than the suppression of physical and fiscal border controls, for fiscal or other reasons.

In practise, in the course of 1988 and 1989, we have seen the credibility of the 1992 process begin to translate into actual changes in corporate behaviour. (The growth of cross-frontier mergers and acquisitions, increased collaboration agreements, greater attraction of the EC for foreign investment, widespread formulation of EC corporate strategies for production, R&D, marketing etc.). Macroeconomically, the EC now witnesses an impressive investment boom in virtually all EC countries, and this surely contains some (unquantifiable) 1992 effect. The failure now to confirm the political agreement to suppress fiscal frontiers would risk undermining this new, positive and fundamental trend.

.../...

This "major argument" for suppressing border controls does not, however, strongly rely upon some other parts of conventional Commission doctrine regarding indirect tax harmonisation. Such elements include:

- the case for treating intra-EC transactions identically to national transactions, or differently to extra-EC transactions in tax accounting systems;

- the complete suppression of travellers' allowances.

It may be observed in the United States for example, inter-state sales by mail-order have been at zero rate for sales tax, and that inter-state travellers are not allowed to carry substantial quantities of excised products such as tobacco and alcohol across frontiers. Phenomena such as these may, doctrinally, be considered imperfections in the internal market. From an economic point of view, however, they have not destroyed (even undermined) the credibility of the internal market in the United States' case, and are unlikely to do so in the EC either.

This means that some of the technical issues concerning the French Presidency's proposal of the destination principle have to be resolved essentially on the basis of fiscal-technical considerations (including the fraud risk) rather than on the basis of macroeconomic argument (see further below in section 4.).

3. The Economic Consequences of Indirect Tax Convergence on the Public Finances of Member States (B).

There are three major arguments concerning:

(i) the risk that free market forces (i.e. open frontiers with no harmonisation of indirect taxes, even minimum rates) would cause an undesirable bias in the process of convergence of tax structures, notably through competitive depreciation of the share of indirect taxes;

(ii) the immediate structural changes that would be imposed on different countries' tax systems and public finances in general.

(iii) the risk of introducing greater rigidity in tax structures at a time when most governments (and economists) see important needs to experiment with tax reforms, given that the optimal tax structure cannot be easily determined for an individual country, let alone for the EC as a whole.

The arguments under these three headings may be developed as follows:

Ad. (i). Bias in the process of convergence. In practise the risk is that there would be competitive downward pressures on both VAT and excise rates. Tax economists agree on this. Taxes would be driven down on mobile factors (goods, services, capital), and

.../...

correspondingly upwards on immobile factors to compensate (incomes of immobile people, property). Or, where income taxes are already very high, there would be pressure to cut public expenditure.

Such tendencies would have the following major disadvantages:

- from an efficiency point of view, the VAT is an attractive tax, and to increase instead the share of income taxes would today be bad supply-side economics for most Member States;

- from an equity point of view, any major disturbance of an initially preferred income distribution is likely to involve a political cost, and the principle of subsidiarity requires that such preferences be determined in Member States, not at the EC level.

- from the point of view of health, energy and environment policy objectives there are obvious disadvantages in reducing the main excise duties.

The minimum rates contained in the Scrivener proposals are an important answer to this risk, and may thus be robustly defended in general terms.

Ad. (ii). Likely changes in actual tax structures. The specific changes in national tax structures that would follow from implementation by the Scrivener proposals would be:

- the very high indirect tax countries (Ireland, Denmark) would no doubt be forced by market pressures to reduce their excise rates and VAT (introducing a lower rate for Denmark). Both countries have also very high public expenditure levels, especially on social policies, and very high personal income tax rates. Economically, these countries should not increase their income taxes further, on the contrary, they should reduce them. Therefore these countries face a major disturbance of their initial public expenditure and income distribution policies.

- the very low indirect tax countries (Greece, Luxembourg) would, of course, raise extra revenue. For Luxembourg the EC has a valid point in saying that this would discipline their free-rider behaviour, which is costly to neighbouring countries. For Greece the political costs would be in terms of confronting tobacco interest groups, and disturbing traditional consumption. All the low indirect tax countries (Portugal and Spain, as well as Greece and Luxembourg) would face price rises, which could aggravate inflation problems for a period, and would call for adjustment to wage indexation mechanisms to avoid this.

- for all other countries the consequential changes are of a qualitatively smaller order of magnitude (assuming that zero-rating continues in the UK, there is special treatment of automobiles which is important for France, Belgium and the Netherlands etc.).

(See Annex 2 for a more systematic account by country).

.../...

Ad. (iii). The impact on tax reform. As regards the issue of freedom to pursue tax reforms, it should be recognised that past Commission proposals (the Cockfield proposals for indirect taxation, and the corporation tax proposals of the 1970s) underestimated the extent and depth of tax reform ideas that are today considered conceivable or desirable. By blocking the structure of some major taxes (à la Cockfield), and also by imposing EMS/EMU disciplines on budget deficits, the risk that the EC might try to force national budgets into excessively tight corsets has been a very real one.

The ideal of some tax harmonisation experts of perfect harmonisation (or as near so as possible) of tax structures and rates, ignored the extent to which the pursuit of the best tax structure relies upon a process of continuous experimentation by independent governments (a number of governments bound by a unanimity requirement represents a very strong rigidity).

This is one of our most powerful arguments

The process of experimentation should only be limited where there are serious risks of countries exporting costs or undesirable pressures on to each other. The Scrivener proposals do, again, contain a safeguard against these risks, through the minimum rates for VAT and excises, but otherwise leaves the field open for tax policy experimentation.

4. The Destination Principle Favoured by the French Presidency.

It is presumed that the destination principle would be combined with the Scrivener proposals for the rates of VAT.

It is assumed in French Presidency proposals that fiscal frontier controls would be effectively suppressed as under the Commission's proposals.

Under these assumptions it is hard to identify a major macro-economic difference between the origin or destination technique.

In particular the psychological and expectational impact on the strategic behaviour of enterprises is unlikely to be very different.

Competitivity issues as between Member States are unaffected by the choice of origin or destination principles (as defined in the Scrivener and French proposals respectively).

As regards the issue of degrees of freedom for decentralised fiscal preferences, there is no real difference either between the Scrivener and French presidency proposals.

The issues are therefore the following:

(a) doctrinal matters. It may be objected that the zero-rating of exports under the destination principle fails to distinguish intra-EC from extra-EC trade. While the political weight of this point may be considered important, it has little or no economic weight;

.../...

(b) the clearing mechanism. Some countries contest that the new macroeconomic method is feasible. At any event the destination system has the advantage that this is no longer necessary;

(c) the fraud problem. The destination system has the disadvantage that this risk seems to be a significant one. At worst one may imagine the kind of problems already experienced with monetary compensatory amounts multiplied in extent. Given the political and financial importance of the MCA example, these matters cannot be dismissed lightly. DG II does not pretend to expertise on this point, Howevever, Annex 4 sets out the logic of the temptations to fraud, which indeed seem rather serious. Independent tax economists (e.g. Professor Cnossen of Erasmus University) consider that the concern is a real one.

(d) the cost of cooperation between fiscal administrations. The French presidency's proposal involves an extended system of information exchange in order to control the fraud problem. Apart from its credibility, there is its cost. Would this be less than that of the clearing mechanism? We are not at all sure;

(e) timing and temporary versus definitive systems. It is argued that the larger changes in the system required by the origin principle could not be ready by 1st January 1993, and that therefore the destination system is necessary in any case as a temporary measure. DG XXI have to judge this important point.

(f) trade statistics. An advantage claimed for the destination system is that the exchange of information by fiscal authorities would be a way of assuring the supply of trade statistics, otherwise threatened by the removal of frontier controls. This also would have to be verified in relation to ongoing work of the Statistical Office.

Conclusion. The foregoing points suggest that the case for the origin versus destination principles hangs upon technical and doctrinal rather than macroeconomic considerations. The destination principle does not seem to threaten per se the fundamental economic benefits that the frontier-free market could offer.

The choice essentially involves a trade-off between the cost of the clearing mechanism versus that of enhanced cooperation between fiscal authorities for information exchange. However, the destination principle clearly involves introducing the greater moral hazard of an incentive to fraud, which should not be treated lightly.

ANNEX 1

COCKFIELD PROPOSALS

- 4-9% and 14-20% VAT bands.
- origin principle (suppression of 0 rated exports; these are exported at home rates, sales in importing country at that country's rates).
- clearing mechanism on basis of transactions accounting
- exact harmonisation of excises
- suppression of travellers' allowances
- suppression of border controls

SCRIVENER PROPOSALS (changes from Cockfield)

- minimum rate only for standard VAT rate, and excises
- clearing mechanism on basis of macro-economic estimates
- destination principle for special categories (automobiles, mail order, supplies to VAT exempt institutions like hospitals and banks):
- derogation for existing zero-rating cases

FRENCH PRESIDENCY PROPOSALS (changes from Scrivener)

- destination principle
- no clearing mechanism
- reinforcement of cooperation between fiscal authorities

Annex 2

Macro-economic impacts of the Scrivener proposals for indirect taxation

Member States with large revenue gains:
Luxembourg: The substantial revenue increase is subject to a high degree of uncertainity given the revenue importance of cross border shopping and the difficulties in predicting the demand behaviour of non-residents after rate adjustments. The macro-economic adjustment problem would include significant price increases and the need to avoid negative effect on competitiveness through adjusting the wage indexation scheme.

Greece: Increased revenue would be in line with national efforts to tackle the budget deficit. The main concern is the inflationary impact. With the present wage indexation scheme the price-wage spiral could be aggravated.

Spain: Increased revenues from indirect taxation would facilitate reductions in direct taxation and/or social security contributions. Inflation would constitute a problem given that it is currently accelerating again.

Portugal: Boosted tax revenues should be welcomed due to the seriousness of public finance imbalances but raise concerns with regard to the short run impact on inflation.

Member States with large revenue losses:
Denmark: Would experience a substantial budgetary loss especially with the market-induced need for downward adjustment towards the Germany level of excises. Counter measures such as cuts in public consumption and/or income transfers as well as a broadening of the income tax base (increases of the already high tax rates would run counter to proposed reform programs) would be necessary. Otherwise there would be an important increase in domestic demand which would further aggravate the external deficit counter to the basic objective of the economic policy.

Ireland: The direct mechanical revenue loss would be comparatively small, but the market-induced need for downward adjustment vis-a-vis the U.K. would be likely to reinforce it substantially. To maintain tax revenues close to their present level in accordance with the consolidation program, would be difficult, given the very high level of income taxation and the authorities' commitment to reduce the income tax burden in the medium term. Cutting public expenditures might be economically desirable but politically very sensitive.

Member States with small changes:
Belgium: Would experience a slight increase in revenues with minimal effects on other macroeconomic variables and offer a possibility of further reducing direct taxation.

<u>Germany</u>: With a small revenue increase hardly any macroeconomic repercussions can be expected.

<u>France</u>: The overall budgetary incidence would be close to zero.

<u>Italy</u>: A small revenue loss could give rise to some concern in the short run given the considerable budgetary deficit.

<u>Netherlands</u>: Budgetary impact close to zero (slightly positive). No macroeconomic effects expected.

<u>United Kingdom</u>: With a continued zero rate no major macroeconomic consequences are likely to occur. Suppression of zero-rating would cause considerable disturbances to income distribution policies.

ANNEX 3

## Origin and destination principles for the VAT

| Country A<br>15% VAT | Country B<br>20% VAT |
|---|---|
| **ORIGIN PRINCIPLE** (Commission proposal) | |
| Exporter bills with 15% VAT → | Importer sells with 20% VAT<br><br>(importer gets credit for the 15% in his tax return; tax authority gets the 15% back from country A through clearing) |
| **DESTINATION PRINCIPLE** (Status quo and French presidency proposal) | |
| Exporter bills with 0% VAT →<br><br>(and recovers VAT paid on his inputs) | Importer sells with 20% VAT<br><br>(importer has no credit to claim on his imports; no clearing necessary) |

ANNEX 4

## The Fraud Risk with the Destination principle

EXPORTER

He exports with 0% VAT, and claims credit for the VAT borne on his inputs.

At present he has documentary proof of exports, which registered at the frontier (e.g. even in the Benelux system the export papers are deposited at the frontier as the truck passes through).

Under the Presidency's proposals this proof could only be obtained through cooperation with the importing country's information sources. If this system were not credible, exporters would be tempted to declare false exports.

IMPORTER

He imports with 0% VAT, and sells at the full home rate (say 20%).

The importer is tempted to buy with 0% VAT and to sell without declaration for VAT purposes, (i.e. on the black market). Since the market price for most products is VAT inclusive, he profits from the VAT margin.

This temptation is restrained at present by frontier controls, requiring immediate payment of VAT by importers.

Under the proposed system, cooperation between VAT authorities would pass information on traded goods from exporting to importing country.

Conclusion. For the destination principle to be superior to the origin principle in an internal market without frontiers, then the cooperation system between fiscal authorities has to be (a) credible and (b) of low administrative cost (i.e. less costly than the alternative of a clearing mechanism with the origin principle system).

TABLE 1

VALUE ADDED TAXES

| | Statutory Rates (1) | | | Scope of Zero Rate | VAT as Percent of total receipts (2) | VAT as Percent of GDP (2) |
|---|---|---|---|---|---|---|
| | Standard rate | Increased rate | Reduced rate | | | |
| Belgium | 19 | 25, 33 | 1, 6 | Newspapers | 15.8 | 7.3 |
| Denmark | 22 | -- | -- | Newspapers, large ships and aircraft | 15.9 | 9.5 |
| France (3) | 18.6 | 28 (4) | 5.5 | -- | 17.8 | 8.7 |
| Germany | 14 | -- | 7 | -- | 13.1 | 5.9 |
| Greece (5) | 16 | 36 | 3, 6 | -- | 18.8 | 7.1 |
| Ireland | 25 | -- | 1.4, 5, 10 | Wide range of items | 19.4 | 8.1 |
| Italy | 19 | 38 | 4, 9 | Newspapers, and some minor items | 13.4 | 5.3 |
| Luxembourg | 12 | -- | 3, 6 | -- | 11.8 | 6.6 |
| Netherlands | 18.5 | -- | 6 | -- | 14.4 | 7.9 |
| Portugal (6) | 17 | 30 | 8 | Basic foods, newspapers, medecines, agricultural inputs | 12.8 | 4.9 |
| Spain | 12 | 33 | 6 | -- | 13.9 | 5.3 |
| United Kingdom | 15 | -- | -- | Wide range of items | 14.1 | 5.7 |

Source: Commission services.

(1) : As of January 1, 1989.
(2) : 1987 except Portugal 1986.
(3) : France applies VAT rates of 2.1 percent to daily newspapers and 13 percent to sales and transfers of building land. Different VAT rates apply in Corsica.
(4) : To be reduced to 25% in September 1989.
(5) : Different rates apply in Dodecanese.
(6) : Different VAT rates apply in the Acores and Madeira.

TABLE 2

# EXCISE RATES AND EXCISE REVENUE IN % OF GDP

| | Cigarettes (tax) | | Spirits (pure) | | Beer (Average) | | Wine (average) | | Petrol | | Diesel | | Heating Gas | | Heavy Fueloil | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | per 1000 | % GDP | per hl | % GDP | per hl | % GDP | per hl | % GDP | per 1000L | % GDP | per 1000L | % GDP | per 1000L | % GDP | per 1000 kg | % GDP |
| Belgium | 48 | 0.6 | 1298 | 0.2 | 11 | 0.1 | 34 | 0.1 | 257 | 0.7 | 121 | 0.3 | 0 | 0 | 0 | 0 |
| Denmark | 141 | 1.2 | 3509 | 0.3 | 76 | 0.6 | 158 | 0.2 | 464 | 1.0 | 221 | 0.7 | 221 | 0.8 | 248 | 0.2 |
| France | 27 | 0.3 | 1108 | 0.2 | 3 | 0.02 | 3 | 0.02 | 397 | 1.2 | 187 | 0.3 | 55 | 0.2 | 17 | 0.02 |
| Germany | 70 | 0.8 | 1231 | 0.2 | 7 | 0.1 | 0 | 0 | 256 | 0.8 | 214 | 0.4 | 8 | 0.03 | 7 | 0.01 |
| Greece | 14 | 1.0 | 39 | 0.02 | 8 | 0.1 | 0 | 0 | 328 | 1.8 | 126 | 0.5 | 87 | 0.5 | 100 | 0.7 |
| Ireland | 90 | 2.2 | 2502 | 0.6 | 92 | 1.5 | 256 | 0.1 | 371 | 1.6 | 281 | 0.5 | 48 | 0.5 | 10 | 0.04 |
| Italy | 39 | 0.7 | 221 | 0.02 | 17 | 0.02 | 0 | 0 | 550 | 1.3 | 155 | 0.4 | 155 | 0.3 | 8 | 0.02 |
| Luxembourg | 34 | 1.8 | 873 | 0.4 | 5 | 0.04 | 14 | 0.1 | 206 | 1.5 | 99 | 0.4 | 0 | 0 | 2 | 0.00 |
| Netherlands | 52 | 0.5 | 1358 | 0.2 | 21 | 0.1 | 35 | 0.04 | 340 | 0.8 | 109 | 0.2 | 44 | 0.1 | 15 | 0.00 |
| Portugal | 23 | 1.0 | 38 | 0.01 | 7 | 0.1 | 0 | 0 | 337 | 1.1 | 153 | 0.9 | 22 | n.a. | 10 | 0.1 |
| Spain | 19 | 0.4 | 480 | 0.2 | 3 | 0.03 | 0 | 0 | 269 | 0.7 | 131 | 0.3 | 41 | 0.01 | 1 | 0.00 |
| United Kingdom | 79 | 1.3 | 2309 | 0.3 | 62 | 0.6 | 155 | 0.1 | 310 | 1.3 | 262 | 0.3 | 17 | 0.01 | 12 | 0.00 |

Source: Commission services

Note: Total tax in ecu per 1000 cigarettes as of April 1, 1987
All other excise rates in ecu as of September 1, 1988
Excise revenues in % of GDP estimated for 1988

cc Mr Wicks, Treasury
Miss Neville-Rolfe
Mr Stow

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1. ~~Mr~~ Evans to see
2. Mr Grice,

BRITISH EMBASSY,
BONN.

J O Kerr Esq CMG
FCO

6 October 1989

The Chancellor may like to see this as political background to his German visit. It seems to me that we need to incorporate this sort of political thinking into the development of our European strategy. We need to use Europe for our own strategic ends, and not let others monopolise it for their own. N.L.W. 21.10

I agree. But need (and Lawson probably not before) should urgently [illegible] the whole [illegible] on enlargement, [illegible] to oppose the FRG on [illegible] how far we should be a [illegible] [illegible]

Dear John

**EC ENLARGEMENT: AUSTRIA**

1. Genscher said in a speech in Austria on 14 September (my telno 982) that the Federal Republic vigorously supported Austria's application for membership of the Community, and that he would oppose anyone who tried to close the door on new members. He repeated both statements in a radio interview on 17 September. Earlier statements by Kohl carried, though in muted terms, the rider that the question of neutrality could be looked at "when the time came". The official German position, described to me on 5 October by Stavenhagen, is that the EC is open to would-be members provided they accept the Treaty and the SEM including the aim of European Union.

2. There is widespread agreement in the FRG that Austrian (or any other) accession is not on until after 1992. But as regards what happens then, opinion here is moving in ways which may affect not only the position taken by the FRG on the accession of Austria but on the future direction of the Community as a whole. The Austrian issue is becoming increasingly intertwined with the new debate over the future of the GDR and the German Question. What is said about Austrian accession tends to reflect unspoken assumptions about these larger issues.

3. There are broadly two schools of thought. The first, reflecting a traditional FRG view of the Community, is frequently found among the Eurocrats of the bureaucracy. It is negative about Austrian accession. It is well reasoned but, in current German conditions, is in danger of seeming out of touch with the political context. The second school is in favour of Austrian accession. It is found with increasing frequency among politicians. It is vague and inconsistent and ignores material difficulties, but responds to a vision of Europe which appeals to many Germans.

ANX E
MALLABY → KERR 6/10

/4.

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4. The Eurocrats' view is the familiar one that Austria is qualified in all respects but one to be a member of the Community; but that the exception, neutrality between East and West, is an important disqualification because it conflicts with thinking about the ultimate political purposes of the Community. 'European Union' is admittedly undefined, but it has the important characteristics of sounding comprehensive and of keeping options open for the further development of the institutions and the competences of the Community, including security policy. The adherents of this view, of course, see political cooperation as a potential precursor of European security cooperation and even defence cooperation which one day, with or without WEU, could provide the framework for a real European pillar of NATO or even, if the Americans disengaged, for a Western European defence system. Proponents of this school believe that adding a neutral voice to political cooperation could inhibit the process in its present form. More important, they think it could well shut off the possibility of the Community developing into a security organisation and meanwhile could strain relations with the United States.

5. The second school would like to have another German-speaking and central European and developed country in the Community, to balance the dominance of other languages and cultures and the Southern and Westward geographical tilt. The economic structure of Austria is similar to that of the FRG in many respects - high GDP per head, much regulation and an agricultural structure resembling Bavaria's - an ally for Germany, if hardly advantageous for the Community as a whole. It is instinctively felt here that the few bilateral problems between the two - of which transit traffic is the most prominent - could more easily be resolved if Austria were in the EC. In Bavaria support on these grounds for Austrian membership is widespread and cancels what otherwise might be the conservative CSU's reservations about admitting a neutral. In much of the public debate in the FRG, neutrality is either ignored or is seen as being overcome during the negotiations (by getting Austria to accept the Treaties without reservations) and/or becoming increasingly irrelevant in a climate of change in Soviet foreign policy and reform in Eastern Europe.

/6.

6. Then there comes a leap in the thinking of some adherents of the second school. They go on to support Austrian accession as a way of opening the Community door to the East. In the FRG the notion of the Community one day embracing the GDR and other countries in Eastern Europe has always existed uneasily alongside the traditional view of Western European integration. The Federal Republic has yearned for two goals - European Union and reunification - whose reconciliation could not be easy and (to say the least) was not for the Federal Republic alone to determine. Many Federal politicians think that reunification could be more palatable to other Europeans if part of, or the result of, some wider process of East-West reconciliation in Europe. They hope that the EC could play a role in this. Many also hope that other Europeans would more easily accept reunification if it was within the Community.

7. Genscher has accompanied his recent welcome for Austrian accession by two other thoughts; first that Poland and Hungary are not "in the first phase" candidates for EC membership, and second that WEU is available as a forum for European security cooperation. He has not mentioned the GDR. This is partly because, unlike many politicians here, he realises that the FRG must be careful, on reunification, not to frighten its neighbours, East or West. A key to that is accepting post-war boundaries and "overcoming" them, rather than trying to abolish or redraw them. He therefore speaks of the two Germanies drawing ever closer together, without saying what might happen in the end. The "overcoming" process, for him, starts with Poland and Hungary, and in that connection the EC can be valuable. He said in an interview on 4 October that the likely future interest of Hungary and othersin EC membership was a reason for not putting the Austrian application on the back burner and he mentioned neutrality as an advantage of Austrian membership. He would not consider Hungary and Poland eligible for membership until much further down the road to democracy, but he would want a democratic Poland or Hungary to join. The consequent loss of potential for the Community as a security organisation would not bother him. He, and many people in the CDU who have GDR membership of the EC in mind as an eventual goal, point to the alternative framework of WEU - which, they would also argue, is composed of countries more relevant to Western security than the Twelve. Stavenhagen reminded me that the CDU Party Congress in 1988 passed a resolution saying that WEU was the forum for European security cooperation.

/8.

8. At the same time Genscher continues to call for closer Western European integration, stressing Economic and Monetary Union. I suspect that an important motive here is reassurance to France and the West more widely. But I am sure that Genscher, like many here, also believes in the EC as a magnet which increases the pressures on Eastern Europe for movement towards democracy and the market economy. There is an incipient debate here about whether the speed of integration in the Community should be reduced, so as to avoid making East European accessions harder in the future. That is not the view of the Federal Government, or of Kohl or Genscher, and it looks at present as though the opponents of deceleration will easily win this debate. Genscher may well think, though there is no explicit evidence, that a multi-tier Community is the inevitable way of squaring the circle between deeper integration and wider enlargement. He has gone so far as to imply clearly in public that EMU will go ahead even if Britain will not participate (my telno 612).

9. Another theme in the emerging debate here is that the Community could have close relations, amounting perhaps to a single market, with EFTA countries. But with Poland and Hungary, it should have "privileged" relations, as Stavenhagen put it to me. When and if Poland and Hungary consolidate their democracy and make considerable economic progress, they might graduate to membership of the wider single market like the EFTA countries. Some would say that they should go no further; others that they might later join the EC itself. Stavenhagen would not be drawn on the place of the GDR in this pattern, but many people here would say that the GDR might follow the same path as Poland and Hungary but some time later. Teltschik said to me on 5 October that all these matters should be looked at together, along with the existing applications for membership.

10. Although I think it unlikely that we shall see German EC policy being held hostage to Ostpolitik, I believe that the Eastern dimension in German thinking about enlargement has come to stay. Genscher, the most powerful advocate to European integration, is also the great activist in Ostpolitik. German thinking about the accession of Austria may increasingly be influenced by this Eastern dimension. My guess is that, when the time comes, the Germans will campaign actively for Austrian membership.

Yours ever

Chris Mallaby

C L G Mallaby

/cc

cc Sir David Hannay KCMG
UKREP BRUSSELS

Ambassadors in EC countries,
Warsaw, Vienna, Budapest

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P Jefferson Smith
Deputy Chairman

Thanks OK with sq brackets passages deleted

Ch. 'FST would prefer to delete the sq. bracketed passages (to leave him some room for manoeuvre)
6/10

FROM: P JEFFERSON SMITH

DATE: 6 OCTOBER 1989

CHANCELLOR

DRAFT LETTER TO M BEREGOVOY

The draft conclusions of ECOFIN came to you under a "cher collegue" letter from M Beregovoy, so that would be a peg for your letter to him. In drafting what follows, I have been explicit about our points of difficulty and proposed solutions; but the Financial Secretary may have a view on how far he wants to trail the [square bracketed] solutions in advance.

"Thank you for your letter of 5 October, with which you sent me a draft of the conclusions of the meeting of ECOFIN on 9 October. I much regret that owing to commitments connected with our Party Conference I am not able to attend the meeting myself. But Peter Lilley will be attending in my place and I have had the opportunity to discuss the issues very fully with him.

The progress made under your Presidency is admirable and a remarkable achievement. I am most keen that the United Kingdom should work with you to reach a satisfactory outcome. It may be helpful to you to know that I find the draft conclusions generally acceptable, subject to two points.

---

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Chairman
Mr P R H Allen
Miss Leech

Mr Bonney, UKREP

**CONFIDENTIAL**

Firstly, the reference in the second paragraph to levying tax in the country of consumption "for a transitional period" gives unnecessary encouragement to those who would wish to move quickly to an origin basis of tax. ~~[A better phrase might be"on a provisional basis".]~~

Secondly, for reasons you will be familiar with, I fear that I cannot accept the references in item 2 of the numbered items to approximation of rates and to determination of the level and extent of variation of rates. As you know, I strongly favour and have publicly advocated substantial increases in travellers' allowances. ~~[I would fully support a conclusion that "removing limits on purchases by travellers will make it possible to introduce freedom of movement and purchase by individuals, subject to safeguards to ensure that transactions of a commercial character bear tax in the country of destination."]~~ I hope we could agree on a formula [on these lines,] which would enable the United Kingdom to give its support to this important aim without having to register dissent on approximation."

P J

P JEFFERSON SMITH

chex.ps/jmt2/12

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

6 October 1989

M. Pierre Bérégovoy
President
Council of Ministers

Dear Pierre

Thank you for your letter of 5 October, with which you sent me a draft of the conclusions of the meeting of ECOFIN on 9 October. I much regret that owing to commitments connected with our Party Conference I am not able to attend the meeting myself. But Peter Lilley will be attending in my place and I have had the opportunity to discuss the issues very fully with him.

The progress made under your Presidency is admirable and a remarkable achievement. I am most keen that the United Kingdom should work with you to reach a satisfactory outcome. It may be helpful to you to know that I find the draft conclusions generally acceptable, subject to two points.

Firstly, the reference in the second paragraph to levying tax in the country of consumption "for a transitional period" gives unnecessary encouragement to those who would wish to move quickly to an origin basis of tax.

Secondly, for reasons you will be familiar with, I fear that I cannot accept the references in item 2 of the numbered items to approximation of rates and to determination of the level and extent of variation of rates. As you know, I strongly favour and have publicly advocated substantial increases in travellers' allowances. I hope we could agree on a formula which would enable the United Kingdom to give its support to this important aim without having to register dissent on approximation.

Yours ever
Nigel

NIGEL LAWSON

CHANCELLOR OF THE EXCHEQUER

PMP

Ch/

**Fiscal frontiers**

You asked whether we knew the nationality of the Commission official who drafted the excellent note on the economics of indirect tax harmonⁿ.

You will not be surprised to learn that it was drafted by a Brit, Michael Emerson (who is a senior economic adviser at the Comm.).

JH

17/10

As I suspected! (But shows how important it is for us to get more Brits into key EC posts) -

FROM: J M G TAYLOR

DATE: 6 October 1989

MR UNWIN - Customs & Excise

cc PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Wicks
Mr R I G Allen
Mr Culpin

Mr Jefferson Smith - C&E
Mr Wilmott - C&E
Mr Allen - C&E
Mr Vernon - C&E

**THE ECONOMICS OF INDIRECT TAXATION HARMONISATION**

The Chancellor was grateful for your note of 5 October. He thought the enclosed document was an excellent paper. (He has asked, incidentally, what is the nationality of the author).

J M G TAYLOR

**CONFIDENTIAL**

HM CUSTOMS AND EXCISE
SINGLE MARKET UNIT
NEW KING'S BEAM HOUSE, 22 UPPER GROUND
LONDON SE1 9PJ
01-620 1313

1992

**FROM: P R H ALLEN**
**SINGLE MARKET UNIT**
**DATE: 12 October 1989**

Thanks.

**CHANCELLOR**

**INDIRECT TAXATION IN THE SINGLE MARKET: THE NEXT STAGE**

Following the general endorsement on 9 October by ECOFIN of the Ad Hoc Group's report and the further remit given to the Group, you may find helpful our analysis of the likely course of events over the next couple of months and the implications for the overall negotiating strategy.

2. The Ad Hoc Group is scheduled to meet twice between now and the next ECOFIN on 13 November, when it is due to report back. The October ECOFIN gave it a heavy remit which it will have difficulty in meeting. We consider that it will concentrate on developing the technical VAT system in order to rebut the Commission's claims that the destination system will be either too fraud-prone, too burdensome to businesses, or both. The need to achieve this balance should help us in our efforts to arrive at arrangements that will be both effective against fraud, but yet avoid the compliance and administrative costs which could arise from variants of the French proposals involving high levels of monitoring and checking.

---

cc Financial Secretary
Economic Secretary
Paymaster General
Sir P Middleton
Mr Wicks
Mr Evans
Mr Scholar
Mr R I G Allen
Mr Culpin
Mr Gilhooly
Mrs Brown
Mr White
Mr Michie
Mrs Chaplin
Mr Tyrie

CPS
Mr Jefferson Smith
Mrs Strachan
Mr Nash
Mr Wilmott
Ms Seammen
Mr Cockerell
Mr Trevett
Mr Savins
Mr Brown
Mr Gaw
Mr Kent
Mr Pratt
Mr Knox
Mr Railton

Sir D Hannay, UKREP
Mr Kerr, FCO
Mr Hadley, Cabinet Office

3. We also expect the special arrangements for vehicles and mail order to be examined in more detail - to placate the Germans. This, too, could be helpful in providing an incentive for simplified systems.

4. The French Presidency are likely to aim at bringing the technical systems for excise duties to the stage of outline proposals: i.e. the same state the VAT proposals are now. If we could get to this stage by the November ECOFIN and with a similar degree of unanimity as on VAT, this would be a considerable achievement. The chances of getting this far are about even.

5. The Ad Hoc Group is also required to consider tax approximation in the context of free movement of private individuals, taking account of the budgetary problems caused by tax approximation to certain Member States. We shall continue to argue that tax approximation is inappropriate (the recent DGII economic analysis is helpful here) and unnecessary. We shall continue to press for a quantitative limit to distinguish between genuine private cross-broder shopping and quasi-commercial transactions. We doubt whether discussions on tax rates will advance much, if at all. It also seems unlikely that there will be any serious development on the Irish and Danish budgetary issues.

6. It seems likely, therefore, that the Ad Hoc Group report to ECOFIN on 13 November will show useful technical progress, but little movement on tax rates. Because of the very full agenda, November ECOFIN will have little time to discuss the subject.

7. However, the French are clearly determined to have a serious discussion on rates before the end of their Presidency. It is unlikely that they envisage a detailed settlement of the indirect tax dossier, but they appear to be seeking broad lines of agreement on tax rates and rate structures as well as technical arrangements, so that subsequent Presidencies have a tight framework within which to work. While it may be too early to expect an agreement of this sort to be achieved, there is a possibility (which Sir David Hannay feels is a real one) that we could get a good deal under the French Presidency, that would give us pretty well all that we want on the essentials.

8. It will be difficult to avoid the issue being raised at the Strasbourg Council even though it will precede the December ECOFIN. The French might well be aiming for agreement in principle at Strasbourg with the formal terms being adopted at ECOFIN. You may well, therefore, need to consider after the November ECOFIN what advice to give the Prime Minister for the Council.

9. Our own view, therefore, is that our best tactics will continue to be to negotiate enthusiastically on the technical arrangements, while playing a dead bat to tax rate issues. We already sense that our successful use of these tactics has increased the French desire to pin us down on tax approximation. To that extent, continued success is likely to make them keener for a full discussion at Ministerial level on tax rates. However, if you agree, we shall continue on these lines, which are consistent with the strategy suggested in Mr Jefferson Smith's submission of [17] September.

10. I should also raise briefly two other related issues:-

(i) Press briefing Coverage of the October ECOFIN by some of the "heavies" was not helpful to us. Indeed, inaccurate and disingenuous Commission briefing was swallowed by some hook, line and sinker. The Brussels correspondents were the worst, but we feel it also worth while having a go at putting the record straight with appropriate journalists here and in Brussels. At this point, we think that the most effective method would be to provide punchy counter-briefing material for press offices here and in UKREP to use pro-actively. But if that fails to have the desired effect, there may be advantage in arranging an informal press briefing with senior officials (on the lines of the one the Chairman took this time last year when you circulated your ECOFIN paper) to ensure our side of the story gets across, around the time of the November ECOFIN.

(ii) Parliamentary debate The Select Committee on European Legislation recommended for debate the Commission Communication which covered Mme Scrivener's revised proposals. Under the procedural rules, we need to let the Select Committee know shortly about the timing of a debate. There is, of course, no compulsion to agree to a debate by a particular deadline, but we would have to provide reasons. There would undoubtedly be a Parliamentary furore if the UK agreed to a deal on this highly sensitive dossier without a debate (which would breach the procedural rules agreed between the Government and the Select Committee). This could make it more difficult to "sell" any compromises the UK might have to make during the negotiations. Of course, much depends on your assessment of the likelihood of an agreement being reached in December, but having a debate before the Strasbourg Council would seem to be a prerequisite for keeping the option available. A debate, on the lines which we could expect, should also do the UK's negotiating position no harm - whether we were in serious negotiation or stonewalling. If you agree, therefore, we suggest that consideration should be given to asking the business managers to arrange a short debate during November.

RA.

P R H ALLEN

CONFIDENTIAL

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

P Jefferson Smith
*Deputy Chairman*

Ch / Content for C+E to approach business managers as at (d), over? Content also for them to brief press, as at (c)? 12/12

OK to (c). As to (d), OK to warn business managers on a contingency basis that I fear that we will want to [illegible] or undertake we will play if we do, the debate [illegible] for 2½ Nov.

FROM: P JEFFERSON SMITH
DATE: 12 OCTOBER 1989

CHANCELLOR

**INDIRECT TAXATION IN THE SINGLE MARKET: THE NEXT STAGE**

1. On the whole the October ECOFIN went quite well for us. The destination principle was accepted, under a formula to placate the Germans, "for a limited period"; but that phrase seems better to me than the Presidency proposal of "transitional". The Commission has failed to shake the Member States' consensus; and its criticisms of the potential bureaucracy involved in policing the destination system are helpful to the UK in resisting bureaucratic accretions that may be proposed by others.

2. The point on which we did not get our way was our attempt to break the link between travellers' allowances and rate approximation: despite your letter to Beregovoy, the French were unhelpful to us. This seems to be a deliberate plan to keep the approximation issue alive: if they let it slide off the agenda, the UK will as they see it get all it wants and will pay no price.

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| Distribution | | |
|---|---|---|
| | Financial Secretary | CPS |
| | Economic Secretary | Mrs Strachan |
| | Paymaster General | Mr Nash |
| | Sir P Middleton | Mr Wilmott |
| | Mr Wicks | Ms Seammen |
| | Mr Evans | Mr Cockerell |
| | Mr Scholar | Mr Trevett |
| | Mr R I G Allen | Mr Savins |
| | Mr Culpin | Mr Brown |
| | Mr Gilhooly | Mr Gaw |
| | Mrs Brown | Mr Kent |
| | Mr White | Mr Pratt |
| | Mr Michie | Mr Knox |
| | Mrs Chaplin | Mr Railton |
| | Sir D Hannay, UKREP | |
| | Mr Kerr, FCO | |
| | Mr Hadley, Cabinet Office | |

3. Mr Allen's note (attached) looks ahead. The main points are:

(a) we can continue discussing technical matters in the ad hoc group, and there will be a further report to the November ECOFIN. You expressed concern about overloading that meeting, and I cannot see how it can do more than note and endorse progress without substantive debate;

(b) we must expect substantive discussion of a broad solution at the Strasbourg Council; after the November ECOFIN, you will almost certainly, therefore, need to consider what advice to give the Prime Minister, especially on the minimum rates issue;

(c) the Commission has done rather too well in misrepresenting the destination system proposals to the press; we intend to counter-brief;

(d) <u>if</u> there is to be the possibility of a settlement at Strasbourg - and we <u>might</u> want this, as being a good deal which would dispose of what would otherwise be a long running cause of dissension - a necessary preliminary would be a short debate in the House of Commons in November, to meet the recommendation of the Select Committee.

4. We ask you to note (a), (b) and (c); and for your authority to approach the business managers over (d).

P J

P JEFFERSON SMITH

FROM: J M G TAYLOR
DATE: 16 OCTOBER 1989

MR P JEFFERSON SMITH - C&E

cc PS/Financial Secretary
PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr H P Evans
Mr Scholar
Mr R I G Allen
Mr Culpin
Mr Gilhooly
Mrs Brown
Mr White
Mr Michie
Mrs Chaplin

Sir D Hannay - UKREP
Mr Kerr - FCO
Mr Hadley - CO

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

**INDIRECT TAXATION IN THE SINGLE MARKET: THE NEXT STAGE**

The Chancellor was grateful for your note of 12 October, and for Mr Allen's note of the same date.

2. He is content for you to arrange press briefing along the lines proposed. As far as a possible debate is concerned, he is content for you to warn the business managers on a contingency basis, though he feels it unlikely that we will want to play it this way. If we do, however, the debate should be held in the second half of November.

J M G TAYLOR

CONFIDENTIAL

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

PMP

(dealt with FRX)

FROM: MRS V P M STRACHAN

DATE: 20 OCTOBER 1989

CHANCELLOR

**INDIRECT TAXATION IN THE SINGLE MARKET: ZERO RATES**

You agreed that our response to Mme Scrivener's less than clear proposals to retain zero rates was to let the Commission initiate discussions. Constans (Mme Scrivener's chef de cabinet) has now contacted UKREP suggesting a meeting at senior official level with him to discuss the zero rate issue before ECOFIN on November 13. UKREP have the impression that he wants an early meeting ie before the Commission "half term" on 1 to 3 November.

2. While we have considerable doubts as to the likelihood of this issue being discussed in any depth at the November 13 ECOFIN, we strongly favour agreeing to a meeting. Not least because in the past the Commission have been quick to tell UK groups lobbying to retain zero rates that the UK Government has not entered into discussions on this question. In view of the Commission's current mood of hostility to the Council on this dossier, we could expect them to make political capital out of a refusal to meet.

---

| cc | | |
|---|---|---|
| cc | Paymaster General | CPS |
| | Economic Secretary | Mr Jefferson Smith |
| | Sir P Middleton | Mr Nash |
| | Mr Wicks | Mr Wilmott |
| | Mr Scholar | Ms Seammen |
| | Mr Culpin | Mr P R H Allen |
| | Mr R I G Allen | |
| | Mrs Chaplin | Mr Bonney UKREP |
| | Mr Tyrie | |

3. Although it is unlikely that the Ad Hoc Group will have made sufficient progress, nor ECOFIN have sufficient time, to consider an overall conclusion of this issue, the 9 October ECOFIN clearly envisaged this possibility. So we feel it advisable to avoid Commission accusations of being obstructive, by trying to meet their proposed timetable. If you agree, Brian Unwin, Peter Jefferson Smith or I could meet Constans.

4. Our approach to the meeting would be to get Constans to clarify the definition of what zero rates could be maintained (if possible, to get him to indicate what UK zero rates he thought were covered by it). We would also want clarification of the basis of the retention of zero rating - ie do the Commission envisage a permanent place for zero rating in the VAT system or are they after some form of derogation (and on what terms)? We would steer well clear of any discussion of batting order of UK zero rates, but would be prepared to explain the reasons (sometimes of a fairly technical nature) why they are applied. We would insist on the meeting being kept confidential and on an entirely technical "without prejudice" basis: we understand that this is Constans' intention, too.

5. I would welcome your early agreement that we could proceed with this meeting on the basis set out above. We would, of course, report back in full on the discussions.

**MRS V P M STRACHAN**

CONFIDENTIAL

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

Ch/ OK? 29/10

OK – provided clear that [illegible] our stance is clarification (x) & Rev (as per the UK's posn) is fully reserved [illegible]

FROM: MRS V P M STRACHAN
DATE: 20 OCTOBER 1989

CHANCELLOR

## INDIRECT TAXATION IN THE SINGLE MARKET: ZERO RATES

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2. While we have considerable doubts as to the likelihood of this issue being discussed in any depth at the November 13 ECOFIN, we strongly favour agreeing to a meeting. Not least because in the past the Commission have been quick to tell UK groups lobbying to retain zero rates that the UK Government has not entered into discussions on this question. In view of the Commission's current mood of hostility to the Council on this dossier, we could expect them to make political capital out of a refusal to meet.

---

cc Paymaster General
Economic Secretary
Sir P Middleton
Mr Wicks
Mr Scholar
Mr Culpin
Mr R I G Allen
Mrs Chaplin
Mr Tyrie

CPS
Mr Jefferson Smith
Mr Nash
Mr Wilmott
Ms Seammen
Mr P R H Allen

Mr Bonney UKREP

**CONFIDENTIAL**

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4. Our approach to the meeting would be to get Constans to clarify the definition of what zero rates could be maintained (if possible, to get him to indicate what UK zero rates he thought were covered by it). We would also want clarification of the basis of the retention of zero rating - ie do the Commission envisage a permanent place for zero rating in the VAT system or are they after some form of derogation (and on what terms)? We would steer well clear of any discussion of batting order of UK zero rates, but would be prepared to explain the reasons (sometimes of a fairly technical nature) why they are applied. We would insist on the meeting being kept confidential and on an entirely technical "without prejudice" basis: we understand that this is Constans' intention, too.

There is, of course, a risk that it will leak anyway.

5. I would welcome your early agreement that we could proceed with this meeting on the basis set out above. We would, of course, report back in full on the discussions.

[signature]

MRS V P M STRACHAN

FROM: J M G TAYLOR
DATE: 23 OCTOBER 1989

MRS V P M STRACHAN - C&E

cc PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr Scholar
Mr Culpin
Mr R I G Allen
Mrs Chaplin
Mr Tyrie

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

Mr Bonney - UKREP

**INDIRECT TAXATION IN THE SINGLE MARKET: ZERO RATES**

The Chancellor was grateful for your note of 20 October.

2. He is content for you to proceed on the basis which you set out - provided that it is made clear that what we are seeking from the Commission is clarification, and that the UK's position is fully reserved.

J M G TAYLOR

**PERSONAL & CONFIDENTIAL**

FROM: N L WICKS
DATE: 23 OCTOBER 1989
Ext : 4369

CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr H P Evans

ANX B
WICKS
23/10

**YOUR TALK WITH WAIGEL**

As background for your talk with Waigel, you should know of my conversation with Tietmeyer at Friday's Monetary Committee meeting in Lisbon.

2. Tietmeyer said that there were those (Delors, Genscher and the French) who were using the developments in Eastern Europe to put pressure on Kohl on EMU. They argued that those developments, which inevitably drew German eyes eastwards, made it necessary to provide conviction that Germany still saw her destiny as lying in the Community. To do that, Germany had to give renewed evidence of her attachment to the Community - that meant pushing ahead fast with EMU as a prelude to European union.

3. Tietmeyer said that both Waigel and himself were telling Kohl that moves to EMU beyond Stage 1 were premature. Certainly the objectives and the prescription in the Delors Report were valid, but it was not necessary to take decisions on implementation until well on into the next decade. Tietmeyer thought that the UK would then be confronted with the difficult choice - did we wish to join the "hard core" of the Community who wished to press ahead or move to the periphery. But it was quite unnecessary to confront us now with that choice.

4. Tietmeyer went on to say that Waigel had been putting these points to Kohl in his capacity as Minister of Finance. There would come a time when he would need to decide whether to ventilate them (presumably publicly) in his capacity as leader of one of the three coalition parties.

N.L.W.

N L WICKS

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MDHIAN 1110

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FRAME ECONOMIC

TAXATION OF SAVINGS: AD HOC WORKING PARTY: 23 OCTOBER

SUMMARY

1. DETAILED TECHNICAL DISCUSSION OF NEW PRESIDENCY WORKING PAPER. DIFFERENCES REMAIN ON DEFINITION OF CIRCUMSTANCES IN WHICH EXCHANGE OF TAX INFORMATION SHOULD TAKE PLACE AND PARTICULARLY IN WHAT CASES, IF ANY, MEMBER STATES SHOULD BE REQUIRED TO SUPPLY INFORMATION TO OTHERS THAT THEY CANNOT OBTAIN FOR THEIR OWN PURPOSES. ON JUDICIAL ASSISTANCE, LUXEMBOURG REQUIRED CLARIFICATION OF TERRITORIAL APPLICABILITY OF COUNCIL OF EUROPE CONVENTION/PROTOCOL. NO MAJOR PROBLEMS ON NATIONAL MEASURES, WHICH THE PRESIDENCY DESCRIBED AS OPTIONAL, OR INTERNATIONAL COOPERATION. CONTINUED MIXTURE OF SCEPTICISM AND SUPPORT FOR TWO YEARLY COMMISSION PROGRESS REPORTS. FURTHER MEETING ON 31 OCTOBER BEFORE REPORTING TO COREPER AND THENCE TO NOVEMBER ECOFIN.

DETAIL

2. THE PRESIDENCY PROPOSED THAT THE MEETING SHOULD GO THROUGH THE DRAFT COUNCIL CONCLUSIONS IN ANNEX II OF ITS NEW WORKING PAPER NO. SN3196/1/89 OF 18 OCTOBER (PARAGRAPH NUMBERS IN THE TEXT BELOW REFER TO ANNEX II.

GENERAL COMMENTS

3. IN GENERAL PRELIMINARY REMARKS, ITALY CLAIMED THAT AGREEMENT ON MUTUAL ASSISTANCE MEASURES WAS NOT ENOUGH ON ITS OWN SIGNIFICANTLY TO REDUCE THE RISK OF FRAUD AFTER THE LIBERALISATION OF CAPITAL MOVEMENTS. THERE SHOULD ALSO BE A COMMUNITY WIDE TAX ON INTEREST INCOME. ITALY HAD A PROPOSAL FOR THE TAX TO BE PAID DIRECT TO THE COMMUNITY AND THEN DEDUCTED FROM MEMBER STATES OWN RESOURCES CONTRIBUTIONS (AN ITALIAN NOTE WILL BE CIRCULATED IN THE NEXT FEW DAYS). IRELAND AGREED THATY AN EC WIDE WITHHOLDING TAX WAS REQUIRED.

4. LUXEMBOURG DID NOT ACCEPT THAT THERE WAS ANY GREAT RISK OF FRAUD AS A RESULT OF THE LIBERALISATION OF CAPITAL MOVEMENTS. ANY EC

WIDE WITHHOLDING TAX WOULD SIMPLY DRIVE CAPITAL OUT OF THE COMMUNITY. IT WAS UP TO THOSE MEMBER STATES WHO FEARED A MASSIVE OUTFLOW OF CAPITAL TO TAKE MEASURES PROVIDED FOR UNDER ARTICLE IV OF THE CAPITAL MOVEMENTS DIRECTIVE.

5. THE UK NOTED THAT ITS POSITION ON WITHHOLDING TAX WAS WELL KNOWN. ON PROCEDURE FOR TODAY'S MEETING, THE UK HOPED THAT DISCUSSION COULD BE LIMITED TO TECHNICAL EVALUATION OF THE PROPOSALS. THE NEW PRESIDENCY'S WORKING PAPER HAD NOT BEEN CIRCULATED IN TIME FOR MINISTERS TO GIVE VIEWS ON THE POLICY IMPLICATIONS. PRESIDENCY AGREED THAT THE DISCUSSION SHOULD FOCUS ON PREPARING THE GROUND TECHNICALLY FOR POLITICAL DISCUSSION AT THE NOVEMBER ECOFIN.

JUDICIAL ASSISTANCE (PARA 8)

6. THE UK NOTED THAT THE LANGUAGE IN THE NEW WORKING PAPER WENT FURTHER THAN BEFORE. THE UK WAS NOT IN A POSITION AS YET TO ACCEPT A GENERAL COUNCIL REQUEST TO SIGN/RATIFY THE COUNCIL OF EUROPE CONVENTION. LEGISLATION HAD TO BE PUT BEFORE PARLIAMENT FIRST. BUT THE UK HAD NO PROBLEM IN PRINCIPLE WITH SIGNING/RATIFICATION. LUXEMBOURG NOTED THAT THE PROTOCOL ALLOWED STATES TO ENTER RESERVATIONS. THERE SHOULD THEREFORE BE AGREEMENT AMONGST MEMBER STATES ON THE DEFINITION IN THE PROTOCOL OF ''TAX OFFENCE'' AND ITS TERRITORIAL APPLICABILITY IN VIEW OF THE FACT THAT SOME MEMBER STATES HAD EXEMPTED PARTS OF THEIR TERRITORY. (COMMISSION TOLD UK IN THE MARGINS THAT THIS WAS A REFERENCE TO THE NETHERLANDS, ANTILLES).

NATIONAL MEASURES (PARAS 9-11)

7. ON DECLARATIONS OF CAPITAL MOVEMENTS, DENMARK ASKED FOR NEW WORDING RECALLING THAT IN CERTAIN MEMBER STATES SUCH PROCEDURES WERE ALREADY IMPLEMENTED THROUGH A GENERALISED SYSTEM OF STATUTORY REPORTING THROUGH FINANCIAL INSTITUTIONS. ON THE REQUIREMENT FOR EXPLICIT ASSURANCES IN TAX RETURNS THAT TAXABLE INCOME FROM SAVINGS HAD BEEN DECLARED, THE PRESIDENCY SAID THAT IT SHOULD BE UP TO MEMBER STATES TO DECIDE THE PRECISE FORM OF SUCH ASSURANCES. GREECE NOTED THAT INCOME FROM SAVINGS WAS NOT TAXABLE IN GREECE. IT COULD THEREFORE ACCEPT THE TEXT IF IT WAS NOTED THAT THE REQUIREMENT DID NOT APPLY TO COUNTRIES WHICH DO NOT TAX SAVINGS. SPAIN AND PORTUGAL NOTED THEIR CONTINUING SCEPTICISM ABOUT THE EFFECTIVENESS OF THESE ASSURANCES OR (PARA 11) THE REQUIREMENT FOR INTEREST PAYING AGENTS TO REMIND TAX PAYERS OF THEIR OBLIGATIONS. THE UK NOTED THAT GOVENMENTS COULD RECOMMEND THAT INTEREST PAYING AGENTS ISSUED REMINDERS BUT THAT ULTIMATELY THIS WOULD HAVE TO BE LEFT TO THE AGENTS THEMSELVES. THE PRESIDENCY NOTED THAT THESE MEASURES SHOULD

BE REGARDED AS OPTIONAL. THEY WERE NOT DESIGNED TO SOLVE THE PROBLEMS OF FRAUD ON THEIR OWN BUT WOULD BE A USEFUL ADDITION TO OTHER MEASURES.

INTERNATIONAL COOPERATION (PARA 12)

8. THE PRESIDENCY EXPLAINED THAT THE NEW DRAFT TOOK ACCOUNT OF THE UK REQUIREMENT THAT THERE SHOULD NOT BE AN IMPLICATION IN THE TEXT THAT THE COMMISSION SHOULD NEGOTIATE ON MEMBER STATES BEHALF IN INTERNATIONAL FORA SUCH AS THE OECD. BELGIUM ASKED FOR THE INCLUSION OF A REFERENCE TO COOPERATION WITHIN THE FRAMEWORK OF THE IMF.

EXTENSION OF NEUTRAL ASSISTANCE TO DIRECTIVE TO COVER TAXES ON INHERITANCE AND GIFTS (PARA 1)

9. LUXEMBOURG NOTED THAT IT HAD TECHNICAL AND LEGAL DOUBTS. THE UK WAS STILL AWAITING LEGAL ADVICE ON WHETHER THE TREATY PERMITTED THIS EXTENSION. THE COMMISSION SAID THAT ITS OWN LEGAL ADVICE INDICATED THAT THE EXTENSION WAS FULLY JUSTIFIED.

BI-ANNUAL COMMISSION REPORTS (PARA 4)

10. NO NEW POINTS WERE MADE BY MEMBER STATES. THE PRESIDENCY SAID THAT THE REPORT OF THE MEETING WOULD NOTE THE RESERVATIONS OF THE UK AND OTHERS ABOUT THE USEFULNESS OF TWO YEARLY COMMISSION REPORTS. THE COMMISION CLAIMED THAT THERE WOULD BE NO ADDITIONAL ADMINISTRATIVE BURDEN ON MEMBER STATES TAX ADMINISTRATIONS. ARTICLE 10 OF THE MUTUAL ASSISTANCE DIRECTIVE ALREADY IMPOSED AN OBLIGATION ON MEMBER STATES TO EXCHANGE INFORMATION ON MUTUAL ASSISTANCE. ALL THAT WAS NOW PROPOSED WAS A DRAWING TOGETHER BY THE COMMISSION OF SUCH INFORMATION.

EXCHANGE OF TAX INFORMATION (PARA 2)

11. THE PRESIDENCY ASKED FOR DISCUSSION TO CENTRE ON HOW TO DEFINE THE FRAMEWORK IN WHICH EXCHANGE OF INFORMATION SHOULD TAKE PLACE AFTER THE ABOLITION OF THE ''ADMINISTRATIVE PRACTICES'' CAVEAT IE. WHAT DID ''SPECIFIC PRESUMPTIONS THAT ASSETS OF A CONSIDEABLE AMOUNT OR THE CORRESPONDING INCOME... HAVE NOT BEEN DECLARED'' MEAN. SOME PRESIDENCY SUGGESTIONS ON DEFINITION INCLUDING A SPECIFIC FIGURE FOR ''CONSIDERABLE AMOUNT'' WERE IN ANNEX III OF THE WORKING PAPER. THE COMMISSION SUPPORTED BY GERMANY, GREECE AND THE UK ARGUED THAT ''CONSIDERABLE AMOUNT'' SHOULD NOT BE DEFINED PRECISELY. THE UK NOTED THAT WHAT WOULD CONSTITUTE A CONSIDERABLE AMOUNT WOULD VARY FROM COUNTRY TO COUNTRY, FROM TAXPAYER TO TAXPAYER AND FROM CASE TO CASE. HOWEVER THE PROPOSED AMENDMENTS TO THE MUTUAL ASSISTANCE DIRECTIVE SHOULD GIVE SOME DEFINITION ON HOW TO DEFINE

''CONSIDERABLE'' OR ''SIGNIFICANT'' BY INCLUDING A REFERENCE TO PROPORTIONALITY. ACCOUNT SHOULD BE TAKEN OF THE ADMINISTRATIVE COSTS TO NATIONAL TAX BODIES, THE COMPLIANCE BURDENS ON INDIVIDUAL TAXPAYERS/FINANCIAL INSTITUTIONS, WHEN DECIDING WHETHER INFORMATION SHOULD BE SOUGHT. FRANCE ITALY AND IRELAND ALL WANTED A SPECIFIC FIGURE FOR ''CONSIDERABLE AMOUNT''. GERMANY SUGGESTED THAT ONE SOLUTION MIGHT BE TO SPECIFY NO FIGURE AT THIS STAGE BUT FOR THE COMMISSION TO CONSIDER IN ITS FIRST TWO YEARLY REPORT WHETHER SUCH A FIGURE WAS NEEDED. A NUMBER OF DELEGATIONS HAD DIFFICULTIES WITH THE WORDING ''SPECIFIC PRESUMPTION''. THE PRESIDENCY NOTED THAT THIS WAS PURELY A DRAFTING PROBLEM. THERE WAS NO DISAGREEMENT ABOUT THE SUBSTANCE.

12. THE PRESIDENCY NOTED THAT THE NEW DRAFT COVERED THE NEED FOR EXCHANGE OF INFORMATION ABOUT ASSETS AS WELL AS THE INCOME ARISING FROM THEM, AS REQUIRED BY THE FRENCH DELEGATION AT THE LAST WORKING GROUP MEETING. GERMANY WANTED A CLEARER DEFINITION OF WHAT ASSETS WERE INVOLVED. IT HOPED THAT ONLY FINANCIAL ASSETS AND INCOME THEREFROM (BANK ACCOUNTS/EQUITIES/SECURITIES) AND NOT EG RENTAL FROM PROPERTY WERE COVERED. SPAIN AND ITALY HOPED THAT ALL ASSETS ARISING FROM FRAUDULENT CAPITAL TRANSFERS WOULD BE COVERED. THE UK SUGGESTED THAT THE DIRECTIVE SHOULD SIMPLY COVER INTEREST INCOME/CAPITAL GAINS/CAPITAL TRANSFERS NOT DECLARED FOR TAX PURPOSES.

BANKING SECRECY (PARA 5)

13. THE PRESIDENCY ASKED THAT DISCUSSION SHOULD FOCUS ON THE DEFINITION OF THE CIRCUMSTANCES IN WHICH MEMBER STATES MIGHT BE REQUIRED TO PRODUCE INFORMATION FOR OTHERS THAT THEY CANNOT OBTAIN FOR THEMSELVES IE WHAT CONSTITUTED ''VERY SERIOUS FRAUD''. THE PRESIDENCY NOTED THAT THERE WERE TWO PROPOSALS ON THE TABLE, ITS OWN DEFINITION AT ANNEX IV OF THE WORKING PAPER AND THE COMMISSION'S APPROACH WHICH WAS TO HAVE NO PRECISE DEFINITION OF VERY SERIOUS FRAUD BUT TO LEAVE THIS TO THE COUNTRY MAKING THE REQUEST. UNDER THE COMMISSION PROPOSAL THE COUNTRY FROM WHOM THE INFORMATION WAS REQUESTED WOULD HAVE NO RIGHT TO CHALLENGE THE DEFINITION. BUT IT COULD HAVE RECOURSE TO A JUDICIAL DECISION ON WHETHER THE EVIDENCE SUBMITTED BY THE REQUESTING COUNTRY WAS SUFFICIENT TO JUSTIFY LIFTING THE VEIL OF BANKING SECRECY. FRANCE, IRELAND AND ITALY WANTED A PRECISE DEFINITION OF ''VERY SERIOUS FRAUD'' INCLUDING THE SETTING OF A SPECIFIC FIGURE. ITALY WAS OPPOSED TO THE SAFETY NET OF JUDICIAL AUTHORISATION. GREECE AND GERMANY SUPPORTED THE COMMISSION APPROACH BUT GERMANY NOTED THAT THE PERSONAL RIGHTS OF INDIVIDUALS TO WITHHOLD INFORMATION SHOULD CONTINUE TO BE PROTECTED. THE UK WHILE RESERVING ITS POSITION ON THE POLICY IMPLICATIONS OF THE

PROPOSAL, COMMENTED THAT THE PRINCIPLE OF PROPORTIONALITY SHOULD AGAIN BE TAKEN INTO ACCOUNT. THERE SHOULD ALSO BE SOME REFERENCE TO A TIME LIMIT (PREVENTING A STATE REQUESTING INFORMATION THAT WAS MANY YEARS OLD). ON JUDICIAL AUTHORISATION THE UK NOTED THAT JUDGES WOULD EXPECT TO HAVE FULL SCOPE TO EXAMINE ALL ASPECTS OF ANY REQUEST FROM ANOTHER MEMBER STATE AND NOT JUST THE QUALITY OF THE EVIDENCE. THERE MIGHT ALSO BE A PROBLEM ABOUT PARTICULAR TAXES. SHOULD A MEMBER STATE BE OBLIGED TO GIVE OUT INFORMATION IN RESPECT OF TAXES WHICH IT DID NOT APPLY DOMESTICALLY?

FUTURE WORK

14. THE PRESIDENCY NOTED THAT A FURTHER MEETING OF THE WORKING GROUP ON 31 OCTOBER WOULD BE REQUIRD TO IRON OUT REMAINING TECHNICAL PROBLEMS BEFORE REPORTING VIA COREPER TO NOVEMBER ECOFIN COUNCIL.

HANNAY

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23/10/89.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

The subjects for discussion are

1. EMU
2. Indirect taxation
3. Taxation of savings / mutual assistance
4. Economy, G7, interest rates (the last of which Waigel has specifically added)
5. Eastern Europe.

In addition to Tietmeyer, Waigel will have his secretary, an interpreter and Dr Pieske, head of the monetary division of the Ministry.

It will start in restricted session with just Waigel & Tietmeyer.

chex.dc/jg/31



FROM: JOHN GIEVE
DATE: 24 OCTOBER 1989

PCP

MR N L WICKS

**TALK WITH WAIGEL**

The Chancellor was grateful for your minute of 23 October.

JG

JOHN GIEVE

105470
MDHIAN 1176

This is now — a v. [illegible]

RESTRICTED
FM UKREP BRUSSELS
TO DESKBY 241000Z FCO
TELNO 3171
OF 240835Z OCTOBER 89
INFO ROUTINE EUROPEAN COMMUNITY POSTS, STRASBOURG, UKDEL OECD
INFO ROUTINE WASHINGTON

FRAME ECONOMIC

MY TELNO 3169: TAXATION OF SAVINGS

1. THE ITALIAN ATTEMPT TO BREATH LIFE INTO THE CORPSE OF THE WHITHHOLDING TAX IS IRRITATING, NOT LEAST TO THE FRENCH PRESIDENCY WHO WERE POISED TO COMPLETE AT THE NOVEMBER ECOFIN A SLEIGHT OF HAND SUBSTITUTION OF INCREASED MUTUAL ASSISTANCE IN PLACE OF THE TAX. IF THE ITALIAN MOVE GETS SUPPORT FROM SOME OF THE OTHER MAIN PROTAGONISTS OF THE TAX (SPAIN, BELGIUM), FRENCH EMBARRASSMENT WILL BE ALL THE GREATER.

2. THE MOVE IS ALSO LIKELY TO COMPLICATE OUR OWN OBJECTIVE OF GETTING THE COMMISSION FORMALLY TO WITHDRAW ITS WITHHOLDING TAX PROPOSAL AS PART AND PARCEL OF AN AGREEMENT ON BALANCED MUTUAL ASSISTANCE. WE SHALL NOW NEED TO FIRM UP THAT LINK AT THE NEXT WORKING GROUP AND AT COREPER AND NOT SIMPLY WAIT FOR IT TO BE DELIVERED TO US.

[illegible]

3. IT WOULD PROBABLY ALSO MAKE SENSE FOR THERE TO BE A BILATERAL CONTACT WITH THE FRENCH SO THAT THEY HAVE A CLEAR UNDERSTANDING OF OUR POSITION. WE WILL MAKE SURE THAT MME SCRIVENER IS IN NO DOUBT ABOUT THE NEED TO DELIVER ON HER UNDERTAKING ABOUT WITHDRAWAL GIVEN TO ME WHEN WE LAST MET. (MY TEL NO 2920).

HANNAY

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MDHIAN 11

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MDHIAN 1280

ANX A MALLABY TELEGRAM

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FM BONN
TO DESKBY 241730Z FCO
TELNO 1012
OF 241704Z OCTOBER 89
INFO ROUTINE UKREP BRUSSELS, OTHER EC POSTS

FRAME ECONOMIC

FEDERAL GERMAN VIEWS ON ECONOMIC AND MONETARY UNION (EMU)

PART I OF II

SUMMARY
1. THE FEDERAL GOVERNMENT HAS YET TO AGREE A CLEAR LINE WHEN AND UNDER WHAT CONDITIONS AGREEMENT SHOULD BE GIVEN TO AN INTER-GOVERNMENTAL CONFERENCE. DESPITE INTENSIVE CONSULTATION BETWEEN FEDERAL MINISTRIES AND THE BUNDESBANK TO COORDINATE THE GERMAN POSITION IN THE HIGH LEVEL GROUP, ARGUMENTS CONTINUE ABOUT THE PACE OF PROGRESS TOWARDS EMU. GENSCHER, THE ADVOCATE OF SPEED, APPEARS TO HOLD THE UPPER HAND WHILE WAIGEL, MUCH MORE CAUTIOUS, NEGOTIATES DETAIL WITH THE BUNDESBANK. KOHL IS KEEPING HIS OPTIONS OPEN, AND MAY DO SO FOR SOME TIME.

DETAIL
2. AFTER CALLS BY MY STAFF ON THE FEDERAL CHANCELLERY, AUSWAERTIGES AMT, FINANCE MINISTRY AND BUNDESBANK, I ASSESS THE POSITION HERE AS FOLLOWS:

- THE POLITICAL AND TECHNICAL SIDES OF THE DEBATE REMAIN LARGELY UNTOUCHED BY ONE ANOTHER, AND THE GOVERNMENT HAS YET TO SEEK A BALANCE BETWEEN THEM,

- THE POLITICAL ARGUMENTS FOR EMU AS THE GOAL AND THE DELORS REPORT AS THE METHOD ARE WIDELY KNOWN AND APPROVED. THEIR ECONOMIC SIGNIFICANCE FOR GERMANY AND THE CHANGES THEY WOULD BRING ARE LITTLE UNDERSTOOD AND LARGELY IGNORED.

- THERE IS NO COHERENT PLAN IN THE GOVERNMENT OR THE BUNDESBANK ABOUT GERMAN PRE-CONDITIONS FOR THE CONVENING OF AN INTER-GOVERNMENTAL CONFERENCE, LET ALONE A DECISION ON A TARGET DATE FOR A CONFERENCE.

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MDHIAN 1280

THE POLITICAL CONTEXT

3. GENSCHER, WHO HAS CAPTURED THE ROLE OF FRONT RUNNER, ARGUES SIMPLY THAT THE TIME HAS COME FOR A FURTHER BIG STEP TOWARDS EUROPEAN UNION AND THAT THE SINGLE MARKET NEEDS EMU FOR ITS FULL REALISATION. THIS VIEW HAS WIDE, IF SUPERFICIAL, APPEAL. GENSCHER'S SENSE OF URGENCY HAS BEEN INCREASED BY EVENTS IN EASTERN EUROPE. HE SEES FURTHER INTEGRATION AS STRENGTHENING THE MAGNETIC INFLUENCE OF THE EC FOR REFORM IN EASTERN EUROPE AND AS COMPATIBLE WITH FUTURE MEMBERSHIP FOR EAST EUROPEAN COUNTRIES THAT BECOME DEMOCRATIC. THIS PRESSURE ON THE ACCELERATOR IS CAUSING THE FINANCIAL AND BUSINESS SECTORS AT LAST TO EXPRESS THEIR LONG-STANDING FEARS. THEY SEE EMU AS MEANING THE TRANSFER OF THE BUNDESBANK SYSTEM TO THE EUROPEAN LEVEL, BUT ARE SCEPTICAL THAT IT WILL WORK SO WELL, EG. THAT DISCIPLINE COULD BE ENFORCED ON THE UNRULY. THEY FEAR THAT HASTE WILL COMPOUND THE DANGERS BY INCREASING THE RISK OF COMPROMISE ON ASPECTS OF THE BUNDESBANK SYSTEM. THIS ARGUMENT, WHICH BOILS DOWN TO SAYING THAT THE FLESH IS TOO WEAK, IS A FORM OF REALISM THAT HAS DIFFICULTY IN MAKING AN IMPACT AGAINST THE IDEALISM OF EUROPEAN UNION. THE SENSE OF WELL BEING IS SO STRONG THAT THERE IS LITTLE APPREHENSION OF THE THREAT THAT EMU COULD POSE TO STABLE PRICES OR THE VALUE OF THE MARK. EVEN THE BUNDESBANK IS RELUCTANT TO USE THIS HIGHLY CONTROVERSIAL ARGUMENT AND NO-ONE YET KNOWS HOW SOON OR HOW FORCEFULLY WAIGEL MIGHT ENGAGE IN THIS KIND OF DEBATE OR HOW KOHL WILL PLAY HIS HAND. HE IS SHOWING CAUTION. THIS TAKES THE PUBLIC FORM OF BEING SILENT ABOUT DETAIL. SITTING BESIDE ANDREOTTI AT A PRESS CONFERENCE LAST WEEK, HE PASSED UP THE OPPORTUNITY TO AGREE THAT AN IGC SHOULD BE CONVENED IN THE SECOND HALF OF 1990.

MALLABY

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FRAME ECONOMIC

PART II OF II

DISCUSSION BETWEEN GOVERNMENT AND BUNDESBANK

4. THE INTER-DEPARTMENTAL GROUP SET UP IN THE SUMMER AT UNDER SECRETARY LEVEL, WHICH INCLUDES THE FINANCE, ECONOMICS AND FOREIGN MINISTRIES, THE CHANCELLERY AND THE BUNDESBANK, HAS ATTRACTED NO PUBLIC ATTENTION. BEYOND COORDINATING GERMAN POSITIONS IN THE HIGH LEVEL GROUP, IT HAS NOT DONE MUCH: THE PARTICIPANTS ARE STILL KEEPING THEIR POWDER DRY. IN THE SHORT RUN, THIS SITUATION WILL NOT CHANGE. DESPITE THE GREAT IMPORTANCE OF THE ISSUES TO THEM, THE GERMANS ARE LIKELY TO REACT TO EVENTS IN BRUSSELS RATHER THAN TO SHAPE OR LEAD THEM. THE HANDLING WITHIN GOVERNMENT SO FAR OF THE IGC EXEMPLIFIES THIS. THE BUNDESBANK HAS PRE-CONDITIONS FOR AGREEING TO ONE, WHICH INCLUDE THE RIGHT QUESTIONS BEING ASKED BY THE HIGH LEVEL GROUP AND SATISFACTORY ANSWERS BEING GIVEN. BUT THERE IS STILL NO INTER-DEPARTMENTAL VIEW AS TO WHETHER THE FRG WILL INSIST ON CONDITONS FOR AN IGC. THERE IS FATALISM IN THE FINANCE MINISTRY THAT GENSCHER WILL ''WIN''.

5. THE STATE OF DEBATE ON THE SUBSTANTIVE ISSUES IS:

- STATUS OF A EUROPEAN CENTRAL BANK. THE INDEPENDENCE OF A EUROPEAN CENTRAL BANK IS A GERMAN RALLYING CRY. BUT NOT MUCH MORE. THE AUSWAERTIGES AMT IS SAID BY THE BUNDESBANK TO BE PRESSING FOR WEIGHTED VOTING WITHIN IT. THIS HORRIFIES THE BANK, SINCE IT IMPLIES DELEGATED MEMBERSHIP RATHER THAN TRUE INDEPENDENCE OF BANK GOVERNORS. THE BUNDESBANK'S CRITERIA ARE THAT THERE SHOULD BE NO NATIONAL (OR OTHER) INSTRUCTIONS TO GOVERNORS, THAT THEIR APPOINTMENT SHOULD BE PROTECTED LIKE THAT OF JUDGES, AND THAT THEY SHOULD HAVE SUFFICIENT POWERS TO DO THE JOB WHICH MUST BE WRITTEN DOWN.

- FEDERALISM, SUBSIDIARITY ETC. THE BUNDESBANK ENVISAGES MONETARY POLICY OPERATING BY INSTRUCTION FROM A EUROPEAN CENTRAL BANK

DOWNWARDS TO MEMBER STATES WHERE THE NATIONAL CENTRAL BANKS WOULD EXECUTE POLICY AS AGENTS. IN THE NAME OF STABLE MONEY, MONETARY FINANCING OF DEFICITS WOULD BE FORBIDDEN. BUT FISCAL POLICY IN LINE WITH SUBSIDIARITY WOULD OPERATE FROM BOTTOM UP, WITHIN CLEAR RULES WHICH WOULD CONSTRAIN NATIONAL (OR LOCAL) AUTHORITIES ON SUCH MATTERS AS BORROWING. THE WAY OF RESOLVING CONFLICTS BETWEEN THESE TWO STREAMS OF POWER, FLOWING IN OPPOSITE DIRECTIONS, IS NOT EXPLAINED. THE FINANCE MINISTRY IS KEENER ON BUDGETARY/FISCAL CONTROL BEING EXERCISED CENTRALLY IN BRUSSELS WITHIN RULES OVER WHICH THOSE IMPLEMENTING THEM (NOT THE COMMISSION) WOULD HAVE CONSIDERABLE CONTROL. BUT THE NATURE OF THE RULES GOVERNING FISCAL POLICY IS AN IMPORTANT UNRESOLVED ISSUE AND IS LINKED TO

- ACCOUNTABILITY. WHILE SAYING LOUDLY THAT A EUROPEAN CENTRAL BANK MUST BE INDEPENDENT, AN INCREASING NUMBER OF GERMANS WILL WHISPER THAT THEY RECOGNISE THAT THE EUROPEAN SYSTEM CANNOT BE QUITE THE SAME AS THE GERMAN ONE. THE BUNDESBANK IS PREPARED TO CONCEDE A (VERY LIGHT) FORM OF ACCOUNTABILITY IN THE FORM OF REPORTING TO THE EUROPEAN PARLIAMENT AND/OR THE COUNCIL OF MINISTERS. THE FINANCE MINISTRY WANTS A MORE TRADITIONAL (AND NATIONAL) APPROACH, WITH ACCOUNTABILITY TOWARDS THE MINISTRY AND THE BUNDESTAG.

- TRANSFERS AND THE LENGTH OF STAGE 1 OF DELORS. THE ECONOMICS MINISTRY HAS PUBLISHED A PAPER POURING COLD WATER ON THE DELORS REPORT'S APPARENT ATTACHMENT TO TRANSFERS AS BEING BOTH EXPENSIVE AND ECONOMICALY INEFFICIENT (MY TELNO 798). THE BUNDESBANK REGRETS THE MENTION OF TRANSFERS IN THE DELORS REPORT, REGARDS THEM AS POLITICALLY UNAVOIDABLE AND WANTS TO MINIMISE THEIR SIZE. THE PROSPECT OF BIG TRANSFERS IN STAGE 2 IS ONE FACTOR WHICH REINFORCES THE BUNDESBANK'S INSISTENCE THAT STAGE 1 MUST BE OF VERY LONG DURATION. THE FINANCE MINISTRY MAKES THE SAME POINT IN A DIFFERENT WAY: ONLY WHEN A HIGH DEGREE OF CONVERGENCE HAS BEEN ATTAINED (MAKING BIG TRANSFERS UNNECESSARY) WILL STAGE 1 BE CONSIDERED ACCOMPLISHED. THIS IMPLIES THAT IT COULD CONTINUE LONG AFTER AN IGC HAD MET OR THE TREATY BEEN AMENDED. THE CHANCELLERY KNOWS , HOWEVER, THAT PRESSURE TO MOVE TO STAGE 2, OR ACCEPT ELEMENTS OF IT, WOULD BE STRONG IN THE WAKE OF TREATY AMENDMENT.

- A SINGLE CURRENCY. DISCUSSION HERE OF HOW TO MOVE TO A COMMON CURRENCY HAS AN ACADEMIC AIR. THE BUNDESBANK'S STRONG PREFERENCE IS THAT IT BE A DISTANT FINAL STAGE. THEY DISLIKE THE NOTION OF COMPETING CURRENCIES FOR POLITICAL REASONS. THEY DO NOT BELIEVE THAT ANY GOVERNMENT WOULD ALLOW ITS NATIONAL CURRENCY TO BE DRIVEN OFF THE MARKET WHILE OTHERS WERE NOT. THEY WOULD PREFER TO THIS TO MOVE

AT AN EARLY STAGE TO THE DISCIPLINES AND BENEFITS OF A COMMON CURRENCY. THE MINISTRIES ARE MORE OPEN MINDED. THEY ARE PREPARED TO LISTEN TO THE ARGUMENT THAT GOVERNMENTS WOULD EXERT DISCIPLINE AT THE NATIONAL LEVEL TO AVOID BEING DRIVEN OUT OF THE SYSTEM

CONCLUSIONS

6. GENSCHER SEES HIS BROAD GOAL CLEARLY AND SEEMS CONFIDENT THAT HE CAN PUSH TOWARDS IT. THE DISAGREEMENT AMONG THE FINANCIAL PRACTITIONERS ON SOME ISSUES WEAKENS WAIGEL'S HAND AND GIVES GENSCHER OPPORTUNITIES. THE BUNDESBANK FEARS THAT KOHL WHO SHARES GENSCHER'S POLITICAL ASSESSMENT BUT DOES NOT WANT TO OVERRULE THE BUNDESBANK, WILL DELAY DECISIONS, PERHAPS UNTIL THE IGC ITSELF.

7. FCO PLEASE ADVANCE TO PS/SOFS, KERR, ARTHUR ECD(I), PS NO 10, PS/ CHANCELLOR OF THE EXCHEQUER, EVANS TREASURY.

MALLABY

YYYY

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of.ed.oct.draft.7.89

CONFIDENTIAL

PLP

From: Huw Evans
Date: 25 October 1989
Extn: 4380

CHANCELLOR

cc

Sir Peter Middleton
Mr Wicks
Mr Odling-Smee
Mr Peretz
Mr R I G Allen
Mr Bottrill

NB Wicks note + EcofiN papers to follow.

**BILATERAL WITH WAIGEL, 26 OCTOBER**

This minute covers the subjects of EMU, Eastern Europe, Nigeria, and trade. You will get separate briefing on indirect tax, tax on savings, and on the German economy. You will not want to raise ERM developments yourself, but Waigel may do so. Mr Peretz's note of 23 October, reporting the Monetary Committee discussion, gives background on the current state of debate between ERM countries, and the line the Germans have been taking. MG will let you have separately details of intervention and exchange rate movements within the ERM in recent weeks.

**EMU**

2. After the Ministerial meeting today, you will be able to take Waigel through the arguments in your EMU paper. The final version of the paper will not be ready in time to give to Waigel, though you could give him a near final draft.

3. You may like to have an early sight of some of the briefing on EMU: Mr Allen is sending this up, in draft, separately.

(in separate folder)

**CONFIDENTIAL**

4. In setting out the points in your paper, you will want to maximise the areas of agreement with Waigel and Poehl. Mallaby's telegram* of yesterday sets out the German positions. Your objectives will be to get Waigel to give your paper as fair a wind as possible at the November ECOFIN, and to reinforce the desirability of the Germans resisting at Strasbourg the French call for an early IGC. (On these, you should see also Mr Wicks' minute to you of 23 October* and his note tomorrow morning on tactics.) I suggest the following line to take:

A* attached.

B

i. Two basic principles we share with Germany. Our objective is price stability, and developments towards EMU must not be allowed to compromise that. And we want a free and open market system, not subject to bureaucracy and controls.

ii. UK, like Germany, fully committed to moves towards EMU: we have signed up to Stage 1, despite some difficulties. It will take many years to implement in full.

iii. UK also committed to exploring moves beyond Stage 1: hence our paper.

iv. UK wants to apply same principles as govern Stage 1 - evolution, maximum use of markets, subsidiarity - to moves beyond Stage 1.

v. On monetary policy, UK recognises key influence of Bundesbank in maintaining low inflation in Europe. Essential that future arrangements ensure at least as good an outcome. Hence our wish not to lose competitive market disciplines which now (more so after full capital liberalisation) cause member states to keep policies in line with best. Need to avoid a new institution which may not be able to deliver low inflation.

vi. On fiscal policy, need to prevent monetary financing of deficits. But binding rules on size of deficits unnecessary and undesirable. Self interest - helped by market pressures (eg high interest rates and, before exchange rates irrevocably fixed, threat of depreciation) - will help to prevent excessive deficits. In addition multilateral surveillance procedures being developed in Stage 1 and conditions imposed on use of Community loans will keep extreme cases in line.

v. Evolution, learning-by-doing, further analysis, taking decisions when they are needed in the light of experience in Stage 1 - we see large areas of common ground with the views of German economic/ financial commentators. We have also read, with general approval, the papers by the Economics Ministry (in July)* and by the Board of Economic Advisers (including Neumann) in June*. The Monetary Committee's discussions last week made it clear just how much more work was needed before we were ready for decisions on beyond Stage 1.

C+D * enclosed

**Eastern Europe**

5. The rapid changes in Eastern Europe are causing the Germans to rethink their attitudes over a wide range of issues - including the economy, EC enlargement (see Mallaby's letter to Kerr of 6 October)*. These changes are causing the French and Delors to stress the need, as they see it, for rapid implementation of EMU in order to tie Germany even more firmly

E attached

into the Community. You may want to explore this with Waigel. Kohl said that "The dramatic changes taking place in Warsaw Pact countries were in part the result of the magnetic attraction exerted by political and economic integration in the EC, which was becoming the point around which European freedom was crystalising. The way to help those seeking freedom was to push ahead with European integration. The EC must remain open to all free peoples. The single market and European Union were important steps on the road to a peaceful order which would one day unite the whole of Europe in freedom".

6. On Poland and Hungary, there are some more specific questions to put to Waigel:

i. What is the likely size of German help for Poland? (Expected to be announced in early November during the Kohl and Genscher "historic reconciliation" visit to Poland.) How are the Germans responding to the Bush proposal for a $1 billion stabilisation fund?

ii. What sort of help do Poland and Hungary most need in order to get moving rapidly down the road to a market economy? We are offering technical assistance, including training, through the Know-How Fund; a contribution to the Stabilisation Fund; and supporting EC action via the budget and EIB.

iii. Poland's economy is in a bad state. The need for a "strong and sustainable" IMF programme is even clearer than when the G7 put this in their communique in September - but the UK and Germany will need to ensure that we all (including the Commission) stick to this line when the going gets difficult. And we need to make as much finance as possible contingent on a Fund programme.

iv. Coordination of Western help is needed: the Commission are not able to coordinate effectively the 24 countries that meet occasionally in Brussels. We need on the ground coordination in Poland of technical assistance and perhaps of investment as well. We are not keen on setting up new multilateral institutions: better to build on existing ones, and ensure role for IFC/World Bank - much more experienced than the Commission. What does Waigel think? (A steer from the Germans could be useful in rebutting FCO pressure for new institutions.)

v. There is a real danger of competitive bidding in providing help to Eastern Europe: for example, the European Parliament is trying to add another 100 mecu to EC Community expenditure on Poland and Hungary, long before there are clear plans for the agreed 200 mecu. Just as bad, the European Parliament is trying to use this proposal to bust the budget limits and to secure expenditure on other policies well in excess of the financial perspective. Any revisions to the financial perspective for this purpose would be very bad news, bringing further pressure on later years as well. It would be very desirable (Mr Mercer's minute of 23 October to the PMG) to get support from Waigel for:

- The Council not going beyond the revision of the financial perspective envisaged at October ECOFIN.

- Not considering more money for Poland/Hungary until the existing tranche had been deployed.

While agreeing that extra money may be needed when a good case is made.

**Nigeria**

7. The Consultative Group, organised by the World Bank, is meeting in Paris on 7-8 November. We need a contribution from the Germans. Arguments you can use with Waigel:

i. The Nigerians have kept to the terms of their IMF programme (though they have not of course drawn any money);

ii. The IMF is proposing, with full UK support, further measures to reduce the budget deficit, raise interest rates, unify exchange rates, etc;

iii. In return, we should continue to give the Nigerians incentives and put in grant money.

[iv. Only if raised by Waigel: yes, the Nigerians have had a sizeable bonus this year from extra oil resources; not, it's not clear what has happened to the money, mostly not been added to reserves; IMF and AAA finding out.]

**Trade**

8. Two items worth raising with Waigel:

i. **Japanese cars:** we are lobbying for abolition of all national VRAs by 1992. The protectionist countries (including France and Italy) are seeking a long transition period, extending into the mid or late 1990s. You have written to Mr Ridley, urging him to take a stronger line with the Commission, and in public. Our immediate objective is to get the Commission to bring forward proposals as soon as possible. The Germans should support us in this because their car market is relatively liberalised.

ii. **Anti-dumping:** you could welcome the concern expressed by Germany about the Commission's policy, and agree on the need to keep together a group of liberal-minded members states (including also the Dutch and Danes) to maintain pressure on the Commission (eg in the context of the GATT negotiations) and to form blocking minorities in specific anti-dumping cases (eg CDs, DRAMs) brought forward by the Commission.

HPE

**H P EVANS**

mg.ee/dlcp/25.10-pps

SECRET

PWP

From : D L C Peretz (MG)
Date : 25 October 1989
x 4460

PPS

cc Mr Wicks o/r
Mr H P Evans
Miss O'Mara

**MEETING WITH WAIGEL : STRAINS IN THE ERM**

You might like as background for tomorrow's meeting to have the attached figures for intervention, and exchange rate movements in the ERM in recent weeks. The Danish intervention nearly all took place on a single day : Friday 13 October.

DLCP

D L C PERETZ

SECRET

# INTERVENTION BY ERM COUNTRIES

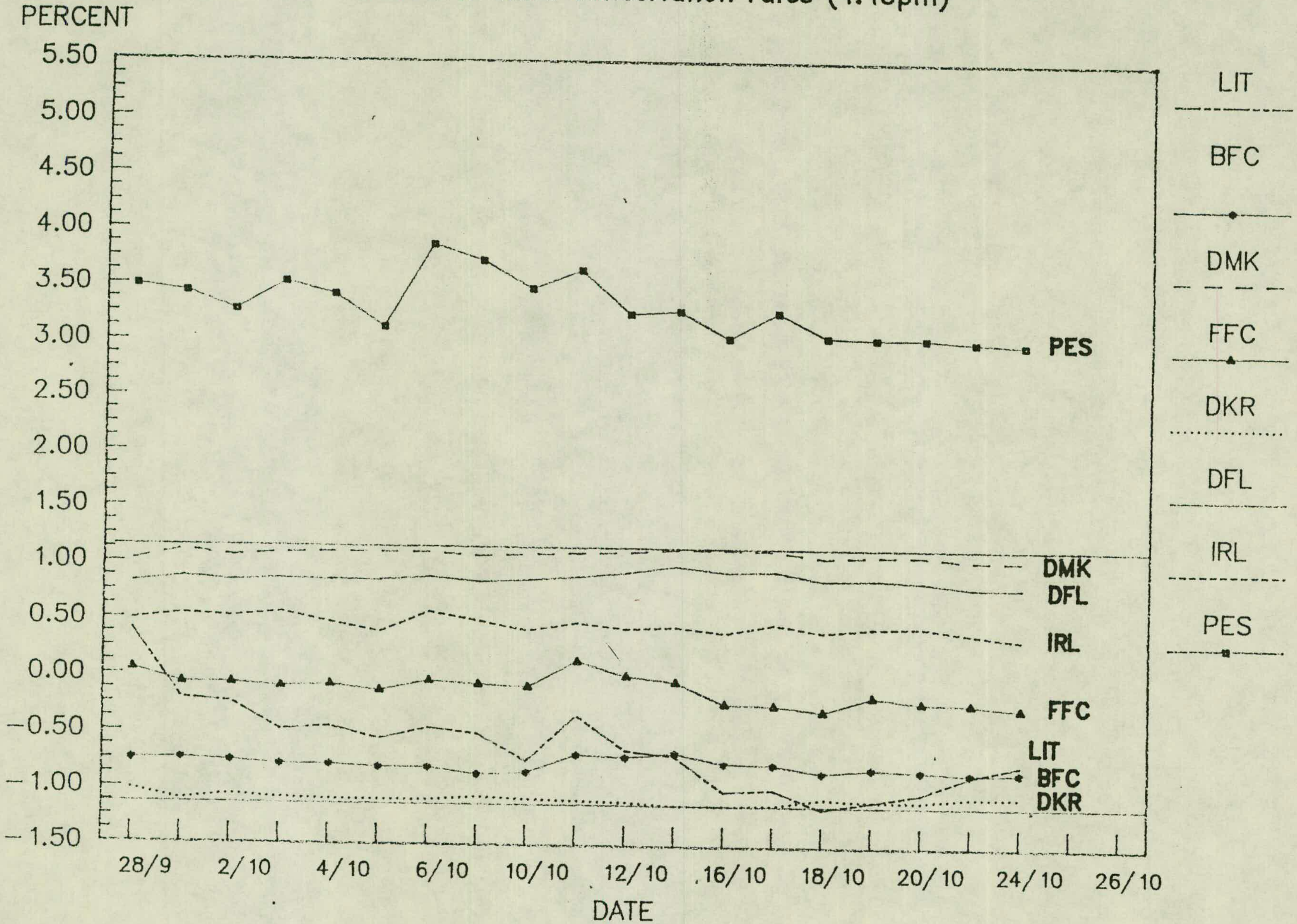
**Million dollar equivalents, by currency**
**(October 2 to October 24 1989)**

| | DEUTSCHEMARK | ECU | DANISH KRONE | FRENCH FRANC | DOLLAR |
|---|---|---|---|---|---|
| West Germany | | | +9 | | −103 |
| Denmark | − 1,738 | | | | − 36 |
| France | − 206 | | | | − 60 |
| Holland | | | | | − 65 |
| Italy | − 387 | −972 | | − 57 | − 1,315 |
| Ireland | − 50 | | | | − 297 |
| Spain | − 165 | −239 | | + 30 | − 653* |
| Belgium | − 32 | | | | − 759 |

* Of which -30$ million against French Francs

# ERM POSITIONS

Based on third concertation rates (1.15pm)



25.10.2 **CONFIDENTIAL**

PCP

FROM: A C S ALLAN (IF)
DATE: 25 October 1989
EXT: 4430

CHANCELLOR

cc Mr Wicks
Mr H P Evans
Mr Odling-Smee
Mr R I G Allen
Mr Peretz
Mr Melliss
Mr Hanks

**VISIT TO BONN: GERMAN ECONOMY**

I attach a note by Mr Melliss and Mr Hanks on recent developments in the German economy.

2. Circumstances could hardly be more favourable for a determined German attack on subsidies, something you have pressed on Waigel before. There are worries about overheating, the trade surplus is large and growing, and tax cuts are due next year, as part of the medium term reform package, at a time when a fiscal stimulus can hardly be appropriate. The time has surely come for Germany to reduce its subsidies to agriculture (where transfers from consumers and taxpayers represent 90 per cent of value added) and to industries such as coal, aerospace, steel and shipbuilding (Mr Edmonds' note of 28 July, attached, dealt with one of Waigel's points on coal).

3. It might also be interesting to ask Waigel for his views on the impact of recent migratation from Eastern Europe - both on the economy and on domestic politics (eg on the relative support for the CSU and the Republican party).

ACSA

A C S ALLAN

**RECENT DEVELOPMENTS IN GERMANY**

1. This note discusses some of the latest developments in the German economy.

Recent Indicators

2. Recent data for Germany have been somewhat erratic. It is clear, however, that growth remains strong and that the external balance will set new records this year. The outlook for inflation is somewhat more ambiguous.

- GNP grew by nearly 5 per cent in the second quarter on a year earlier. This meant that in the first half of 1989 GNP was up 4½ per cent on the first half of 1988. Growth has accelerated sharply since the end of 1988 stimulated by investment and net exports.

- Total industrial production rose by 2.1 per cent over a year earlier in August. This series has, however, been very erratic and a more accurate picture of the strength of activity is given by the rise of 4.3 per cent in the period June to August compared to a year earlier. Total orders in manufacturing were up 5 per cent on a year earlier in August but their growth has slowed of late.

- The trade surplus in August was $7 billion, the second highest monthly figure so far this year. Germany is on course for a current account surplus of around $60 billion this year (nearly 5 per cent of GDP). Exports of goods rose by 12.6 per cent in the first half of this year compared to a year earlier, whilst imports rose by 9.4 per cent in the same period. The current account has also been boosted this year by a decline in the invisibles deficit of which a strengthening of the IPD balance has been a major feature. (Net foreign assets are estimated to have increased over threefold between end 1985 and mid 1989, and now represent almost 20 per cent of GDP.)

- Consumer price inflation rose to 3.1 per cent in September as against a rate of 2.9 per cent in August and an earlier peak of 3.1 per cent in June. Producer price inflation was 3 per cent in August, down from its peak of 3.5 per cent in April but unchanged for the third month in a row. The labour market is continuing to tighten with unemployment at 7.3 per cent in September compared with 8.1 per cent in the same month a year ago and over 50 per cent of industry reporting skilled labour shortages.

These points are illustrated in tables A and B below.

**Table A: Recent Developments**

| | April | May | June | July | Aug. | Sept. | Oct. 19 |
|---|---|---|---|---|---|---|---|
| Consumer price inflation* | 3.0 | 3.1 | 3.1 | 3.0 | 2.9 | 3.1 | |
| Producer price* | 3.5 | 3.4 | 3.0 | 3.0 | 3.0 | n.a | |
| Industrial production* | 7.4 | 2.2 | 4.3 | 7.7 | 2.6 | n.a | |
| M3 growth** | 6.1 | 5.3 | 4.3 | 4.9 | 5.2 | n.a | |
| Interest rates | 6.4 | 7.0 | 7.0 | 7.1 | 7.1 | 7.4 | 8.3 |
| Unemployment*** | 7.9 | 7.6 | 7.4 | 7.7 | 7.5 | 7.3 | ~~8.3~~ |
| Trade surplus $ billion | 6.0 | 5.2 | 6.4 | 6.3 | 7.0 | n.a | |
| Effective exchange rate**** | 112.8 | 112.1 | 112.4 | 113.3 | 112.6 | 112.6 | 115 |

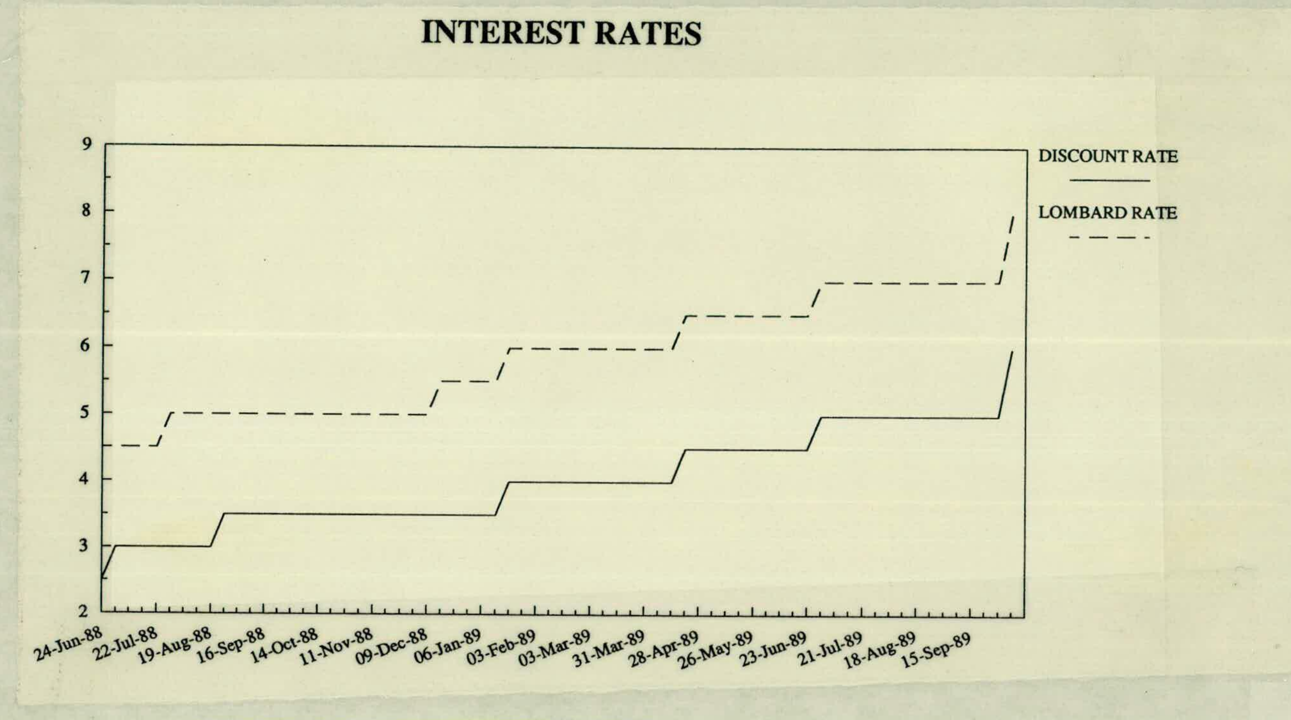
* Percentage change on a year earlier.
** Change at annual rate over final quarter of 1988.
*** Seasonally unadjusted as a percentage of dependent labour force.
**** 1985 = 100

**Table B: National Accounts**

| | Percentage change on a year earlier | | | |
|---|---|---|---|---|
| | 1988Q3 | 1988Q4 | 1989Q1 | 1989Q2 |
| Private consumption | 2.5 | 1.7 | 1.5 | 2.0 |
| Machinery Investment | 8.1 | 8.8 | 6.9 | 14.1 |
| Construction Investment | -0.3 | -0.2 | 12.6 | 5.3 |
| Domestic Demand | 3.6 | 3.0 | 2.8 | 2.9 |
| Exports of goods and services | 6.2 | 5.1 | 10.0 | 15.1 |
| Imports of goods and services | 6.5 | 5.3 | 5.5 | 9.7 |
| GNP | 3.4 | 3.0 | 4.4 | 4.9 |

## Monetary Policy

3. The rise of one per cent in German interest rates on 5 October, taking the Lombard rate to 8 per cent, was the eighth rise since mid 1988.




The reason officially given for the rise was that it was an attempt to constrain monetary growth. M3 grew by an annualised 5.2 per cent in August, close to the official growth target for the year to end 1989 compared to end 1988 of 'around' 5 per cent. Monetary growth fell continually this year until June, since when it has started to pick up again, a development that the Bundesbank wanted to nip in the bud. The Budensbank are also concerned about the rapid growth of deutschemark Eurodeposits held by residents, which are not captured in M3.

4. Other factors, however, also influenced the decision to push up interest rates again:

- Firstly, the continuing strength of economic activity, which will receive a further boost with Dm20 billion cuts in personal taxation in January 1990, and the threat it poses to price stability. The Bundesbank is concerned lest the German economy should overheat and this spill over into a higher rate of inflation.

- Secondly, the inflationary potential posed by the coming wage round. Approximately two-thirds of German labour contracts are up for renewal in 1990. With inflation having been higher than expected over the recent past and the unions again pressing for shorter hours there is a danger of a sharp rise in labour costs. The rise in interest rates is a signal to employers that monetary policy will not accommodate price rises designed to finance large wage settlements.

- Finally, the Bundesbank is concerned about the value of the Deutschemark. Despite a rising current account surplus and low level of inflation the Deutschemark has depreciated over the last 18 months or so. The depreciation has been much more marked against the dollar than against other European currencies but the Bundesbank is keen to see the value of the DM rise both for internal and external reasons. The Bundesbank believes that the rise in the current account surplus does not threaten the international economic environment but is a reflection of the recent strength of investment in Europe and the partially fixed exchange rate. In 1988 65 per cent of Germany's total trade surplus was accounted for by its surplus with EC countries compared to 49 per cent in 1986.

Fiscal policy

5. German fiscal policy is based on a medium term strategy to reduce the fiscal deficit and reform the tax system. The pursuit of these dual aims has, however, led to the budget deficit following a 'zig-zag' path. At the start of this year expenditure taxes were raised, boosting revenue by about DM8 billion in a full year. At the start of 1990 there will be reductions in personal taxation worth DM20 billion. By 1991 the general government deficit is expected to be about 1% of GDP, compared with 2% in 1988. The recent buoyancy of tax revenues has helped in the task of reducing the deficit.

UK bilateral trade with Germany

6. It is always dangerous to make too much of bilateral trade data (witness the Japanese imports of gold shipped via the US to reduce their bilateral trade surplus). The Germans have been pointing to the fact that much of the increase in their surplus is caused by booming exports to other EC countries. In value terms, UK imports from Germany have been growing slightly less fast than imports from other developed countries recently, though UK exports to Germany have also not been as buoyant as exports to other countries. The UK's bilateral trade balance with Germany has widened, but not as markedly as the deterioration in the trade balance as a whole.

**Table C: UK bilateral trade with Germany**

(£m OTS basis: exports fob; imports cif)

| | **Exports** | **Imports** | **Balance** |
|---|---|---|---|
| 1986 | 8540 | 14120 | -5580 |
| 1987 | 8400 | 15780 | -6380 |
| 1988 | 9520 | 17670 | -8150 |
| 1989 HI | 5150 | 9620 | -4470 |

**Growth rates (%)**

| | **Exports to:** | | **Imports from:** | |
|---|---|---|---|---|
| | **Germany** | **Total Developed** | **Germany** | **Total Developed** |
| 1987 | 10.1 | 11.4 | 11.8 | 9.9 |
| 1988 | 1.2 | 2.2 | 11.9 | 13.2 |
| 1989 HI (*) | 8.2 | 9.6 | 8.9 | 10.9 |

(* HI/1988 at an annual rate)

Immigration

7. The Germans are expecting an inflow of around 1 million immigrants over the next three years, adding close to 0.7 per cent a year to their stagnant level of population. This influx of refugees should help to push up the level of productive potential in the German economy towards 3 per cent as against recent estimates which put it in the $2\frac{1}{4}$-$2\frac{1}{2}$ per cent range. So far this year there have been about 300,000 immigrants.

8. The immigrants divide up into two distinct groups. The largest group are ethnic Germans who come from Poland, the Soviet Union and Romania, known as 'Aussiedler'. This group is young and relatively unskilled but are likely to be more flexible than the existing labour force in terms of the jobs, hours, wages and locations that they will accept. The second group are the East Germans, known as 'Ubersiedler', who are also predominantly young but whose skills and training should enable them to help relieve the current skill shortages in German industry.

Prospects

9. The latest WEP forecast sees Germany continuing to combine strong growth, modest inflation and a rising current account surplus. Growth so far this year has been fuelled by a prodigious net export performance, expected to amount to $1\frac{1}{2}$ percentage points of GDP, and growth in business investment expected to be even more rapid than in 1988. In 1990 and 1991 domestic demand will make a larger contribution to growth with consumption being stimulated by cuts in income taxes, the growth in employment and renegotiation of wage contracts. With the consumer tax increases dropping out of the consumer price index at the start of 1990, a firm monetary policy, and likely productivity gains this year, the rise in inflation should be halted. The trade and current account surpluses are now so large that they have acquired a momentum of their own, which the expected moderation in export growth over the forecast period can do little to stop.

**Table D: WEP Autumn Forecast**

| | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|
| Private consumption | 2.7 | 1.7 | 3.3 | 3.1 |
| Business investment | 7.4 | 8.0 | 5.3 | 4.2 |
| Domestic Demand | 3.7 | 2.5 | 3.1 | 2.9 |
| Exports | 6.4 | 9.6 | 4.6 | 3.8 |
| Imports | 6.1 | 4.9 | 4.2 | 5.1 |
| GNP | 3.6 | 4.1 | 3.3 | 2.5 |
| Consumer prices | 1.2 | 2.9 | 2.1 | 1.7 |
| Current balance | 48 (4.0) | 58 (4.8) | 66 (5.1) | 72 (5.2) |

( ) Percentage of GNP

35/3/IF2/to.6.20.7



German box

FROM: P EDMONDS (IF2)
DATE: 28 July 1989
x5546

PS/CHANCELLOR

cc PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr Evans
Mr R I G Allen
Mr Gieve
Mr Melliss
Ms Symes
Mr Gibbs
Mr Hanks
Mr Tyrie

**HERR WAIGEL AND SUBSIDIES IN GERMANY**

In his meetings with the Prime Minister and the Chancellor, Herr Waigel said that subsidies had been reduced, particularly subsidies to the coal industry. Subsidies are notoriously hard to measure, but data collected by the IMF for the recent Article IV consultation suggest a continuing increase in subsidies to German industry, including subsidies to the coal industry.

2. On an OECD national accounts basis, German subsidies were 4.3 per cent of GDP in 1986 compared to a UK figure of 3.8 per cent (3.7 per cent for France, 5.0 per cent for Italy). But while UK subsidies have since been reduced further - to about 3¼ per cent of GDP in 1987-German subsidies have not. Table 1 suggests that Federal and Lander subsidies in Germany, on German national definitions, have remained at 3 per cent of GNP since the mid-1980s. Table 2 shows that subsidies to coal roughly doubled between 1984 and 1988, and that subsidies to the coal industry are dominated by subsidies for its use in the production of steel and electricity. The appreciation of the DM against the dollar triggered higher subsidies to compensate for the reduced competitiveness of the German coal industry. In 1988, subsidies to the coal industry were about equal to its labour costs.

3. The agreement to subsidise the use of coal for steel production runs until 1992, and the agreement to subsidise the use of coal in electricity production runs until 1995. Attempts are



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being made to limit the growth of these subsidies, but no significant reductions have yet been agreed.

4. There is now a ceiling on the previously open-ended support for the use of coal in steel production: government subsidies for steel production are to be limited to DM 11 bn over the three year period 1989-91. Payments in 1990 will be reduced from those in 1989, but this ceiling does not represent any significant reduction from the DM 3½ bn subsidies of 1988. No limit has been set to the levy collected from consumers of electricity: this was recently raised from 7½ per cent of the cost of electricity to 8½ per cent.

5. Pressure to reform the system of subsidies is growing. German industry, angry at its relatively high electricity bills, is pressing for reform. The Commission, prompted by the French Government (and possibly by German industry) has told the German Government to come up with proposals for reductions of its coal subsidies, and has asked to have these by the end of September. The Federal government is to use this opportunity to produce a long-term strategy for the coal industry, but it remains to be seen whether any substantive proposals will be made: informed opinion in Germany is that difficult decisions may be put off until 1991.

P. Edmonds

P EDMONDS

35/3 IF2/cl.6a20.7

## Table 1. Germany: Subsidies by Federal Government and Lander

(DM bn)

| | 1970 | 1975 | 1980 | 1985 | 1986 | 1987 | 1988 | 1989 Budget |
|---|---|---|---|---|---|---|---|---|
| Federal Government | | | | | | | | |
| Payments | 7.8 | 10.1 | 12.5 | 11.9 | 12.4 | 12.4 | 12.3 | 14.6 |
| Preferential tax treatment | 6.2 | 9.7 | 12.1 | 15.7 | 15.7 | 15.9 | 16.7 | 16.4 |
| Total | 14.0 | 19.8 | 24.6 | 27.6 | 28.1 | 28.2 | 29.0 | 30.9 |
| Lander and municipalities | | | | | | | | |
| Total | 13.7 | 20.8 | 28.2 | 32.3 | 31.7 | 33.3 | 34.2 | .... |
| Total subsidies | 27.7 | 40.6 | 52.8 | 60.0 | 59.5 | 61.5 | 63.2 | .... |
| (In percent of GNP) | (4.2) | (4.0) | (3.6) | (3.2) | (3.0) | (3.0) | (3.0) | .... |

Source: IMF, Recent Economic Developments paper for Article IV Consultation, July 1989. Based on Ministry of Finance data and Fund staff estimates.

But this understates subsidies according to OECD

Table 2: Subsidies to Coal Mining

DM billion

| | 1980 | 1984 | 1988 1/ |
|---|---|---|---|
| For use in steel production | 1.63 | 1.71 | 3.46 |
| For stockbuilding | 0.11 | 0.13 | 0.11 |
| Investment support | 0.63 | 0.19 | -- |
| Closure aid | 0.40 | 0.18 | 0.22 |
| Company specific measures | 0.23 | 0.24 | 0.34 |
| Social measures | 0.26 | 0.24 | 0.36 |
| For use in electricity generation (Kohlepfennig) | 2.04 | 2.20 | 6.70 |
| Research | 0.52 | 0.31 | 0.12 |
| Miscellaneous | 0.22 | 0.49 | 0.48 |
| Total | 6.05 | 5.68 | 11.79 |

Sources: IMF (RED Table 37) from BMWi Tagesnachrichten, December 1, 1988; and Ministry of Economics.
1/ Partly estimated.

chex.ps/jmt2/60

RESTRICTED

FROM: J M G TAYLOR
DATE: 25 OCTOBER 1989

MR ISAAC - INLAND REVENUE

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

**TAXATION OF SAVINGS**

The Chancellor has seen your reporting note on Monday's meeting of the Ad Hoc Group, and also UKREP TelNo.3171.

2. He has commented that the Italian attempt to revive the withholding tax is new, and very tedious. He agrees that we shall now need to firm up the link between getting the Commission formally to withdraw its withholding tax proposal and an agreement on balanced mutual assistance (paragraph 2 of UKREP TelNo.3171).

J M G TAYLOR

RESTRICTED

CONFIDENTIAL

PCP

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC
25 October 1989

CHANCELLOR OF THE EXCHEQUER

YOUR MEETING WITH HERR WAIGEL
TAXATION OF SAVINGS

1. Your office has asked for a brief on taxation of savings, for when you meet Herr Waigel.

attached

2. I will not try to repeat here the report which I sent forward yesterday on the last meeting of the Ad Hoc Group in Brussels. But it might perhaps be worth picking out the following main points.

- Recognise that the French are desperately anxious to have a clear Ministerial decision on mutual assistance at the November EcoFin (this may be the last occasion during their Presidency, if the December EcoFin is as crowded as one would expect).

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cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Wicks
Mr Scholar
Mr Walsh
Mr R I G Allen
Mr Odling-Smee
Mr Culpin
Mr Gilhooly
Mr Ilett
Mr Sharples
Mrs Chaplin
Mr Lightfoot
Mr Tyrie

Mr Jefferson Smith (Customs)
Sir D Hannay ) UKRep
Mr Bonney ) Brussels

Mr Isaac
Mr Beighton
Mr Roberts
Mr Houghton
Mr Corlett
Mr Cleave
Mr Norris
Mr Bryce
PS/IR

- The French seem to be well aware that progress on mutual assistance depends (inter alia) on the Commission finally dropping the nonsense of a withholding tax. Hope that we do not need to take seriously the Italian suggestion, at the meeting of the Ad Hoc Group on 23 October, for reviving the withholding tax issue - and that it is not a pretext for some new unwelcome Italian initiative (such as reneging on the capital liberalisation commitment).

- For the UK's part, anxious to go as far as reasonably or politically possible to meet French political needs and strengthen mutual assistance.

- In this context, hope Germans agree that any new EcoFin initiative should explicitly recognise need for balance in information powers for tax authorities. Cannot undertake open-ended commitment. On one hand, clear duty to co-operate against tax evasion. On other hand, have regard to compliance costs and reasonable (within reasonable limits) privacy rights.

- Hence, UK suggestion at Ad Hoc Group that any new Council resolution should recognise principle of "proportionality": justification for any particular information request to be judged in the light of all the facts of the case, having regard to the amount of tax at stake, administrative costs, compliance costs for taxpayer, financial institutions etc.

- Similarly, an essential point that any new information commitment should be explicitly prompted by and relevant to evidence of tax evasion: income or capital gains not declared for IT/CGT purposes, or (if extended to inheritance tax) transfer of assets not declared for IHT purposes.

- We cannot impose "declarations of capital assets", or "capital movements" per se, unless there is specific evidence of relevant tax evasion.

- Generally, all too clear that a lot of work still needs to be done and a lot of thinking needs to be clarified, if dossier is to be ready for EcoFin in November. Very much agree with what Germans said on this at Ad Hoc Group on 23 October.

- In particular, what do Germans think of prospect for "minimum commitment" requirement that in cases of very serious fraud, and subject perhaps to judicial authority, national authorities should provide evidence to Community partners, even if they do not have similar information powers for their own tax purposes? Is it really a starter? Does Herr Waigel think that this can be ready for decision by November EcoFin? What will the Luxembourgers/Greeks do?

3. For purposes of defensive briefing, I can imagine that Herr Waigel might well seek to probe your position on two main points which are not already very familiar to you, or covered by the notes above.

(i) What is the UK attitude to the "minimum commitment"? Unless you rule this completely out on political grounds, your line might be that - as the Germans themselves emphasised in the Ad Hoc Group on Monday - this idea needs a lot more working up and clarification before Ministers can sensibly take a decision on it. [For example, the present draft seems to leave the information requirements absolutely open-ended. And again, it seems to imply that - to take an example - a country should take legislative powers to collect information relevant to a wealth tax, even if (like the UK) it has no wealth tax and has no intention whatever of introducing one.]

(ii) What is the position on the Channel Islands and Isle of Man? You might say that, as agreed, the Commission will be providing factual information for the next meeting of the Ad Hoc Group. In brief, the Channel Islands and Isle of Man are not part of the United Kingdom. They are not covered by the EC Treaty (except for certain very limited and carefully defined purposes); they are not covered by the Mutual Assistance Directive; the constitutional convention is that the UK Parliament does not legislate for the Islands on tax matters; and any further developments here would therefore seem to be for the Islands themselves and their own Legislative Assemblies.

A J G ISAAC

PCP

CONFIDENTIAL

P Jefferson Smith
*Deputy Chairman*

Board Room
H M Customs and Excise
New King's Beam House
22 Upper Ground

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GTN Number 3913 .............

FROM: P JEFFERSON SMITH
DATE: 25 OCTOBER 1989

CHANCELLOR OF THE EXCHEQUER

BILATERAL WITH WAIGEL

As requested, I attach briefing on indirect tax matters, concentrating on developments from the ad hoc group of experts set up by ECOFIN to look at proposals for the abolition of fiscal frontiers.

If the opportunity to discuss indirect tax matters presents itself you might like to encourage the Germans to take a more constructive line towards the destination principle proposals being discussed under the French Presidency. Although by no means perfect, these represent the best route towards agreement on the broad principles of the post-1992 VAT and excise arrangements. At ECOFIN, the Germans gained their point that the destination system should be adopted for 'a limited period' and we would hope that they could now put their energies into making it work, and minimising burdens on business, rather than encouraging Commission carping.

PJS

P JEFFERSON SMITH

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| | | |
|---|---|---|
| cc | PS/Paymaster General | CPS |
| | PS/Economic Secretary | Mrs Strachan |
| | Mr H P Evans | Mr Wilmott |
| | Mr R I G Allen | Mr P R H Allen |
| | | Mr Railton |

**CHANCELLOR'S MEETING WITH HERR WAIGEL 26 OCTOBER 1989**

**TAX APPROXIMATION**

**UK OBJECTIVE**

To emphasise the need, identified by the Madrid Council, for member states to reach agreement in principle on an indirect tax system by the end of the year. Stress that - better to reach agreement on an imperfect system that can be implemented by 1/1/93, than reach no agreement at all.

**POINTS TO MAKE**

1. Pleased that ECOFIN have endorsed work of Ad Hoc Group.

2. Strongly support German view that any new system must lighten the burdens on business.

3. Unfortunate if agreement on workable system not achieved by deadline set by Madrid Council because of unrealistic adherence to the ideology of the origin system by Commission and Germany. Hope that Germany will now take a constructive role in forthcoming discussions.

4. UK still regards enforced tax approximation as unnecessary and inappropriate. Must retain ability to apply zero rates. [A minimum rate system would be preferable to the fourchette concept now being pressed by the Commission. (This does not go beyond your comments to Mme Scrivener at Antibes).]

**GERMAN POSITION**

1. Germany accepted the Commission's original proposals in principle and was the only member state not to express serious reservations about the "clearing house".

2. In response to the Commission's revised thinking; were content to accept a minimum rate provided it did not exceed their standard rate of 14%; accepted zero rate proposals, but they must be limited to goods which did not distort competition and cited books as a potential problem; was the only member state to welcome the macro-economic clearing system.

3. In the Ad Hoc Group, Germany has been slow to catch up with the general change of direction among member states. On 6 September 1989 they published a note on their views of the discussions in the Ad Hoc Group, in which they remain ideologically committed to the origin system but say they are willing to accept the destination system on the proviso that it is for a "transitional" period (pressed for this to be for a maximum of 5 years). Also expressd serious reservations about the special schemes for mail order and sales of vehicles, although understood the arguments for the exempt sector.

4. It was at the insistence of the Germans, at ECOFIN on 9 October, that the destination system was agreed subject to "limited period" and the special schemes for vehicles and mail order agreed subject to further consideration by the Ad Hoc Group.

5. Following recent informal contacts between Cabinet Office and the French Embassy we understand that in order to get the Germans on the side of the destination system, the French have given them an undertaking that they will press member states to reach broad conclusions on tax approximation by the end of the year. The French view is that member states should accept a standard rate bands of 14-20 per cent.

**BACKGROUND**

1. <u>Main elements of Commission's revised thinking:-</u>

i) 14-20 per cent rate band replaced by a minimum rate, unspecified. Reduced rate band of 4-9 per cent remains unchanged.

ii) Acceptance that zero rates may be retained on a limited number of items but still see need for some measure of tax approximation.

iii) Retention of destination system for some EC traffic. Origin system for remaining EC trade, with a clearing mechanism based on macro-economic trade statistics.

iv) minimum (unspecified) excise rates for alcohol and tobacco; rate bands for oils.

[We have received details (in confidence - please protect) of revised Commission's proposals for excise duty rates. Proposals involve minimum duty rates from 1/1/93 with target rates to be reached by 1/1/98. Exceptions are for oils, for which a combination of duty bands for some products and minima (with or without target rates) for others is envisaged. It is not known if these have also been leaked to the Germans]

2. <u>Main criticisms of Ad Hoc Group proposals (and responses)</u>

a) <u>the proposals will not provide a true Single Market</u>

True that continued use of destination system means that intra-Community commercial transactions treated differently from domestic but -

(i) destination system is only system so far to achieve unanimous acceptance of Member States (unlike the Commission proposals): Better to have an acceptable compromise than failure to agree on a perfect solution.

(ii) destination system offers only prospect of removing fiscal frontiers by the end of 1992: Commission proposals could not be implemented by then.

(iii) Commission proposal relied on complex and bureaucratic revenue clearing mechanism which was unacceptable to all Member States.

b) <u>the Ad Hoc Group proposals would run increased risk of fraud (because exports are tax-free)</u>

The Commission's favoured origin system was just as prone to fraud - from false input tax claims and from the complexity of a system which, of course, retained tax-free exports to countries outside the EC. Ad Hoc Group (of fiscal experts) considerations suggest that an effective system can be devised to combat fraud without increased compliance costs for businesses.

c) <u>the Ad Hoc Group proposals would mean heavy compliance costs on traders</u>

Modalities of monitoring system not yet agreed. All Member States agreed that business compliance costs must be less than at present. Commission proposals would certainly have involved separate compliance burdens for businesses in regard to tax and trade statistics. Under destination system these can be collected together.

d) <u>the unresolved problem of divergent VAT and excise duties</u>

Tax approximation/harmonisation is merely a means to the end of removing fiscal frontiers. Not an end in itself. The Commission's own economic analysis recognises that the tax rates appropriate for any particular economy cannot be determined centrally.

e) checks at frontiers on travellers may have to be retained, so a single market is not achieved

UK considers that checks will continue to be necessary to catch drugs smugglers, etc. For goods subject to VAT and excise, need occasional spot check to ensure that people claiming to be private travellers are not in fact importing on a commercial scale for commercial purposes. Commission have accepted that frontiers are not a "no go" area for spot checks. This does not mean that we anticipate current levels of checking - but a highly selective spot check arrangement.

Sent FAX

**CONFIDENTIAL**

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Telephone: 01-620 1313

FROM: MRS V P M STRACHAN
DATE: 3 NOVEMBER 1989

**CHANCELLOR**

INDIRECT TAXATION IN THE SINGLE MARKET: ECOFIN 13 NOVEMBER

Your office have asked for an overview of the key issues likely to arise on this dossier at ECOFIN on 13 November. The following contains a rapid appreciation of where matters stand.

2. The French Presidency have just produced draft ECOFIN conclusions, which will be discussed at the Ad Hoc Group on the Abolition of Fiscal Frontiers (where Mr P R H Allen represents the UK) on 6/7 November. At present, they contain a number of unsatisfactory elements, some of which we are unlikely to be able to negotiate away next week because of lack of support from other Member States.

3. The French are pressing hard for an agreement covering a substantial part of the indirect taxation dossier, primarily the VAT element. They appear keen to

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| | | |
|---|---|---|
| cc | Chief Secretary | CPS |
| | Financial Secretary | Mr Jefferson Smith |
| | Paymaster General | Mr Nash |
| | Economic Secretary | Mr Wilmott |
| | Sir P Middleton | Ms Seammen |
| | Mr Wicks | Mr P R H Allen |
| | Mr Scholar | Mr Cockerell |
| | Mr Evans | Mr Trevett |
| | Mr R I G Allen | Mr Brown |
| | Mr Culpin | Mr Peach |
| | Mrs M Brown | Mr Kent |
| | Mr W White | Mr Gaw |
| | Mr Michie | Mr Pratt |
| | Mrs Chaplin | Mr Knox |
| | Mr Tyrie | Mr Railton |

Sir D Hannay (UKREP)
Mr Kerr (FCO)
Mr Hadley (Cabinet Office)

resolve the issue at the 13 November ECOFIN, but we have already warned them that this seems over-optimistic. They evidently wish to avoid discussion at the Strasbourg Council: UKREP think that if a deal cannot be sewn up at the November ECOFIN a form words telling the December ECOFIN to resolve the matter is likely to be included in the conclusions of the Council, but without discussion.

4. The key issues are as follows:

(i) Preservation of UK zero rates
(ii) Approximation of VAT rates
(iii) Private importations of alcohol and tobacco
(iv) Technical arrangements for applying VAT to intra-EC commercial transactions
(v) Excise duties

(a) Preservation of UK zero rates

As you will know, although only three zero rate categories (food, domestic energy and young childrens' clothing and footwear) have been subject to specific Government pledges, we have resisted all attempts to remove any UK zero rate categories. Although we cannot expect either other Member States or the Commission to agree at this stage that we should retain all our zero rates - (indeed, were we to try and force the issue we should be quickly isolated) - any overall deal must contain a form of words which satisfactorily protects our position. This will not be easy, but the Commission know that no deal is possible without it, and we shall have a better idea of our chances of success after the Ad Hoc Group meeting next week.

(b) Approximation of VAT rates

The draft French ECOFIN conclusions suggest a VAT standard rate band of 14 to 20%, with further discussions between now and the end of 1991 to limit the rate band still further. They propose to defer discussions on the scope and level of reduced rates.

The proposal on the VAT standard rate is wholly unacceptable. The UK has argued long and hard (but, admittedly, in isolation) that tax approximation is unnecessary and inappropriate. We believe, however, that there is a reasonable chance of agreement on the basis of a minimum rate of 15%. The Commission and other Member States consider that this would, in effect, embody the UK market forces approach. The minimum rate is intended to prevent the competitive bidding down of tax rates.

As you will recall, the Prime Minister rejected a minimum rate earlier this year. If, therefore, it appears in the next few weeks that an acceptable deal could be done on this basis, the issue will need to be referred back to her. We are giving thought to how best this might be done. In the meantime, as far as November ECOFIN is concerned, we suggest no real change in the UK line, but perhaps a slight presentational change of emphasis on to providing scope for market forces and away from calling tax approximation unnecessary and inappropriate. (This would enable any acceptance of minimum rates at a subsequent meeting to seem rather less of a volte face.)

(c) Private importations of alcohol and tobacco

The French conclusions are that the allowances for travellers to purchase goods, subject to limits, VAT - and excise duty-paid in another Member state should be removed in 10 Member States - ie private individuals would be able to purchase unlimited quantities of tax-paid goods in another Member State (no proposals are made in relation to duty-free purchases); but that Denmark and Ireland should be able to retain travellers' allowances for a (limited!) period until tax rates have been harmonised.

The removal of these limits on VAT-paid goods is in line with UK proposals. However, this is unacceptable as far as the excise duties on alcohol and tobacco are concerned. We have argued that a distinction (based on quantitative limits) should be made between genuine travellers, purchasing for their own consumption, and those who are in practice bringing goods into the country for re-sale. Although our approach received the support of around half the Member States, the Presidency, Commission and some other Member States are resolutely of the opinion that the retention of any quantitative limits on private individuals' cross border purchases would be contrary to the Single European Act. There is general agreement that qualitative controls (eg distinguishing wine imported in bottles from wine imported in bulk) at the frontier or internal controls (eg using fiscal stamps) could be applied.

All this creates considerable difficulty for us and we will brief in greater detail on the problems, including the risk of substantial revenue loss. We may need, subject to next week's Ad Hoc Group, to argue for a similar derogation to that for Denmark and Ireland.

(d) Technical arrangements for applying VAT to intra-EC commercial transactions

Our success, albeit with lingering Commission grumbling and some opposition from the Germans, is in retaining the destination principle and thus avoiding the unacceptable clearing house proposal. But the technical front runner for the new arrangements is a much more burdensome (on both Government and business) system than we should like to see. At present we are outnumbered, although we shall argue our case again next week at the Ad Hoc Group. We shall probably want to advise you not to accept the Presidency conclusions without a more detailed analysis of the business compliance and administrative cost implications of their proposals. But this judgement will have to be made in the context of the likelihood of an acceptable deal overall.

(e) Excise duties

There has been little progress here. But we have no more problems than others. The Presidency propose to carry out further work on the basis of a (generally acceptable to the UK) system for commercial transactions and defer discussions on rates. We have tended to argue that consideration of excise duties should not be allowed to lag behind that of VAT. In the current circumstances, in view of the unsatisfactory recent Commission proposals on minimum rates for excise duties (which for alcohol and tobacco are too low and would give rise to the cross-border shopping problems outlined at (c) above), there is something to be said for letting this dossier run on into the Irish Presidency.

5. General tactics

Our present feeling is that it would be best to mark time at the November ECOFIN and take stock thereafter on whether we should make a push for a deal in December, subject to the Prime Minister's support. It is likely, however, that M Beregovoy will wish to discuss the prospects of a deal privately with you at the November ECOFIN. You will wish to ensure that he is aware of the critical elements of any deal for us and if he is prepared to satisfy our requirements, that he can deliver the agreement of the other Member States.

6. Subject to your views, we shall incorporate this in our briefing for ECOFIN. Mr Allen will also report back immediately after the Ad Hoc Group meeting on 6/7 November.

MRS V P M STRACHAN