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PART A

Part . A .

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Chancellor's (Lawson) Papers:

Harmonisation on Taxation Issues

Following the Implementation of  
The Single European Market .

DD's: 25 Years

*Anderson*

23/2/96.

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PT.A.





MINUTES OF A MEETING HELD IN THE CHANCELLOR'S ROOM,  
HM TREASURY AT 4.00PM ON MONDAY, 9 MAY 1988

Present:

Chancellor of the Exchequer	Mr McGivern - IR
Paymaster General	Mr Unwin - C&E
Economic Secretary	Mr Jefferson-Smith - C&E
Sir Peter Middleton	Mr Nash - C&E
Sir Geoffrey Littler	P R H Allen - C&E
Mr Byatt	Mr Knox - C&E
Mr Lankester	
Mr Scholar	
Mr Culpin	
Mr Riley	
Miss Sinclair	
Mr Ford	
Mr Cropper	
Mr Tyrie	

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**THE SINGLE EUROPEAN MARKET**

Papers: Miss Sinclair's annotated agenda of 6 May, and papers listed.

2. The Chancellor noted that the annex to Miss Sinclair's paper of 5 May showed that there were wider differences between the proportions of social security contributions to GDP in different countries than between the proportions of tax to GDP. Mr Byatt confirmed that there were no current proposals to harmonise these. The Chancellor noted the curiosity that efforts were devoted to harmonisation between countries in the areas of lesser difference. He also noted that there were no current proposals to harmonise local taxes.

3. The Chancellor said that the contents of Mr Jefferson-Smith's minute of 29 April were most worrying. Mr Jefferson-Smith said that it was still safe to assume that changes under the SEA



required unanimity. It was not clear what would happen, however, if 1993 arrived before unanimity had been achieved. The Economic Secretary said that the declaration accompanying the SEA - that it was a political decision and not legally binding - might have been thought to provide a safeguard. Mr Unwin said this may indeed been the view at the European Council; but the precise position might be different. The Chancellor invited Mr Unwin to consider further whether the Law Officers should be consulted. He should advise by the end of May on how any questions might be put, and on how the Law Officers might be expected to respond.

4. The meeting considered the questions set out in Miss Sinclair's annotated agenda.

5. Is any form of centrally determined tax approximation acceptable, given the implications for economic sovereignty?

The Chancellor said that the general answer to this question was "no".

6. Is this a question which can be settled by legal advice; or is it essentially political? What are the pros and cons of consulting the Law Officers?

The Chancellor said these questions should be considered in the light of the further advice from Mr Unwin.

7. Are we in danger of losing some of the benefit of a wider internal market if we oppose tax approximation in principle?

The Chancellor said there might be a small loss of the benefit, but this would be outweighed by the substantial - and not merely political - difficulties arising from a centrally imposed system. These arose particularly from the possible approximation of direct taxes, which could in turn raise the possibility of the Commission's undermining national tax strategy. Mr Byatt noted that, to the degree that taxes on consumption were not economically



distorting while direct taxes were, replacing direct taxes with consumption taxes might be economically desirable. Mr Unwin said that, if the Chancellor thought the "sovereignty" argument sustainable, this would give Customs a firm basis for planning. The Chancellor said that, subject to legal advice, Customs should plan on the basis that we would continue to oppose the Commission's tax approximation proposals in principle. (For further discussion of this point, see paragraph 16 below).

8. Would acceptance of a degree of indirect tax approximation make it more difficult to oppose proposals for direct tax approximation? Should our response to the commitment to a Europe without frontiers be (a) to keep frontier enforcement of the "social" controls over drugs etc; (b) not to abandon radically all other controls over intra-Community freight and passengers; but (c) to prepare an attractive simplification package?

The Chancellor said that the answers to these questions were broadly, "yes". Mr Unwin said that Customs did envisage genuine simplifications, in particular in relation to freight. The Chancellor noted that we should also seek greater freedom in relation to cross-border shopping. He agreed, however, that a future system should entail our being able to bring other countries exports into our tax system (eg in particular those products sold here by unregistered traders).

9. Can we hope to secure any major allies - eg the French or Germans - if we oppose centrally determined tax approximation in principle? If not, is it in our interest to assist, in a low key way, in producing deadlock on the Commission's proposals before presenting our alternative approach? Would we do better to put our views clearly on record, against the background of the Commission's inexorable ambitions and other member states' reluctance to be seen to challenge them?

The Chancellor noted that our tactical approach was complicated by the need to make our case both at Westminster and in Brussels. We



should present our alternative, free market approach as something which should be studied in parallel with the Commission's proposals. This should be taken forward in the EPC framework. We ought also to seek to bring out the economic policy aspects of the various proposals. The Chancellor noted that he had put on record our alternative approach in his speech to the Konigswinter Conference in Cambridge.

10. In further discussion, the Chancellor said we should encourage others to put forward their alternatives for parallel study. Sir Peter Middleton noted that we would need to deploy our arguments carefully, in order to ensure that further study progressed in a suitable direction. The Chancellor agreed. At this stage we should limit ourselves to the procedural proposal that the market alternatives should be studied.

11. Mr Unwin noted that the DTI "1992" campaign and the expectations which it was bringing about, had implications for our own proposals. The Chancellor agreed; he might need to write shortly to Lord Young.

12. Would we assist member states' acceptance of our case (and protect ourselves under Community Law) if we accepted removal of frontier controls as an eventual goal - notwithstanding difficulties over drugs, terrorism etc - and presented our simplification alternative as a step on the way. If a high profile results in isolation, what do we stand to lose?

The Chancellor said we should accept removal of frontier controls - except those required to control drugs, terrorism etc. - as an eventual goal, and present our simplification alternative as a step on the way. This should encourage member states' acceptance of our case. A position of eventual isolation would not be intolerable. But we should play our hand to ensure that this did not arise; though we might be isolated in objecting to the principle of the



Commission's proposals, it was highly unlikely that we would be the sole opponent of the Commission's plans. We should take a high profile at the informal ECOFIN in Lubeck, to stiffen the resolve of others.

13. If we are opposed in principle to centrally determined tax approximation, is it logical to propose centrally determined minimum rates of duty?

The Chancellor said we should continue to propose minimum rates of duty on alcohol and tobacco which were higher than those proposed by the Commission. This could and should be justified on health, rather than economic, grounds.

14. Proposals for direct tax approximation are now beginning to emerge. Should we take the initiative in putting an early paper to OD(E) - setting out the Chancellor's position on direct and indirect tax approximation?

The Chancellor said there was a case for alerting OD(E) to the potential dangers of direct tax approximation. There was also a case for a more general paper. A draft should be prepared after the informal ECOFIN, for circulation before Hanover, setting out the issues clearly. It would also be helpful to have a regular report from FP on developments across the whole tax approximation field, to ensure that we were not taken by surprise by any sudden changes.

15. The Chancellor invited officials to prepare briefing for the informal ECOFIN along the lines indicated by the discussion. This should cover both the line to take at the ECOFIN itself, and the subsequent line to take with the Press.

16. The Chancellor said it was important that Customs should not plan - even on a contingency basis - on the assumption that we might sign up to the Commission's proposals. Nor should work be done in the Treasury or elsewhere on proposals which involved imposing positive rates of VAT on "pledged" items. Customs should,



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however, take forward its proposals for possible simplification of the freight procedures. Consultations with the freight industry should be undertaken, as appropriate.

*JMG*

J M G TAYLOR

11 May 1988

Distribution

Those present  
Financial Secretary  
Mr A J C Edwards

FROM: R G MICHIE

DATE: 23 May 1988

PS/CHANCELLOR

cc Mr Byatt  
 Mr Culpin  
 Mr Edwards  
 Miss O'Mara  
 Mr Mortimer  
 Mr Riley  
 Miss Hay

Mr P R G Allen - C&amp;E

Mr B Shepherd - IR

**EC TAX APPROXIMATION : CHANCELLOR'S PAPER FOR OD(E)**

At the Chancellor's meeting on 9 May, he said that there was a case for alerting OD(E) to the potential dangers of direct tax approximation. I attach a draft of a paper first prepared by Miss Sinclair prior to her departure to Number 10, and which now reflects comments from others in the Treasury, together with those from Customs and Excise and the Inland Revenue.

2. The paper is designed to point out to Ministerial colleagues the dangers involved in any form of centrally determined tax approximation. It also draws attention to the fact that the Commission's approach to tax approximation is at odds with the deregulation and liberalisation which we believe are the important features of a single European market.

3. It would be helpful to know if the Chancellor considers the paper to be on the right lines, and if he wishes it to be discussed at OD(E) on 16 June, or merely read by way of background.

4. Should the Chancellor wish the paper to be discussed at OD(E), FP can, in consultation with others, finalise its contents, then re-submit the paper to the Chancellor in time for him to approve its issue by 9 June.

*R. George Michie*

R G MICHIE

*Thanks. A few stages. At this stage, I think it will be enough to have the paper on background or it will be discussed. Mr. Ch. Content with paper? Mr. Mortimer (OK X)*

*X*

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DRAFT OD(E) PAPER

CABINET  
DEFENCE & OVERSEAS POLICY COMMITTEE  
SUB-COMMITTEE ON EUROPEAN QUESTIONS

## DIRECT &amp; INDIRECT TAX APPROXIMATION

## Note by the Chancellor of the Exchequer

In my note of 25 September (OD(E)(87)19) I set out our approach to the issue of indirect tax approximation within the Community. This was broadly endorsed by OD(E) on 1 October. The issue is now widening, <sup>h.w.k.v.,</sup> (to include proposals for direct tax approximation. Although these are unlikely to feature at the Hanover Summit at the end of June, it is not too soon to consider the wider implications of the Commission's approach, and to frame our tactics accordingly.

2. Tax approximation is a means, not an end. The end to which we are fully committed is the completion of the Single European Market. This will increase competition and improve economic efficiency within the Community. It will involve opening up markets, such as capital markets, which in some member states have been protected from foreign competition. It will also involve removing constraints on internal EC trade by eliminating differences in technical standards, and by removing or reducing as far as possible the costs imposed by controls at customs posts.

3. It is important to keep to the fore the vision of a better functioning market, building on the concept of deregulation which we introduced into the Community. There is no point in moving towards greater integration of the European economies if the process results in greater regulation at a Community wide level. It is not integration per se which will bring greater prosperity to the twelve member states. That will only come if market forces are given more leeway. The recent history of the UK economy

demonstrates the benefits which flow from deregulation, from freeing markets and from dismantling barriers and controls, all within the proper framework of financial discipline.

4. The Commission's approach to the single market does not always reflect market-oriented thinking. The Commission are not natural deregulators. This is particularly evident on tax, where the only solution they have for the problem of cross border shopping is a system of centrally determined VAT and excise rates. But that is not the only solution. The market approach, which would leave member states free to make their own adjustments to VAT and excise rates in the face of competitive pressures, is a valid alternative. This would involve raising intra-Community traveller's allowances substantially so that market forces would have an increasing influence through consumer's behaviour; while for freight it would mean continuing and significant reductions in frontier controls to minimise the effect that these controls have on the free functioning of the single market.

5. There is no need to approximate VAT and excise rates on competitive grounds. In principle different rates of VAT and excise duties do not distort competition. Under the destination principle which applies in the Community, goods bear the same rate of VAT within a given country regardless of where they are produced. The same is true of excise duties, although some countries do seek to favour domestically produced goods. For example, taxes on wine are generally lowest in those countries which are substantial producers, but such discrimination has been limited by a series of European Court judgements. Harmonisation of indirect taxation, with the costs and complications of the Commission's proposed clearing house system, is a considerable over-reaction to the problems of cross-border shopping which may arise when frontier controls are relaxed. But harmonisation is not a pre-condition of an effective single European market.

6. At the informal meeting of ECOFIN on 13-14 May, the UK was invited to prepare a paper looking at whether a more limited form of tax harmonisation might be adequate. We have agreed to prepare such a paper and will use the opportunity to reiterate our view

that centrally-directed harmonisation is not only unacceptable to the UK, it is unnecessary for the completion of the single market. We expect that the Community's economic experts will consider our paper at a meeting on 8 July.

7. In principle, a stronger argument can be mounted for harmonising certain direct taxes on the grounds of competitive neutrality. Taxes which affect production costs and profitability do affect competition. This will often be true for taxes on profits; and is certainly true for taxes on labour (eg both employers' and employees' social security contributions and income tax). There are much greater differences in member states' social security contributions expressed as a percentage of GDP, than there are between indirect taxes.

8. In practice proposals for centrally determined direct tax approximation are open to as many objections as those for VAT and excise duties.

9. First, there is the question of economic sovereignty. We have already considered this in the context of the proposals for indirect tax approximation. If tax approximation extends to direct taxes, there would be considerable risk that fiscal flexibility in individual countries would be progressively eroded, tending to a complete loss of fiscal sovereignty in the long run. The UK would effectively be tied in to levels of ~~public expenditure~~<sup>taxation</sup> and ~~borrowing~~ in other member states. This is not obviously a desirable outcome. If such developments went hand in hand with moves towards monetary union, the combination of direct and indirect constraints would make sizeable inroads into our ability to take independent action affecting the UK economy.

*Other member countries are likely to have similar restrictions though some may seek to use this as a means of pulling the UK from gaining the advantages of lower tax rates.*

10. Second, a rational approach to tax reform would become much more difficult. One of the problems we have long recognised with the Commission's proposals for harmonised rates of VAT and excise duties is that they have no particular economic logic. They simply represent a middle position between the extremes of prevailing rates in the Community. This is unlikely to produce economically ~~desirable~~<sup>optimal</sup> rates or structures of taxation. Even if the Commission

base proposals for tax approximation on widely accepted economic principles (eg broad base, low rates, few/no special reliefs), the outcome of negotiation in Brussels is likely to be random, reflecting what can be accepted by twelve different countries. The UK is now a low tax country by EC standards. If social security contributions are included, tax as a percentage of GNP is lower in the UK than in the other major EC countries. Low taxes give us a competitive edge.

11. We stand to lose this edge if we enter the cartel arrangements implicit in the Commission's approach to tax harmonisation. Even if specific bands of rates or other arrangements allowed us to keep much of our present tax structures intact, room for further change, including still lower rates of tax, would be limited. Where we wanted to reduce the lower limit of a given harmonised tax, we could only do so by unanimous agreement within the Community. We would no longer be able to reduce taxes when conditions in the UK permitted. We would be tied to other people's economic policies, including their levels of public expenditure. No doubt we would be pushed into replicating some of their special tax reliefs. These would be welcome to those who benefitted, but the price - over and above economic distortions - would be higher tax rates for all.

12. In sum, we stand to lose much of benefit we are now reaping as a result of our tax reforms.

13. A third and significant objection to the Commission's proposals for direct and indirect tax approximation is that they are unnecessary to achieve a single European market. Certainly the latter will function more effectively if the disparities in the taxes which affect production costs and profitability in the member states are not too wide. But market forces are likely to bring this about over time without dirigiste intervention by the Commission. Moreover, market forces will always push taxes downwards, as long as there are member states or other important third country competitors, with low rates of tax. There is nothing to be gained by the Community lumbering itself with a cumbrous

While Central  
differed tax rates  
will act to prevent  
this from occurring.

system of integrated tax rates, with adjustment constrained by the need for unanimity among twelve countries, while the USA and Japan remain free to cut taxes subject only to the constraints of their own domestic politics.

14. There is little doubt that the mainspring of pressure for centrally determined tax approximation is fear of competition. Thus the French, who tax investment income relatively heavily, argue that a common withholding tax applied to such income in all member states is essential if full liberalisation of capital movements is not to lead to massive tax evasion. They ignore the fact that third countries, where tax was not withheld, would continue to exist; and companies which wanted to pay interest gross would issue through those countries. The Euromarkets and internationally mobile bank deposits would be driven out of Europe, taking business, jobs and taxable profits with them.

15. Countries with those fears have not succeeded in making harmonisation of withholding taxes a pre-condition of capital liberalisation but they are still pressing for Community measures to combat tax evasion to be considered in parallel. They seek either common withholding taxes or a common system for passing information about interest receipts from banks to other countries' Revenue authorities. The latter might have lesser problems for the UK but could involve substantial compliance costs for the banks and fiscal authorities; might be of limited effectiveness in preventing evasion; and would run risks of driving <sup>some</sup> deposits (though not the Euro-markets) out of Europe. (A high-level meeting of member states' officials was held on 27 May [where the UK argued that no Community-wide action is necessary].)

16. A number of draft Directives on certain aspects of direct taxation have been under discussion for many years, with little real progress being made. The Commission's latest initiative is the preparation of a preliminary draft Directive on the harmonisation of the business tax base, ie the measure of taxable business profits. The draft proposals are unclear in a number of important respects and would in any case need detailed study

and clarification if they were to be taken further. But the underlying point is that the Commission have not made out their case for harmonisation per se in this area. (The proposals are to be discussed with the Commission at a meeting of senior tax officials on 14 June.) But it is already clear from the broad thrust of the proposals that they would involve radical changes to the present UK regime. In particular, they would mean putting into reverse, to some considerable extent, ~~the move since~~ the 1984 business tax reforms <sup>with clear move to</sup> a broader tax base and lower rates. A very tentative and, in view of the uncertainty in key areas, necessarily speculative estimate, suggests that the scale of costs to the UK Exchequer would be very large indeed, possibly of the order of £3 billion or more which, on a revenue-neutral basis, would require a rate of corporation tax of about 42 per cent, <sup>inevitably also</sup> (compared with the present 35 per cent). This would involve a redistribution of the tax burden from the financial and commercial sectors to manufacturing. All this would clearly be unacceptable.

17. Detailed tactics for dealing with these and possibly other proposals for direct tax approximation will need to be developed in due course. Meanwhile the Committee's attention is drawn to the wide-ranging implications of accepting centrally determined tax approximation; and the antithesis between such an approach and the fundamental aims of the single market. I believe that deregulation rather than harmonisation, and co-ordination on measures to reduce the costs of crossing borders should be the UK's main aims, and that we should reject arrangements such as centrally imposed tax approximation which <sup>with</sup> are designed to shackle competitive forces within the Community <sup>while it is necessary to have</sup> (they cannot protect it <sup>from</sup> competition from outside). <sup>member states fully open to</sup> <sup>Re Community</sup>

18. I invite the Committee to endorse the conclusion in paragraph 17.





FROM: J M G TAYLOR

DATE: 24 May 1988

A handwritten signature in blue ink, appearing to be 'JMG Taylor', located in the top right corner of the document.

MR R G MICHIE

cc Mr Byatt  
Mr Culpin  
Mr A J C Edwards  
Miss O'Mara  
Mr Mortimer  
Mr Riley  
Miss Hay  
  
Mr P R G Allen - C&E  
Mr B Shepherd - IR

**EC TAX APPROXIMATION: CHANCELLOR'S PAPER FOR OD(E)**

The Chancellor was grateful for your minute of 23 May and the enclosed draft paper.

2. He has a few amendments to the draft, which are set out below. He has commented that, at this stage, he thinks it would be enough to have the paper read by way of background, without any discussion at OD(E). But he recognises that the paper still needs to be "finalised".

3. The Chancellor's comments on the text are:

Paragraph 1, line 4: to read: "... now widening, however, to include ...".

Paragraph 9, lines 7 and 8: to read: "... the UK would effectively be tied in to levels of taxation in other member states."

Paragraph 9: add new sentence at end: "Other member countries are likely to have similar reservations, though some may seek to use this as a means of preventing the UK from gaining the advantage of lower tax rates."

Paragraph 10, lines 6 and 7: to read: "This is unlikely to produce economically optimal rates or structures of taxation."



Paragraph 13, line 10: to read: "... with low rates of tax; while centrally determined tax rates will act to prevent this from occurring."

Paragraph 15, line 10: to read: "... and would run risks of driving some deposits ...".

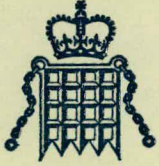
Paragraph 16, lines 15 and 16: to read: "... to some considerable extent, the 1984 business tax reforms with their move to a broader tax base and lower rates."

Paragraph 16, line 22: to read: "This would theoretically also involve a redistribution ...".

Paragraph 17, lines 10 to 12: to read: "... centrally imposed tax approximation which will shackle competitive forces within the Community while necessarily leaving member states fully open to competition from outside the Community."

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

J M G TAYLOR



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

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FROM: THE CHAIRMAN  
 DATE: 27 MAY 1988

CHANCELLOR OF THE EXCHEQUER

CC Chief Secretary  
 Paymaster General  
 Financial Secretary  
 Economic Secretary  
 Sir P Middleton  
 Sir G. Littler  
 Mr Byatt  
 Mr Lancaster  
 Mr Scholar  
 Mr Edwards  
 Mr Culpin  
 Mr Gilhooly  
 Mr Cropper  
 PS/IR  
 Mr McGivern IR

*Thank -  
 Agree -  
 Per fix -  
 mtg with A-G -  
 where have  
 v. brief -  
 mtg -  
 information -*

*Ch. Agree with Mr U. that we  
 should put the jims to the  
 Law Officers; but that, first,  
 you should consult colleagues  
 at OD(E) and at least have  
 a word with the A-G?  
 I will ask 27/5*

**TAX APPROXIMATION: EFFECT OF SINGLE EUROPEAN ACT**

At your meeting on 9 May you asked me to consider further whether the Law Officers should be consulted, how any questions might be put and how the Law Officers might be expected to respond in relation to the UK's tax approximation obligations under the Single European Act.

Inaternal Circulation:

- |                    |             |              |
|--------------------|-------------|--------------|
| Mr Jefferson Smith | Mr Nissen   | Mr Kent      |
| Solicitor          | Mr Allen    | Mr Cockerell |
| Mr Nash            | Mr Fotherby | Mr Knox      |
| Mr Wilmott         |             |              |

## Background

2. The specific origin of your request was the Commission's claim (in footnotes to the EPC Report) that alternatives to their tax approximation proposals were inconsistent with the Single European Act. You wanted to know what the SEA did and did not oblige us to do; whether the Commission's contentions were justified; and what would be the legal position on a "market based" approach.

3. We have put these issues to a group of lawyers from interested Departments, including the Cabinet Office. Their conclusions, with which we agree, are that at this stage restricting the exercise to a number of key questions on general issues rather than going too greatly into specifics would be more likely to obtain helpful advice from the Law Officers. It may well be necessary and would, of course, be possible to ask more specific questions later when more details of how the Commission's and the "market forces" approaches would work in practice are available.

## Questions

4. Our discussions with the lawyers and other Departmental officials suggest that the questions might best be posed in the form attached.

- Questions 1 to 3 are addressed to what in the context is the critical aspect of Article 8A - what is "an area without internal frontiers"?

- Question 4 addresses the "necessity" of indirect tax harmonisation.

- Questions 5 to 8 ask what would be the legal consequences of failing to harmonise or remove internal frontiers by the end of 1992.

5. The post-1992 questions (5 to 8) are particularly important. If the SEA did anything, it must have created some greater compulsion to harmonise. Although the Government are committed to progress towards the single market and want substantial achievements by end-1992, we neither want nor expect to see tax harmonisation. So the effect of the SEA is likely to go beyond being a matter for debate and become a practical issue. But how far does it impose a legal as distinct from a political pressure? And if legal, whose finger would be on the trigger? You will note that question no. 8 asks whether after 1992 there would be an inhibition on tax measures which diverged from the path of harmonisation. The lawyers have suggested its inclusion as a result of experience over Community fisheries policy.

#### Likely attitude of Law Officers

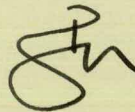
6. I am afraid we have not been able to get very far on this. Lawyers from the Law Officers' Department have, not unexpectedly, commented that the questions raise very wide issues, which range beyond indirect taxation. They have not been prepared to give any indication of what the views of the Law Officers may be. This suggests some apprehensiveness about the outcome. They have also stated that because of the sensitivity and complexity of the issues involved, an early response should not be expected.

#### Conclusions

7. I start from a position of some apprehension about putting questions to which we might get awkward answers. This is why I thought, when you made your original request, that we should pause to consider thoroughly with the lawyers and among ourselves what the questions should be. I should still feel a little easier if we were able to go into this with a clearer indication of the outcome. Nevertheless, I am on balance persuaded that it would be

better to have the answers now - however unwelcome they may be - rather than face the prospect in the next few years of unpleasant legal surprises, which could be politically embarrassing or seriously damage our planning for the single market. The near certainty that we shall not be alone in failing to implement the Commission's present proposals also gives me some reassurance.

8. I recommend, therefore, that the questions attached, which in my view cover the key issues, should be put to the Law Officers. It occurs to me, however, that you might want to seek some support from your colleagues before so doing. If so, the OD(E) meeting on 16 June might be a convenient opportunity, although that would mean a little further delay. It might in any case be prudent to have an informal word with the Attorney General before any papers are put to him. He is aware of the work in hand.



J.B. UNWIN

## QUESTIONS

1. Does Article 8A require the removal of all internal frontiers as such or only to the extent necessary to guarantee that the free movement of goods is ensured in accordance with the provisions of the EEC Treaty?
2. What has to be done to guarantee that the free movement of goods is ensured.
3. (a) does an "area without internal frontiers" in Article 8A require the absence of all border controls for indirect tax purposes; or  
  
(b) is it compatible with Articles 8A and 99 for certain limited controls to be retained at the border for such purposes; and  
  
(c) is the answer to 3(a) and (b) different if the controls in question are carried out inland rather than on the occasion of the movement of goods across a national boundary?
4. (a) what is "necessary to achieve the establishment and functioning of the internal market" in the fiscal context?  
  
(b) is compulsory approximation or harmonisation of indirect tax rates "necessary"? or  
  
(c) is it reasonably argued that it is compatible with Article 99 for Member States to remain free to set their own rates of such taxation, and that the harmonisation obligations set out in that Article do not necessarily require the harmonisation or approximation on a Community-wide basis of the rates themselves?

POST 31 DECEMBER 1992

5. What is the legal effect, if any, of the Conference Declaration on Article 8A?
6. What legal steps will be open to the Commission if the Council or the Member States fail in their obligations?
7. Would an individual be able to rely on the direct effect of Article 8A against provisions of national law to resist or to claim damages in respect of any interference in the passage of his goods across a previously national frontier or to refuse to pay a national rate of indirect tax, in the absence of harmonisation/approximation having been achieved?
8. Will Member States be prevented from diverging from the range of indirect tax rates the subject of the Commission proposals on indirect tax harmonisation/approximation if 31 December 1992 has been reached without harmonisation/approximation of such rates having been achieved? Is there a "standstill" obligation thereafter?



8/6



1. In the  
MB Chimes  
29216201  
M. organize a bilateral  
(e.g. after  
Cabinet next week  
+ let Mr. Unwin's  
of the kind)

FROM: J M G TAYLOR  
DATE: 1 June 1988

MR UNWIN C&E

- cc Chief Secretary
- Paymaster General
- Financial Secretary
- Economic Secretary
- Sir P Middleton
- Sir G Littler
- Mr Byatt
- Mr Lancaster
- Mr Scholar
- Mr Edwards
- Mr Culpin
- Mr Gilhooly
- Mr Cropper
- PS/IR
- Mr McGivern IR
- Mr Jefferson Smith C&E
- Mr Nash C&E
- Mr Wilmott C&E
- Mr P R H Allen C&E
- PS/C&E

**TAX APPROXIMATION: EFFECT OF SINGLE EUROPEAN ACT**

The Chancellor was grateful for your note of 27 May.

2. He agrees that we should put these questions to the Law Officers. He will, however, first have a word with the Attorney General. He would be grateful for a very brief aide memoire for this.

JT

J M G TAYLOR

FROM: P J CROPPER  
DATE: 6 June 1988

CHANCELLOR

cc Chief Secretary  
Financial Secretary  
Paymaster General  
Economic Secretary  
Mr R Allen  
Mr Tyrie  
Mr Call

PS/Customs

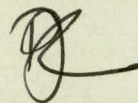
*Thank. Initials. Strategy for committee. J.S. C.S.*

**HARMONISATION**

Alan Reid, the public finance specialist on the EDG Secretariat at Strasbourg, reports that at the end of a three day meeting of the Economic Committee, the tentative conclusions of Ben Patterson MEP were:

- (i) it does not matter whether frontiers come down under the "Irish solution" (Lawson solution?), or in conjunction with commission-style approximation/harmonisation.
- (ii) Differing VAT rates have only a relatively small impact on prices, and the French argument for a very narrow VAT band cannot be sustained.
- (iii) VAT lower rate products are not greatly sensitive to "smuggling" and a band of 0-9% could be envisaged; for the standard rate a minimum might be more appropriate than a band.
- (iv) The clearing system is broadly correct, and could be simpler for traders than present systems for the zero-rating of exports.
- (v) Problem areas needing further investigation include the definition of food; mail order; group registration on a Community basis; and purchases in low-rate currencies by exempt bodies in high rate countries.

2. He goes on: "As for excise duties, the Commission do not seem to have provided the answer. Proposals with more flexibility are needed, with an eye to the US situation where the states do their own internal checks."



P J CROPPER

FCO  
COMMENTS

CONFIDENTIAL



Foreign and Commonwealth Office

London SW1A 2AH

7 June 1988

R G Michie Esq  
HM Treasury

Dear Michie,

**EC TAX APPROXIMATION**

1. Thank you for showing me, with your letter of 25 May, the draft of the Chancellor's paper for OD(E).
2. I have six comments, all of which arise from the rather Manichean terms of the draft.
3. First, I very much agree with Roger Lavelle on the case for touching on the Commission's case for indirect tax approximation. They would agree that it is a means not an end. Their objective is to allow the abolition of frontiers, and they see the, perhaps substantial, losses in tax revenue implied by a continuation of the destination principle as a major source of resistance to opening frontiers. This may seem fanciful to us, given the Channel, but for countries with extensive land frontiers and neighbours with much lower indirect tax rates, the problem is not negligible. This is the reason why, Luxembourg apart, the principle of the Commission's approach is not challenged other than by countries on the periphery of the Community.
4. Second, the paper does not consider the problem of our zero-ratings, presumably because, rightly in my view, you judge that if we were to overcome our wider objections of principle to the whole Cockfield package, we would in practice be able to secure the continuation of the pledged zero-rates. Given that much of the UK domestic political debate has centred on them, it might be better to spell this out. ✓
5. Third, when you turn to direct taxation it might be best to make rather earlier the point in para 17<sup>6</sup> that most of the proposals already tabled are dormant. The fact is that the only real action at present is from the French (hotly opposed by the Germans et al), on withholding tax on investment income; and the only other nascent threat is (from the Commission) on harmonisation of the business tax base. You may wish to consider whether these facts do not make the argument in paras 9 and 11 a little extreme: the risk of our having to adopt "other peoples levels of public expenditure" (para 11) looks rather remote, given the absence of any current proposal for harmonisation of income tax.

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6. Fourth, it is perhaps worth noting that if our real concern is, as your para 10 suggests, to maintain the competitive edge we obtain by being a low tax country, we might in theory do well to encourage harmonisation of indirect taxes, while ensuring (and, given the facts in my para 5 above, this ought to be relatively easy) that direct tax regimes remain free. Arguably we would in this way tie the hands of the high direct tax countries, since they could not erode our competitive advantages by cutting direct tax and raising indirect taxes to compensate. I suppose that they might choose to extricate themselves by foregoing compensation and instead adopting our level of public expenditure, but the political difficulties for them will not escape you.

7. Fifth, I can see that - as para 7 of the paper says - the arguments on grounds of competitive neutrality for harmonising certain direct taxes may be stronger than those for harmonising indirect taxes. This of course does not apply to income tax; but my main point is that I do not agree with the paper's implicit deduction that if we give any ground on indirect taxation we shall be on a slippery slope leading inexorably to harmonisation of business taxes, at higher rates than those now applying here, as a result of the 1984 budget. The Commission's economic arguments may be stronger on business taxes; but the fact is that the issue would be highly political; and I see no reason to expect our partners to think it politically possible for the UK Government to reverse its strikingly successful policy of reducing taxes on business. Our partners have more conceptual difficulty in understanding why we so strongly oppose Cockfield's indirect tax plans, given that the Government has pursued a policy of widening the indirect tax base and shifting the balance from taxes on income to taxes on spending. But they can be in no doubt at all about the difficulties of pushing us up a slippery slope on business taxes.

8. Finally, the implication of the paper is that on most, if not all, the issues discussed the line-up is UK v all The Rest, with the Commission leading a united pack of the ill-intentioned. In fact all the Commission's various ideas evoke opposition in varying degrees from varying groups, sometimes the majority, of our partners. You might wish to consider describing some of these groups, and making the point that we shall not lack for allies, if we want them, and if we can avoid the temptation to stake out the kind of absolutist objection across the board which would scare off potential supporters on particular issues.

*Perhaps so: will  
not be clear  
until after high  
level gp meeting  
on 14th.*

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9. I appreciate that rounding out the paper in these ways would make it a little longer, and less clear. But some of the issues are not perhaps quite as black and white as the draft suggests, and the occasional shades of grey might better reflect reality. Of course the paper as now drafted is well suited to touch off a ministerial debate, and if that is your intention you may not wish to make many amendments. But in that case one will have to envisage discussion in OD(E), which would probably - as Roger Lavelle says - have to be not on 16 June, when the agenda is already crowded, but after the Hanover European Council.

10. Copies of this letter go to the other recipients of yours, and to Tim Lankester and Michael Scholar.

*Yours ever,*

J O Kerr

cc: R G Lavelle Esq, Cabinet Office  
T P Lankester Esq, HMT  
M Scholar Esq, HMT  
P R H Allan Esq, C&E  
B Shepherd Esq, IR  
Miss M Neville-Rolfe, DTI

CONFIDENTIAL



BF 2116

FROM: MISS M P WALLACE

DATE: 7 June 1988

PS/CUSTOMS

cc Chief Secretary  
Financial Secretary  
Paymaster General  
Economic Secretary  
Mr R Allen  
Mr Tyrie  
Mr Call  
Mr Cropper

**HARMONISATION**

The Chancellor has read Mr Cropper's minute of 6 June with interest. He would be grateful for Customs' comments on it.

A handwritten signature in cursive script, appearing to read 'Mpw'.

**MOIRA WALLACE**



*Ch. Given the delicate nature of this chat, would you prefer to see the A-G alone (i.e. without a PS)?*

CONFIDENTIAL

*25  
7/6*

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

FROM : THE CHAIRMAN  
DATE : 7 June 1988

CHANCELLOR OF THE EXCHEQUER

**TAX APPROXIMATION : EFFECT OF SINGLE EUROPEAN ACT**

You asked for an aide memoire on this before having a word with the Attorney General. I hope the attached will be helpful. The Attorney is aware of the background work that has been taking place, and the main point of having a word with him will presumably be to discover whether for any reason he would want to caution you against a formal approach at this stage.

J B UNWIN

Circulation:

- |                     |                    |
|---------------------|--------------------|
| Chief Secretary     | Mr Jefferson Smith |
| Paymaster General   | Solicitor          |
| Financial Secretary | Mr Nash            |
| Economic Secretary  | Mr Wilmott         |
| Sir P Middleton     | Mr Nissen          |
| Sir G Littler       | Mr Allen           |
| Mr Byatt            | Mr Fotherby        |
| Mr Lankester        | Mr Kent            |
| Mr Scholar          | Mr Cockerell       |
| Mr Edwards          | Mr Knox            |
| Mr Culpin           |                    |
| Mr Gilhooly         |                    |
| Mr Cropper          |                    |
| PS/IR               |                    |
| Mr McGivern IR      |                    |



CONFIDENTIAL

**AIDE-MEMOIRE FOR WORD WITH ATTORNEY-GENERAL**

1. Commission's proposals, designed to remove frontier barriers, include approximation of VAT rates into two rate bands and full harmonisation of excise duty rates. Serious UK objections related to loss of VAT zero rating, low level of excise duties on alcohol and tobacco and, generally, to loss of fiscal sovereignty. UK not alone in seeing serious problems.

2. Do not in any case believe these proposals necessary in economic or practical terms for completion of single market. Alternative approach of reducing frontier controls for freight, while increasing scope for cross-border shopping by individuals, would allow market forces to have growing influence on development of common structure of indirect tax rates. But Commission claim this is inconsistent with Single European Act.

3. Am very concerned about this. When Single European Act agreed, we believed we had preserved our fiscal sovereignty by preserving unanimity rule for tax harmonisation. Commission's interpretation of SEA commitment to create area without internal frontiers casts doubt on this - not least as to what position might be in 1993 if Member States have not agreed harmonisation.

4. Inter-Departmental group of lawyers has prepared submission to Law Officers. Issues are complex and uncertain, and I appreciate there is risk of getting unwelcome answers. Nevertheless, think we must know now where we stand.

5. Main points questions will cover are:-

- (a) what is "an area without internal frontiers" for purposes of the Single European Act (Article 8A)? Does it allow us to continue to apply some measure of control on goods imported from or exported to the Community?
- (b) is indirect tax approximation "necessary" to achieve the internal market under Article 99 of Treaty?
- (c) what would be legal consequences of failing to harmonise or remove frontier controls?

6. Don't pull any punches. Unless you see any major objections now, grateful for your early advice.

DATE: 9 JUNE 1988

Board Room

H M Customs and Excise

New King's Beam House

22 Upper Ground

London SE1 9PJ

Telephone: 01-620 1313



*Ch. Agree with Mr J-S's line?*  
*Agree*  
*W 9/6*

- cc Chief Secretary
- Paymaster General
- Financial Secretary
- Economic Secretary
- Sir Peter Middleton
- Sir G Littler
- Mr Byatt
- Mr Scholar
- Mr Lankester
- Mr R I G Allen
- Mr Michie
- Mr Cropper

CHANCELLOR

SINGLE EUROPEAN MARKET: TAX HARMONISATION

1. The informal ECOFIN in May decided to reconvene the high level ad hoc working party which met in 1986 to consider the Commission's VAT clearing house proposals and related issues.

2. The German Presidency has called a meeting for Thursday 16 June which I shall attend. The stated object is "to prepare a list of points on which policy decisions are required with a view to further proceedings". A list of possible topics has been circulated: a copy is annexed. As we understand it, the meeting is just to settle the topics, and later meetings will tackle the answers.

3. The list of problems is evidently written from the standpoint of those who accept fiscal harmonisation at least in principle. We do not. We need to expand the general section (a) by adding points on the lines of:

"- How might the single market be achieved without fiscal harmonisation.

- whether harmonisation should be across the board or selective and addressed to areas of actual or potential distortion."

---

Internal distribution:      Chairman                      Mr Allen  
    Mr Nash                         Mr Knox  
    Mr Wilmott                     Mr Oxenford

When it comes to providing the answers, the first of these points would be the peg for the market based approach.

4. On the rest of the topics, it will be for the proponents of harmonisation to make the running. But on the clear understanding that it is without prejudice to the basic question, we can note with approval the inclusion in the VAT list of the reference to zero rating, and in the excise list the references to minimum rates and to health.

5. I think we should seek inclusion of the need to identify the costs, to businesses and administrations, of the VAT clearing house, the excise linked bonded warehouse system, and excise banderoles (this appears as "tax symbols" in the list of topics) as compared with the present costs of border controls and the costs of any other system which would ensure the correct attribution of revenues to member states while still achieving the objectives of the single market. It may be objected that these are not policy problems; but we can say that an appreciation of costs ought to underpin policy decisions. It is no good looking for the gains from abolition of border controls as identified by Cecchini without taking into account the costs of alternatives; and we shall want to demonstrate that the right way ahead is drastically to simplify present controls without putting on all the burdens of the clearing house in their place.

6. I would be grateful to know if you are content with the line in paragraphs 3-5 above.

Ph ↵

P JEFFERSON SMITH

"Chairman of ad hoc working party intends to tackle following problems in particular:

(a) general:

need for tax harmonisation in view of completion internal market;

(b) re added-value tax:

- two-tier system including correlation of turnover and problem of zero-rates;
- band for normal rate and reduced rate;
- completion of harmonisation of basis of assessment;
- need for and basic structures of a clearing system.

(c) re special excise duties:

- various approaches to harmonisation:
  - approach of EEC Commission;
  - possibility of making this approach more flexible (eg band, minimum tax rates;
  - approach of Economic Policy Committee;
- possible use of tax symbols;
- greater account taken of non-fiscal aspects instead of average rates proposed by Commission (eg environmental, energy and transport objectives in the case of mineral oil tax, health policy objectives in the case of tax on alcoholic beverages and tobacco);
- community monitoring system (eg tax linkage)."



FROM: J M G TAYLOR

DATE: 9 June 1988

PHP

**NOTE FOR THE RECORD****TAX APPROXIMATION: EFFECT OF SINGLE EUROPEAN ACT**

The Chancellor had a word with the Attorney General yesterday, on the basis of Mr Unwin's aide memoire of 7 June.

2. The Chancellor said that the nub of the matter was that the Prime Minister would never have agreed to the Single European Act had it not been agreed as part of it that any decision on the tax front required unanimity. He noted that Delors had, without prompting, confirmed that unanimity was required at the last informal ECOFIN. There were, however, those in Brussels who argued that by signing the SEA, Member States had signed away their veto, because completion of the internal market required fiscal harmonisation. Was this something on which we ought sensibly to seek advice from the Law Officers?

3. The Attorney General said that he needed to know more about the details both of the current position and of the Commission's proposals. But it was clear that there was a sufficient margin of interpretation for it to be worth consulting the Law Officers. It did not seem to him, on the face of it, that there was an open and shut case against our position. He commented, further, that he did not think that harmonisation of rates was likely to be held by the Court to be necessary for completion of the internal market. The Attorney General stressed that he would need careful and full instructions before giving a final view.

4. The Chancellor said he would arrange for proper instructions to be despatched. The Attorney General said he would seek to give a general view of the field as soon as he had received instructions, followed by more definitive advice when he had considered them fully. He agreed with the Chancellor that this matter should be considered in conditions of tightest security.



5. I have conveyed the substance of this discussion to PS/Customs. I have also spoken to Mr Saunders, the Attorney General's legal secretary. We are all clear about the next steps, and Mr Saunders has already alerted the Cabinet Office legal advisers with a view to getting instructions.

J M G TAYLOR

CONQUEROR

11

Confidential

FROM: R & MICHIE  
DATE: 10 June 1988

P/S CHANCELLOR

cc: Mr Byatt  
Mr Culpin  
Mr R I G Allen  
Miss O'Mara  
Mr Gilhooly  
Mr Mortimer  
Mr Riley

Mr P R G Allen - C&E

Mr B Shepherd - IR

*Thanks. Contact with Mr Michie's draft, amended. Re X, as I have now discussed this with Mr Michie's draft? content with Mr Michie's comm. I am now discussing this with Mr Michie's comm. but still for circulate.*

**EC TAX APPROXIMATION: CHANCELLOR'S PAPER FOR OD(E)**

Your note of 24 May recorded the Chancellor's decision that the above papers be provided for OD(E) by way of background reading only, and outlined some amendments which the Chancellor wished made to the draft.

2. The revised paper has been circulated and now reflects certain of the views of the Cabinet Office, FCO and DTI as well as those of the Treasury, Customs and Inland Revenue.

3. I attach (P/S Chancellor only) a copy of the comments from the FCO on the original draft. I have, to vary degrees, reflected most of the FCO comments in the revised paper. However, I have some difficulty with the comments outlined in paragraph 6 of the letter: namely that the paper should reflect the theory that we might do well to encourage harmonisation of indirect taxes, while ensuring that direct tax remains free. I have some difficulty in reconciling this proposition with the remainder of the paper, and would welcome guidance on whether the Chancellor wishes such a reference to be included. You will note also, that the FCO do not agree with what they interpret to be the paper's implicit deduction that if we give ground on indirect tax

*Mr Kerr's comments are more subtle than this implies. But I agree that this proposition is best left out.*



approximation, we shall be on the slippery slope leading to harmonisation of business taxes (paragraph 7 of the letter). I would be grateful for advice on whether the Chancellor is content with the tone of the paper.

Mr Kerr disagrees party: he thinks other countries will recognize the political imperatives. But see Mr. [unclear] note in the enclosed folder. J.

X |

4. You will note that in paragraph 9 in this letter, the FCO suggest that if the Treasury do not wish to take on board the suggested FCO amendments, then some discussion should take place at OD(E). Given the already crowded agenda for the forthcoming meeting, the suggestion is that the paper would then be held back until after the Hanover European Council. Although we do not expect tax approximation to feature at the Summit, the Chancellor may consider that Ministerial colleagues should be given the opportunity to see the background papers before then. I have deleted paragraph 18 from the original draft, so that it is clear that the Chancellor is not inviting Ministerial colleagues to endorse the line reflected in the paper.

5. If the paper is to be made available for the forthcoming OD(E) meeting, I understand that it should be distributed by close of play on 14th. FP can arrange for any amendments to the paper and liaise with Cabinet Office over distribution.

*R. George Michie*

R G MICHIE

DRAFT  
OD(E)  
PAPER

201/23/AC

CONFIDENTIAL

Please get typed  
up as final paper  
- do get dist  
from Mr Michie  
(FP)

DRAFT OD(E) PAPER

CABINET  
DEFENCE & OVERSEAS POLICY COMMITTEE  
SUB-COMMITTEE ON EUROPEAN QUESTIONS

DIRECT & INDIRECT TAX APPROXIMATION

Note by the Chancellor of the Exchequer

In my note of 25 September (OD(E)(87)19) I set out our approach to the issue of indirect tax approximation within the Community. This was broadly endorsed by OD(E) on 1 October. By contrast to their approach on indirect taxation, the Commission's policy on direct tax harmonisation is still at a preliminary and incomplete stage. The <sup>Commission's</sup> 1985 White Paper on indirect taxation promised a complementary White Paper on direct taxation but this has never appeared. However, the signs now are that the Commission may be trying to press forward with greater vigour than hitherto, relying upon other moves towards the single market as leverage. Although these are unlikely to feature at the Hanover Summit at the end of June, it is not too soon to consider the wider implications of the Commission's approach, and to frame our tactics accordingly.

2. Tax approximation is a means, not an end. The end to which we are fully committed is the completion of the Single European Market. This will increase competition and improve economic efficiency within the Community. It will involve opening up markets, such as capital markets, which in some member states have been protected from foreign competition. It will also involve removing constraints on internal EC trade by eliminating differences in technical standards, and by removing or reducing as far as possible the costs imposed by controls at customs posts.

3. It is important to keep to the fore the vision of a better functioning market, building on the concept of deregulation which we introduced into the Community. There is no point in moving towards greater integration of the European economies if the process

results in greater regulation at a Community wide level. It is not integration per se which will bring greater prosperity to the twelve member states. That will only come if market forces are given more leeway. The recent history of the UK economy demonstrates the benefits which flow from deregulation, from freeing markets and from dismantling barriers and controls, all within the proper framework of financial discipline.

4. The Commission's approach to the single market does not always reflect market-oriented thinking. This is particularly evident on tax, where the only solution they have for the problem of cross border shopping is a system of centrally determined VAT and excise rates. But that is not the only solution. The market approach, which would leave member states free to make their own adjustments to VAT and excise rates in the face of competitive pressures, is a valid alternative. This would involve raising intra-Community traveller's allowances substantially <sup>over a period of years</sup> so that market forces would have an increasing influence through consumer's behaviour; while for freight it would mean continuing and significant reductions in frontier controls to minimise the effect that these controls have on the free functioning of the single market.

MP # Customs and Excise are currently developing "fast lane" schemes (as agreed by OD(E) in January) which would allow certain intra-Community traffic more favourable treatment based on immediate clearance at the border, and relaxation of conditions for Customs entry declarations. It is hoped that these schemes will be in use in 1989. Customs and Excise are also reviewing inland controls (as recommended in E.Q.O.(87) 150) and are looking at ways of expanding the use of the existing simplified export procedures. Whilst these measures fall short of the Commission's objective of complete abolition of frontier controls, they provide a starting point for a viable alternative, and avoid the substantial costs and complications for the Commission's proposed clearing house system. MP Moreover, in the longer term, the 14th VAT Directive (Postponed Accounting System), the abolition of MCAs, a much simplified computerised community transit system, and the collection of statistics direct from traders would reduce to the absolute minimum frontier formalities apart from preventive checks for excise goods, drugs, terrorism and health.

*As a result ~~of~~ <sup>analysis</sup> in no Institute of Fiscal Studies has <sup>pointed out,</sup> ~~commented~~*

5. There is no need to approximate VAT and excise rates on competitive grounds. In principle different rates of VAT and excise duties do not distort competition. Under the destination principle which applies in the Community, goods bear the same rate of VAT within a given country regardless of where they are produced. The same is true of excise duties, although some countries do seek to favour domestically produced goods. For example, taxes on wine are generally lowest in those countries which are substantial producers, but such discrimination has been limited by a series of European Court judgements. Centrally imposed harmonisation of indirect taxation, with the costs and complications of the Commission's proposed clearing house system, and the withdrawal of zero-rates, is a considerable over-reaction to the problems of cross-border shopping which may arise when frontier controls are relaxed, and such harmonisation is not a pre-condition of an effective single European market. ~~[Even if we did accept the need for centrally imposed approximation - and we do not - it is likely that we would, by way of derogation, be able to secure continuation of the pledged zero-rates].~~

6. At the informal meeting of ECOFIN on 13-14 May, the UK was invited to prepare a paper looking at whether a more limited form of tax harmonisation might be adequate. We have agreed to prepare such a paper and will use the opportunity to reiterate our view that centrally directed harmonisation is unnecessary for the completion of the single market. We will also use the paper to present the merits of the market approach, and stress the need for coordinated action to reduce the costs of crossing frontiers. We expect that the Community's economic experts will consider our paper (together with one from the Danes which is likely also to argue along similar lines) at a meeting on 7 July. Many other member states have reservations about aspects of the Commission's proposals, (particularly those which relate to the clearing house system), and the papers for discussion on 7 July should provide the opportunity for constructive discussion on alternative approaches.

7. In principle, a stronger argument can be mounted for harmonising certain direct taxes on the grounds of competitive neutrality. Taxes which affect production costs and profitability do affect competition. This will often be true for taxes on profits; and is certainly true for taxes on labour (eg both employers' and employees' social security contributions and income tax). There are much greater differences in member states' social security contributions expressed as a percentage of GDP, than there are between indirect taxes.

+ 8. <sup>Not valid</sup> ~~In practice~~ proposals for centrally determined direct tax approximation are open to as many objections as those for VAT and excise duties.

9. First, there is the question of <sup>all what might be known</sup> economic sovereignty. We have already considered this in the context of the proposals for indirect tax approximation. Although we cannot expect this argument to ~~hold much sway amongst other~~ <sup>be explicitly advanced by other</sup> member states, we ~~must bear in mind~~ <sup>the fact remains as is intended,</sup> that if tax approximation extends to direct taxes, ~~there would be considerable risk that our~~ fiscal flexibility would be progressively eroded, tending to a complete loss of fiscal sovereignty in the long run. The UK would effectively be tied in to levels of taxation in other member states. ~~[This is not obviously a desirable outcome.]~~ <sup>particularly</sup> ~~If such developments went hand in hand with moves towards monetary union, the combination of direct and indirect constraints would make sizeable inroads into our ability to take independent action affecting the UK economy.~~ <sup>(This)</sup>

10. Second, a rational approach to tax reform would become much more difficult. One of the problems we have long recognised with the Commission's proposals for harmonised rates of VAT and excise duties is that they have no particular economic logic. They simply represent a middle position between the extremes of prevailing rates in the Community. This is unlikely to produce economically optimal rates or structures of taxation. Even if the Commission base proposals for tax approximation on widely accepted economic principles (eg broad base, low rates, few/no special reliefs), the outcome of negotiation in Brussels is likely to be random,

reflecting what can be accepted by twelve different countries. The UK is now a low tax country by EC standards. If social security contributions are included, tax as a percentage of GNP is lower in the UK than in the other major EC countries. Low taxes give us a competitive edge.

11. We stand to lose this edge if we enter the cartel arrangements implicit in the Commission's approach to tax harmonisation. Even if specific bands of rates or other arrangements allowed us to keep much of our present tax structures intact, room for further change, including still lower rates of tax, would be limited. Where we wanted to reduce the lower limit of a given harmonised tax, we could only do so by unanimous agreement within the Community. We would no longer be able to reduce taxes when conditions in the UK permitted.

12. In sum, we stand to lose much of benefit we are now reaping as a result of our tax reforms.

13. A third and significant objection to the Commission's proposals for direct as for indirect tax approximation is that they are unnecessary to achieve a single European market. Certainly the latter will function more effectively if the disparities in the taxes which affect production costs and profitability in the member states are not too wide. But market forces are likely to bring this about over time without dirigiste intervention by the Commission. Moreover, market forces will ~~always~~ <sup>tend to</sup> push taxes downwards, as long as there are member states or other important third country competitors, with low rates of tax; while centrally determined tax rates will act to prevent this from occurring. There is nothing to be gained by the Community lumbering itself with a cumbrous system of integrated tax rates, with adjustment constrained by the need for unanimity among twelve countries, while the USA and Japan remain free to cut taxes subject only to the constraints of their own domestic ~~politics and public expenditure~~ <sup>levels ← political programme.</sup>

14. There is little doubt that the mainspring of pressure for centrally determined tax approximation is fear of competition. Thus the French, who tax investment income relatively heavily,

argue that a common withholding tax applied to such income in all member states is essential if full liberalisation of capital movements is not to lead to massive tax evasion. They ignore the fact that third countries, where tax was not withheld, would continue to exist; and companies which wanted to pay interest gross would ~~issue through~~ <sup>work through</sup> those countries. The Euromarkets and internationally mobile bank deposits would be driven out of Europe, taking business, jobs and taxable profits with them.

15. Countries with those fears have not <sup>yam</sup> succeeded in making harmonisation of withholding taxes a pre-condition of capital liberalisation but they are still pressing <sup>at the moment</sup> for Community measures to combat tax evasion to be considered in parallel. They seek either common withholding taxes or a common system for passing information about interest receipts from banks to other countries' Revenue authorities. The latter might have lesser problems for the UK but could involve substantial compliance costs for the banks and fiscal authorities; might be of limited effectiveness in preventing evasion; and would run risks of driving some deposits (though not the Euro-markets) out of Europe.

16. A number of draft Directives on certain aspects of direct taxation have been under discussion for many years, with little real progress being made. The Commission's latest initiative is the preparation of a preliminary draft Directive on the harmonisation of the business tax base, ie the measure of taxable business profits. The draft proposals are unclear in a number of important respects and would in any case need detailed study and clarification <sup>before</sup> ~~if~~ <sup>could</sup> they were to be taken further. But the underlying point is that the Commission have not made out their case for harmonisation per se in this area. (The proposals are to be discussed with the Commission at a meeting of senior tax officials on 14 June.) But it is already clear from the broad thrust of the proposals that they would involve radical changes to the present UK regime. In particular, they would mean putting into reverse, to some considerable extent, the 1984 business tax reforms with their move to a broader tax base and lower rates. A very tentative and, in view of the uncertainty in key areas, necessarily speculative estimate, suggests that, <sup>for the UK, the</sup> ~~the scale of costs~~

*proposed Community Success tax structure would,*

~~to the UK Exchequer would be very large indeed, possibly of the order of £3 billion or more which, on a revenue-neutral basis, would require a rate of corporation tax of about 42 per cent, (compared with the present 35 per cent). This would theoretically also involve a redistribution of the tax burden from the financial and commercial sectors to manufacturing. All this would clearly be unacceptable.~~

17. Detailed tactics for dealing with these and possibly other proposals for direct tax approximation will need to be developed in due course. Meanwhile the Committee's attention is drawn to the wide-ranging implications of accepting centrally determined tax approximation; and the antithesis between such an approach and the fundamental aims of the single market. I believe that deregulation rather than harmonisation, and co-ordination on measures to reduce the costs of crossing borders should be the UK's main aims, and that we should reject arrangements such as centrally imposed tax approximation which will shackle competitive forces within the Community while necessarily leaving member states fully open to competition from outside the Community.



## DRAFT OD(E) PAPER

CABINET  
DEFENCE & OVERSEAS POLICY COMMITTEE  
SUB-COMMITTEE ON EUROPEAN QUESTIONS

## DIRECT &amp; INDIRECT TAX APPROXIMATION

## Note by the Chancellor of the Exchequer

*lined margin shows amendments/additions*

*shows where passage dropped.*

In my note of 25 September (OD(E)(87)19) I set out our approach to the issue of indirect tax approximation within the Community. This was broadly endorsed by OD(E) on 1 October. By contrast to their approach on indirect taxation, the Commission's policy on direct tax harmonisation is still at a preliminary and incomplete stage. The 1985 White Paper on indirect taxation promised a complementary White Paper on direct taxation but this has never appeared. However, the signs now are that the Commission may be trying to press forward with greater vigour than hitherto, relying upon other moves towards the single market as leverage. Although these are unlikely to feature at the Hanover Summit at the end of June, it is not too soon to consider the wider implications of the Commission's approach, and to frame our tactics accordingly.

2. Tax approximation is a means, not an end. The end to which we are fully committed is the completion of the Single European Market. This will increase competition and improve economic efficiency within the Community. It will involve opening up markets, such as capital markets, which in some member states have been protected from foreign competition. It will also involve removing constraints on internal EC trade by eliminating differences in technical standards, and by removing or reducing as far as possible the costs imposed by controls at customs posts.

3. It is important to keep to the fore the vision of a better functioning market, building on the concept of deregulation which we introduced into the Community. There is no point in moving towards greater integration of the European economies if the process

results in greater regulation at a Community wide level. It is not integration per se which will bring greater prosperity to the twelve member states. That will only come if market forces are given more leeway. The recent history of the UK economy demonstrates the benefits which flow from deregulation, from freeing markets and from dismantling barriers and controls, all within the proper framework of financial discipline.

4. The Commission's approach to the single market does not always reflect market-oriented thinking. This is particularly evident on tax, where the only solution they have for the problem of cross border shopping is a system of centrally determined VAT and excise rates. But that is not the only solution. The market approach, which would leave member states free to make their own adjustments to VAT and excise rates in the face of competitive pressures, is a valid alternative. This would involve raising intra-Community traveller's allowances substantially so that market forces would have an increasing influence through consumer's behaviour; while for freight it would mean continuing and significant reductions in frontier controls to minimise the effect that these controls have on the free functioning of the single market. Customs and Excise are currently developing "fast lane" schemes (as agreed by OD(E) in January) which would allow certain intra-Community traffic more favourable treatment based on immediate clearance at the border, and relaxation of conditions for Customs entry declarations. It is hoped that these schemes will be in use in 1989. Customs and Excise are also reviewing inland controls (as recommended in E.Q.O.(87) 150) and are looking at ways of expanding the use of the existing simplified export procedures. Whilst these measures fall short of the Commission's objective of complete abolition of frontier controls, they provide a starting point for a viable alternative, and avoid the substantial costs and complications for the Commission's proposed clearing house system. Moreover, in the longer term, the 14th VAT Directive (Postponed Accounting System), the abolition of MCAs, a much simplified computerised community transit system, and the collection of statistics direct from traders would reduce to the absolute minimum frontier formalities apart from preventive checks for excise goods, drugs, terrorism and health.

5. There is no need to approximate VAT and excise rates on competitive grounds. In principle different rates of VAT and excise duties do not distort competition. Under the destination principle which applies in the Community, goods bear the same rate of VAT within a given country regardless of where they are produced. The same is true of excise duties, although some countries do seek to favour domestically produced goods. For example, taxes on wine are generally lowest in those countries which are substantial producers, but such discrimination has been limited by a series of European Court judgements. Centrally imposed harmonisation of indirect taxation, with the costs and complications of the Commission's proposed clearing house system, and the withdrawal of zero-rates, is a considerable over-reaction to the problems of cross-border shopping which may arise when frontier controls are relaxed, and such harmonisation is not a pre-condition of an effective single European market. [Even if we did accept the need for centrally imposed approximation - and we do not - it is likely that we would, by way of derogation, be able to secure continuation of the pledged zero-rates].

6. At the informal meeting of ECOFIN on 13-14 May, the UK was invited to prepare a paper looking at whether a more limited form of tax harmonisation might be adequate. We have agreed to prepare such a paper and will use the opportunity to reiterate our view that centrally directed harmonisation is unnecessary for the completion of the single market. We will also use the paper to present the merits of the market approach, and stress the need for coordinated action to reduce the costs of crossing frontiers. We expect that the Community's economic experts will consider our paper (together with one from the Danes which is likely also to argue along similar lines) at a meeting on 7 July. Many other member states have reservations about aspects of the Commission's proposals, (particularly those which relate to the clearing house system), and the papers for discussion on 7 July should provide the opportunity for constructive discussion on alternative approaches.

7. In principle, a stronger argument can be mounted for harmonising certain direct taxes on the grounds of competitive neutrality. Taxes which affect production costs and profitability do affect competition. This will often be true for taxes on profits; and is certainly true for taxes on labour (eg both employers' and employees' social security contributions and income tax). There are much greater differences in member states' social security contributions expressed as a percentage of GDP, than there are between indirect taxes.

8. In practice proposals for centrally determined direct tax approximation are open to as many objections as those for VAT and excise duties.

9. First, there is the question of economic sovereignty. We have already considered this in the context of the proposals for indirect tax approximation. Although we cannot expect this argument to hold much sway amongst other member states, we must bear in mind that if tax approximation extends to direct taxes, there would be considerable risk that our fiscal flexibility would be progressively eroded, tending to a complete loss of fiscal sovereignty in the long run. The UK would effectively be tied in to levels of taxation in other member states. [This is not obviously a desirable outcome.] <sup>lastingly,</sup> If such developments went hand in hand with moves towards monetary union, the combination of direct and indirect constraints would make sizeable in-roads into our ability to take independent action affecting the UK economy.

10. Second, a rational approach to tax reform would become much more difficult. One of the problems we have long recognised with the Commission's proposals for harmonised rates of VAT and excise duties is that they have no particular economic logic. They simply represent a middle position between the extremes of prevailing rates in the Community. This is unlikely to produce economically optimal rates or structures of taxation. Even if the Commission base proposals for tax approximation on widely accepted economic principles (eg broad base, low rates, few/no special reliefs), the outcome of negotiation in Brussels is likely to be random,

reflecting what can be accepted by twelve different countries. The UK is now a low tax country by EC standards. If social security contributions are included, tax as a percentage of GNP is lower in the UK than in the other major EC countries. Low taxes give us a competitive edge.

11. We stand to lose this edge if we enter the cartel arrangements implicit in the Commission's approach to tax harmonisation. Even if specific bands of rates or other arrangements allowed us to keep much of our present tax structures intact, room for further change, including still lower rates of tax, would be limited. Where we wanted to reduce the lower limit of a given harmonised tax, we could only do so by unanimous agreement within the Community. We would no longer be able to reduce taxes when conditions in the UK permitted.

12. In sum, we stand to lose much of benefit we are now reaping as a result of our tax reforms.

13. A third and significant objection to the Commission's proposals for direct as for indirect tax approximation is that they are unnecessary to achieve a single European market. Certainly the latter will function more effectively if the disparities in the taxes which affect production costs and profitability in the member states are not too wide. But market forces are likely to bring this about over time without dirigiste intervention by the Commission. Moreover, market forces will always push taxes downwards, as long as there are member states or other important third country competitors, with low rates of tax; while centrally determined tax rates will act to prevent this from occurring. There is nothing to be gained by the Community lumbering itself with a cumbrous system of integrated tax rates, with adjustment constrained by the need for unanimity among twelve countries, while the USA and Japan remain free to cut taxes subject only to the constraints of their own domestic politics.

14. There is little doubt that the mainspring of pressure for centrally determined tax approximation is fear of competition. Thus the French, who tax investment income relatively heavily,

argue that a common withholding tax applied to such income in all member states is essential if full liberalisation of capital movements is not to lead to massive tax evasion. They ignore the fact that third countries, where tax was not withheld, would continue to exist; and companies which wanted to pay interest gross would issue through those countries. The Euromarkets and internationally mobile bank deposits would be driven out of Europe, taking business, jobs and taxable profits with them.

15. Countries with those fears have not succeeded in making harmonisation of withholding taxes a pre-condition of capital liberalisation but they are still pressing for Community measures to combat tax evasion to be considered in parallel. They seek either common withholding taxes or a common system for passing information about interest receipts from banks to other countries' Revenue authorities. The latter might have lesser problems for the UK but could involve substantial compliance costs for the banks and fiscal authorities; might be of limited effectiveness in preventing evasion; and would run risks of driving some deposits (though not the Euro-markets) out of Europe.

16. A number of draft Directives on certain aspects of direct taxation have been under discussion for many years, with little real progress being made. The Commission's latest initiative is the preparation of a preliminary draft Directive on the harmonisation of the business tax base, ie the measure of taxable business profits. The draft proposals are unclear in a number of important respects and would in any case need detailed study and clarification if they were to be taken further. But the underlying point is that the Commission have not made out their case for harmonisation per se in this area. (The proposals are to be discussed with the Commission at a meeting of senior tax officials on 14 June.) But it is already clear from the broad thrust of the proposals that they would involve radical changes to the present UK regime. In particular, they would mean putting into reverse, to some considerable extent, the 1984 business tax reforms with their move to a broader tax base and lower rates. A very tentative and, in view of the uncertainty in key areas, necessarily speculative estimate, suggests that the scale of costs

to the UK Exchequer would be very large indeed, possibly of the order of £3 billion or more which, on a revenue-neutral basis, would require a rate of corporation tax of about 42 per cent, (compared with the present 35 per cent). This would theoretically also involve a redistribution of the tax burden from the financial and commercial sectors to manufacturing. All this would clearly be unacceptable.

17. Detailed tactics for dealing with these and possibly other proposals for direct tax approximation will need to be developed in due course. Meanwhile the Committee's attention is drawn to the wide-ranging implications of accepting centrally determined tax approximation; and the antithesis between such an approach and the fundamental aims of the single market. I believe that deregulation rather than harmonisation, and co-ordination on measures to reduce the costs of crossing borders should be the UK's main aims, and that we should reject arrangements such as centrally imposed tax approximation which will shackle competitive forces within the Community while necessarily leaving member states fully open to competition from outside the Community.

1 <



FROM: J M G TAYLOR

DATE: 10 June 1988

MR JEFFERSON SMITH

cc Chief Secretary  
Paymaster General  
Financial Secretary  
Economic Secretary  
Sir Peter Middleton  
Sir G Littler  
Mr Byatt  
Mr Scholar  
Mr Lankester  
Mr R I G Allen  
Mr Michie  
Mr Cropper

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

**SINGLE EUROPEAN MARKET: TAX HARMONISATION**

The Chancellor has seen your minute of 9 June. He agrees with the line you propose to take.

**J M G TAYLOR**



RESTRICTED

*B. De X, 1 low  
open to Siby  
Toronto*

FROM: T P LANKESTER  
DATE: 10 June 1988

CHANCELLOR

cc Chief Secretary  
Paymaster General  
Financial Secretary  
Economic Secretary  
Sir Peter Middleton  
Sir G Littler  
Mr Byatt  
Mr Scholar  
Mr R I G Allen  
Mr Michie  
Mr Cropper  
Mr Unwin (C&E)  
Mr Jefferson-Smith (C&E)

*Ch.  
This is the minute  
which Tim mentioned to you yesterday  
at Northolt (it only arrived in this  
office later yesterday). You indicated  
that you were content with Tim's  
line - are you?  
2/19/88*

SINGLE EUROPEAN MARKET: TAX HARMONISATION

*Yes; but we want no  
work to cover up all my  
suggestion but also no  
'Benelux' solution.  
M.*

Mr Jefferson-Smith in his minute of 9 June reports that the German presidency has called a meeting of the high level ad hoc working party of indirect tax officials for next week to start looking at a range of policy issues relating to tax harmonisation. Mr Jefferson-Smith says - rightly - that the topics to be covered do not go wide enough because they do not include the alternative, market-based approach which you have put forward.

2. Sir Peter Middleton held a meeting this afternoon with Mr Unwin and others to discuss all this.

3. You will recall that at Travemunde Stoltenberg concluded that further work on the basic policy issues should be done in EPC, and he invited the UK to put in a paper setting out our approach. In the event, it appears that Germans have decided to remit the work to the ad hoc working party. We think there is no objection to this provided the working party covers the ground fully, including of course your alternative approach. We agreed that Mr Jefferson - Smith, when he attends the meeting next week, should seek - indeed insist on - additions to the terms of reference on the lines he has proposed. But we also thought it would be helpful - not least to show that we are not being simply negative - if he were to spell out a little for the benefit of the working party what your approach might entail - i.e increased travellers

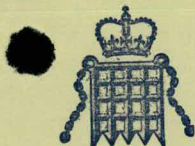
allowances, substantially simplified border controls etc. We could then put in for a later meeting of the working party a paper which Mr Byatt in consultation with Customs is drafting. Meanwhile, EPC can continue to do some further work on the economics of moves to the single market, including looking at the Cecchini report findings.

X 4. We think it would be worthwhile your having a word with Stoltenberg in Luxembourg on Monday to make sure that he is fully on board with this way of proceeding.

5. Finally, we felt it would be a good idea if the Prime Minister were to go to Hanover armed with a speaking note arguing against the principle of the Commission's proposals and offering your approach as an alternative. She would use this if, and only if, tax harmonisation is raised by others. The Germans have said they don't intend to raise it. Nonetheless, it still might come up - particularly if, as is quite possible, the Commission try to slip something in on this subject into the draft communique.



T P LANKESTER



HM CUSTOMS AND EXCISE  
 NEW KING'S BEAM HOUSE  
 22 UPPER GROUND  
 LONDON SE1 9PJ

01-620 1313 Ext. 5023

FROM: P R H ALLEN

DATE: 10 June 1988

CHANCELLOR OF THE EXCHEQUER

HARMONISATION

*Ch*  
 (Para 7) I am sure that  
 UKREP (+ pres. also PMG) have made our views clear to the EEC.  
 But the EEC can be a pretty dodgy lot.

*John Tyler:* | Perhaps BT to try to see them when they are next  
 meeting in London? *of 1976*

The tentative conclusions of Mr Ben Patterson MEP following the three day meeting of the Economic Committee, as set out in Mr Cropper's note of 6 June, suggest that there remains a significant gap between Mr Patterson's vision of "1992" and that of the Government. Although Mr Patterson has moved a little way towards the Government's free market approach, he continues to be wedded to some form of tax approximation using a clearing house system - i.e. moving away from the current system of taxation based on the destination principle.

2. Mr Patterson's starting point, like that of the Commission, is the complete abolition of frontier formalities. To that extent item (i) is at variance with the UK approach, which is to allow greater scope for market forces through increased intra-Community travellers' allowances and to reduce substantially, but not abolish, frontier controls. Indeed, we would argue that it does matter whether frontiers are removed under the "Irish Solution", which would abolish frontier controls without any tax approximation, or under Commission-style tax

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- |              |                     |                    |
|--------------|---------------------|--------------------|
| Circulation: | Chief Secretary     | CPS                |
|              | Financial Secretary | Mr Jefferson Smith |
|              | Paymaster General   | Mr Wilmott         |
|              | Economic Secretary  | Mr Knox            |
|              | Mr Byatt            | Mr Oxenford        |
|              | Mr R I G Allen      |                    |
|              | Mr Culpin           |                    |
|              | Mr Gilhooly         |                    |
|              | Mr Cropper          |                    |
|              | Mr Tyrie            |                    |
|              | Mr Call             |                    |

approximation. Both are unacceptable. However, the "Irish Solution", would involve economic disruption, potential for tax evasion and revenue changes (e.g. probable complete loss of revenue from UK excise duties on alcohol and tobacco) exceeding those which we might face under the Commission's proposals. The rate structure suggested, at item (iii), (coupled with Mr Patterson's advocacy of abolishing frontier controls), seems to us to approach the "Irish solution".

3. This illustrates a certain naivety of approach which pervades a number of the conclusions. For example (item (ii)), though it is perfectly true (as the Cecchini study showed) that differing VAT rates have only a relatively small impact on prices overall within the Community, certain tax rate differentials - especially on excises - have a noticeable impact at some national frontiers. In such circumstances, the French arguments would have some validity, though we would argue that a selective approach, involving continuing controls or minimum rates, would be more realistic.

4. Similarly, conclusion (iv) that the VAT clearing house proposals are broadly correct and could be simpler for traders than present systems ignores the almost unanimous reservations expressed by fiscal experts in the Council's Financial Questions Group. The Group were in broad agreement that the proposed arrangements were wider open to abuse; failed to provide adequate guarantees that the right revenues would accrue to the right country; and potentially involved additional costs to both traders and administrations. The simpler the clearing house arrangements, the greater the potential revenue risk. Moreover, other simplified arrangements (e.g. a postponed accounting system) would be easier for traders than the clearing house.

5. From the preceding paragraphs, it is clear that despite Mr Patterson's apparent belief, these first order problems are not solved by his proposals. The second order problems listed at item (v) are merely a few among many.

6. It is not at all clear what Mr Patterson envisages in relation to excise duties. On one interpretation he could be advocating continuing freedom for Member States to set duty rates while at the same time removing frontier controls. We would have strong reservations about this because of the great revenue risks.

7. In view of the continuing divergence of approach between the Government and the British EDG MEP's, notably Mr Patterson, I wonder whether a suitable opportunity might not be sought fairly soon to brief them on the Government's approach?

A handwritten signature consisting of the letters 'R' and 'A' in a stylized, cursive font, with a horizontal line extending from the top of the 'A'.

P R H ALLEN

1. Bonath  
2 prep



FROM: A C S ALLAN

DATE: 13 June 1988

MR MICHIE

cc Mr Byatt  
Mr Culpin  
Mr R I G Allen  
Miss O'Mara  
Mr Gilhooly  
Mr Mortimer  
Mr Riley  
  
Mr P R H Allen - C&E  
Mr B Shepherd - IR

**EE TAX APPROXIMATION: CHANCELLOR'S PAPER FOR OD(E)**

The Chancellor was grateful for your minute of 10 June, and was ... content with your draft, with some amendments. I attach a copy of the final version.

2. On the FCO argument that some discussion should take place at OD(E), the Chancellor is more than happy for this in due course, but feels that the paper should be circulated now.

*ACSA*

A C S ALLAN

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OD(E)(88)12  
13 June 1988

COPY NO.

## CABINET

DEFENCE & OVERSEAS POLICY COMMITTEE  
SUB-COMMITTEE ON EUROPEAN QUESTIONS

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## DIRECT &amp; INDIRECT TAX APPROXIMATION

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## Note by the Chancellor of the Exchequer

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In my note of 25 September (OD(E)(87)19) I set out our approach to the issue of indirect tax approximation within the Community. This was broadly endorsed by OD(E) on 1 October. By contrast to their approach on indirect taxation, the Commission's policy on direct tax harmonisation is still at a preliminary and incomplete stage. The Commission's 1985 White Paper on indirect taxation promised a complementary White Paper on direct taxation but this has never appeared. However, the signs now are that the Commission may be trying to press forward with greater vigour than hitherto, relying upon other moves towards the single market as leverage. Although these are unlikely to feature at the Hanover Summit at the end of June, it is not too soon to consider the wider implications of the Commission's approach, and to frame our tactics accordingly.

2. Tax approximation is a means, not an end. The end to which we are fully committed is the completion of the Single European Market. This will increase competition and improve economic efficiency within the Community. It will involve opening up markets, such as capital markets, which in some member states have been protected from foreign competition. It will also involve removing constraints on internal EC trade by eliminating differences

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in technical standards, and by removing or reducing as far as possible the costs imposed by controls at customs posts.

3. It is important to keep to the fore the vision of a better functioning market, building on the concept of deregulation which we introduced into the Community. There is no point in moving towards greater integration of the European economies if the process results in greater regulation at a Community wide level. It is not integration per se which will bring greater prosperity to the twelve member states. That will only come if market forces are given more leeway. The recent history of the UK economy demonstrates the benefits which flow from deregulation, from freeing markets and from dismantling barriers and controls, all within the proper framework of financial discipline.

4. The Commission's approach to the single market does not always reflect market-oriented thinking. This is particularly evident on tax, where the only solution they have for the problem of cross border shopping is a system of centrally determined VAT and excise rates. But that is not the only solution. The market approach, which would leave member states free to make their own adjustments to VAT and excise rates in the face of competitive pressures, is a valid alternative. This would involve raising intra-Community traveller's allowances substantially over a period of years so that market forces would have an increasing influence through consumers' behaviour; while for freight it would mean continuing and significant reductions in frontier controls to minimise the effect that these controls have on the free functioning of the single market.

5. Customs and Excise are currently developing "fast lane" schemes (as agreed by OD(E) in January) which would allow certain intra-Community traffic more favourable treatment based on immediate clearance at the border, and relaxation of conditions for Customs entry declarations. It is hoped that these schemes will be in use in 1989. Customs and Excise are also reviewing inland controls (as recommended in E.Q.O.(87) 150) and are looking at ways of expanding the use of the existing simplified export procedures. While these measures fall short of the Commission's objective



of complete abolition of frontier controls, they provide a starting point for a viable alternative, and avoid the substantial costs and complications for the Commission's proposed clearing house system.

6. Moreover, in the longer term, the 14th VAT Directive (Postponed Accounting System), the abolition of MCAs, a much simplified computerised community transit system, and the collection of statistics direct from traders would reduce to the absolute minimum frontier formalities apart from preventive checks for excise goods, drugs, terrorism and health.

7. As a recent analysis by the Institute of Fiscal Studies has pointed out, there is no need to approximate VAT and excise rates on competitive grounds. In principle different rates of VAT and excise duties do not distort competition. Under the destination principle which applies in the Community, goods bear the same rate of VAT within a given country regardless of where they are produced. The same is true of excise duties, although some countries do seek to favour domestically produced goods. For example, taxes on wine are generally lowest in those countries which are substantial producers, but such discrimination has been limited by a series of European Court judgements. Centrally imposed harmonisation of indirect taxation, with the costs and complications of the Commission's proposed clearing house system, and the withdrawal of zero-rates, is a considerable over-reaction to the problems of cross-border shopping which may arise when frontier controls are relaxed, and such harmonisation is not a pre-condition of an effective single European market.

8. At the informal meeting of ECOFIN on 13-14 May, the UK was invited to prepare a paper looking at whether a more limited form of tax harmonisation might be adequate. We have agreed to prepare such a paper and will use the opportunity to reiterate our view that centrally directed harmonisation is unnecessary for the completion of the single market. We will also use the paper to present the merits of the market approach, and stress the need for coordinated action to reduce the costs of crossing frontiers. We expect that the Community's economic experts will consider

our paper (together with one from the Danes which is likely also to argue along similar lines) at a meeting on 7 July. Many other member states have reservations about aspects of the Commission's proposals, (particularly those which relate to the clearing house system), and the papers for discussion on 7 July should provide the opportunity for constructive discussion on alternative approaches.

9. In principle, a stronger argument can be mounted for harmonising certain direct taxes on the grounds of competitive neutrality. Taxes which affect production costs and profitability do affect competition. This will often be true for taxes on profits; and is certainly true for taxes on labour (eg both employers' and employees' social security contributions and income tax). There are much greater differences in member states' social security contributions expressed as a percentage of GDP, than there are between indirect taxes.

10. Nevertheless, proposals for centrally determined direct tax approximation are open to as many objections as those for VAT and excise duties.

11. First, there is the question of what might be termed economic sovereignty. We have already considered this in the context of the proposals for indirect tax approximation. Although we cannot expect this argument to be explicitly advanced by other member states, the fact remains that if tax approximation extends to direct taxes as is intended, fiscal flexibility would be progressively eroded, tending to a complete loss of fiscal sovereignty in the long run. The UK would effectively be tied in to levels of taxation in other member states. This would make sizeable inroads into our ability to take independent action affecting the UK economy.

12. Second, a rational approach to tax reform would become much more difficult. One of the problems we have long recognised with the Commission's proposals for harmonised rates of VAT and excise duties is that they have no particular economic logic. They simply represent a middle position between the extremes of prevailing

rates in the Community. This is unlikely to produce economically optimal rates or structures of taxation. Even if the Commission base proposals for tax approximation on widely accepted economic principles (eg broad base, low rates, few/no special reliefs), the outcome of negotiation in Brussels is likely to be random, reflecting what can be accepted by twelve different countries. The UK is now a low tax country by EC standards. If social security contributions are included, tax as a percentage of GNP is lower in the UK than in the other major EC countries. Low taxes give us a competitive edge.

13. We stand to lose this edge if we enter the cartel arrangements implicit in the Commission's approach to tax harmonisation. Even if specific bands of rates or other arrangements allowed us to keep much of our present tax structures intact, room for further change, including still lower rates of tax, would be limited. Where we wanted to reduce the lower limit of a given harmonised tax, we could only do so by unanimous agreement within the Community. We would no longer be able to reduce taxes when conditions in the UK permitted.

14. In sum, we stand to lose much of benefit we are now reaping as a result of our tax reforms.

15. A third and significant objection to the Commission's proposals for direct as for indirect tax approximation is that they are unnecessary to achieve a single European market. Certainly the latter will function more effectively if the disparities in the taxes which affect production costs and profitability in the member states are not too wide. But market forces are likely to bring this about over time without dirigiste intervention by the Commission. Moreover, market forces will tend to push taxes downwards, as long as there are member states or other important third country competitors with low rates of tax; while centrally determined tax rates will act to prevent this from occurring. There is nothing to be gained by the Community lumbering itself with a cumbrous system of integrated tax rates, with adjustment constrained by the need for unanimity among twelve countries, while the USA and Japan remain free to cut taxes subject only

to the constraints of their own domestic public expenditure levels and political preferences.

16. There is little doubt that the mainspring of pressure for centrally determined tax approximation is fear of competition. Thus the French, who tax investment income relatively heavily, argue that a common withholding tax applied to such income in all member states is essential if full liberalisation of capital movements is not to lead to massive tax evasion. They ignore the fact that third countries, where tax was not withheld, would continue to exist; and companies which wanted to pay interest gross would use those countries. The Euromarkets and internationally mobile bank deposits would be driven out of Europe, taking business, jobs and taxable profits with them.

17. Countries with those fears have not yet succeeded in making harmonisation of withholding taxes a pre-condition of capital liberalisation but they are still pressing at the very least for Community measures to combat tax evasion to be considered in parallel. They seek either common withholding taxes or a common system for passing information about interest receipts from banks to other countries' Revenue authorities. The latter might have lesser problems for the UK but could involve substantial compliance costs for the banks and fiscal authorities; might be of limited effectiveness in preventing evasion; and would run risks of driving some deposits (though not the Euro-markets) out of Europe.

18. A number of draft Directives on certain aspects of direct taxation have been under discussion for many years, with little real progress being made. The Commission's latest initiative is the preparation of a preliminary draft Directive on the harmonisation of the business tax base, ie the measure of taxable business profits. The draft proposals are unclear in a number of important respects and would in any case need detailed study and clarification before they could be taken further. But the underlying point is that the Commission have not made out their case for harmonisation per se in this area. (The proposals are to be discussed with the Commission at a meeting of senior tax officials on 14 June.) But it is already clear from the broad

thrust of the proposals that they would involve radical changes to the present UK regime. In particular, they would mean putting into reverse, to some considerable extent, the 1984 business tax reforms with their move to a broader tax base and lower rates. A very tentative and, in view of the uncertainty in key areas, necessarily speculative estimate, suggests that, for the UK, the proposed Community business tax structure would, on a revenue-neutral basis, require a rate of corporation tax of about 42 per cent, (compared with the present 35 per cent). This would theoretically also involve a redistribution of the tax burden from the financial and commercial sectors to manufacturing. All this would clearly be unacceptable.

19. Detailed tactics for dealing with these and possibly other proposals for direct tax approximation will need to be developed in due course. Meanwhile the Committee's attention is drawn to the wide-ranging implications of accepting centrally determined tax approximation; and the antithesis between such an approach and the fundamental aims of the single market. I believe that deregulation rather than harmonisation, and co-ordination on measures to reduce the costs of crossing borders should be the UK's main aims, and that we should reject arrangements such as centrally imposed tax approximation which will shackle competitive forces within the Community while necessarily leaving member states fully open to competition from outside the Community.



*Pmp*

FROM: J M G TAYLOR  
DATE: 15 June 1988

MR LANKESTER

cc Chief Secretary  
Paymaster General  
Financial Secretary  
Economic Secretary  
Sir Peter Middleton  
Sir G Littler  
Mr Byatt  
Mr Scholar  
Mr R I G Allen  
Mr Michie  
Mr Cropper  
Mr Unwin (C&E)  
Mr Jefferson-Smith (C&E)

**SINGLE EUROPEAN MARKET: TAX HARMONISATION**

The Chancellor has seen your minute of 10 June, and Mr Jefferson-Smith's minute of 9 June.

2. He is content with the line you propose; though he has commented that we want the Working Party to cover not only his own approach, but also the "Benelux" solution.

3. He may have a word with Stoltenberg in Toronto about all this.

A handwritten signature in dark ink, appearing to be "J M G Taylor".

J M G TAYLOR



FROM: S P JUDGE  
DATE: 17 June 1988

*PHP*

PS/CHANCELLOR

cc PS/Chief Secretary  
PS/Financial Secretary  
PS/Economic Secretary  
Mr Byatt  
Mr R I G Allen  
Mr Culpin  
Mr Gilhooly  
Mr Cropper  
Mr Tyrie  
Mr Call  
PS/Customs & Excise  
Mr P R H Allen - C&E

**HARMONISATION**

The Paymaster General has seen Mr Allen's submission of 10 June.

2. The Paymaster thinks that, for reasons related to the European Parliament elections in 1989, it would be a good idea to brief the EDG on the Government's approach. The Paymaster is talking to the EDG on the afternoon of Monday 27 June, and can see an argument for the **Economic Secretary** joining the session. I would be grateful for Mr Tyrie's views on this.

**MINISTER IMMEDIATE**

S P JUDGE  
Private Secretary

UNCLASSIFIED



FROM: J M G TAYLOR

DATE: 27 June 1988

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

MR P R H ALLEN - CUSTOMS

cc PS/Chief Secretary  
PS/Financial Secretary  
PS/Paymaster General  
PS/Economic Secretary  
Mr Byatt  
Mr R I G Allen  
Mr Culpin  
Mr Gilhooly  
Mr Cropper  
Mr Tyrie  
Mr Call

Mr Unwin  
Mr Jefferson Smith  
Mr Wilmott

**HARMONISATION**

The Chancellor was grateful for your note of 10 June. He agrees that we should seek a suitable opportunity to brief the EDG on the Government's approach. The Economic Secretary's office will take this forward.

A handwritten signature in the bottom right area of the page.

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

FROM : THE CHAIRMAN

DATE : 6 July 1988

CHANCELLOR OF THE EXCHEQUER

## TAX APPROXIMATION : LEGAL OPINION ON EFFECT OF SINGLE EUROPEAN ACT

I thought that I should let you know briefly how matters stand following your meeting with the Attorney General on 8 June.

2. The formal submission to the Law Officers is being prepared by an inter-Departmental group of lawyers, including the Cabinet Office Legal Advisers. To reduce the time that the Attorney and his own legal officials will need to consider the matter and produce their opinion, a representative of the Law Officers' Department is closely involved as a member of the group.

3. The Law Officers' Department have required some amendment to the wording and number of the questions to be asked of the Attorney. This is, however, a matter of form only. The substance of the issues set out in the list of draft questions attached to my minute to you of 27 May 1988 is unchanged and the revised formulation will better reflect the understanding that it was the "broad over-view" of the matter that was amenable to a legal opinion.

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### Distribution

#### Treasury

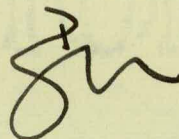
Paymaster General  
Economic Secretary  
Sir Peter Middleton  
Sir Geoffrey Littler  
Mr Byatt  
Mr Lankester  
Mr Culpin

#### Customs and Excise

Mr Jefferson Smith  
Mr Nash  
Mr Nissen  
Mr Wilmott  
Mr Allen

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4. Although I have been a little impatient at the time the legal advisers are taking to finalise the formal submission, I think that the care being exercised on such an important issue is well spent. I am assured also that it will produce an earlier response from the Attorney. He expects to be in a position to give his opinion in mid-August, and he may wish at the time to circulate it to OD(E). This should give enough time to digest the contents before the ECOFIN round resumes after the Summer break.



J B UNWIN

CONFIDENTIAL



FROM: J M G TAYLOR

DATE: 8 July 1988

MR UNWIN C&amp;E

cc PS/Paymaster General  
PS/Economic Secretary  
Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Lankester  
Mr Culpin

Mr Jefferson Smith  
Mr Nash  
Mr Nissen  
Mr Wilmott  
Mr Allen

**TAX APPROXIMATION: LEGAL OPINION ON EFFECT OF SINGLE EUROPEAN ACT**

The Chancellor was grateful for your minute of 6 July.

A handwritten signature in dark ink, appearing to be "J M G TAYLOR".

**J M G TAYLOR**



FROM: MISS C M BRAND  
EXTN: 6304  
DATE: 25 JULY 1988

- 1. MR MCGIVERN *This is for Ministers' information. I don't believe any action is called for at present.*
  - 2. CHANCELLOR OF THE EXCHEQUER *The Parliament's endorsement was predictable, given its track record on earlier harmonisation proposals.*
- Not ✓* *25/7*

**DIRECT TAX HARMONISATION: RESOLUTION BY THE EUROPEAN PARLIAMENT ON CREATION OF A EUROPEAN FINANCIAL AREA**

- 1. We thought you might like to be aware of the attached Resolution by the European Parliament on the creation of a European financial area, which mentions tax approximation at paragraphs 15-17.
- 2. The Parliament notes with approval the Commission's programme for liberalisation of the capital markets, but says that creation of a genuine European financial area requires

- 
- |                          |             |
|--------------------------|-------------|
| cc. Chief Secretary      | Mr Isaac    |
| Financial Secretary      | Mr Painter  |
| Paymaster General        | Mr Houghton |
| Economic Secretary       | Mr McGivern |
| Sir P Middleton          | Mr Johns    |
| Sir G Littler            | Mr Pitts    |
| Mr Byatt                 | Mr Deacon   |
| Mr Lankester             | Mr Cleave   |
| Mr Scholar               | Mr Spence   |
| Mr Culpin                | Mr Elliott  |
| Mr Riley                 | Mr Cayley   |
| Mr Gilhooly              | Mr Shepherd |
| Mr Ford                  | Mr Keith    |
| Mr Cropper               | Mr Alpe     |
| Mr Tyrie                 | Miss Brand  |
| Mr Unwin (C/E)           | PS/IR       |
| Mr Jefferson Smith (C/E) |             |

more than this. It looks to the Commission to make proposals for tax approximation in the areas of corporation tax, collective investment funds and savings. It notes the danger of increased evasion which may accompany liberalisation of capital movements and calls on the Commission to counter this by making proposals for a general withholding tax on interest. Further, in recognition of the danger that capital may leak out of the Community, it proposes discussions on harmonisation and anti-evasion measures with countries outside the Community.

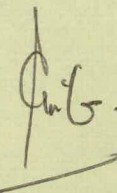
3. The European Parliament has no formal standing in this matter; its opinion is advisory only and not binding on the Commission or the Council. However, since on this occasion the opinion supports the Commission's own stance, they can be expected to exploit it to the full. Indeed, the latest version of the draft Directive on capital movements, which came out late last month, includes a paragraph in the preamble which appears to respond to the European Parliament's opinion, referring to the need to tackle the risk of distortion and tax evasion resulting "from the diversity of national systems for taxation".

4. We shall let you know of any further developments.

CMB

MISS C M BRAND

Apologies for the quality  
of the copy resolution  
(which is due to the  
blotches on our copy).



3. Capital movements - Balances of payments

Doc. A 2-70/88

RESOLUTION

on the creation of a European financial area

The European Parliament,

- having regard to the communication by the Commission on the creation of a European financial area (COM(87) 550 final - Doc. C 2-310/87)
- having regard to the report by the Committee on Economic and Monetary Affairs and Industrial Policy and the opinion of the Committee on Budgets (Doc. A 2-70/88),

A. DEVELOPMENT OF THE INTERNATIONAL FINANCIAL MARKET

1. Notes that profound changes have been taking place on the international financial market in recent years, involving:
  - a radical change in its method of operation in terms of both quantity and quality, with regard to the volume, speed and yield of transactions, as a result of the application of information technology;
  - globalisation and increased interpenetration of markets;
  - a wide range of new financial products designed to reduce the risks arising from floating exchange rates and unstable interest rates;
  - a move towards deregulation of financial activities and a preference for mediation by the markets rather than the banks;
2. Notes that the accumulation of power in the financial markets has led to a major expansion of the financial sector which has not been matched by a parallel growth of the economy as a whole;

3. Notes that the excessive dominance of the financial sector, marked by the extreme volatility of capital markets, the spiral of speculation and a proliferation of holding companies, has been detrimental to the development of the economy as a whole;
4. Notes that deviations from the international financial system result in a deflection of economic resources which penalizes productive economic investment, widens the gap between industrial countries and indebted Third World nations and exacerbates the economic and social inequalities even within industrialized countries;

B. THE NEED FOR AND OBJECTIVES OF THE CREATION OF A EUROPEAN FINANCIAL AREA IN THE COMMUNITY

5. Emphasizes, in view of the development of the world financial market and despite the aberrations it is currently undergoing, the inappropriate nature of the present organization and operation of the financial markets in the Community;
6. Approves therefore in principle of the Commission's programme for completing, by adding the final phase, the opening up of the capital markets in the Community in the light of the completion of the internal market by 1992;
7. Considers that, if the concept of the financial area is to have any meaning, it must be characterized by closer relation between the countries of Europe than between Europe and the rest of the world, to ensure that:
  - European savings are channelled first and foremost into European projects,
  - capital mobility is greater within Europe than between Europe and the rest of the world,
  - disturbances originating in other parts of the world do not affect European countries in such a way as to destabilize their reciprocal financial relations;
8. Considers that the opening up of the capital market must benefit the citizens of the Community and Community undertakings seeking to invest and must therefore be regarded as a growth factor and as favouring Europe's economic and social cohesion;
9. Considers it essential for the Community, which does not currently occupy the place on the world financial market appropriate to its economic and

commercial significance, should become a financial centre of world importance, the bedrock of an area of monetary stability centred on the ECU;

### C. CONDITIONS FOR THE CREATION OF A EUROPEAN FINANCIAL AREA

10. Notes, however, that the creation of a genuine European financial area requires, in parallel with the liberalization of capital movements, the fulfilment of a number of other favourable and essential conditions in the banking, fiscal and monetary fields;

#### (a) Approximation of banking laws

11. Considers that the liberalization of capital movements must be accompanied by the full liberalization of financial services, allowing all financial agents to offer their services to Community investors either through the setting-up of branches or through the provision of services throughout the Community;

12. Stresses, moreover, the need to safeguard the integrity of the European markets and the protection of savings;

13. Insists, therefore, on the speedy implementation of the measures envisaged by the Commission in its White Paper on the completion of the internal market, in order to remove the obstacles to the freedom of establishment and the free provision of services by financial agents, to achieve harmonization of prudential rules and to ensure equivalent levels of information and protection for investors;

14. Insists likewise, in the present state of development of the financial market, on the importance of introducing monitoring and prudential supervision at Community level in order to safeguard the quality and credibility of the European financial area, over which the Community can maintain complete control;

#### (b) Approximation of fiscal laws

15. Stresses the importance of approximating fiscal laws regarding corporation tax, the taxation of collective investment undertakings for transferable securities (CIUTS) and savings incentives in the Community, without which funds would be unevenly allocated and the benefits of integration undermined;



therefore expects the Commission to take rapid steps to submit proposals in these fields;

16. Stresses also that in the present state of fiscal and banking legislation, the liberalization of capital movements in the Community may increase the risk of tax evasion and thus of illegal delocalization of investments, to the detriment of the less economically developed Member States and, in short, of the economic interests of the Community;
17. Calls therefore on the Commission to submit as soon as possible the necessary proposals for reducing the risk of tax evasion by generalized application of a withholding tax on interest from bonds and bank deposits; also calls on the Commission, in order to prevent the risk of a flight of capital to countries outside the Community, to seek at international level, in particular within the OECD and the Council of Europe, the conclusion of agreements on the harmonization of fiscal systems and reciprocal administrative assistance to combat tax evasion;

(c) Affirmation of the monetary identity of the Community

18. Stresses that effective management of the European financial area in the economic and social interests of the Community is inconceivable without a reaffirmation of the objectives and a significant strengthening of the scope of the EMS; at this stage, there is a close link between the monetary and the financial;
19. Considers that it is vital for the ECU to play a meaningful role:
- as an asset to encourage movement in European savings;
  - as an instrument to which a lower degree of risk attaches than the dollar;
- parallel currency strengthening monetary coordination, and that further progress must be made towards establishing a single European currency;
20. Stresses likewise that until all the Member States accept that exchange rate discipline is an essential element of their economic policies and of European policy, the financial area will not bring the benefits which may be expected of it; on the contrary, the present imbalances in the EMS are likely to be exacerbated by the complete liberalization of all capital movements;

21. Stresses, finally, that the measures contained in the Commission's proposals on the financial area for the regulation of international currency flows and the specific safeguard clause are not adequate to deal with the financial and monetary difficulties which may lie in store for the Community;
22. Stresses, therefore, the risks of accentuation of the economic divergences within the EEC, the possible segmentation of the Community and an increase in monetary disequilibria which are attached to any move to liberalize capital movements alone, since the effects of such a move could be very damaging, particularly for the less developed countries;
23. Considers, therefore, that the implementation of the directive on the liberalization of capital movements must be accompanied by a whole range of measures provided for by the Commission to meet the requirements for the creation of a genuine European financial area in the banking, fiscal and currency fields. The liberalization of capital movements therefore makes it urgently necessary to take European initiatives to  
implement the second phase of the EMS. If such  
measures are not taken, liberalization will be likely to have the effect  
of weakening the Community's position in the world financial market;
24. Considers that, as was requested in its resolution of 22 October 1986 on the first phase of the liberalization of capital movements (1)  
Parliament must be kept regularly informed of developments and  
progress arising from the entry into effect of the directive implementing  
in full Article 67 of the EEC Treaty;  
o o
25. Instructs the President to forward this resolution and the report by its committee to the Council and the Commission of the European Communities.

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(1) OJ No. C 297, 24.11.1986, p.46

UNCLASSIFIED



FROM: J M G TAYLOR  
DATE: 1 August 1988

*pm*

MISS BRAND - IR

cc Mr McGivern IR

**DIRECT TAX HARMONISATION: RESOLUTION BY THE EUROPEAN  
PARLIAMENT ON CREATION OF A EUROPEAN FINANCIAL AREA**

The Chancellor has seen and noted your minute of 25 July.

*JMG*

J M G TAYLOR

CONFIDENTIAL

Bf 1878

12/8

Mar 1988  
a very thorough  
and helpful  
interview



CH/EXCHEQUER	
REC.	11 AUG 1988
ACTION	Mr UNWIN-C&E
COPIES TO	PS/PME, PS/EST, SIR P. MIDDLETON, SIR G. LITTLER, Mr BYATT, Mr LANKESTER, Mr CULPIN, Mr JEFFERSON SMITH, Mr NASH.

Mr NISSEN  
Mr WILMOTT  
Mr ALLEN } C&E

THE CHANCELLOR OF THE EXCHEQUER

11/8/88. Miss Weldon T50L

EUROPEAN ECONOMIC COMMUNITY:

HARMONISATION OF INDIRECT TAXATION LEGISLATION

1. We met in June to discuss what legal advice could usefully be provided to assist in formulating our response to the Commission's proposals in the field of indirect taxation. We agreed that it was too early to consider specific proposals, but that it would be helpful to have a broad overview of what the Treaty requires and to give consideration to what might occur if the obligations imposed by the Treaty were not met.

2. I have considered a Memorandum accordingly prepared by Customs and Excise with the assistance of the Treasury Solicitor's Department. Comments were also received from other departments. It is clear that much hard work has gone into what were necessarily detailed instructions.

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3. I have also discussed this matter with the Solicitor General for Scotland, and what follows represents our joint view.

4. This is a very difficult area in which to offer firm advice. The Community texts which fall to be interpreted are the result of political compromise and contain conflicting indications of their underlying purpose. Little assistance is gained from the jurisprudence of the European Court. It is difficult, at the best of times, to predict with confidence the outcome before that Court of proceedings which have important political/constitutional implications. It is still more difficult some five years at least before the Court will be asked to consider the Treaty provisions in question; in the meantime, there will be developments both in the deliberations in the Council and in the jurisprudence of the Court.



5. Some propositions can, however, be stated with confidence.

- (a) The obligations imposed by Article 99 read with Article 8A of the Treaty are those of the Council, not of the Member States. While the latter have a general obligation, under Article 5, to ensure fulfilment of the obligations arising out of the Treaty and to facilitate the achievement of the Community's tasks, the Court has not held that such an obligation applies to a Member State in its capacity as member of the Council.
- (b) The obligation under Article 99 is to take measures by the end of 1992. Until 1st January 1993 there can be no question of default in relation to that obligation.
- (c) The Council must act in relation to indirect taxation, by unanimity. This is so both before and after the end of 1992.

(d) The Council is required to enact harmonising measures concerning indirect taxation, but only to the extent necessary to achieve the internal market. The Single European Act did not involve the surrender of fiscal competence by Member States. The Court is bound to find that the Council has a large measure of appreciation in deciding what is necessary. Within broad limits, therefore, harmonising measures are a matter for negotiation and it does not follow from the Treaty as amended that there can be no more than a single route to the achievement of that objective.

6. Beyond these statements, any advice must be considered less certain. I have considered, as the Memorandum of instructions suggested, four broad questions. As will be apparent, they overlap considerably. The first three relate to the Council's margin of appreciation. The fourth looks ahead to 1993 and beyond in the event that the Council fails to act as Article 99 requires.



Question 1: Should "an area without internal frontiers" in Article 8A be interpreted as requiring the removal of all border controls affecting goods?

7. I approach this question solely in the context of indirect taxation. The internal market is a legal concept; although underpinned by economic principles, the term will fall to be interpreted by the European Court in the light of the relevant provisions of the Treaty and their underlying purpose. In my view, it is clear that the Court will find that Article 8A has legal effects, and is not simply a restatement of provisions as they stood before the Single European Act. It is even more clear to me that the Court will not find, as has been argued elsewhere, that Article 8A actually diminishes the acquis communautaire.

8. In relation to the bona fide flow of goods in the course of ordinary trade, the Court is likely to hold that in principle controls for indirect taxation purposes at the borders of the Member States do constitute a form of internal frontier which Article 8A requires the Community to



eliminate by the end of 1992. The Court might be prepared to uphold derogations, agreed on by the Council, where clearly justified on principles consistent with Community law. But it is most unlikely to permit Member States to retain border controls, unless such controls can properly be described as a legitimate exercise of Member States' remaining fiscal competence and constitute an insignificant barrier to trade or, perhaps, impose on a cross-frontier trader a burden no heavier than that falling on the domestic trader. The heavier the border controls, the more difficult it will be to persuade the European Court to accept them. It would also be helpful if the Court could be persuaded that any alternative regime would be more burdensome for traders overall.

9. I should emphasise that my conclusion is reached in the context of measures to be enacted in the field of indirect taxation. In areas other than indirect taxation on which Article 8A impinges (for example, legislation concerning the misuse of drugs, the prevention of disease, and the movement of persons), additional considerations will apply.



Question 2: Should an area without internal frontiers, as defined in Article 8A, read with Article 99, be interpreted as requiring the removal of all border controls for indirect tax purposes?

10. Since the Council is required by Article 99 to enact harmonising measures "to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market within the time limit laid down in Article 8A", and since border controls for indirect tax purposes are likely to be held to be incompatible in principle with an area without internal frontiers, the short answer to the question is Yes, subject to the possibility of derogations to the extent I have indicated above.

11. But for your purposes a further question needs to be posed, namely, whether the process of harmonising Member States' legislation necessary to achieve that result has to embrace the abolition of the destination principle and the substitution for it of the country of origin principle, as the Commission contend.



12. Although the Commission will pray in aid of its view the fact that the VAT Directives have envisaged from the beginning that the destination principle will ultimately be dispensed with, those Directives cannot bind the Council so as to preclude its reaching a conclusion different from that of the Commission in the light of the relevant circumstances. Certainly the existing VAT regime which relies heavily on controls undertaken at the borders could not be maintained by the Community consistently with Article 99. But what is crucial to the question under discussion is whether the absence of most or all border controls for indirect taxation purposes could nevertheless permit the destination principle to survive, albeit adjusted as to its mode of application. In that event it would not be "necessary" to substitute the country of origin principle for it.

13. Those matters are outside my province; but I have read with interest what I have been told about Postponed Accounting Systems, and I do not see any inherent impossibility in treating imports essentially in the same manner as domestic supplies for VAT purposes. I acknowledge, however, that a solution on these lines would not be possible for excise duties.

Question 3: Does Article 99 require the harmonisation of rates of indirect taxation?

14. There is no express requirement in the Treaty, as amended, that rates of indirect taxation be harmonised. Whether that is nevertheless the effect of Articles 8A and 99 depends on whether that element of harmonisation is necessary to achieve the internal market. In this regard not only the elimination of existing border controls for indirect tax purposes is required; equal conditions of competition, in the limited sense that all goods traded in one Member State, whether imported or of domestic manufacture, bear equal rates of tax, must also be maintained.

15. If the Commission are right in contending that it is an inescapable concomitant of abolishing border controls for indirect taxation purposes that the country of origin principle must replace the destination principle, and that accordingly VAT rates must be approximated (else unequal conditions of competition will pertain), then the short answer to the question under discussion is Yes. At this point, however, I draw your attention to what in any event

seems to be a flaw in the Commission's own argument at any rate so far as it applies to the vast bulk of trade undertaken by registered traders. Under the country of origin system all importing registered traders would be able to deduct input tax (at whatever rate it had been levied in the exporting country) and would thereafter supply their products taxed at the rate which goods domestically produced attract. So where is the inequality in the conditions of competition?

16. However, if the destination principle is retained, there will again arise no question of different rates affecting competition among registered traders, because exports are zero-rated and imports attract tax at the rate applicable to goods produced domestically.

17. The position is different where imports by final consumers and non-registered traders are concerned. Among the latter it has to be conceded that competition would be affected by differences in rates, but the degree of significance of that factor will be a function of the turnover level at which exemption from the VAT is fixed. In this context I have noted the proposal to harmonise the registration threshold by means of the Small-Medium Enterprises Directive.

18. Private consumers similarly will exploit differing rates, in cross-border shopping: that too must be conceded. But the Council could persuasively argue that the effect of this upon conditions of competition would be de minimis in the overall flow of trade, and would properly be incurred in maintaining that sovereignty in fiscal matters of the Member States whose importance even the Commission recognises.

19. The "market forces" argument, incidentally, seems rather dangerous in this context, since such forces can hardly be expected to move governments where the effects of inequality of competition would have the slight significance we contend for.

20. Different arguments apply in the case of excise duty. The abolition of border controls appears to me to render the prevention of evasion of duty on excisable goods extremely difficult, if not impossible, wherever there is the opportunity to take goods from areas of low tax to areas of high tax. You would, I assume, see no difficulty with the Commission's warehousing scheme, since this would enable trade to take place under equal conditions of competition without approximating rates of duty. But unless there is a requirement that all cross-border traffic be conducted through warehouses, and unless such a system could be properly enforced, evasion would undermine the warehousing system.

21. Taking the view I do of the legal effect of Articles 8A and 99 (Question 1), I think it unlikely that the retention by Member States of the necessary anti-smuggling controls, on the grounds of Member States' competence to fix rates of duty in pursuance of their separate social and health policies, would be upheld by the Court. Such a submission would be likely to fail on grounds of proportionality. But it may be possible to devise a Community regime which gives full respect to Member States health policies, while employing minimal controls justified on the grounds of prevention of evasion.

Question 4: What legal effects flow if the Council fails to act in accordance with Article 99?

22. This question looks ahead to the position after 31st December 1992. I considered this question at the time when the Single European Act was being negotiated and find nothing to alter the view I took then.

23. In the event that the Council fails to enact measures in accordance with Article 99, I would expect the only recourse to be by way of an action against the Council in the European Court under Article 175, brought by the Commission or the European Parliament, or perhaps by a Member State. I do not consider that an action would lie against a Member State which maintained legislation inconsistent with the establishment of the internal market when the Community had not harmonised the relevant legislation. I would expect any claim in the national courts by an individual seeking to rely on the direct effect of the relevant Treaty provisions to be likely to fail. Even in the case of Article 175 proceedings, it is difficult at this stage to envisage circumstances which would enable the Court to make an effective order, but there must be a risk that the Court would require the Council to take a decision on particular proposed measures. In that event a Member State would have great difficulty in relying on the requirement for unanimity to block further progress, particularly if it were isolated. The pressure to reach agreement could become overwhelming.



24. I have considered the possibility that after 1992 the Member States might be found to be under some duty not to enact national measures restricting the operation of the internal market. It might be said, for example, that the Member States must effectively abide by a "standstill" arrangement. There is support in the jurisprudence for a limited form of standstill in areas of Community law where competence has passed wholly to the Community. This would not, however, be the case in relation to indirect taxation, and my conclusion at this stage is therefore that the possibility of a judicially imposed standstill is remote.

#### Conclusion

25. I understand that you will circulate a paper, suggesting an alternative approach to that proposed by the Commission, for informal discussion by the Community's Finance Ministers. I should be happy to advise on any further questions which may arise in the course of preparation of that paper.

26. You will have perceived that I do not think that it will be persuasive (when challenging the Commission's proposal) to rely solely on the contention that market forces will have the effect of pushing Member States' governments into completing the internal market - because the Court is likely, in my opinion, to hold that Articles 8A and 99 require the Council in any event to effect some harmonisation of legislation concerning indirect taxation, albeit only to the extent described in Article 99. The way to go about it, in my view, will be to recognise that the Council will have to adopt some measures which will alter the way in which indirect taxes are administered, but that the measures outlined by the Commission do not constitute the only means by which the Council can, consistently with the Treaty, fulfil its obligations. In particular, in relation to VAT, the establishment of the internal market does not depend on - does not need - a change to the country of origin principle, nor the harmonisation of rates of tax.

11 August 1988

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FROM: P JEFFERSON SMITH

DATE: 12 AUGUST 1988

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

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*begin*  
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CHANCELLOR

cc Chief Secretary  
Financial Secretary  
Paymaster General  
Economic Secretary  
Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Lankester  
Mr Scholar  
Mr R I G Allen  
Mr Culpin  
Mr Riley  
Mr Cropper  
*MS WHELDON T502*

HARMONISATION OF INDIRECT TAXATION LEGISLATION: LAW OFFICERS' ADVICE

1. The Attorney-General has now written to you (minute of 11 August) with his advice on indirect tax harmonisation. It merits careful study, but perhaps I can offer some first thoughts.

2. The advice is cautious in how firm it can be, because the Treaty provisions in question contain fudges, and the future approach of the European Court is difficult to predict. But the following points are helpful:

- (a) there is no express requirement to harmonise rates;
- (b) the Commission cannot contend that theirs is the only possible route to achievement of the single market;
- (c) we may question whether achievement of the single market requires replacement of the destination principle by the origin principle;
- (d) the obligations under Articles 8A and 99 are on the Council, not individual Member States;

Internal distribution:

CPS	Mr Allen
Mr P V H Smith	Mr Kent
Mr Wilmott	Mr Fotherby
Mr Nissen	Mr Knox

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- governing
- (e) if the Council fails to enact harmonisation measures by the end of 1992, any legal action would have to be against the Council and claims by individuals in national courts would be likely to fail;
  - (f) if rates are not harmonised after 1992, the possibility of a judicially imposed standstill is remote.

3. But there are also a number of warnings and indications of weak ground:

- (a) we should not argue that no harmonisation steps need be taken, and everything can be left to market forces. (See final paragraph of the advice, which we understand was added to it by the Attorney-General personally.)
- (b) if the Council does not take harmonisation decisions by the end of 1992, there is a risk that the Court might direct it to do so, and it would then be difficult for a Member State to maintain its veto in isolation;
- (c) there is in principle a requirement to remove all border controls for indirect tax purposes, and while there are arguments for maintaining some minimal level of controls necessary to continue with effective national tax regimes, they are held with reservations;
- (d) a regime consistent with these criteria would require relaxations of VAT controls (the Attorney-General has in mind reintroduction of Postponed Accounting) and there would be very serious, almost insuperable difficulties for control of the excise duties.

4. In the light of this, we and Treasury officials are looking again at your paper for the September informal ECOFIN. In particular we shall need to consider a slight shift of emphasis away from putting most of the emphasis on the market forces arguments towards stressing our practical proposals for progressively removing fiscal frontier controls. In other words we do support harmonisation, but of a deregulatory nature and only to the extent necessary to allow market forces to shape tax rates. The plan is to circulate very quickly to other departments a text which takes account of the Law

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Officers' advice and also a number of helpful presentational points by Sir David Hannay, with a view to putting to you a final version by the end of this month.

ph -

P JEFFERSON SMITH

CONQUEROR

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MDLIAN 4527

DISTORTION OF TRADE WAS NOT DISSIMILAR FROM OUR ORGANIC APPROACH AND WILLINGNESS TO LEAVE APPROXIMATION TO TAKE PLACE NATURALLY. STAVENHAGEN DID NOT DISSENT.

4. CONTACTS AT OFFICIAL LEVEL HAVE HOWEVER BEEN LESS FORTHCOMING. HECK (FINANCE MINISTRY) CONFIRMED THAT THERE WAS NO CHANGE IN THE GERMAN POSITION, ESPECIALLY THEIR POSITION ON ZERO RATING. HE WAS THE QUESTION AS ONE OF THE MOST DIFFICULT THINGS THE EC HAD HAD TO DEAL WITH. HE WAS NOT AWARE OF PREPARATIONS FOR INTERIM OR PARTIAL MEASURES IF NEGOTIATIONS BROKE DOWN. SCHUERMAN (HEAD OF THE SEM DEPARTMENT, AUSWAERTIGES AMT) STRESSED THAT IN HIS MINISTRY'S VIEW THE SEM WOULD BE IMPOSSIBLE WITHOUT TAX HARMONISATION AND HOPED THE UK WOULD ABANDON ITS ISOLATED POSTION ON ZERO RATING.

5. THERE HAS BEEN LITTLE PUBLIC DEBATE ON THE ISSUE AND THE GOVERNMENT HAS NOT BEEN SUBJECTED TO CRITICISM BY BUSINESS: GERMAN VAT RATES ARE LEAST LIKELY TO BE AFFECTED IF CURRENT PROPOSALS ARE ACCEPTED.

MALLABY

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*Stavhagen!  
however, does have  
some support.*

FRAME ECONOMIC

YOUR TELNO 219 TO ATHENS: **INDIRECT TAX APPROXIMATION**

SUMMARY

1. STAVENHAGEN (STATE MINISTER, CHANCELLERY) BELIEVES THE OBJECTIVE OF TAX APPROXIMATION SHOULD BE TO AVOID DISTORTIONS OF TRADE, NOT THE PURSUIT OF HARMONISATION FOR ITS OWN SAKE. OFFICIALS ARE LESS FORTHCOMING. NO SUPPORT AT ANY LEVEL FOR OUR POSITION ON ZERO-RATING. LITTLE PUBLIC DEBATE ON THE ISSUE AND NO DISCERNIBLE CRITICISM OF THE GOVERNMENT.

DETAIL

2. I TOOK THE OPPORTUNITY OF A CALL ON STAVENHAGEN (STATE MINISTER, CHANCELLERY) ON 5 SEPTEMBER TO RAISE THIS. I QUESTIONED THE NEED FOR ANY ORGANISED HARMONISATION AND SUGGESTED THAT APPROXIMATION OF TAX RATES WAS LIKELY TO COME ABOUT NATURALLY POST-1992. I STRESSED OUR DESIRE TO MAINTAIN THE RIGHT TO A ZERO RATE ON CERTAIN GOODS.

3. STAVENHAGEN REPLIED THAT WE WERE COMMITTED TO THE ABOLITION OF FRONTIER CONTROLS, AND THAT IT WAS DIFFICULT TO DO THAT WITHOUT APPROXIMATING INDIRECT TAXES. WE MUST THEREFORE MAKE PROGRESS, AND NOT LEAVE THE QUESTION ON THE BACK BURNER. THE COMMISSION'S PROPOSAL FOR A CLEARING-HOUSE SYSTEM HAD ITS MERITS, BUT THE FRG COULD NOT ACCEPT A PATTERN OF VARYING TAX RATES WHICH CONSTITUTED A DISTORTION OF TRADE. HE ACCEPTED THAT DOING AWAY WITH ZERO RATING WOULD BE A PROBLEM FOR THE UK, BUT COUNTRIES WITH A HIGH THIRD BAND OF VAT HAD PROBLEMS TOO. HE COULD ACCEPT THE IDEA OF SPECIAL TREATMENT FOR TOBACCO AND ALCOHOL, BUT WOULD NOT AGREE WHEN I TRIED TO ESTABLISH A LINK WITH ZERO-RATING. BUT WE NEED NOT NECESSARILY FOLLOW EXACTLY THE COMMISSION'S PROPOSALS. NOT ALL VARIATIONS IN NATIONAL TAXES CONSTITUTED A DISTORTION OF TRADE. SOME SERVICES WERE LOCALISED, AND NO ONE WOULD TRAVEL TO LONDON TO BUY SALT IN ORDER TO AVOID GERMAN SALT TAX, FOR EXAMPLE. I SUGGESTED THAT THIS CRITERION OF APPROXIMATING TAXES ONLY WHEN THEY CONSTITUTED A SIGNIFICANT



FROM: MISS M P WALLACE

DATE: 7 September 1988

SIR G LITTLER

cc PS/Economic Secretary

## INDIRECT TAX APPROXIMATION: GERMAN POSITION

The Chancellor has seen Bonn Telno 867\*, reporting that there is no German support for our position on zero rating. He has noted that Stoltenberg himself, however, does have some sympathy.

A handwritten signature in dark ink, appearing to read 'mpw'.

MOIRA WALLACE

\* attached

*Ch* This minute prompted Geoff to suggest that this & a variety of other issues might suggest bilateral with Stoltenberg on Crete a good idea. Germans not arriving in time for Fri evening, but perhaps Saturday breakfast? If you agree, Geoff to have word with Tietmeyer? [and do you still want bilateral in Berlin?]

A handwritten signature in dark ink, appearing to read 'mpw'.



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DISTORTION OF TRADE WAS NOT DISSIMILAR FROM OUR ORGANIC APPROACH AND WILLINGNESS TO LEAVE APPROXIMATION TO TAKE PLACE NATURALLY. STAVENHAGEN DID NOT DISSENT.

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5. THERE HAS BEEN LITTLE PUBLIC DEBATE ON THE ISSUE AND THE GOVERNMENT HAS NOT BEEN SUBJECTED TO CRITICISM BY BUSINESS: GERMAN VAT RATES ARE LEAST LIKELY TO BE AFFECTED IF CURRENT PROPOSALS ARE ACCEPTED.

MALLABY

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FRAME ECONOMIC

YOUR TELNO 219 TO ATHENS: INDIRECT TAX APPROXIMATION

SUMMARY

1. STAVENHAGEN (STATE MINISTER, CHANCELLERY) BELIEVES THE OBJECTIVE OF TAX APPROXIMATION SHOULD BE TO AVOID DISTORTIONS OF TRADE, NOT THE PURSUIT OF HARMONISATION FOR ITS OWN SAKE. OFFICIALS ARE LESS FORTHCOMING. NO SUPPORT AT ANY LEVEL FOR OUR POSITION ON ZERO-RATING. LITTLE PUBLIC DEBATE ON THE ISSUE AND NO DISCERNIBLE CRITICISM OF THE GOVERNMENT.

DETAIL

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FROM: S M A JAMES  
DATE: 13 September 1988



APS/CHANCELLOR

2

**INDIRECT TAX APPROXIMATION**

The Economic Secretary has seen your minute of 12 September.

2. He has commented that he does not believe in practice the Irish are worried about the UK possibly undercutting them by reducing our standard rate below 14 per cent. They know this is an unlikely development and are simply worried by present differentials.

S M A JAMES

Private Secretary

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5. FCO PLEASE PASS TO HM TREASURY.

JENKINS

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OF 131515Z SEPTEMBER 88  
INFO ROUTINE UKREP BRUSSELS  
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YOUR TELNO 255 TO ATHENS : CHANCELLOR'S PAPER ON INDIRECT TAX

1. THE DUTCH HAVE YET TO TAKE A FINAL DECISION ON THEIR LINE AT ECOFIN. A MEETING WILL BE HELD LATER THIS WEEK BUT OFFICIALS EXPECT RUDING TO TAKE A BACK SEAT AND SEE HOW DISCUSSION DEVELOPS. THEIR POSITION ESSENTIALLY REMAINS THAT DESCRIBED IN OUR TELNO 327. THE FOLLOWING VIEWS WERE GIVEN TO US ON A PERSONAL BASIS BY DE VRIES (DEPUTY DIRECTOR, EXTERNAL FINANCIAL RELATIONS, MINISTRY OF FINANCE).

2. DE VRIES SAID THAT THE DUTCH WERE DISAPPOINTED THAT THE BRITISH PAPER APPEARED TO CONTAIN NO NOVEL IDEAS. IT SEEMED INTENDED TO SERVE BRITISH INTERESTS AND THE DUTCH FEARED THAT IT MIGHT PUT A BRAKE ON FURTHER DISCUSSION. THERE WAS LITTLE APPRECIATION OF THE DIFFICULTIES NON-ISLAND MEMBER STATES WOULD HAVE. HE MENTIONED THE POSSIBILITY OF A VAT WAR WHICH WOULD EVENTUALLY REDUCE INDIRECT TAX RATES TO ZERO : A POLICY GOAL WHICH RAN COUNTER TO MOST ECONOMIC THEORY.

3. HE AGREED THAT PROBLEMS DID NOT REALLY ARISE FOR LOWER BAND ITEMS. HE SAW NO REAL PROBLEMS WITH A CERTAIN AMOUNT OF ZERO RATING AND AGREED THAT US EXPERIENCE SHOWED THAT A FREE TRADE SYSTEM COULD COPE WITH WIDE DIFFERENCES IN TAX ON LOW VALUE ITEMS. BUT HE REMAINED WORRIED ABOUT HIGHLY TAXED ITEMS. HE WAS CYNICAL ABOUT THE HEALTH REASONS CITED FOR ALCOHOL AND TOBACCO TAXES. HE HIMSELF SAW THESE AS PRODUCTS WITH LOW PRICE ELASTICITY WHICH COULD BE MILKED FOR REVENUE PURPOSES.

4. THE ONLY PRESS COVERAGE SO FAR HAS BEEN IN THE NRC HANDELSBLAD (FT EQUIVALENT) WHICH HAS CARRIED TWO LARGELY FACTUAL NEWS ITEMS ABOUT THE PUBLICATION OF THE CHANCELLOR'S PAPER, AND ABOUT THE REACTION IN BRUSSELS. THE LATTER QUOTED A SPOKESMAN FOR LORD COCKFIELD AS SAYING THAT THE PUBLICATION OF SUCH PROPOSALS MIGHT BE USED BY OTHER MEMBER GOVERNMENTS AS A PRETEXT TO PUT OFF COMPLETION OF THE INTERNAL MARKET.

PAGE 1  
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MDHIAN 3501

HE HAD SUBMITTED TO COLOMBO ON THIS QUESTION.

4. WE HAVE THIS WEEK SENT AN ITALIAN TRANSLATION OF THE  
CHANCELLOR'S PAPER TO A WIDE RANGE OF ECONOMIC AND MEDIA CONTACTS  
AND HOPE THIS MAY PRODUCE FURTHER SUBSTANTIVE COMMENTS.

THOMAS

YYYY

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INFO ROUTINE OTHER EC POSTS

(FRAME ECONOMIC)

YOUR TELNO 255 TO ATHENS: THE CHANCELLOR'S PAPER ON INDIRECT  
TAX APPROXIMATION

SUMMARY

1. CHANCELLOR'S PAPER DESCRIBED IN FINANCIAL PRESS BUT MOST  
DAILIES GIVE MORE COVERAGE TO COMMENTS BY ROCARD. NO GOVERNMENT  
COMMENT YET. REVIGLIO, PRESIDENT OF ENI, EXPRESSES PRIVATELY  
STRONG SUPPORT FOR BRITISH VIEWS.

DETAIL

2. THE TWO FINANCIAL DAILES IL SOLE 24 ORE AND ITALIA OGGI  
CARRIED FACTUAL ACCOUNTS OF THE CHANCELLOR'S PAPER BY LONDON  
CORRESPONDENTS ON 9 SEPTEMBER. ROCARD'S ATTACK ON THE COMMISSION'S  
PROPOSALS HAS PRODUCED GREATER PRESS COVERAGE BECAUSE AS ALL THE  
PAPERS NOTE IT WAS BOTH MORE POLEMICAL IN TONE AND CAME AS A  
SURPRISE. WE HAVE SO FAR SEEN NO MEDIA COMMENT ON THE MERITS OF  
THE CHANCELLOR'S PROPOSALS.

BRUSSELS (IE COMMISSION) SOURCES ARE QUOTED AS SAYING THEY WOULD  
NOT FULFIL THE REQUIREMENTS OF THE SINGLE MARKET. THE PAPERS ALL  
REFER TO BRITAIN'S WELL KNOW INSISTENCE ON MAINTAINING ZERO RATING  
AND COMMENT THAT WITH THE BRITISH AND FRENCH SIMULTANEOUSLY  
ATTACKING THE COMMISSION'S PROPOSALS, ALBEIT FROM QUITE DIFFERENT  
POINTS OF VIEW, THE PROSPECTS FOR AGREEMENT HAVE DIMINISHED.

3. THERE IS NO GOVERNMENT REACTION YET. HOWEVER WHEN I CALLED  
ON REVIGLIO, PRESIDENT OF ENI, YESTERDAY ON OTHER MATTERS HE  
RAISED THE ISSUE OF TAX APPROXIMATION WITH ME AND EXPRESSED HIS  
CONCERN ABOUT THE EFFECT OF BOTH THE COMMISSION'S VAT AND EXCISE  
PROPOSALS ON ITALIAN ENERGY PRICES AND HENCE CONSUMPTION, NOT TO  
MENTION THE LOSS OF REVENUE TO THE TREASURY. REVIGLIO SAID HE  
STRONGLY AGREED WITH THE BRITISH ARGUMENTS IN FAVOUR OF A  
MARKET-BASED APPROACH. HE PROMISED ME A COPY OF A PAPER WHICH

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FM PARIS

TO IMMEDIATE FCO

TELNO 885

OF 131606Z SEPTEMBER 88

INFO PRIORITY UKREP BRUSSELS, OTHER EC POSTS

FRAME ECONOMIC

MIPT: INDIRECT TAX APPROXIMATION.

SUMMARY

1. IN AN INTERVIEW GIVEN AT THE END OF AUGUST BUT PUBLISHED ON 9 SEPTEMBER M. ROCARD QUESTIONS THE GOAL OF VAT APPROXIMATION. THIS RADICAL DEPARTURE FROM EXISTING POLICY HAS TAKEN OBSERVERS BY SURPRISE. IT PROBABLY REPRESENTS A PERSONAL VIEW AT THIS STAGE, BUT MAY REINFORCE THE FRENCH INCLINATION TO PLAY VAT APPROXIMATION LONG.

DETAIL

2. THE ECONOMIC MAGAZINE L'EXPANSION PUBLISHED ON 9 SEPTEMBER AN INTERVIEW WITH M. ROCARD (GIVEN AT THE END OF AUGUST) IN WHICH HE QUESTIONS THE GOAL OF VAT APPROXIMATION. HE ARGUES THAT THE LOSS OF STATE REVENUE IMPLIED BY THE COMMISSION'S PROPOSALS (FF80 - 100 BILLION AT LEAST) WOULD LEAD TO UNACCEPTABLE CUT-BACKS IN GOVERNMENT SPENDING ON SOCIALLY NECESSARY ITEMS SUCH AS HEALTH, RESEARCH AND EDUCATION. HE DISMISSES THE OPTION OF INCREASING DIRECT TAXES ON THE GROUNDS THAT PUBLIC OPINION IS INCREASINGLY RELUCTANT TO ACCEPT THIS FORM OF TAXATION - AND JUSTIFIABLY SO. HE CONCLUDES THAT FOR THE NEXT TWO YEARS PROGRESS ON THE VAT FRONT CAN BE RESISTED ON THE GROUNDS THAT PRIORITY MUST BE GIVEN TO APPROXIMATING THE TAXATION OF FINANCIAL ASSETS AND HOPES THAT BY 1990 PEOPLE WILL HAVE COME TO SEE THE WISDOM OF HIS VIEW AND NO ONE WILL WANT TO DO WHAT IS PLANNED TODAY.

3. THESE PRONOUNCEMENTS HAVE TAKEN FRENCH OBSERVERS BY SURPRISE. THEY HAVE BEEN SEEN AS REPRESENTING A RADICAL DEPARTURE FROM THE LINE TAKEN BY THE GOVERNMENT HITHERTO AND, DESPITE THE EFFORTS OF SPOKESMEN AT THE ELYSEE AND MATIGNON, AS AT ODDS WITH PRESIDENT MITTERRAND'S COMMITMENT TO THE GOAL OF VAT APPROXIMATION IN HIS LETTER TO THE FRENCH DURING THE PRESIDENTIAL CAMPAIGN. THEY HAVE BEEN CRITICISED BY POLITICIANS ON THE RIGHT AND REPORTED AS AROUSING SURPRISE AND CONCERN IN THE EUROPEAN COMMISSION.



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MDHIAN 3408

MARKET HAS BEEN WEAKENING FOR SEVERAL MONTHS, AND SUGGESTS THAT OTHER MEMBER STATES MAY SEE LITTLE ATTRACTION IN THE CHANCELLOR'S IDEAS. POINTING OUT THAT BRITISH VAT RATES ARE LOWER THAN ELSEWHERE, IT IMPLIES THAT THE PROPOSALS ARE SELF-INTERESTED BUT CONCLUDES BY QUOTING A MINISTRY OF FINANCE SOURCE WHO SUGGESTS THAT THE UK WILL HAVE AN INTEREST IN NEGOTIATING A PACKAGE BECAUSE THERE ARE OTHER AREAS IN WHICH BRITISH TAX RATES ARE RELATIVELY HIGH.

5. LE MONDE DESCRIBES THE PROPOSALS AS ANOTHER EXAMPLE OF THE UK GOING IT ALONE, AND AS CONTRARY TO THE SINGLE MARKET OBJECTIVES SET BY THE COMMISSION. IT POINTS OUT, HOWEVER, THAT THEY SHOULD CAUSE NO-ONE SURPRISE: ABANDONING ZERO-RATING AS PROPOSED BY THE COMMISSION WOULD RESULT IN CONSUMER FURY, A PROSPECT THAT NO GOVERNMENT COULD BE EXPECTED TO FACE WITH EQUANIMITY.

6. LE QUOTIDIEN DE PARIS DESCRIBES COMMISSION SOURCES AS REACTING TO THE BRITISH PROPOSALS WITH GREAT CIRCUMSPECTION AND AS EXPRESSING SURPRISE AT THEIR PUBLICATION IN ADVANCE OF ECOFIN DISCUSSION. IT POINTS OUT LORD COCKFIELD'S ROLE IN ELABORATING THE COMMISSION'S PROPOSALS AND REMINDS READERS THAT HE IS DUE TO BE REPLACED BY MR BRITTAN, QUOTE A FAITHFUL LIEUTENANT OF MRS THATCHER UNQUOTE.

7. THE CHANCELLOR'S PAPER MIGHT HAVE ATTRACTED MORE COMMENT HAD ITS PUBLICATION NOT BEEN FOLLOWED 24 HOURS LATER BY THE PUBLICATION IN THE ECONOMIC MAGAZINE QUOTE L'EXPANSION UNQUOTE OF AN INTERVIEW WITH M. ROCARD (GIVEN AT THE END OF AUGUST) IN WHICH HE QUESTIONS THE GOAL OF VAT APPROXIMATION. SEE MIFT.

FERGUSSON

YYYY

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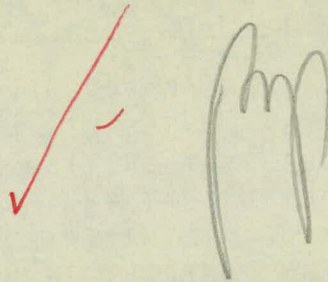
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FRAME ECONOMIC

YOUR TELNO 255 TO ATHENS: REACTIONS TO THE CHANCELLOR'S PAPER ON  
INDIRECT TAX APPROXIMATION.

SUMMARY

1. PRELIMINARY OFFICIAL REACTION WELCOMES OUR CRITICISM OF  
CLEARING-HOUSE MECHANISM AND PROPOSAL FOR REDUCTIONS IN FRONTIER  
CONTROLS, BUT UNENTHUSIASTIC ABOUT APPROXIMATION THROUGH COMPETITION  
OR THE MAINTAINANCE OF FRONTIERS IN THE LONG-TERM.
2. FRENCH PRESS COVERAGE MAINLY FACTUAL. SUGGESTION IN LE FIGARO  
THAT THE PROPOSALS ARE SELF-INTERESTED AND IN LE MONDE THAT THEY  
REPRESENT ANOTHER EXAMPLE OF THE UK GOING IT ALONE.

DETAIL

3. SPEAKING PERSONALLY A MEMBER OF M. BEREGOVY'S CABINET TOLD US ON  
13 SEPTEMBER THAT HE THOUGHT M. BEREGOVY WAS LIKELY TO BE ABLE TO  
EXPRESS PARTIAL BUT NOT TOTAL SUPPORT FOR THE CHANCELLOR'S PAPER  
DURING DISCUSSIONS IN CRETE. ITS CRITICISM OF THE COMMISSION'S  
CLEARING-HOUSE PROPOSALS WAS WELCOME TO THE FRENCH AS WAS THE  
PROPOSAL FOR A SUBSTANTIAL REDUCTION IN FRONTIER CONTROLS. BUT  
FRANCE WAS UNLIKELY TO BE ABLE TO ACCEPT THAT APPROXIMATION SHOULD  
BE BROUGHT ABOUT BY CREATING A COMPETITION BETWEEN INDIRECT TAXATION  
SYSTEMS THAT WOULD FAVOUR MEMBER STATES WHERE RATES WERE LOW AT THE  
EXPENSE OF THOSE LIKE FRANCE WHERE THEY WERE HIGH. ALSO THE  
CHANCELLOR'S PROPOSALS WERE INCONSISTENT WITH FRANCE'S LONG-TERM SEA  
COMMITMENT TO THE ABOLITION OF INTRA-COMMUNITY FRONTIERS.
4. MOST FRENCH DAILIES HAVE REPORTED THE PUBLICATION OF THE  
CHANCELLOR'S PROPOSALS AND THE FACT THAT GENERALLY THEY ARE AT ODDS  
WITH THE COMMISSION'S PROPOSALS. SOME OUTLINE THEM AND MENTION THAT  
THEY ARE DUE TO BE DISCUSSED AT THE INFORMAL ECOFIN IN CRETE.  
COMMENT ON THEM HAS BEEN LIMITED. LE FIGARO QUOTES SENIOR MEMBER OF  
THE COMMISSION AS SAYING THAT BRITISH ENTHUSIASM FOR THE SINGLE



JWP

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM HM TREASURY  
AT 10.15 am ON WEDNESDAY 21 SEPTEMBER 1988

Present: Chancellor  
Sir Peter Middleton  
Sir Geoffrey Littler  
Mr Byatt  
Mr Lankester  
Mr Culpin  
Mr R I G Allen  
Mr Gilhooly  
Mr Riley  
Mr Cropper  
Mr Tyrie

Mr Unwin (Customs & Excise)  
Mr Wilmott (Customs & Excise)  
Mr Oxenford (Customs & Excise)

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**TAX APPROXIMATION**

The Chancellor, opening the discussion, thanked all those who had worked on the paper which he had circulated for the informal ECOFIN. Though only Luxembourg had firmly endorsed the UK market based approach, the paper had been universally regarded as a good one. At the end of the discussion, Delors had confirmed that it remained on the table. The Chancellor said he now wished to consider how best to follow up the progress made at ECOFIN. The Commission proposals were in very considerable difficulty. Our own proposals had changed the nature of the discussion for the better.

2. The Chancellor said we should seek to define precisely which border controls would remain under our preferred scheme. A number of other Member states - in particular Germany and the Netherlands - were very exercised about this question, and our position on this would be significant in attracting support for our approach. Mr Unwin said that, on the basis of recent work, it should be



possible to assert that the UK approach was consistent with the eventual abolition of all fiscal frontiers - the excise duties on alcohol and tobacco were the biggest problem areas to be overcome. The Chancellor agreed that this would greatly improve the attractiveness of our approach.

3. The Chancellor asked for a paper to be worked up on how the United States coped with widely different liquor taxes in the different States. It was in this area - and to a lesser extent tobacco - where the biggest variations in excise taxes lay. Customs undertook to provide a paper along these lines.

4. The Chancellor said that the Commission were given a remit at ECOFIN to refine their proposals in time for consideration at the European Council in December. In the meantime, each member state was invited to make high level representations to it. We should make joint Treasury/Customs - rather than UKREP - representations. We should also make use of our contacts in the Commission to keep track of Commission thinking.

5. The Chancellor said that other ECOFIN colleagues were beginning to realise that it was a nonsense for the Commission to insist on VAT ranges. All that was necessary were minima. We could usefully build on this by arguing that there should be only one minimum rate - say 14% - together with a specified list of goods for which each country would be free to set its own rates. This list should include all items currently zero-rated in the UK. This approach could be worked up as a fall-back position. The Chancellor commented that a two-rate system, with derogations, would not be an acceptable substitute for a system of this sort.

6. The Chancellor said an immediate question was the approach which we should take in the forthcoming discussions with Lord Cockfield. We should stress that a major problem lay with the harmonisation of excise duties. The current range of rates



within EC12 was far too big to accommodate the changes envisaged by the Commission. There was little point in seeking to tackle the VAT problem until the excise problem was solved. We should also point out that the ECOFIN discussion had shown that the clearing house system for VAT was a non-starter. We ought not to put forward at this stage the proposition that a minimum start rate of VAT should be substituted for VAT ranges: it would be better tactically if this were proposed by another member state.

7. In further discussion, the following points were made:

i. The main problem with abolishing fiscal frontiers lay with passenger traffic rather than with freight. This would need to be addressed specifically in the work undertaken by Customs;

ii. on the alleged incompatibility of retaining even residual frontier controls with the Single European Act, Lord Cockfield's position appeared to be that controls for drugs, terrorism etc should be administered away from frontiers. This issue was clearly one which would exercise the Home Office;

iii. if there were no fiscal controls at frontiers, however, as our own approach might envisage, we would need to be precise about what form border controls would take. Future work should consider this;

iv. a list of items to which, under the fallback approach, <sup>the</sup> minimum VAT rate would apply across the Community should be compiled as part of our future work.

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8. The Chancellor, summing up, invited officials to prepare a paper on the next steps. We would need to make our representations before the end of October, and the timetable for future work should be dictated by this.

A handwritten signature in black ink, appearing to be "J M G Taylor".

J M G TAYLOR

Copies to:

Those present  
Economic Secretary  
Paymaster General

Mr J M G Taylor



A couple of knock points on letter  
On X (para 9), Sir D Hamman

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

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letter he was back box of a very  
good chance of spinning the discussion  
our work after the December European Council and until he has

FROM : THE CHAIRMAN  
DATE : 28 September 1988

CHANCELLOR OF THE EXCHEQUER

Commission is in place. Indeed, he

Commission are currently giving higher priority to how strong of  
the Taxation of Savings or until they are committed to making

TAX APPROXIMATION AND FRONTIER CONTROLS

movement dates by end - year.

On 7 (para 10), here is the (important) qualification that we

At your meeting on 21 September you commissioned some further work  
on our approach to frontier controls and tax approximation.  
Detailed work is in hand, and will come forward separately, on the  
tax arrangements in the United States and on the implications of  
the VAT possibilities we discussed both for us and for other  
member states. You may, however, find it helpful to have now the  
following further comments on the frontier control strategy we are  
developing and on the tactics for discussion with Lord Cockfield.

Freight controls

2. As I indicated at your meeting, we are currently studying  
proposals for effectively eliminating fiscal controls on freight  
at the frontier. That is certainly my aim. A great deal of  
further detailed work, however, needs to be done, and this is a  
difficult area requiring radical changes and involving consider-  
able risks. It will therefore be some time before a definitive

Chief Secretary  
Paymaster General  
Economic Secretary  
Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Lankester  
Mr Allen  
Mr Culpin  
Mr Cropper

Mr Jefferson Smith  
Mr Nash  
Mr Wilmott  
Mr Allen  
Mr M Knox  
Mr Oxenford

arranging work not expect to abolish fiscal controls within the  
Commission's timescale (ie 1992).

RA. 28/9

304/a

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blueprint emerges. But the following findings are already emerging from the studies on which we are pressing forward:-

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4. This note is concerned primarily with fiscal measures. As we have consistently stated, necessary preventive checks (eg for drugs and terrorists) would continue at the frontier. In maintaining such controls we are legally on firmer ground, in view of the provisions of Article 36 of the EEC Treaty and the General Declaration appended to the Single European Act. As part of our present work, however, we are also considering how far these controls could be acceptably lightened (eg so that fewer vehicles are stopped and passengers questioned). We shall also be questioning with other Departments the need for all the present checks on plant and animal health, pornography etc that we are

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Presentation of UK position

5. The great advantage of the above approach is that it could change the nature of the debate in our favour, by demonstrating that, contrary to much of the recent criticism, assuming we could devise acceptable arrangements the UK could abolish most if not all frontier fiscal controls without tax approximation, without the origin system, and without the clearing house mechanism. Tax approximation could thus be shown to be a response to a problem which the UK does not have. That said, the single market will not come about without tax approximation unless all Community countries can dismantle their fiscal frontiers. Other Member States have more problems connected with border trade, and as these countries enter the debate the question of rates is certain to arise again. This brings us back to the possibility of a fallback position on VAT which might meet other Member States' fears whilst continuing to avoid the undesirable dirigisme of the Commission's proposals and, so far as possible, safeguarding our zero rates.

Possible fallback position on VAT

6. As you suggested at your meeting on 21 September, a possible means of reducing other Member States' fears as to the effects of market forces would be agreement on a minimum rate of VAT (say, 14%), accompanied by a list of excluded items which could be taxed at any rate and which would desirably cover all our present zero rates. Member States' main fears centre on the possibility of neighbouring states operating substantially lower VAT rates, leading to excessive cross-border shopping and unacceptable revenue loss. This is obviously a far greater problem for states with extensive land boundaries than it is for the UK. The key selling points would be that a minimum rate would do much to reduce the cross-border problem, particularly if the excluded items had a low value-to-weight ratio; and that an upper limit is irrelevant to Member States' revenue fears, and hence a totally unnecessary feature of the Commission's proposals. A country choosing to impose high indirect tax rates would not gain at its

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7. The main political and presentational problem with this approach is that it would undoubtedly involve some additional loss of fiscal sovereignty, however slight. On specifics, we might also find particular problems in excluding the highly sensitive areas of childrens' footwear and clothing. It could therefore be portrayed as a volte face, with the UK conceding to the Commission's view and reneging on pledges. As against that, a minimum rate alone could scarcely be described as "tax approximation"; an exclusion list should enable the UK to maintain at least most of our zero rates; Member States would remain free to set rates above the minimum, without posing a revenue threat to their neighbours; market forces would operate on Member States' decisions to set rates substantially above the minimum; and the UK would be demonstrating a willingness to act flexibly in a constructive spirit.

8. You would obviously need to consider with the Prime Minister and other colleagues whether an approach on these lines was even a starter. There is no doubt, however, that a minimum rate with appropriate exclusions could be presented as a positive compromise - if not a UK victory - which stopped short of tax approximation and permitted the retention of zero rates. Moreover, if coupled with retention of the destination principle, the proposal would not require a clearing house mechanism and could be coupled with inland controls as envisaged in the market-based approach.

Bilateral discussions with Lord Cockfield

9. If an approach on the above lines - subject to the further detailed studies on frontier controls which we are taking forward as quickly as possible - proves acceptable, it would form a good basis for the proposed bilateral discussions with Lord Cockfield. It would also give the Prime Minister a much stronger position at the December European Council, assuming - as seems certain - that these issues, including tax approximation, are on the agenda.

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- the excise problem is by far the most difficult and must be tackled first. It is absolutely clear that the Commission's present proposals are unacceptable. What are their further proposals?

4 | - it is not true that our intention is to keep fiscal controls at the frontier in place. On the contrary, subject to the problems of passengers and excise duties, we aim to remove fiscal frontiers and believe this is consistent with retention of the destination principle and the market based approach (and without the generally acknowledged defects of a clearing house mechanism).

11. Development of such an approach would serve to highlight the defects of the Commission's package, provide an opportunity to restate the advantages of the market-based approach, set the record straight on our approach to fiscal frontier controls, and perhaps win some support from those Member States inclined to play the whole question long. It is for consideration, however, whether we should go a little further at this stage and float the ideas on VAT outlined in paragraphs 6-8 above. You were inclined last week not to do so, but to regard this as a fallback position for deployment later if necessary, preferably by another Member State. It might be possible to get away with this. The risk is that, since VAT is such an important ingredient in the Commission's proposals, refusal to discuss it beyond the terms of your recent ECOFIN paper would cause the remainder of our proposals to be treated simply as a wrecking or delaying tactic.

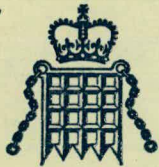
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J B UNWIN



*Ch. NB also RIGA's*  
*Comments in separate copy,*  
*behind.*  
*H*  
*24/9*

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

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FROM : THE CHAIRMAN

DATE : 28 September 1988

CHANCELLOR OF THE EXCHEQUER

*\* 12 may be*  
*look into*  
*SM*  
*STB*  
*P.M.*

*Thanks, Re X, must be*  
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*worked. Re Y, who will need*  
*to discuss a duty course!*  
*but in public*

TAX APPROXIMATION AND FRONTIER CONTROLS

At your meeting on 21 September you commissioned some further work on our approach to frontier controls and tax approximation. Detailed work is in hand, and will come forward separately, on the tax arrangements in the United States and on the implications of the VAT possibilities we discussed both for us and for other member states. You may, however, find it helpful to have now the following further comments on the frontier control strategy we are developing and on the tactics for discussion with Lord Cockfield.

Freight controls

2. As I indicated at your meeting, we are currently studying proposals for effectively eliminating fiscal controls on freight at the frontier. That is certainly my aim. A great deal of further detailed work, however, needs to be done, and this is a difficult area requiring radical changes and involving considerable risks. It will therefore be some time before a definitive

- |                    |                    |
|--------------------|--------------------|
| Chief Secretary    | Mr Jefferson Smith |
| Paymaster General  | Mr Nash            |
| Economic Secretary | Mr Wilmott         |
| Sir P Middleton    | Mr Allen           |
| Sir G Littler      | Mr M Knox          |
| Mr Byatt           | Mr Oxenford        |
| Mr Lankester       |                    |
| Mr Allen           |                    |
| Mr Culpin          |                    |
| Mr Cropper         |                    |

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*until his departure,*  
*& save that*

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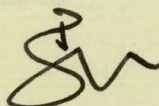
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J B UNWIN

*Jf.* 8/10



FROM: J M G TAYLOR  
DATE: 29 September 1988

MR UNWIN - Customs and Excise

cc Chief Secretary  
Paymaster General  
Economic Secretary  
Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Lankester  
Mr Allen  
Mr Culpin  
Mr Cropper

Mr Jefferson Smith )  
Mr Nash )  
Mr Wilmott ) *Customs*  
Mr Allen ) *& Excise*  
Mr M Knox )  
Mr Oxenford )

TAX APPROXIMATION AND FRONTIER CONTROLS

The Chancellor was grateful for your note of 28 September.

2. He believes that we could present a minimum rate with appropriate exclusions as a UK victory if we so wished.

3. He has noted that you are inclined to think that there could be advantage in exploring with the Commission the question of the relevance of, and need for, upper limits to the VAT rate bands. He has commented that we will need to discuss this in due course (and that it might be worth inviting Sir David Hannay to take part), but that his present view remains as expressed at the meeting on 21 September. He does not believe we will get anywhere with the present Commissioner: we should therefore play for time until his departure, and save this concession as the basis of a "deal" with his successor. The Chancellor will, in any case, need to discuss this with the Prime Minister at the right time.

J M G TAYLOR