PO-CH/WL/0560

PART A

Part. A.

CONFIDENTIAL
(Circulate under cover and notify REGISTRY of movement)

Begins: 18/2/88.
Ends: 27/5/88.

THIS FOLDER HAS BEEN REGISTERED ON THE REGISTRY SYSTEM

PO - CH/NL/0560. Pt.A.

Chancellor's (Lawson) Papers:
The Single European Market and Fiscal Harmonisation: The United Kingdom Approach.

DD's: 25 Years

26/4/96.

PO - CH/NL/0560. Pt.A.

CABINET OFFICE PAPER

The following Cabinet Office papers have been taken off the file. If you require access to these papers please contact the Cabinet Office.

Reference	Date Of Paper
OD (E) (88)	29/4/88

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

CONFIDENTIAL

FROM: THE CHAIRMAN
DATE: 18 February 1988

CHANCELLOR OF THE EXCHEQUER

cc Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Geoffrey Littler
Mr Scholar
Mr Edwards

THE SINGLE EUROPEAN MARKET

I visited Brussels earlier this week to meet officials concerned with customs and fiscal policy. I also talked to Lord Cockfield and David Williamson and David Hannay. For what it is worth, you may be interested in my main impressions.

2. This was my first visit since my days of closer involvement in the Treasury. The chief impression I brought away (even after allowing for the attempts, of course, to bend my ear) was of the strength of the tide that seems to be flowing on the single market, sans frontieres and all. It is clear that, with the budget and future financing issues again off the agenda for a while, this will now be the main focus of Community attention, not least at the June and December summits.

Internal Circulation: Mr Knox
Mr Jefferson Smith
Mr Nash
Mr Allen

3. So far as Hanover (in June) is concerned, Kohl will undoubtedly want to push through a single market package. I think it is unlikely, however, that this will contain fiscal proposals likely to embarrass us. I found no disposition among officials in the Commission to try this on (and David Williamson thinks it would be a mistake) and the package is therefore likely to consist of a mix of worthy measures (like mutual recognisition of diplomas, and perhaps progress on insurance and banking) which we should be able to welcome. If there are signs of trouble on the fiscal front, you will in any case have an opportunity at the April and (informal) May ECOFIN Councils to try to head them off.

4. December, however, could be more difficult. The Greeks will be in the Presidency, and this could make it easier for the Commission to assert their influence rather than the reverse. In addition, it will be this Commission's (and presumably Cockfield's) last throw; and in any case the Single European Act (SEA) formally requires the Commission to report on progress on the Single Market at the end of the year. The Prime Minister could, therefore, find great pressure being exerted on some of the areas that cause us most trouble.

5. Our two main difficulties are, of course, with the tax approximation/harmonisation proposals, and with the proposals on abolition of frontier controls. We are not alone in our objections; but we will probably find more problems than anyone else, and some of our present allies are far from reliable.

6. On the <u>fiscal</u> side, I think we are likely to come under the greatest pressure on VAT. The excise proposals present greater problems Community wide (their effects are startlingly perverse both in revenue and social policy terms) and we shall, at least for some time, have allies. But if the Commission were to adopt the tactic of setting aside the excise part of the package (and there were some signs of this, though not from Lord Cockfield),

and focusing on the VAT approximation, we might find our position increasingly hard to defend. Indeed, we could end up being isolated. Movement of rates elsewhere in the Community will not generally have to be too great to come within or very near the Commission's ranges (I am told that Chirac, for example, recently told French businessmen that they should not expect reductions in company taxation because of the need to move French VAT rates downwards); and there will not be too much sympathy for UK claims for continuing zero rate derogations, especially if, as budget contributions mount, there is further resentment of our rebatement arrangements (not least from the Germans, whose net contribution over the next 3 or 4 years could reach £7 or 8 billion, or the Italians who should soon become - and high time too - net contributors).

7. I foresee, therefore, a difficult ride on VAT in particular. For the moment, especially if the E.P.C. paper proves helpful, you will no doubt be able to continue to boot this into touch. But we could find ourselves up against it by December; and it will be worth considering further our tactics on the excise proposals. In some ways they present greater problems; but it might be better tactically to ensure that they remain in the package, since that will give us more allies.

8. So far as frontier controls are concerned, we could again find ourselves out on a limb. Others share some of our problems, but, by dint of geography above all, our position is unique. No one else sees quite the same range of difficulties in relation to the physical and other controls we believe we must continue to exercise.

9. Our present tactic is to continue work on our 'alternative package', (though we must not yet call it that) which contains some very constructive proposals on freight and passenger facilitation etc and for which, as you know, I think we ought to

start taking more positive public credit. But the emphasis will still be on the problems that have to be solved before frontier controls can be simplified, if not removed; whereas the Commission's viewpoint, which others may increasingly come to share, is to assume a frontier free Community by 1993 and then to ask how it will actually be made to work.

10. Of course the notion of no frontier controls is simplistic nonsense. In fact, the Commission do their own cause a tactical disservice by talking in these terms, despite the wording of the S.E.A. In reality, arrangements will have to continue to make it possible to conduct frontier checks for a range of purposes - security, drugs, plant and animal health and so on - and I am sure that Commission officials realise this. But their objective will be to make free passage of goods and persons the norm, with controls only exercised where there is specific reason to do so; and it will not be easy, either presentationally or in substance, to reconcile our approach with this or to carry others with us. For the moment, I think the right thing is to press on with the range of work we have put in hand following the recent OD(E) discussion, including the difficult technical question of the collection of trade statistics; but we may need soon to start some more radical thinking.

11. In sum, the impression I have is that, unless some of our present allies stand unexpectedly firm, or other issues steal the limelight, we may find our position on the fiscal and frontier controls aspects of the single market an increasingly uncomfortable one. The pressures on the other side of the channel will increase; and we could come under greater pressure from industry at home too. Lord Young's new campaign will in part be designed to win British companies to our way of thinking; but its success could have the perverse effect of stimulating support for some of the Commission's less acceptable proposals too, particularly for dismantling frontier controls.

12. As noted above, I do not advocate any major changes in our approach now, and I am, of course, well aware of the overriding political constraints in some of the key areas discussed. But I am concerned about how long our present position will be tenable; and we shall need to keep it under very sharp review, not least in the light of how you get on at ECOFIN. When the Budget is out of the way, you may think it could be useful to have another discussion of some of these issues with those in the Treasury and in Customs concerned.

J B UNWIN

RJ4.38

CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 22 February 1988

MR UNWIN - CUSTOMS AND EXCISE

cc PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Edwards
Mr Knox - C&E
Mr Jefferson-Smith - C&E
Mr Nash - C&E
Mr P R H Allen - C&E

THE SINGLE EUROPEAN MARKET

The Chancellor was most grateful for your minute of 18 February. He has commented that this provides a useful insight.

2. He agrees that it would be useful to have another discussion of some of these issues when the Budget is out of the way; this office will organise.

J M G TAYLOR

I should be grateful for a full note on this. (I don't understand, incidentally, para 4). MC.

UNCLASSIFIED

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MDHIAN 9011

Ch/ Balladur's difficulties with tax approximation differ from ours - but it is v. helpful, nonetheless, that he has difficulties

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25/2

UNCLASSIFIED
FM PARIS
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OF 241717Z FEBRUARY 88
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EC FISCAL HARMONISATION: FRENCH BOITEUX COMMISSION REPORT

SUMMARY

1. RESULTS OF A STUDY OF THE FISCAL IMPLICATIONS FOR FRANCE OF THE CREATION OF A SINGLE MARKET, LED BY MARCEL BOITEUX, FORMERLY PRESIDENT OF ELECTRICITE DE FRANCE, DUE TO BE PUBLISHED SHORTLY. THREE MAIN AREAS: VAT APPROXIMATION, EXCISE DUTIES, THE TAXATION OF SAVINGS. STUDY CRITICAL OF COMMISSION VAT PROPOSALS. BALLADUR ESSENTIALLY IN AGREEMENT WITH BOITEUX'S CONCLUSIONS.

DETIAL

2. FRENCH NEWSPAPERS THIS WEEK HAVE PUBLISHED BRIEF EXTRACTS FROM A STUDY COMMISSIONED BY BALLADUR LAST MAY INTO THE FISCAL IMPLICATIONS FOR FRANCE OF THE CREATION OF A SINGLE MAKRET (THE BOITEUX COMMISSION), AND BALLADUR DEVOTED A PRESS CONFERENCE TO THE SUBJECT TO-DAY.

3. PRESS ACCOUNTS SUGGEST THE BOITEUX REPORT CONCENTRATES ON 3 ISSUES:

A) THE EC COMMISSION'S PROPOSALS FOR VAT APPROXIMATION

B) THE EC COMMISSION'S PROPOSALS FOR HARMONISATION OF EXCISE DUTIES

C) THE IMPLICATIONS FOR THE FISCAL TREATMENT OF INVESTMENTS OF THE LIBERALISATION OF CAPITAL MOVEMENTS.

4. ON VAT APPROXIMATION BOITEUX CONCLUDES THAT BECAUSE THE BANDS PROPOSED BY THE COMMISSION ARE WIDE (5 POINTS FOR THE 'REDUCED' BAND AND 6 POINTS FOR THE 'NORMAL' BAND) REMOVING FISCAL FRONTIERS COULD HAVE A DISTRUPTIVE EFFECT ON INTRA-EUROPEAN TRADE. IT RECOMMENDS THAT FRANCE SHOULD ONLY ACCEPT THE COMMISSION'S PROPOSALS IF FRENCH RATES CAN BE SET NO HIGHER THAN 2 POINTS ABOVE THE LOWEST RATE IN ANY MEMBER STATE IN THE NORMAL BAND.

5. IMPLICITLY ACCEPTING BOITEUX'S CONCLUSIONS, BALLADUR TOLD THE

PARIS TELNO 227

PRESS THAT WIDE BANDS COULD HAVE SERIOUS CONSEQUENCES FOR THE FRENCH ECONOMY IF ACCOMPANIED BY THE REMOVAL OF FISCAL FRONTIERS, IE A LOSS OF BUSINESS TO NEIGHBOURS WITH LOWER RATES. HE DOUBTED WHETHER THE COMMISSION WERE RIGHT TO CONSIDER REMOVING FISCAL FRONTIERS AN ESSENTIAL PRECONDITION OF THE CREATION OF A SINGLE MARKET IN GOODS. FOR FRANCE IT WOULD NOT BE A PRIORITY: REDUCING THE VAT BURDEN ON FRENCH COMPANIES WAS MORE IMPORTANT. HE ADDED THAT VAT APPROXIMATION WOULD DEPRIVE THE FRENCH GOVERNMENT OF SIGNIFICANT FISCAL RECEIPTS.

6. HARMONISATION OF EXCISE DUTIES IS CONSIDERED LESS PROBLEMATIC BY BOITEUX, WHO DELIVERS A FAVOURABLE JUDGEMENT ON THE COMMISSION'S PROPOSALS, CALCULATING THAT THEY WOULD ENTAIL AN INCREASE IN RECEIPTS FOR THE FRENCH GOVERNMENT OF F5.5 BILLION. BALLADUR'S VIEW IS THAT IT MAY BE NECESSARY TO DISTINGUISH BETWEEN TOBACCO AND PETROLEUM PRODUCTS (HEATING FUEL, INDUSTRIAL GAS ETC) ON THE ONE HAND, AND ALCOHOL AND PETROL ON THE OTHER. RAPID HARMONISATION FOR THE FORMER WOULD BE IN ORDER: FOR THE LATTER THE ECONOMIC AND SOCIAL VALUE OF HARMONISATION (WHICH FOR FRANCE WOULD MEAN DEARER ALCOHOL AND CHEAPER PETROL) WOULD NEED CAREFUL CONSIDERATION.

7. BOITEUX'S THIRD THEME IS THE LIBERALISATION OF CAPITAL MOVEMENTS. NOTHING THAT THE COMMISSION HAVE NOT SO FAR GIVEN DETAILED CONSIDERATION TO THE FISCAL ASPECTS OF THE CREATION OF A EUROPEAN FINANCIAL SPACE, HE HIGHLIGHTS THE RISKS THAT THE REMOVAL OF ALL CONTROLS ON THE MOVEMENT OF CAPITAL WILL RESULT IN SAVINGS FLOWING INTO THE MARKET THAT OFFERS THE MOST ATTRACTIVE TERMS. HE RECOMMENDS THAT THE FRENCH GOVERNMENT CONSIDER SEEKING HARMANISATION OF EC TAX TREATMENT OF THE SAVINGS OF NON-RESIDENTS, AND REDUCTION TO 27 PERCENT OF FRENCH TAXES ON A NUMBER OF FINANCIAL INSTRUMENTS PRESENTLY TAXED AT 35.3 PERCENT AND 47 PERCENT (EG CERTIFICATES OF DEPOSIT AND TREASURY NOTES).

8. BALLADUR TOLD THE PRESS THAT LIKE BOITEUX HE THOUGHT LIBERALISING CAPITAL MOVEMENTS NECESSARILY IMPLIED HARMONISING THE TAXATION OF SAVINGS, AND THAT THIS WAS PROBABLY OF GREATER IMPORTANCE THAN ANY OTHER ASPECT OF FISCAL HARMONISATION. HE THOUGHT THE PRIORITIES WERE TO LOVER FRENCH COMPANY TAX RATES, INCREASE THE REAL VALUE OF TAX CREDITS TO FRENCH COMPANIES, AND CONSIDER WITH EC PARTNERS HOW TO APPROXIMATE TAX RATES ON FINANCIAL INSTRUMENTS AS WELL AS THE FISCAL STATUS OF UNIT TRUSTS AND INVESTMENT MANAGEMENT FUNDS.

9. THE BOITEUX REPORT IS NOT YET AVAILABLE PUBLICLY, BUT CONTACTS IN THE TRESOR HAVE PROMISED TO LET US HAVE 2 COPIES ON 25 FEBRUARY. A MORE DETAILED ANALYSIS WILL THEN FOLLOW BY BAG.

123206
MDHIAN 9011

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UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 26 FEBRUARY 1988

MR A J C EDWARDS

cc Mr Byatt

PS/Customs & Excise

EC FISCAL HARMONISATION: FRENCH BOITEUX COMMISSION REPORT

The Chancellor has seen Paris Tel.No. 227 (attached). He would be grateful for a full note on this report.

J M G TAYLOR

JMGT
26/2

RJ4.65

CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 1 March 1988

MR MACAUSLAN

cc PS/Financial Secretary
Sir P Middleton
Mr Monck
Mr Burgner
Mr A J C Edwards
Mr Mercer
Mr Wynn Owen

EC MERGER CONTROL REGULATION

As you know, this was discussed at OD(E) last week. The minutes have now been circulated.

2. The Chancellor has commented that he will raise this issue with the Prime Minister after the Budget. Meanwhile, the line must be held.

J M G TAYLOR

JMGT 1/3

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CABINET OFFICE

70 Whitehall, London SW1A 2AS Telephone 01-233

CONFIDENTIAL

Qz 06011 3 March 1988

H H Liesner Esq CB
Deputy Secretary
Department of Trade and Industry
1 Victoria Street
London SW1H 0ET

Dear Hans

EC MERGER CONTROL

Following OD(E) on 25 February we have been giving thought to further work which might be done before Ministers look at the subject again.

The starting position, as I see it, is that the Commission has committed a fair amount of capital to attempting to get agreement on a regulation: the question is whether this provides an opportunity to improve the present, rather messy, legal position or is likely to lead to a dangerous extension of Commission powers, and leave us worse off than we are now.

Debate so far has helped to identify some of the main disadvantages and advantages of agreeing to a regulation and it may be helpful to try to summarise them. In favour of a regulation, it might

- open up the continental market to British firms;
- create a more orderly procedure (instead of the present system of retroactive investigations);
- clarify the criteria against which a merger was likely to be approved or prevented.

On the debit side, a regulation might

- extend very significantly the number of cases examined by the Commission;
- not expunge existing powers in Articles 85 and 86;
- either overlap with domestic procedures, creating "double jeopardy" for companies and possibly failing to achieve real liberalisation of EC markets or lead to substantial loss of national sovereignty by making a whole class of mergers subject to Community control alone.

In the OD(E) discussion it seems fair to say that no-one favoured a widely drawn regulation. In that context, interest was expressed in whether a regulation could be drawn up in a way which would restrict the Commission to a greater extent than Articles 85 and 86; and whether future recourse to these Articles could be prevented. At a tactical level, Ministers saw merit in avoiding isolated UK opposition to a regulation if possible, partly in order to minimize the likelihood that the Commission would try to find ways of proceeding without need for unanimity, although the Chancellor remained firm that we should stand alone if need be.

What now seems to be required in the way of further work is to probe some of the legal and negotiating possibilities in a way which tests the validity of the advantages and disadvantages referred to above, and takes account of the points made at OD(E). To this end, I suggest it would be useful if the DTI could produce a paper which addresses the following issues:

a. Scope. OD(E)(88)4 suggested that a regulation might catch only those cases caught anyway by Articles 85 and 86. Further thought is required on how this could be achieved, and whether our concern is simply to restrict the numbers of cases caught or to match the regulation's criteria as closely as possible to those in Articles 85 and 86. The latter option raises the possibility of qualified majority voting (see (e) below). One way of illustrating the issue might be to look at a number of mergers and consider the effects of different types of regulation on them, compared with action under Articles 85 and 86.

b. Continuing effect of Articles 85 and 86. We need to establish, if we can, how far it is legally and practically possible to make our agreement to a regulation conditional on watertight assurances from the Commission about refraining from the use of Articles 85 and 86 for the purposes of merger control; and whether there are any means to prevent use of the Articles by third parties who were for instance dissatisfied with the Commission's stance in a case caught by the regulation or wished to intervene in a merger not caught by the regulation.

c. Community and domestic controls. Lord Young's paper suggested that we should avoid a double filter. We should consider in more detail the different circumstances in which there could be a clash between national and Community controls. For example we perhaps need:

- to consider if it is the Commission's general intention that the areas affected by Community and domestic controls should be mutually exclusive; how far this would be dependent on whether the Commission's decision was to exempt or prohibit a merger; and the relevance of any provision for appeal to the ECJ;

- to consider whether a Commission decision would take priority over that of member states based on grounds other than competition policy (eg prudential controls). If so how would this be achieved? In this context, concern was expressed at OD(E) that other member states would be able to frustrate the impact of a regulation through domestic controls. It might be worth, in conjunction with overseas posts, examining the present controls that at least major member states possess.

- to examine the implications of the Commission's proposed right to take into account wider industrial and economic benefits in assessing mergers. How far could this have the effect of permitting mergers which we would have stopped on competition grounds or blocking mergers with third country companies which were regarded as contrary to EC industrial interests?

Could the fall-back position suggested in OD(E)(88)4 of a double filter be achieved without creating excessive burdens on industry and undermining the liberalising purpose of the Directive?

d. Benefits of a regulation. It would be helpful to have a more detailed assessment of the areas where a regulation might help UK industry (assuming it overrode national controls). How much help would it be if its field of application were as restricted as Lord Young has proposed? What examples are there of activity which has been thwarted in the past by national controls in other member states which this regulation might have allowed?

e. A regulation subject to qualified majority voting. Some concern was expressed at OD(E) that if the UK were isolated the Commission might try to bring forward a regulation for adoption by QMV, possibly under Article 87. It was thought this might also happen if we tried to restrict the scope of the regulation to that of Articles 85 and 86. We need to clarify what sort of regulation could be brought forward subject to QMV. How far might it share the characteristics of the Commission's present proposal?

f. Present Commission proposals. UKREP Brussels Telno 668 reports that the Commission have now produced their revised draft regulation. It would be useful, having examined our own objectives, to see how far what the Commission have put forward is consistent with them.

If you and others agree that the issues set out above are the ones on which we should be concentrating, I suggest that we should hold a discussion later this month in EQS on the basis of a paper responding to them. This would be produced by DTI but other Departments would be consulted, particularly on the legal points. I see no real difficulty, and some advantage, in holding this meeting after the next Brussels working party discussion on 14/15 March. At the working party discussion, we should of course continue to reserve our position, and adopt a questioning tone; we could also try to smoke out further how far other member states share the concerns expressed above and try to clarify the Presidency's intentions on handling, either via UKREP or Bonn.

Following EQS, I envisage production of a note by officials which could be submitted to Ministers for a further meeting of OD(E), probably soon after Easter. We can discuss at EQS the precise format and how it might relate to any further Ministerial papers.

Yours sincerely,

Roger Lavelle

R G LAVELLE

cc Sir David Hannay - UKREP Brussels
Mr T P Lankester)
Mr J MacAusland) HMT
Mr R Q Braithwaite)
Mr J O Kerr) FCO
Mr C W Roberts)
Mr R Allen) DTI
Mr D Hadley - MAFF
Mr D Holmes - D/Transport
Mr S Parker - Law Officers Department
Mr M Blythe - T/Sol
Mr G H Chipperfield - D/Energy
Mr J H Holroyd)
Mr J H M Alty) Cabinet Office

100/G/IEP/3/30

CONFIDENTIAL

FROM: P WYNN OWEN

DATE: 7 March 1988

MR MACAULAN

2 PS/CHANCELLOR

cc PS/PMG
Sir P Middleton
Mr Lankester
Mr Monck
Mr Burgner
Mr A J C Edwards
Mrs Lomax
Mr R I G Allen
Mr Ilett
Miss Noble
Miss Barber
Mr Bent
Mr Kroll
Mr Parkinson

a good letter.

EC MERGERS

As a follow-up to OD(E) on 25 February the Cabinet Office has been identifying which questions need to be pursued by officials.

2. Roger Lavelle has now helpfully written the attached letter of 3 March to DTI posing a number of difficult questions - many of which were raised by the Chancellor at OD(E). We do not think you need bother the Chancellor with the whole letter, but you might alert him to the facts that a further Brussels working party discussion on the latest Commission proposal is due on 14/15 March; DTI will attend; and that the proposed **line to take** towards the end of Roger Lavelle's letter is that the UK "should of course continue to reserve our position, and adopt a questioning tone; we could also try to smoke out further how far other member states share the concerns expressed" in Roger Lavelle's letter and "try to clarify the Presidency's intentions on handling, either via UKREP or Bonn". This seems as firm as we could hope for, given the summing up of OD(E).

3. Roger Lavelle plans an EQS meeting (of senior officials) once DTI have attempted to answer the questions in this letter, followed by a further meeting of OD(E), probably soon after Easter.

4. Quite separately, the Chancellor might also wish to be aware that the outcome of discussions between **BA and the EC Commission** over the BA/B.Cal takeover is likely to be announced tomorrow. We have cleared the DTp briefing line, which sticks to the specific issue, without straying into the wider matter of EC Mergers policy.

Philip Wynn Owen.

P WYNN OWEN

WYNN OWEN 7/3

mjd 2/1Jn

CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 8 March 1988

MR WYNN OWEN

cc PS/Paymaster General
Sir P Middleton
Mr Lankester
Mr Monck
Mr Burgner
Mr A J C Edwards
Mrs Lomax
Mr R I G Allen
Mr Ilett
Mr MacAuslan
Miss Noble
Miss Barber
Mr Bent
Mr Kroll
Mr Parkinson

JMGT 8/3

EC MERGERS

The Chancellor was grateful for your minute of 7 March. He agrees that Mr Lavelle's letter is most helpful.

J M G TAYLOR

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FRAME INDUSTRIAL
SUBJECT: ECONOMIC QUESTIONS GROUP, 28-29 MARCH

MERGER CONTROL REGULATION

SUMMARY

1. UNFOCUSSED AND OFTEN INCONSEQUENTIAL DISCUSSION OVER ONE AND A HALF DAYS COVERED DEFINITION OF MERGERS, PRIOR NOTIFICATION, SCOPE AND CRITERIA FOR APPRAISAL. LITTLE CLARIFICATION OR MEETING OF MINDS. READINESS OF PRESIDENCY TO PEDDLE TEXTS PREPARED BY GERMAN DELEGATION TO MEET GERMAN CONCERNS DID NOT ASSIST. FRANCE MAINTAINED A STREAM OF PROBING COMMENTARY WITHOUT COMMITTING HERSELF TO A POSITION. ITALY ANNOYED AT PRESIDENCY'S HANDLING AND STRONGLY OPPOSED ANY POSSIBILITY OF DECISIONS ON MERGERS CAUGHT BY THE REGULATION REVERTING TO MEMBER STATES. UK THEREFORE ABLE COMFORTABLY TO MAINTAIN QUESTIONING STANCE. NO FURTHER MEETING UNTIL MAY.

DETAIL

DEFINITION OF CONCENTRATIONS (ART 3)

2. IN RESPONSE TO QUESTIONS (MERGERS) FROM SEVERAL DELEGATIONS, THE COMMISSION EXPLAINED THAT ART 3.2, WHICH PROVIDES THAT COORDINATION OF THE OPERATIONS OF INDEPENDENT COMPANIES DOES NOT CONSTITUTE A CONCENTRATION, WAS NEEDED TO ENSURE THAT JOINT VENTURES WHICH DID NOT AMOUNT TO MERGERS WOULD BE EXCLUDED. THE UK, ITALY, AND FRANCE AMONG OTHERS PRESSED FOR THE PARAGRAPH TO BE REDRAFTED TO MAKE ITS APPLICATION CLEARER, PARTICULARLY AS REGARDS JOINT VENTURES. THE UK AND FRANCE ARGUED FOR A GENERALLY CLEARER AND BRIEFER DEFINITION OF CONCENTRATION BUT THE COMMISSION REPLIED THAT ARTICLE 3 WAS CLOSELY MODELLED ON ARTICLE 66 OF THE ECSC TREATY, WHICH HAD WORKED WELL OVER MANY YEARS.

PRIOR NOTIFICATION (ART 4)

3. FRANCE ENTERED A RESERVE, SUGGESTING THAT ALTERNATIVES TO PRIOR NOTIFICATION SHOULD BE CAREFULLY CONSIDERED IN VIEW OF THE EXTRA BURDENS AND POTENTIAL PENALTIES FOR NON-COMPLIANCE WHICH WOULD BE PLACED UPON FIRMS. SPAIN FAVOURED A VOLUNTARY SYSTEM, AND THE UK POINTED OUT THAT OUR VOLUNTARY NATIONAL SYSTEM WORKED EFFECTIVELY, SINCE COMPANIES PRENOTIFIED WHEN THEY KNEW MERGERS WERE SUBJECT TO CONTROLS. THE COMMISSION WAS SUPPORTED BY THE NETHERLANDS, GREECE,

GERMANY AND DENMARK IN ARGUING THAT PRENOTIFICATION WAS AN INDISPENSABLE ELEMENT IN THE DIRECTIVE, SINCE WITHOUT IT THEY WOULD BE FACED WITH THE IMPOSSIBLE TASK OF TRYING TO UNSCRAMBLE MERGERS AFTER THEY HAD TAKEN PLACE. GERMANY FELT THAT THE WORDS ''WHETHER AGREED OR NOT'' WERE SUPERFLUOUS, BUT THE COMMISSION INSISTED THAT IT WAS NECESSARY TO MAKE IT CLEAR THAT OPPOSED BIDS WOULD BE COVERED.

SCOPE (ART 1)

4. THE COMMISSION CIRCULATED A TABLE SHOWING IN DETAIL WHICH CLASSES OF MERGER WOULD BE CAUGHT (OR EXCLUDED) BY THE THRESHOLDS IN ART 1. THIS PROVOKED A DISCUSSION ON THE HANDLING OF MERGERS INVOLVING 3RD COUNTRY UNDERTAKINGS. REPLYING TO THE UK, THE COMMISSION EXPLAINED THAT THE ACQUISITION BY AN EC FIRM OF A 3RD COUNTRY UNDERTAKING WITH NO EC TURNOVER WAS NOT MEANT TO BE CAUGHT (AND THAT THE TEXT PROVIDED FOR THIS): WHETHER AN ACQUISITION BY A 3RD COUNTRY UNDERTAKING OF AN EC COMPANY WAS CAUGHT WOULD DEPEND ON WHETHER THERE WAS A COMMUNITY DIMENSION IN TERMS OF ARTICLE 1.

5. FRANCE SUGGESTED THAT IT WOULD BE BETTER TO CONSIDER THE MARKET SHARE POSITION AFTER A MERGER, RATHER THAN THE INDIVIDUAL SHARES OF THE UNDERTAKINGS CONCERNED, IN DETERMINING COMMUNITY DIMENSION, AND ALSO ARGUED AGAINST THE USE OF WORLDWIDE RATHER THAN COMMUNITY TURNOVER AS THE BASELINE. FRANCE ALSO WARNED OF THE DANGEROUS IMPLICATIONS FOR EXTRATERRITORIALITY IN THE APPROACH TO 3RD COUNTRY COMPANIES, WHICH COULD REBOUND ON THE COMMUNITY. GERMANY AND THE COMMISSION HOWEVER DEFENDED THE USE OF WORLDWIDE TURNOVER FIGURES, SO AS TO BRING ACQUISITIONS BY EG LARGE US AND JAPANESE COMPANIES UNDER THE REGULATION. THE COMMISSION CONCEDED THAT FURTHER STUDY OF 3RD COUNTRY ISSUES WAS NEEDED.

6. SPAIN ARGUED THAT THE CONCEPT OF COMMUNITY MARKET SHARE SHOULD BE REINTRODUCED AS A CRITERION OF COMMUNITY DIMENSION, BUT THE COMMISSION MAINTAINED THAT IT WOULD MAKE PRENOTIFICATION TOO UNCERTAIN FOR FIRMS WHO MIGHT NOT KNOW WHAT THEIR SHARE WAS. THE UK WAS CONCERNED AT THE COMMISSION'S WILLINGNESS TO DELETE ARTICLE 1.2, WHICH REFERS TO THE GEOGRAPHICAL AREAS IN WHICH FIRMS' PRINCIPAL FIELDS OF ACTIVITY MUST TAKE PLACE IN ORDER TO BE SUBJECT TO THE REGULATION. THE COMMISSION BELIEVED IT WAS UNNECESSARY BECAUSE THE POINT WAS MADE SEVERAL TIMES IN THE PREAMBLE, BUT AGREED TO THINK FURTHER. THE COMMISSION MADE NO REPLY TO THE UK'S POINT THAT THERE SHOULD BE PROVISION FOR THE THRESHOLDS TO BE UPDATED REGULARLY, TO PREVENT MORE AND MORE MERGERS BECOMING SUBJECT TO THE REGULATION OVER TIME.

APPRAISAL OF MERGERS (ARTICLE 2)

7. GERMANY PROPOSED AN ALTERNATIVE APROACH TO THAT IN ARTICLES 2 AND 6, UNDER WHICH ONLY MERGERS WITH A THRESHOLD ABOVE 10 BECU WOULD BE

SUBJECT TO COMMUNITY LEVEL CONTROL, BUT THE COMMISSION WOULD HAVE ABSOLUTE JURISDICTION. IT APPEARED (THOUGH WAS FAR FROM CLEAR) THAT THE MERGERS CONCERNED WOULD BE DEEMED TO CREATE DOMINANT POSITIONS, THUS NECESSITATING COMMISSION DECISIONS FOR OR AGAINST. CONFUSINGLY, THE GERMANS PROPOSED A FURTHER ALTERNATIVE WHICH WAS CLOSER TO THAT IN THE COMMISSION'S TEXT: A 1 BECU THRESHOLD, BUT WITH THE 'CREATION OF A DOMINANT POSITION' BEING SUBSTITUTED FOR A 'CHANGE IN COMPETITIVE STRUCTURE' IN DETERMINING WHETHER PROCEDURES SHOULD BEGIN - IF THEY DID NOT, OR WERE DROPPED, MEMBER STATES COULD DEAL WITH THE MERGERS CONCERNED. IN A FORMAL TOUR DE TABLE, ONLY DENMARK AND SPAIN APPEARED PREPARED TO SUPPORT THE FIRST ALTERNATIVE. BELGIUM, THE NETHERLANDS AND PORTUGAL PREFERRED THE 1 BECU THRESHOLD, BUT WANTED NO SCOPE FOR DECISIONS TO REVERT TO THE NATIONAL LEVEL - A POINT ON WHICH ITALY INSISTED AS A PRECONDITION FOR ACCEPTING THE REGULATION. FRANCE REFUSED TO BE DRAWN. IRELAND HOWEVER WANTED SCOPE FOR NATIONAL DECISIONS, IN ORDER THAT MERGERS WHICH APPEARED ACCEPTABLE AT COMMUNITY LEVEL COULD BE BLOCKED IF THEY HAD AN ADVERSE IMPACT IN SMALL MEMBER STATES. THE UK ARGUED THE NEED FOR NATIONAL CONTROLS TO REMAIN FOR NON-COMPETITION PUBLIC INTEREST REASONS. GREECE REJECTED THE 10 BECU THRESHOLD ON THE GROUNDS THAT TOO MANY MERGERS OF COMMUNITY SIGNIFICANCE WOULD THUS BE LEFT TO NATIONAL CONTROLS (A POINT ALSO MADE BY THE COMMISSION), AND WOULD FORCE DIRECT APPLICATION OF ARTS 85-6 IN THESE CASES. GERMANY EXPRESSED A STRONG PREFERENCE FOR HER SECOND ALTERNATIVE, SINCE THERE WOULD BE SCOPE FOR NATIONAL DECISIONS WHERE APPROPRIATE, BUT NOT WHERE THERE WAS A MARKET DOMINANCE, WHERE ONLY THE COMMISSION COULD GIVE EXEMPTIONS, IN WHICH CASE ITS DECISIONS SHOULD NOT BE OVERRIDDEN.

8. THE GERMANS ALSO CIRCULATED A REDRAFT OF ARTICLE 2 ON THE LINES OF THEIR PREFERRED OPTION. FRANCE EXPRESSED SERIOUS CONCERN OVER THE USE OF THE DOMINANT POSITION CONCEPT. IT SHOULD NOT IN ITSELF BE PRESUMED INCOMPATIBLE WITH THE TREATY, AND SHOULD BE THE STEPPING STONE TO THE OPENING OF PROCEDURES ONLY WHEN THERE WAS LIKELY TO BE DAMAGE TO COMPETITION. THE EVOLVING CONCEPT OF JOINT DOMINANT POSITIONS WOULD ALSO NEED CAREFUL HANDLING. ITALY AGREED, AND SPAIN WAS ALSO SUPPORTIVE. THE UK AGREED THAT THE IDEA OF DAMAGE TO COMPETITION WAS RELEVANT: THE CONCEPT OF AN EFFECT ON INTRA-EC TRADE SHOULD ALSO BE INCLUDED, AS IT HAD BEEN IN PREVIOUS DRAFTS. Understatement ?

9. THE GERMAN TEXT ALSO REFORMULATED THE GROUNDS ON WHICH EXEMPTIONS COULD BE GRANTED. FRANCE OBJECTED TO WORDING TO THE EFFECT THAT THEY COULD BE GIVEN WHEN A MERGER WAS ''REQUIRED'' FOR THE PURPOSE OF ACHIEVING STATED COMMUNITY OBJECTIVES ON THE GROUNDS THAT IT WAS TOO NARROW: MERGERS ALLOWING THE POSSIBILITY OF ACHIEVING SUCH ENDS SHOULD BE ELIGIBLE FOR EXEMPTION SUBJECT TO THE SAFEGUARDS LAID

DOWN. SPAIN WANTED THE IMPROVEMENT OF EMPLOYMENT AND REDRESSING OF REGIONAL IMBALANCES TO BE ADDED TO THE GROUNDS FOR EXEMPTION. TIME RAN OUT AT THIS POINT, BUT THE UK INDICATED FIRMLY THAT WE HAD MANY MORE QUESTIONS ON THE CENTRAL ISSUE OF APPRAISALS AND EXEMPTIONS.
FUTURE WORK
10. NEXT MEETING ON 3 MAY, TO CONTINUE CONSIDERATION OF ARTICLE 2, TOGETHER WITH 'INTENSIVE CONSIDERATION' OF ARTS 5,7,17,18,21,22. IN ORDER TO SPEED UP PROGRESS, THE PRESIDENCY ASKED FOR WRITTEN COMMENTS ON THE MORE TECHNICAL ARTS 10-12, 13-16, 20 AND 23 BY 25 APRIL, THOUGH 13-14 WOULD PROBABLY HAVE TO BE DISCUSSED IN THE GROUP. THE COMMISSION OFFERED TO HOLD AN INFORMAL TECHNICAL MEETING BEFORE THE NEXT GROUP MEETING TO CONSIDER THE NUMBER OF MERGER CASES LIKELY TO BE WITHIN THE REGULATION'S SCOPE UNDER THE ART 1 THRESHOLDS: GERMANY, FRANCE, UK, SPAIN, IRELAND, PORTUGAL AND GREECE EXPRESSED AN INTEREST IN ATTENDING.

HANNAY

YYYY

DISTRIBUTION 30

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MACAUSLAND H M TREASURY
HOWE OFT
EMDEN OFT

NNNN

CONFIDENTIAL

FROM: J MACAUSLAN
DATE: 30 March 1988

1 MR MONCK

2 CHANCELLOR

cc: Paymaster General
Sir P Middleton
Mr Lankester
Mr A J C Edwards
Mrs Lomax
Mr Ilett
Miss Noble
Miss Barber
Mr Bent
Mr Kroll
Mr Parkinson
Ms Roberts
Mr Wynn Owen

MAC - AUSLAN 30/3

EC MERGER CONTROL

1. OD(E) on 25 February concluded that "some strong objections had been expressed to a [EC Merger Control] Regulation, but it appeared imprudent to stand aside from negotiations at this stage ... it would be desirable for officials to examine the issues further". This note reports the outcome to date of that further work.

2. Roger Lavelle wrote to DTI on 3 March setting them tough questions on the alleged merits of a regulation. EQ(S) met this morning under Roger Lavelle's chairmanship to discuss the DTI response.

3. Mr Monck said that the DTI paper in practice reinforced the position you took at OD(E). It showed that the regulation would extend the Commission's role without providing benefits to the UK. It would not much improve the prospects for UK companies wanting to make overseas acquisitions. It would allow the Commission to run its own anti-competitive industrial strategy. It would detract from our ability to control mergers of domestic importance. And some double jeopardy for companies would remain.

4. Mr Monck concluded that OD(E) should meet again soon to discuss whether we should try to kill the regulation. The improvements recommended by DTI were not practicable. We should therefore be lobbying for sympathisers among other delegations, and ensuring that the item is removed from the European Council agenda in June.

5. There was little defence of a regulation. There was much sympathy with the idea that a regulation would be anti-competitive: the Commission seemed intent on using it for an industrial strategy. Its scope would be wider than that of Articles 85/6.

6. But there were strong objections to an attempt to kill it immediately. If we declared unqualified opposition, the Commission would be less inclined to give weight to any concerns we might express about the detail of the regulation; Sutherland would be less inclined to be co-operative over Rover; the French would not be able to offer us open support before their election, and might hide behind our opposition thereafter; and we might drive the Commission to exploring the possibility of a new regulation to implement Articles 85 and 86 - which they might be able to introduce through qualified majority voting, jeopardising our interests.

7. The conclusion was that OD(E) would meet on 28 April. The DTI paper setting out answers to Roger Lavelle's questions would be re-written for the meeting; Cabinet Office would put a short summary on top, drawing out the main points. This paper would be cleared with us in mid-April. Lord Young might (well) put his own paper in as well, setting out his view of the tactics. My guess is that he will say that we can safely keep talking about the regulation through the German Presidency, and through the ensuing three or four Presidencies without risk of agreement on a regulation. We mentioned that you might want to put in your own paper. We can decide on that later.

8. (Mr Sutherland will be touring capitals in about May to discuss the regulation. We will want to get OD(E) agreement that Sutherland be told that the issue should not be on the agenda for the Hanover summit.)

J MACAULSAN

European Fiscal Harmonization

Comments by the Minister on the report of the Committee chaired by Mr Boiteux

The single European market of 1992 is based on freedom of trade in goods, services and capital in an area without internal frontiers.

This will involve decisions in the fiscal sector.

For the moment the European Commission has restricted itself to proposals relating to VAT and excise duties.

In reality, the impact of the single market will extend well beyond indirect taxation.

For this reason the interim report of the Committee chaired by Mr Boiteux also examined the fiscal implications of the single market for savings.

For this reason the effects of the single market on taxation of inherited wealth will also have to be examined. And for this reason, above all, we will have to look at whether our system of direct taxation reduces the competitiveness of French companies.

1. Before examining in more detail matters relating to VAT, excise duties and taxation on savings, I would like to make some general comments.

a) The objective of the single market in 1992 is a priority and must guide our economic and fiscal policy in the coming years. We have already set an example over the past two years, in that a significant part of the 70 billion franc tax cuts we have made has been undertaken with this in mind.

b) In general terms, at the economic level, the first priority is to implement the measures which most affect the competitiveness of our companies.

This means that we must continue with determined action to reduce

fiscal burdens on the cost price of goods and services, and take active measures to prevent taxation of goods, services or investment income leading to diversion to countries with less strict systems of taxation.

c) This policy will be possible only at the cost of determined action to control public expenditure, because France has a higher level of compulsory deductions than its main EEC partners, particularly Germany. The difference between France and West Germany is currently of the order of 7% of the GNP; it increased by about 3% of the GNP between 1980 and 1985. It is essential for this difference to be progressively eliminated.

Reducing taxes without reducing expenditure would be to lead France into deficit. So continuing efforts will have to be made to reduce the budget deficit.

This means that the room for manoeuvre available to us cannot be extended indefinitely.

d) The policy of harmonization must be a concerted effort by all the European countries.

Each country must make an effort to achieve harmonization. It is not acceptable that this should always be a one-sided process.

2. VAT

For the moment European harmonization of VAT raises more problems than it provides solutions.

Our aim should be to make the movement of goods as flexible as possible. To this end the radical abolition of all customs formalities at Community internal frontiers is a basic objective of the Internal Market. The main point to establish is whether this is an absolute and urgent priority.

The European Commission regards the abolition of fiscal frontiers as a prerequisite of the internal market; it considers the current system, which provides for relief from VAT on exports and taxation in the country of destination, as an obstacle to trade. I still

cannot see how this system has such an adverse effect on the working of the market.

Whilst we agree on the ultimate aim proposed by the Commission, and to discuss it in Brussels, we are also sceptical about the methods proposed, which in my opinion cannot be retained in their present form.

As regards the methods proposed, the Commission, in order to achieve its aims, gives priority to bringing the rates together into two 'bands', with a reduced rate of between 4 and 9%, and a standard rate of between 14 and 20%.

This would have very serious consequences for our economy. Not only would a spread of rates of 5 or 6% on the same goods lead to diversions of trade for certain activities to countries with low rates, but the national budget would also be deprived of significant revenues.

It should be added that technically the Commission's proposals are far from specific, particularly as regards the system of compensation between Member States.

As is shown by the report of the Committee chaired by Mr Boiteux, the plan of the Brussels Commission would therefore have very questionable budgetary and economic consequences. Some of our partners have already stressed these difficulties.

In my opinion, harmonization of VAT should not therefore be considered as an absolute priority and a prerequisite for the implementation of a large internal market in 1992, though it is, I repeat, a constituent element of its ultimate complete integration.

This does not mean that nothing needs to be done. On the contrary.

The first objective we must set ourselves relates to the VAT burden borne directly by companies and which is known as residual VAT (non-deductible VAT on fuel oil, fuels etc). Residual VAT relating to running costs restricts the competitiveness of our companies. Abolishing this, perhaps partly at first, is a

government priority.

The second objective concerns rates. Clearly there will be no ultimate harmonization without simplifications and revisions of certain rates.

It is likely that, from the economic point of view, lowering VAT will benefit the French economy. It may provoke a cumulative deflationary movement and at the same time stimulate demand. This 'knock-on effect' may be entirely beneficial to French companies, and the projections the experts have been able to make on this basis show that ultimately the effect of such measures is not very different from reducing direct burdens on companies.

The priority must therefore be to lower the rates which restrict the development of some of our industrial markets. This is in fact what we did for cars last year.

Generally, efforts will have to be made to ensure that ultimately goods fall within the same rate bands in all the EEC countries.

This being so, the objective of two rates, though it may appear desirable, would not appear to be attainable in the short term, for the simple reason that if we are contemplating an ultimate harmonization, we will necessarily have to permit the existence of numerous intermediate rates for some time.

As regards frontiers, the objective must be to give top priority to abolishing the physical constraints which they entail. This means that controls should be very rapidly reduced, customs procedures should be diverted to within Member States as much as possible, and the tax exemptions granted to travellers should be greatly increased.

3. Excise duties

I have two comments to make on the harmonization of excise duties on petroleum products, alcohol and tobacco:

- harmonization will have contrasting effects - a sharp rise in taxation on some goods and a sharp reduction on others.

- harmonization should take into account certain important points: energy policy, agricultural policy and the movement of prices.

I therefore feel it would be useful to distinguish two types of excise duties.

There are those for which rapid harmonization could be accepted: those on tobacco for reasons of public health, and certain petroleum taxes which reduce companies' competitiveness (fuel oil, industrial gas, diesel oil).

For the rest, the objective of harmonization should be weighed against its economic and social effects. This is the case for taxes on fuel and alcohol. The French government does not intend to commit itself.

4. Taxation of savings

I share Mr Boiteux's opinion that harmonization of taxation on savings is an essential condition for successfully freeing movement of capital. It is probably even a priority as regards the other aspects of fiscal harmonization.

I would like an ad hoc group to be set up in Brussels to look at this point as quickly as possible. It is the job of the joint institutions to make proposals for harmonization in this field.

I have already had the opportunity to tell my fellow Finance Ministers that the provisions necessary for fiscal harmonization should be integrated in this respect with the work to free movement of capital. They appeared to me to be in agreement.

What changes do we have to contemplate in our tax system?

If I may digress a moment: French taxation of savings and inherited wealth should from now on take account of the European liberalization. Thus for example it would be impossible for France to reimpose a general annual tax on inherited wealth since it already imposes capital gains tax and death duties are high; it would thus be the only country in Europe to make these taxes cumulative.

The first change, which is essential, is to seek to reduce the rate of corporation tax and correspondingly raise the real rate of tax credit. Thus a danger of share investment being diverted could be avoided; at the same time we would seek to improve our companies' competitiveness and strengthen their own capital resources.

The second change relates to loan income (bonds, cash vouchers etc). Currently this is subject to levies at source which are overall higher in France than elsewhere (46% for cash vouchers for example). It is obviously necessary to discuss with our partners bringing the rates closer together in the Member States. Equally, the fiscal status of unit trusts and investment funds will probably have to be re-examined.

Finally, specific taxation in France on activities of companies in the credit and insurance sectors will have to be looked at again in the light of the examination of the conditions of international competition. This extends from taxation on insurance income or stock exchange tax to certain taxes imposed solely on financial undertakings.

This examination should be placed in the general context of competitiveness of undertakings in this sector and of the development of Paris as a financial market. It should be the subject of wide-ranging consultations with the market.

In this respect I would mention that the report I requested from Mr Achard, the Inspector General of Finance, on the prospects opened up by the single market in 1992 for the banking and insurance sector has been submitted to me. It can form the basis of a far-reaching examination we will undertake with the market on the relative competitiveness of this sector of our economy, which exhibits weaknesses which must be corrected, even though it has real assets in the face of its competition.

The three-year-plan for public finance provided for tax cuts of 15 billion francs a year. Preparing for the 1992 deadline is both the plan's main objective and its top priority.

Harmonization of VAT will be continued, but at the same time

room will have to be found for the measures needed to harmonize taxation on savings. Lowering taxes which directly affect companies' competitiveness and reducing the still excessively progressive nature of income tax will also find their place.

Please note:

In section 4 (Taxation of savings) the translator had some difficulty with the word "patrimoine". In the end he translated it as "inherited wealth" which seems to fit the context, although it can mean something much broader such as "assets".

TRANSLATION SERVICE

Summary and Conclusions of the Report of the Committee on Economic Affairs chaired by Mr Boiteux

The Committee on Economic Affairs chaired by Mr Boiteux has just made its first "interim report". It examines the fiscal problems posed by the attainment of the large European internal market.

Two important questions linked to the 1992 deadline were therefore examined as a priority. Firstly, indirect taxes: VAT and excise duties, which affect trade in goods and services. Secondly, taxation on income from savings: shares, bonds and other negotiable securities; also affected are movements of capital and supplies of financial services.

The stakes represented by a satisfactory response to these two tax questions may easily be imagined: a European area without frontiers where goods, services and capital are traded freely. Not only stakes, but also a challenge, because the 1992 deadline will test Europe's capacity to overcome national attitudes, and France's capacity to continue updating its tax system in order to give its companies the advantages of increased competitiveness.

The stakes and the challenge are both measured by the size of the fiscal resources thus affected, which overall amount over the next few years to tens of billions of francs.

1. Indirect Taxation: VAT and Excise Duties

In this field the Commission of the European Communities presented the Member States with proposals for directives aimed at bringing closer together the conditions for taxation which currently exist in the Europe of the Twelve.

As regards VAT, the Community proposals aim to abandon the current system whereby exported goods are exempt from tax and are taxed on importation, and to replace it with a system in which exports are subject to VAT in the country from which the goods or services are exported. Secondly, rates of VAT would be brought closer together and the spread of rates would not be allowed to exceed 5% for the reduced rate and 6% for the standard rate; thus only

two types of rate will remain, within which all goods and services would be classified consistently in all countries. Thirdly, systems of compensation would be set up to refund to the States the budgetary resources which the abolition of frontiers would prevent them from collecting in future.

The Committee for Economic Affairs felt bound to put forward proposals to improve this scheme.

It did not feel that it had been shown that the Community scheme would not entail very substantial dangers of diverting flows of trade and increased distortions in competition: a system of free movement of goods and services and spreads of VAT rates which could vary by as much as 6% are on the evidence likely to entail such consequences by reason of the number and size of economic operators who would be affected by them: individuals, banks, insurance companies, private and public administrations, hospitals and clinics, all of which are not currently subject to VAT, and who potentially may be encouraged to base their purchasing decisions on the differences in taxation which would remain.

Consequently, the Committee for Economic Affairs recommended that there should be a study to find a way of reducing to a maximum of 2% the difference in rates which would be allowed to remain between our national rates and the lowest rates of our partners on the same types of goods. If this is not done, the principle of applying the VAT rate of the importing country should be retained for the time being, whilst still reducing frontier controls as much as possible.

At any rate, our system of VAT should be simplified by progressively reducing to two the number of current rates and consequently reclassifying all goods and services in the same rate bands throughout the Community. A progressive reduction of residual VAT should be made concurrently, giving priority to cases where this disadvantages our companies when they make exports.

As regards excise duties, the Commission's proposals are aimed at harmonizing the duties on widely used products: tobacco, alcohol and petroleum products.

The aim of harmonization as defined would mean for our country a significant rise in excise duty on tobacco and alcohol; in contrast, duties on petroleum products would have to be reduced overall.

The Committee for Economic Affairs considered that overall the Community proposals on tobacco and alcohol were going in the right direction. However, it would take a more qualified attitude in the case of refined petroleum products: priority should be given to reducing taxes which are a heavier burden for French companies than for companies in other member countries. Reducing taxes on fuel would thus appear to be a secondary objective.

In total, the Community proposals relating to indirect taxes call for improvement before they are implemented. But the time remaining between now and the 1992 deadline should be used profitably in our country to continue the work of simplification and reduction which has already been undertaken.

II. Taxation of Income from Savings

As opposed to indirect taxes, there are no overall Community proposals on taxation of income from savings. However, the Commission intends to implement very significant reforms to bring about complete freedom of movement of capital and a progressive freeing of supplies of services. The combined effect of these two trends will be to create a European financial area.

Unlike movements of goods, movements of capital may be instantaneous, and due to the world-wide nature of international financial transactions they may involve considerable sums of money. The retention of even small differences in taxation will thus have a decisive influence on where national savings are placed. This is why harmonizing taxation on savings appears to be urgent and a priority, from the point of view of freeing movement of capital.

As regards taxation of dividends, the Committee for Economic Affairs was thus led to recommend implementing full tax credit.

The equivalent of full tax credit could be achieved by continuing to reduce the rate of corporation tax to 33%. This measure is the most crucial one for enabling French companies to strengthen their own

capital resources and to finance in a more appropriate manner all the types of investments which they make to increase their competitiveness.

As regards taxation of interest, the Committee for Economic Affairs recommended two courses of action:

the first concerns our country: it consists in aligning within the same rate all levies at source now in force; these are currently very diverse;

the second course of action is to be taken at Community level: it should aim to generalize deductions at source on interest paid to non-residents and to fix the rate of such deductions within a jointly accepted band.

The objective here is to try to align the taxation systems for residents and non-residents to simplify our tax system, and finally, to bring about fiscal neutrality for decisions relating to income from savings.

The Committee for Economic Affairs felt it was desirable in the case of banks and insurance companies to progressively abolish taxation which is specific to them in France and which thereby puts them in an unfavorable position as regards competition with their main competitors: tax on outstanding bills and tax on financial institutions. Moreover, there will have to be an improvement in the conditions under which banks are subject to VAT.

Finally, in order to improve the situation of the Paris Market vis-à-vis other European stock markets, there should be a progressive abolition of stock exchange tax.

These various measures do not deal with all the problems posed in the field of taxation by the 1992 deadline.

However, according to the studies by the Committee for Economic Affairs, they are very significant. In particular, the Committee felt action should be taken quickly to overcome the danger of an

unfavorable flow of national savings occurring as a result of the retention of a tax system which would rapidly become inadequate in an increasingly unrestricted financial environment.

SINCLAIR FRENCH BOITEUX REPORT 30/3

4483/44

CONFIDENTIAL

FROM: MISS C E C SINCLAIR
DATE: 30 March 1988

CHANCELLOR

cc PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Lankester
Mr Byatt
Mr Culpin
Mr A Edwards
Mr Riley
Miss O'Mara
Mr Michie
Miss Hay
Mr Cropper

PS/Inland Revenue
Mr Houghton
Mr Shepherd

PS/Customs & Excise
Mr Jefferson Smith
Mr P R H Allen

EC FISCAL HARMONISATION: FRENCH BOITEUX COMMISSION REPORT

You asked for a full analysis of this report (Mr Taylor's minute of 26 February to Mr Edwards). I attach detailed papers by Customs and Excise and Inland Revenue on their respective areas of interest. This cover note has been discussed with them, and with Mr Byatt, MG and EC.

SINCLAIR FRENCH BOITEUX REPORT 30/3

2. As part of its approach to 1992, the French Government set up a "Commission of economic reflection" under the chairmanship of Monsieur Boiteux (formerly President of Electricité de France). Members include industrialists, academics, journalists and civil servants. The first report produced by this body is about taxation: it concentrates on the Commission's VAT and excise duty proposals, and on the taxation of savings and investments.

3. Monsieur Balladur agrees with the broad thrust of the Boiteux recommendations. His main stated objective is to reduce taxation by 15 billion francs a year between 1988 and 1992 to bring it

closer in general incidence to that of Germany.

4. There is good news and bad for the UK in the Boiteux report and M. Balladur's comments on it.

5. The good news is that M. Balladur has gone on record as saying that he does not think a VAT system involving approximation of rates should be an absolute priority in the short term. He also points up a number of difficulties with the excise duty proposals. In the short term he would wish to see frontier controls reduced, and allowances for travellers crossing frontiers increased. This sounds very similar to our own view.

6. The bad news is that M. Balladur has said that harmonisation of the taxation of investment income is an essential condition for successful liberalisation of capital markets.

7. The Boiteux report itself reveals differences between the economic experts who contributed to it. The most trenchant advocate of the market view (Professor Salin of the University of Paris) argued: "It is unjust and confiscatory taxation which causes private individuals and their wealth to leave a country which they find hostile and go to other, more welcoming countries." But this view was put forward in a minority report.

8. While it is useful to us to be able to quote expert arguments which support the UK line - notably in the EPC - it is ultimately M. Balladur's comments which matter in terms of the policy we can expect the French to pursue on the fiscal implications of the single market.

Indirect tax harmonisation

9. The Boiteux report identifies three options for VAT in the context of the single market:

(a) a system which would involve harmonisation of rates, but within a narrower band than proposed by the Commission (2 per cent instead of 5-6 per cent). The French are

worried that under the Commission's proposals a band as wide as 5-6 per cent would still allow substantial diversion of trade through purchases by businesses not subject to VAT (and thus unable to reclaim it) in Member States with lower tax rates;

(b) a mechanism whereby an exporting country would levy VAT at the point of production at the rate in force in the importing country and transmit the proceeds directly to the importing country;

(c) provisional retention of zero rating of exports and taxation of imports between Member States, with the greatest possible reduction of controls at frontiers.

10. These are all separate options. (a) would not suit us at all: it appears to be the Commission's proposal but with even less freedom of manoeuvre left to Member States. It is not clear how it can be reconciled with the Boiteux criticisms of the clearing house mechanism. Conceivably it is a way of slowing up discussion of VAT harmonisation without appearing to criticise the Commission's general approach.

11. (b) is not a new proposal and, because of its potential complexity (for both businesses and tax administrations) is unwelcome. (c) would mean retaining the present arrangements for VAT and concentrating on reducing frontier controls across the board as much as possible. This would suit us very well indeed.

12. The attached note by Customs at Annex A looks at other detailed aspects of the Boiteux recommendations on VAT and excise duties. An important point is that the French are clearly not prepared to pursue harmonisation of VAT at the expense of increasing direct taxation. A key priority for them is the reduction of taxes on companies and individuals. On excise duties the French views show how difficult, if not impossible, it will be to make progress in this area.

13. The French position on indirect tax harmonisation remains rather opaque. You will want to consider what use we can make of the points made by Boiteux and Balladur.

14. M. Balladur has said that VAT harmonisation should not be seen as an absolute priority and a pre-condition to the setting up of a single market in 1992 - though it should be part of its perfect integration at the end of the day.

15. The French seem mainly concerned at the speed of change involved in indirect tax harmonisation by 1992. Boiteux implicitly considers it unrealistic. But it is acknowledged that lower VAT rates would benefit the French economy. The principle of moving to a common range of VAT rates appears to be accepted, but at a slower rate than is implied by a target of 1992, to allow for adjustment. The single market can get underway in 1992 provided efforts are made to reduce frontier controls as much as possible. Approximation of indirect tax rates can come later.

16. In arguing for a gradual approach to tax harmonisation there is no suggestion that this will happen "from below", as a result of market forces. The French seem to accept the Commission's view that harmonised rates will need to be imposed "from above", but they want more time in which to adapt their own structure. I think this is quite a long way from our position. It is not clear how far the French share our determination to retain sovereignty in fiscal matters; and how far they would be prepared, at the end of the day, to see some sacrifice of sovereignty provided the harmonised arrangements suited them.

17. But if our position, and that of the French, is not the same, the arguments advanced by M. Balladur and the members of Boiteux Commission can be tactically useful. We can welcome the fact that the French do not see indirect tax harmonisation as a necessary pre-condition for the single market in 1992. And we can support arguments for focussing work in the Community on reducing frontier controls and increasing travellers' exemptions.

Taxation of savings

18. The Inland Revenue note at Annex B sets out the Boiteux proposals on the taxation of savings in the context of fully liberalising capital markets. The French argue that unless steps are taken to harmonise the taxation of savings of residents and non-residents within EC borders, opening up capital markets will lead to tax evasion on a large scale. French residents will invest in countries which either do not levy withholding taxes on non-residents (the UK); or have a lower level of withholding tax than France (FRG after 1990).

19. We have wondered whether one reason the French are making great play of the risks of tax evasion is to distract attention from their basic reluctance to open their own capital market to competition. But the Treasury and Inland Revenue representatives who have attended discussions in Brussels have the strong impression that the French are genuinely concerned that capital liberalisation will create greater scope for tax fraud in France: unlike the UK pre-1979, the French rely heavily on their system of exchange controls to prevent tax evasion. They claim to be particularly concerned about the taxation of savings since they think it is households whose opportunity to evade tax will increase most on the abolition of controls (companies are already free of most controls). The fact that the French are showing considerable interest in the experience of those Member States who have already liberalised sugggests that they regard tax evasion as a real problem.

20. We do not want to apply withholding tax to the investment income of non-residents investing in the UK. The effect would simply be to drive such investment out of the UK to a friendlier haven. If a withholding tax is applyed to (third party) non-residents across the EC, that investment will move out of Europe.

21. The arguments against imposing a withholding tax (and any disclosure obligations) apply even more forcefully to the

Euromarkets. The Germans have told us that they have not yet decided whether they should extend their own withholding tax should to the Euromarkets. They are clearly conscious that to do so would simply drive the business elsewhere within the Community.

22. The above is a fundamental objection to the French approach. It is not simply a question of ensuring that any harmonised rate of withholding tax is low enough to accommodate our goal of 20p for the basic rate.

23. Our tactics for making progress on the liberalisation of capital markets while parrying French pressure for tax harmonisation depend in part on the attitude of other Member States. The Dutch and Germans (despite their own plans) oppose the imposition of a Community-wide withholding tax. The Danes and Irish do not think it would solve the problems of tax fraud which capital liberalisation would pose for them. The Luxemburgers are also unenthusiastic; they see difficulties with a high rate but believe a low one would be inequitable.

24. Closer to the French view are the Belgians who would like a high withholding tax. The Spanish are also "fairly favourable" to a high tax, seeing little value in a low one; and the Greeks would probably support one too, while saying careful thought would need to be given to the rate. The Italians' provisional view is that a Community-wide tax could be a good solution, provided "some important problems could be solved" but they acknowledge the risk of flows offshore. The Portuguese position is unclear.

25. A recent report from HM Embassy Paris quotes Christian Aubin, the rapporteur to the Boiteux Commission, as having advocated a global solution to the problem of taxing savings. This would presumably involve agreement between the EC Member States, the US and Japan on a withholding tax at a common rate, or within a band of rates.

26. It is clear that the concept of a common withholding tax will not be readily accepted by all Member States. Our objective will continue to be to decouple progress on direct tax harmonisation

from the liberalisation of the capital market. Fortunately the Commission have to date supported this view, describing tax harmonisation in this area as a "complementary issue" (not a pre-condition).

Conclusion

27. This note provides, as requested, a commentary on the Boiteux Commission's first report on taxation in the context of the European Single Market. But it raises a number of issues, and shows how the debate on tax approximation is widening beyond indirect tax. FP will co-ordinate a more considered piece on these wider issues for discussion at your meeting on EC tax approximation in April.

pp P D Nelson

CAROLYN SINCLAIR

ANNEX A

TAX APPROXIMATION : BOITEUX REPORT ON FISCAL HARMONISATION

(A) VAT

(i) BOITEUX COMMISSION'S COMMENTS

1. The report is generally sceptical of the Cockfield proposals on VAT. Special criticism is levelled at the clearing house system's bureaucratic complexity. Alternative mechanisms, either of retaining zero-rating on exports and taxation of imports, or levying VAT in the exporting country at the importing country's rate, are suggested.

2. Other criticisms levelled against the proposals are the allocation of supplies between the proposed reduced and standard rate bands (for example, the application of reduced rather than standard rate to domestic heating and lighting) and the width of the proposed bands - the Boiteux Commission considers a width of more than 2% would lead to unacceptable distortion of trade.

3. The report also addresses itself to problems inherent in the existing French VAT system, and suggests abolition of the luxury rate, gradual alignment of the 5 other rates towards the Cockfield proposals proposed bands, and reductions in blocked input tax borne by French business.

ANNEX A

(ii) M BALLADUR'S REACTION

4. M Balladur broadly endorsed the Boiteux Commission's report. He criticised the clearing house proposal (emphasising that he did not understand the Commission's opposition to the current system of zero-rating exports), and the spread of the proposed rate bands, and supported the proposed changes to the French VAT system.

5. M Balladur also made some interesting general comments on the VAT proposals. He saw the overall purpose of the Single Market as the 'most flexible movement of goods possible', and

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the abolition of Customs controls and harmonisation of VAT as long-term objectives but not urgent priorities, and was sceptical of the techniques proposed.

(B) EXCISE

(i) BOITEUX COMMISSION'S COMMENTS

6. The report notes that the proposals on excise duties would significantly increase the duty on alcohol and tobacco in France *[by between 10 and 950% and by 40% respectively] and reduce those on hydrocarbon oils *[by 10%]; it supports those for alcohol and tobacco but considers that more work is needed on the oil duties.

(ii) M BALLADUR'S REACTION

7. The Minister considered that the Excise proposals should be viewed in the light of their impact on energy, agricultural and price policies. He could accept the tobacco duty rise on health grounds, and the lowering of oil duties as this would affect industrial costs, but was not prepared to give a commitment on motor fuel and alcohol taxes.

(C) GENERAL

8. Neither the report nor M. Balladur's comments on it provide any significant new insight into the tax harmonisation proposals, but they are an interesting indication of French opinion. Clearly, the most useful features from the UK's point of view are M. Balladur's stated preference for simplification of frontier controls over fiscal harmonisation as a priority in the completion of the internal market, and the public statement of French reservations on the clearing house system and the Excise proposals. How far this will be reflected in the French negotiating stance in the months ahead remains to be seen.

* figures in square brackets are UK calculations.

EC: EUROPEAN FINANCIAL AREA:THE "BOITEUX" REPORT

Contribution by Inland Revenue to commentary on the Boiteux report requested by Treasury Ministers March 1988.

1. Part II of "Boiteux" deals with the taxation of private individuals' savings considered in the round and as opposed to Part I Indirect Taxation (VAT and Excise Duties).

2. In summary, Part II proposes

a. taxation of dividends: the objective should be a reduction in the rate of corporation tax to a rate in the range of 33-35%, combined with complete avoidance of economic double taxation by making available to the private shareholder a full tax credit (avoir fiscal) at a rate of 50%.

b. taxation of interest: a two-fold approach

i. within France to align all the different current rates of withholding tax to a single rate (these range at present from 27% to 52%). There is an implied preference for 27%.

ii. Within the EC to make general across all Member States the practice of charging withholding tax on payments of interest to non-residents, and to approximate the rate of deduction within a band to be agreed. The committee see some attractions from the point of view of France in adopting a rate of 27% (which happens to be the present rate, intended as a payment in full settlement of liability, applied to income from new securities). But they perceive that it may be difficult to secure Community agreement to a rate higher than 25% (and they recognise that going as far as 25% will be difficult for some member states).

The purpose of this change would be to achieve fiscal neutrality so that undeclared income from investments made abroad would bear a withholding tax at source at a rate equivalent to the withholding in full settlement applied to income from investments made in France.

c. A complementary review needs to be put in hand of the tax treatment of unit trusts and investment funds across Member States.

ANNEX B

d. Finally, outside the direct tax context, the specific taxation in France of the activities of financial undertakings and insurance companies calls for review (a related report by Achard is in point).

3. Some indications of dissent

At various points in the Boiteux report there are indications that opinions of the economic experts were divided. The principal philosophical division appears to be between those who view liberalisation of the capital markets as an opportunity to open up the Community to the world and those who wish simply to re-erect at the EC frontier, controls, including fiscal mechanisms, which currently exist at national and in particular at France's frontiers. One member, Professor P Salin (of the University of Paris IX) in a minority report articulated the open market view pungently. "It is unjust and confiscatory taxation which causes private individuals and their wealth to leave a country which they find hostile and go to other, more welcoming countries." On this reading, what is needed is not community level harmonisation which can for example mean aligning at some arbitrary average rate and thus lead to a generalisation of fiscal mistakes, but instead each country should seek to eliminate errors and discriminations in its own national taxation.

4. French Government response

Welcoming the report, Balladur described harmonisation of the taxation of personal savings as "an essential condition for the successful liberalisation of capital markets. It should probably take priority over other aspects of fiscal harmonisation".

He expressed the hope that an ad hoc working group at Community level should be set up as soon as possible. It was up to the Commission ("Instances Communes") to put forward proposals for harmonisation. Balladur said that he had made this point directly to his fellow Community Finance Ministers and "they seemed to me to be in agreement".

On the detailed proposals (paragraph 2 above) Balladur reacted as follows:

2a. Dividends

Agreed it was essential to get the rate of Corporation Tax down together with a related increase in the level of tax credit ('avoir fiscal') - with the objective of preventing diversion outside France of private investment in equities.

2b. Debt interest (debentures and bearer bonds)

Noting that the rates of withholding tax are currently higher in France than elsewhere (46% for interest coupons on bearer bonds for example), he commented "it is obviously necessary to discuss with our partners bringing rates closer together"

2c. Taxation of unit trusts and investment funds and (2d) special taxes on insurance companies and financial undertakings

Noting the read across to the separate "Achard" review Balladur endorsed the need for an internal French review of these in the interest of developing Paris as a financial market.

5. Implications for UK negotiating stance

Having sight of the Boiteux report and of Balladur's reaction to it is helpful as a further indication of where France can be expected to apply pressure in discussion at Brussels. The UK withholding rate for non residents cannot exceed basic rate (currently set at 25% and with a target rate of 20%) and any Community "band" of rates would therefore need to be wide enough to include a prospective 20% basic rate for UK. Moreover, on wider economic policy grounds, we would wish to preserve our existing exclusion of Eurobonds from the system of withholding tax; and - on grounds of the additional compliance costs both for the banking sector and the Inland Revenue we would prefer to retain the ability to permit no withholding of CRT on bank interest going to non residents.

J B SHEPHERD

21/3/88

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BF 14/4 to J

FROM: MISS M P WALLACE
DATE: 7 April 1988

MR MACAUSLAN

cc Paymaster General
Sir P Middleton
Mr Monck
Mr Lankester
Mr A J C Edwards
Mrs Lomax
Mr Ilett
Miss Noble
Miss Barber
Mr Bent
Mr Kroll
Mr Parkinson
Ms Roberts
Mr Wynn Owen

WALLACE 7/4

EC MERGER CONTROL

The Chancellor was most grateful for your minute of 30 March. He has commented that Lord Young will be anxious not to alienate Sutherland until the Rover/BAe deal has been cleared. The Chancellor wonders what the practicalities would be of a strategy of playing for time until that is out of the way, and then going for a quick kill.

MOIRA WALLACE

DTI PAPER

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Our ref
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Date 7 April 1988

Dear John.

EQS, at its meeting on 30th March, commissioned a revision of the DTI paper on an EC Merger Control Regulation, in the light of discussion at that meeting.

I now enclose a revised paper. The annexes (not enclosed) are unchanged.

I am copying this letter to Linda Duffield FCO, Stephen Parker Law Officers Department, John MacAuslan Treasury, Graham Hobrough MAFF, Simon Whiteley Department of Transport.

Yours ever,

Regs

R E ALLEN

SLFABK

888-249

Cabinet paper

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ODE(88) COPY NO

April 1988

CABINET

DEFENCE AND OVERSEAS POLICY COMMITTEE

SUB COMMITTEE ON EUROPEAN QUESTIONS

EC MERGER CONTROL REGULATION

Memorandum by the Department of Trade and Industry

Objective

1. Following OD(E)(88)4 it was agreed that further work should be done to assess the balance of advantages and disadvantages between two broad policy options. These are:

(a) opposing a Regulation in principle, however limited in scope, and accepting that the Commission is likely, if thwarted, to seek to make greater use of its powers under Articles 85 and 86 of the Treaty to control mergers. From this follow two tactical alternatives : opposing a Regulation openly ourselves, or relying on other Member States to do so;

(b) seeking to negotiate a Regulation which would be relatively limited in scope. This could take a number of forms depending on the policy objectives adopted. We could, for example seek to limit the number of cases caught by a Regulation approximately to the number against which the Commission might act under the Treaty Articles or to limit the Regulation's scope to that of the Treaty Articles in terms of the actual mergers 'caught'. We might, alternatively wish to accept a Regulation with rather wider scope, on condition that national authorities had the right to take action against a merger which had been authorised by the Commission.

2. This paper does not attempt to draw conclusions for policy, but examines, against the background of the EC Commission's latest revised proposals, four areas in which we need to assess in more detail the possible effects of a Regulation as compared with those which might be expected from increased Commission application of Articles 85 and 86 of the Treaty to mergers. These are:

(i) scope of a Regulation ie. the number and types of mergers which would be affected by a Regulation as compared with Articles 85 and 86

(ii) the relative advantages and disadvantages of a Regulation vs Articles 85 and 86, in relation to national controls

(iii) the interrelationship between a Regulation and the application of Articles 85 and 86

(iv) the benefits which might flow from a Regulation as compared with no Regulation, but an increased use of Articles 85 and 86.

Latest Commission Proposal

3. A summary of the provisions in the latest Commission proposal (announced by the Commission on 2 March) is attached at Annex A. The new draft contains certain changes which have been made in response to comments and criticisms made by Member States. The summary and the following analysis also take account of clarifications made by the Commission at subsequent Working Party meetings. Of particular significance to the UK, in the light of reservations we expressed about the previous draft are:

(a) the limitation of the Regulation's applicability to 'all concentrations having a Community dimension';

(b) the higher minimum joint turnover threshold for the Regulation to apply (1000 MECU as opposed to 750 MECU) with a de minimis exemption where the target has a turnover of 50 MECU or less (formerly 30 MECU);

(c) the exclusion of purely domestic mergers (defined as those involving 2 or more undertakings where each achieves at least 75% of its Community turnover within one and the same Member State - the 'single Member State' criterion);

(d) the periods for Commission examination of a merger have been shortened : to up to 2 months for an initial examination, plus another 4 months if proceedings are opened.

4. These clearly go some way towards meeting the reservations which the UK has expressed in general terms about the scope of the Regulation and about timescales for investigation, but do not resolve the many uncertainties, notably those arising from the interrelationship between the Regulation, national merger controls and Articles 85 and 86. The text of Articles 85 and 86 is at Annex B.

SLEABL

A SCOPE

5. It has been suggested that one possible negotiating objective would be to seek to limit the mergers which the Commission could address under a Regulation to either:

(a) the approximate number which the Commission might be able to act against under the Treaty Articles; or

(b) those actual mergers against which the Commission could alternatively have used the Treaty Articles. (This course would involve making a Regulation co-extensive with the Treaty Articles, but possibly giving the Commission some new procedural advantages - see para 10 below).

(i) Numbers

6. The number of mergers to which the Regulation as currently drafted would apply is determined, firstly, by the worldwide turnover thresholds and, secondly, by the exclusion of mergers between companies in a single Member State. Information on Community turnover is not readily available, so it is not possible to assess the number of mergers which would be excluded on the 'single Member State' criterion. We have, however, made estimates (at Annex C) of the number of mergers considered in 1985-87 inclusive under the Fair Trading Act which would have qualified on various turnover thresholds in a Regulation. A comparison of these figures with the handful of cases in which the Commission has taken action under the Treaty Articles leads to the conclusion that even with a more vigorous attempt to apply the Treaty Articles to mergers, the Commission migh well not reach the number of mergers it would be able to control under a Regulation, even one with turnover thresholds higher than those in the current draft.

7. The figures for mergers caught under a Regulation would be somewhat reduced by excluding those which met the 'single Member State' criterion. Moreover, if Community turnover was substituted for worldwide turnover, a significant number of mergers involving companies whose non-UK activities are outside the Community (eg. BAT and Hanson Trust) would be excluded. Articles 85 and 86, on the other hand, have no turnover thresholds and a much less rigorous test (effect on trade between Member States) than the test of 'Community dimension'.

8. The view that fewer cases would be caught under Articles 85 and 86 than under a Regulation is supported by an examination of the scope which the Commission would have had for acting under a Regulation or Articles 85 and 86 in 12 recent merger cases (Annex D). Of these 12 cases, all except Strong & Fisher/Garnar Booth would have qualified on the worldwide turnover thresholds in the Regulation. It is not known how many of the remaining 11 might have been excluded under the 'single Member State' criterion since

figures for Community turnover are not readily available : but Ferruzzi/Berisford certainly would not have been, and BTR/ Pilkington probably not. Assuming that they all qualified, it seems likely that procedings would have been opened in the cases of GEC, Tate & Lyle, Ferruzzi, P&O, BA/BCal and probably Swedish Match. It is not possible to assess how many of these might have been authorised on the grounds of 'contributing to the achievement of the basic objectives of the Treaty' (Article 2(4)).

9. The scope for action under the Treaty articles in these 12 cases is even more uncertain; but undoubtedly more limited than under a Regulation. Three out of 12 would almost certainly have been beyond the reach of either Article (Hanson/Imperial, BTR/Pilkington and Trusthouse Forte/assets of Hanson). The THF merger might well not have had an effect on trade between Member States. Article 85 would not have been relevant to the other two, since either the bids were contested or the mergers could probably not have been shown to have an effect on competition and it is doubtful that any would have been held to enhance a dominant position, thereby rendering Article 86 inapplicable. The Commission might have attempted to apply Article 86 against Tate and Lyle/Berisford and P&O/European Ferries on the basis of joint dominance : or might conceivably in the Guinness/Distillers, Ferruzzi/British Sugar and Swedish Match/Allegheny cases have argued that Article 86 was breached by virtue of the dominant target company's agreement to acquisition by a competitor. GEC/Plessey might have been held to have been an abuse of a dominant position under Article 86 if the UK authorities had not prevented the merger. The Commission clearly considered that the BA/BCal merger contravened Article 86, but the case did not lead to a formal decision since BA were willing to make certain concessions. In the cases of Guinness/Distillers and P&O/European Ferries (where offers were recommended by the target company's management) agreements to which Article 85 would apply might have been found to exist. But much uncertainty must remain about the chances of success in the use of Article 85 and 86 in these cases. To summarise, the Commission under a Regulation would probably have had control over 11 out of the 12 cases (although it would probably have opened proceedings only in 5 or 6 cases : under the Treaty Articles there might conceivably have been scope for Commission action in 9 cases out of 12. It is however worth noting that the Commission may influence decisions whether or not to merge by informal means - by notifying companies that it is considering action under Articles 85 or 86 - even where it is doubtful that a formal Commission action would succeed.

(ii) A Regulation limited to those mergers which the Commission could address under Articles 85 and 86

10. It seems possible in principle that a Regulation could be devised which limited the Commission's powers to those mergers which it could reach under the Treaty Articles, although the Commission is unlikely to view this as anything but a last resort. If the Regulation were limited purely to implementing Articles 85 and 86 the Commission could put it forward under Article 87 of the Treaty

alone as opposed to Articles 87 and 235, as in the case of the current draft. This would have the undesirable effect of making the draft Regulation subject to qualified majority voting (QMV) as opposed to unanimity as at present.

11. In a Regulation under Article 87 it seems likely that the Commission could set up a mechanism for the prior vetting of mergers within the scope of Article 85 or 86 (although this 'scope', as illustrated by discussion of the judgment in recent Philip Morris ECJ case is rather an uncertain concept). This would enable companies to ascertain in advance whether the Commission considered that the merger was within the scope of Article 85 of Article 86, and, in the case of Article 85, to grant exemptions. (Companies might well regard some form of prior notification as preferable to the current position under Articles 85 and 86, where the Commission can only act after the event). It might even provide expressly that no such exemption could be granted if the merger was not notified in advance. It would also enable the Commission formally to impose conditions on mergers which would otherwise contravene Article 86. The same procedural provisions as regards liaison with Member States and other enforcement arrangements could be incorporated as are set out in the draft Merger Control Regulation and in Regulation 17 (the implementing Regulation which sets out the procedure for applying Articles 85 and 86). Such a Regulation would extend the powers available to the Commission in practice, as companies would be likely to notify even where there was doubt as to the applicability of Articles 85 or 86, and prior control is easier to exercise than control ex post facto.

B INTERRELATIONSHIP BETWEEN A REGULATION AND NATIONAL CONTROLS

12. The impact of a Regulation on the UK would also depend on whether or not national authorities would be able to exercise control over at least some of the mergers which came within the Regulation's scope. The European Employers Federation, UNICE, with the CBI's support has argued strongly against a 'double filter' system, in favour of a 'one stop shop' for companies wishing to merge who may at present have a number of differing national régimes to contend with.

13. Under the Regulation as currently drafted, the Commission would have three alternative courses of action open to it in relation to a merger coming within its scope:

- the merger could be cleared;
- it could be prohibited;
- it could be authorised, (or 'exempted' in previous drafts), on the grounds that it contributed to the attainment of the basic objectives of the Treaty (Article 2(4)).

It is clear that in the case of a <u>prohibition</u>, national authorities

would not have the power to allow a merger to go ahead. In the case of authorisation, the Commission also clearly believes that its action would preclude any action by Member States to prevent the merger (although this is a point which the UK has not conceded in relation to exemptions under Article 85(3), on which the Regulation's authorisation provision is based). Commission spokesmen have stated clearly that national controls could apply to the remaining category of mergers which are cleared as not giving rise to a substantial change in the competitive structure of the Community. This Commission view is set out in the flow chart attached at Annex E, which was tabled at the recent Working Party meeting. However this view has not been reflected in a recent statement made by Commissioner Sutherland (EC Colloquium, 11 March). He has suggested that Member States would not have the right to take action on a merger even if it had been cleared by the Commission. There may be a possibility that the Commission would seek to retain a text which is ambiguous on this point, which would be left to the interpretation of the European Court if the Regulation were adopted.

14. The Commission's proposal reduces but does not eliminate the potential for 'double jeopardy' which is inherent in increased use of Articles 85 and 86. (A much starker contrast with the present situation would be provided by Mr Sutherland's 'one stop shop' view). Since, subject to the possibility of the use of interim measures, Articles 85 and 86 can only be applied after the completion of a merger, the co-existence of the Treaty powers with national controls means that certain mergers would be subjected to two successive tiers of control : a recent example is the case of BA/BCal, where the merger has been subjected to scrutiny lasting 8 months, of which the UK end of the process took slightly less than half.

Application of different criteria under European and national regimes

15. The question of the interrelationship between a Regulation and national controls relates not only to which mergers would be caught under different régimes, but what criteria would be applied. The draft Regulation is based on the premiss that its function is pro-competitive : its aim is to control mergers which would substantially alter the structure of competition within the Community. This is not inconsistent with HMG's position on domestic mergers, as re-affirmed in the recent White Paper : DTI - Department for Enterprise - that the main criterion for determining whether a merger should be referred to the Monopolies and Mergers Commission (MMC) is its effect on competition. However under the Fair Trading Act 1973 the Secretary of State has discretion to make references where he considers that public interest issues of any description may be raised by a merger : and the MMC have a widely-cast remit to assess whether a merger operates against the public interest. Ministers have stated that they wish to retain the discretion to refer mergers to the MMC on grounds other than competition : and there is always a possibility that the MMC may find a merger to be against the public interest on grounds other than competition. If the

Commission, through a Regulation, gained exclusive control over a defined category of mergers the possibility of national action against one of those mergers on public interest grounds would be removed.

16. A related question is the position under a Regulation of sectors of the economy where special régimes exist for the vetting of changes of control. In the UK there is a special régime for newspaper mergers in the Fair Trading Act, which makes particular provision for an assessment of 'the need for accurate presentation of views and free expression of opinion'. There are also special powers concerning prudential requirements and the fitness of controllers in such sectors as insurance and banking. Similar national controls apply in other Member States. We could argue in negotiations on a Regulation either that such sectors should be excluded from the application of a Regulation; or else that Member States should retain the power to block on prudential or other grounds mergers authorised by the Commission. The Commission's position on this point is not yet clear; but it seems more likely to be sympathetic to the exercise of national controls, eg. on prudential grounds, than to their exercise on competition grounds where it had 'authorised' a merger.

17. There are two areas under the Treaty where Member States may achieve some exemption from the application of Community legislation. The first relates to defence. Article 223 provides that any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of, or trade in, specified arms, munitions or war material. The second is under Article 90-2 which provides a limited derogation from the application of Articles 85 and 86 for revenue - producing State monopolies and for services of a general economic interest (eg. PTTs and water authorities). The exemption for defence products could not legally be overriden and it is probable that the limited derogation in Article 90(2) would also apply without express provision being made : but, in any event, it is unlikely to be significant in practice.

18. The summary of other countries' merger controls attached at Annex F shows that even countries without specific merger control regimes have certain sectoral provisions governing transfers of control, notably in banking and insurance. If we pressed for the exclusion of these sectors from a Regulation, or for the ability of national authorities to veto on prudential or public interest grounds, we could expect these national provisions to act as a potential obstacle to UK companies seeking to expand in Europe in these sectors.

Implication of authorisation provision in a Regulation for competition in domestic markets

19. The provision in Article 2.4 of the current draft for authorisation by the Commission on the grounds that a merger 'contributes to the attainment of the basic objectives of the

Treaty' could have implications for our domestic competition policy. Assuming that national authorities would not be able to prohibit a merger authorised by the Commission this could mean that the Commission allowed some mergers which we might wish to have prohibited on the grounds of their effect on competition in the UK. (It may, however, be considered that the achievement of the Single Market in 1992 should contribute to a more competitive environment in the UK).

20. Article 2(4) of the Regulation cites as examples of contribution to the attainment of the basic objectives of the Treaty

- improving production and distribution

  promoting technical or economic progress

- improving the competitive structure within the common market, taking due account of the competitiveness of the undertakings concerned and of the interests of consumers.

The objectives of Articles 2 and 3 of the Treaty would also seem to be relevant. The Commission appears to attach considerable importance to this 'industrial policy' aspect of a Regulation : it is based on the belief that some mergers may be beneficial by contributing to the restructuring, for example, of industries in decline, or necessary to enable European companies to compete with those in third countries. It appears to see the provision for authorisation as an important means to avoid the blocking by national authorities of such mergers.

21. It is impossible to assess how the Commission would interpret these criteria. It is at least conceivable that a merger with significant anti- competitive effects in the UK could proceed unchecked. An example of a merger prohibited in the UK which the Commission might have wished to authorise is GEC/Plessey, where arguments were put forward that the merger was essential to enable the company to compete internationally in telecommunications. The MMC considered that the benefits in relation to System X did not outweigh the detriments to competition in defence electronic equipment and the merger was prevented. If the EC Commission had authorised the proposal, we might not have been able to stop it from going ahead. (Even if the products were within the scope of Article 223, it might have been difficult to argue that the prohibition of the merger was necessary for the protection of the security of the UK).

22. Another example of a possible area of concern - if the UK was indeed unable to prohibit a takeover authorised by the Commission - is that of bids for UK companies by Community companies which were state-owned and possibly state-aided. An area which could be particularly affected is that of aviation, in which the Scandinavian national airline (SAS) made a recent offer for British Caledonian. Much again would depend on how the Commission intended to use 'authorisation'. One of a number of possible means to avoid this situation would be to ensure that the Commission, in assessing

a merger, took into account the status of a bidder (and, by implication, did not 'authorise' a bid by a state-aided for a private company). In the aviation sector it would also be desirable to build into the Commission's assessment of a merger an examination of the international implications of authorisation, for example the damage which could ensue to the international business of a British airline taken over by a foreign company.

A 'Double filter'?

23. The current draft of the Regulation provides for a 'double filter' system whereby national authorities would have a 'second bite' at some of the mergers within a Regulation's scope, those mergers which the Commission cleared during the initial two-month examination, or where proceedings, once opened, were closed. It might also be possible to negotiate for national controls to be applied in particular sectors where controls other than those based mainly on competition exist (see para 15 above). It seems highly improbable - and indeed contrary to the Regulation's objective - that the Commission would contemplate a general double filter in the case of all mergers, including those which it wanted to authorise as contributing to the attainment of a Treaty objective.

24. Maintaining our own national controls over certain categories of mergers would have the corresponding disadvantage that other Member States would be able to block takeovers by UK companies in those areas. The significance which should be attached to this possibility depends on a number of factors:

(a) the extent to which we consider that the Commission might use the authorisation procedure to prevent a Member State blocking a merger;

(b) the extent to which other Member States are likely to wish to block takeovers by UK companies in the areas concerned (areas such as banking and insurance may be prime candidates);

(c) the extent to which 'covert' methods might be used by other Member States to discourage foreign takeovers in those areas, or institutional and cultural barriers to foreign takeovers might remain even if the Commission had authorised a merger.

25. There are number of imponderables here : the Commission's approach to authorisation is of particular significance and might be explored further in discussion in Brussels.

C INTERRELATIONSHIP BETWEEN A REGULATION AND THE APPLICATION OF ARTICLES 85 AND 86

Articles 85 and 86 and mergers within the Regulation's scope

26. The revised draft Regulation amends the Regulations implementing Articles 85 and 86 so that they do not apply to mergers within the scope of the Regulation. The Commission therefore clearly intends that mergers within the scope of the Regulation should be controlled under the Merger Control Regulation, rather than Regulation 17 and its equivalents in the transport sector. So far as transport mergers are concerned, theoretically Articles 88 and 89 (which contain the rudimentary powers for implementing Articles 85 and 86 in the absence of a Regulation) could continue to be applied by Member States and the Commission, respectively. However it seems very doubtful that Article 89 would be used by the Commission; and the use of Article 88 by Member States is also unlikely.

27. In theory a private action under Article 85 or 86 could be taken in national courts to prohibit a merger within the scope of the Regulation, particularly if the Commission cleared a merger Regulation as opposed to authorising it. However it seems unlikely that the Commission would in practice clear a seriously anti-competitive merger, thereby giving grounds for a private action. Moreover, it is thought that the courts would be reluctant to find that a merger that the Commission had cleared or authorised contravened Article 85 or 86.

28. Articles 85 and 86 cannot be amended to exclude their application to mergers. There is power under Article 87 to define the scope "in the various branches of the economy" of Articles 85 and 86. It seems doubtful whether this power could be used to exclude mergers in general, though it could be used to exclude mergers in particular sectors.

Articles 85 and 86 and mergers outside the Regulation's scope

29. The Commission appears to intend that where mergers outside the Regulation's scope are within the scope of Articles 85 and 86, they should remain subject to control under Regulation 17 and its equivalents.

30. There is power under Article 87 to exclude mergers from the scope of Regulation 17 etc., although it might be argued that this should only be done on an interim basis, as Article 87 was intended to provide for the implementation of Articles 85 and 86, rather than for their non-implementation. The French have argued that Regulation 17 should be disapplied to mergers if a Regulation is agreed, and there seems some possibility that the Commission might accept this since it might be reluctant to police mergers below the turnover thresholds in the Regulation (depending on what thresholds were agreed).

31. If Regulation 17 were disapplied to mergers, action by the Commission under Article 89 seems much more likely in relation to mergers outside the scope of the Merger Control Regulation than in relation to those within its scope, but the powers in Article 89

are much more limited than those in Regulation 17. Action by other Member States under Article 88 seems just as unlikely as in the case of mergers falling within the scope of the Regulation, though they might act under their own national legislation.

32. The possibility of private actions under Articles 85 and 86 would however remain; and would be greater than that of such actions in respect of mergers within the scope of the Regulation (see para 27 above).

D BENEFITS OF A REGULATION

33. Assuming that the Commission was prepared to use the authorisation provision on grounds of 'contribution to the basic objectives of the Treaty' to prevent other Member States from blocking takeovers by UK firms on nationalistic grounds, we could expect benefits to UK firms in terms of increased ease of expansion through acquisition in European markets. Such benefits are not easily quantifiable since - as suggested in para 22 above - 'covert' methods of deterring foreign takeovers or institutional barriers might at least to some extent replace overt systems of merger control.

34. Some of the most significant barriers within the Community to foreign takeovers are set up by institutional features which a Regulation alone could not be expected to combat, although progress within the Community towards a single market and competitive pressures from the US and Japan might erode them. An example of such structural barriers is the constitution of German companies, in which most shares are not tradeable. Barriers of a more administrative nature - such as those typically erected by the French - would perhaps be less resistant to the influence of a Regulation. Other Member States might be less willing to resort to 'covert' methods of deterrence in the face of Commission 'authorisation' of a merger under a Regulation.

35. Information on the number of acquisitions prevented in the past by informal interventions or structural barriers is by definition difficult to obtain. There are public procedures for the notification of investigations by competition authorities under the 1986 OECD Recommendation on Co-operation between Member Countries on Restrictive Business Practices affecting International Trade : some information is also available in OECD and EC Commission reports on Competition Policy.

36. The published figures do not necessarily reveal the full story. The German Cartel Office, for example quotes a figure of 18 direct acquisitions by UK companies of German companies during 1986 and 1987, all of which were examined under German merger control provisions, but none of which were prohibited. We know, however, of at least one case in 1987 which was abandoned following a Cartel Office investigation - the proposed acquisition by a Pilkington subsidiary (Flachglas) of Tegla - and there may have been others. Other cases of mergers blocked by the German authorities are Rothmans/Philip Morris (German

subsidiaries) (1980), Eurotech Mirrors International Ltd/Deutsche Uhrglasfabrik (1980) and GKN/Sachs (1976).

37. Likewise the French authorities claim that 16 mergers between French and British companies were authorised under French merger control regulations during 1986 and 1987 : only one (no details available) was prevented. However the current proposed acquisition by Pearson of Les Echos illustrates the obstacles which may be placed in the way of foreign acquisitions under special sectoral regimes : the French Press laws prevent any foreign company not based in a Community country from acquiring directly or indirectly a holding of more than 20% in a French press group. Another example of a merger being blocked by methods other than statutory merger control is the case of Lucas' proposed takeover of Ducellier in 1976.

38. There could, however be benefits for UK firms other than those connected with the removal of barriers to takeovers in Community markets : notably benefits arising from the prevention, under a Regulation, of anti-competitive mergers between companies in other Member States with little or no merger control.

39. A Regulation could have some, not easily quantifiable benefits for UK companies wishing to expand in Europe. A sector which could benefit particularly is that of financial services, if the Regulation had as its effect the limitation of other Member States' powers to keep UK firms out of their financial markets. But this would only be to the extent that other Member States did not resort to other, informal, methods of merger control or that institutional factors no longer acted as barriers. There could also be benefits UK firms from more effective controls over anti-competitive mergers between firms in other Member States. But both these potential benefits would be reduced proportionately as the number of mergers within the Regulation's scope was narrowed down.

RM6.87

CONFIDENTIAL

FROM: MOIRA WALLACE
DATE: 7 April 1988

MISS SINCLAIR

cc PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Lankester
Mr Byatt
Mr Culpin
Mr A Edwards
Mr Riley
Miss O'Mara
Mr Michie
Miss Hay
Mr Cropper
PS/IR
Mr Houghton - IR
Mr Shepherd - IR
PS/C&E
Mr Jefferson Smith - C&E
Mr Allen - C&E

MPW
EC FISCAL HARMONISATION 7/4

EC FISCAL HARMONISATION: FRENCH BOITEUX COMMISSION REPORT

The Chancellor was most grateful for your minute of 30 March. He has commented that the most useful thing for us to fasten on is the reports argument for focussing work on reducing frontier controls and increasing travellers' exemptions (your paragraph 17). He has also commented that we must insist on decoupling harmonisation of the taxation of investment income and liberalisation of capital markets (your paragraph 6) pointing out that even if there were to be any harmonisation of withholding tax, it would have to be on a global, not EC basis, which is probably not negotiable.

MOIRA WALLACE

psl/8A

RESTRICTED

1. Jonathan
2. BF 18/4

FROM: A C S ALLAN
DATE: 8 April 1988

PS/CUSTOMS & EXCISE

cc PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr A J C Edwards
Mr Cropper
Mr Jefferson-Smith - C&E

ACSA → PS/C&E 8/4

TAX APPROXIMATION ETC.

The Chancellor has been thinking further about the UK line on the Cockfield proposals. He feels we should table an alternative proposal on the following lines:

(i) there should be no restrictions on personal imports of goods and services (VAT and duty paid) from one EC country to another;

(ii) there would be no (new) restrictions on levels of VAT rates on different goods in different EC countries;

(iii) there would be minimum duty rates on alcohol and tobacco, probably set slightly below the present EC average. There would probably be no minimum duty rate for petrol;

(iv) duty free concessions on intra-EEC travel would be ended (this is not something we ourselves would propose; but if the Commission proposed it - as they presumably would - we would not oppose it).

2. The Chancellor would be grateful for a note on these proposals, by close of play on Friday 15 April, discussing the implications for the UK and other EC countries, and the likely reactions.

ACSA

A C S ALLAN

XM2L/621

BANKING SUPERVISION DIVISION

Telephone - 01-601 5005

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

13 April 1988

Nicholas Kroll Esq
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Nicholas

EC MERGER CONTROL REGULATION

You asked in your letter of 7 March for views on two aspects of the Commission proposal for a regulation on the above subject, namely the interaction with the Banking Act powers over controllers of authorised institutions and the likely methods by which UK banks might expand further into Europe.

The first issue you raise is the likely impact of the proposed regulation on the Banking Act powers to vet potential controllers of authorised institutions. As you suggest, we would not wish a decision by the Commission that a proposed merger was not anti-competitive to remove the scope for national level blocking on non-competitive grounds, such as the interests of depositors. We would thus wish there to be an explicit reference to this in Article 8. The alternative scenario you mention is where the Bank wishes to encourage a merger to strengthen the banking system or otherwise in the interests of depositors but the Commission rules that such a merger would not be compatible with the common market. We think that to ask for the power to authorise a merger which has been declared anti-competitive would be wasted effort.

The regulation as drafted does, however, give the opportunity for the competent authorities directly concerned by the concentration to make their views known before such a decision would be made (Article 18) and it would be helpful if such competent authorities were stated as including any regulatory bodies of the undertakings involved.

Furthermore, the interaction with non-competitive legislation may not be limited to the national level. The provisions of the Second Co-ordination Directive, such as those for the approval of shareholder controllers, may also provide non-competitive grounds for blocking an acquisition, though those between authorised credit institutions would, as you suggest, be difficult to impede. It is also possible that the Directive's reciprocity provisions (whatever form these ultimately take) could be invoked to prevent a merger which was permitted by a Commission decision under this regulation. The interaction between the competitive and non-competitive European legislation is not made clear; the Commission should be encouraged to clarify such important matters with an explicit provision in the Regulation.

Your second point is rather hard to assess at the moment. The questionnaire circulated under the aegis of the City Liaison Committee should provide a clearer picture of the intention of UK banks etc in Europe, and particularly the relative importance they will place on acquisitions. Initial reactions suggest only that this is an avenue which is being explored: a badly-drafted EC regulation would clearly have a considerable impact on any such plans, but our information is insufficient to quantify it.

Please contact me if you wish to discuss any of these points in more detail.

Yours sincerely

J C W Osborn
Manager

53/2/MAD/3762/50

FROM: G R WESTHEAD
DATE: 15 April 1988

cc: PS/Chancellor 14/2
Mr Monck
Mr MacAuslan
Mr Wynn Owen

PS/EST 15/4

NOTE FOR THE RECORD

EC MERGERS

I spoke to Andy Heyn, Private Secretary to the Parliamentary Under Secretary of State for Corporate and Consumer Affairs, Mr Maude, this evening to let him know that the Economic Secretary had reconsidered his decision about a meeting with Mr Maude next Tuesday to discuss the EC Merger Control Commission Directive.

2. I said that the Economic Secretary had not been fully aware of the background to this when he had met Mr Maude in the Lobby yesterday. On reflection, he did not think a meeting appropriate, since the Chancellor had indicated that he wished to take the lead himself and would be discussing the subject with Cabinet colleagues in OD(E) on 28 April. In the circumstances, he did not think that a meeting would be either useful or desirable.

3. Mr Heyn said he would report this to Mr Maude over the weekend. He doubted that Mr Maude would be pleased, but noted our position.

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary

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

Ch/ To discuss at your meeting on 9/5?

FROM: P JEFFERSON SMITH

DATE: 15 APRIL 1988

CHANCELLOR

cc Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr A J C Edwards
Mr Cropper

TAX APPROXIMATION ETC

1. You asked for a note on your suggested alternative proposal (Mr Allan's note of 8 April). Without clarifying the various definitions (eg of "personal imports" and "minimum duty rates") we cannot, of course, quantify the revenue or other implications, but our immediate reactions to your proposals are as follows:

GENERAL IMPLICATIONS

2. Your proposal on "personal imports" raises a difficult question of definition. It could be seen as referring solely to what individuals can physically carry when they return from overseas. However, it could also include car or even van loads of high value (typically excisable) goods for own or family consumption and not for resale. Indeed, it might be regarded as encompassing mail order operations (for example, of tobacco products imported by individuals from a low tax country such as Belgium).

Internal circulation:	CPS	Mr Cockerell
	Mr Nash	Mr Kent
	Mr Finlinson	Mr Allen
	Mr Wilmott	Mr Brown
		Mr Knox
		Mr Oxenford

3. Whatever the precise definition, the implications of the proposal must be that Member States charging higher rates of VAT or excise duty would lose revenue to countries charging lower VAT rates or the EC minimum excise duty rates. The scale of the revenue loss would depend on (a) tax rate differentials (b) the precise definition of "personal imports" (c) (related to (b)) the ease with which people could obtain goods taxed at lower rates in another Member State and (d) price differentials (recent unpublished EC figures seem to suggest that indirect tax rates account for only a third of price differentials, but high excise duty rates are an exception to this). There is a range of possibilities; at one end, an increase in the quantities purchased on normal trips abroad; at the other, large scale and regular shopping abroad to meet normal household consumption.

IMPLICATIONS FOR UK

4. For the UK the main problem area at current duty rates would be with alcohol and tobacco. UK duty rates are between 20% and 60% higher than the EC arithmetic average rate for alcohol and between 11% and 54% higher on tobacco (See table attached); and the more relevant comparison would be with countries sticking at the minimum rates. There would therefore be considerable incentive to avoid paying UK duty rates, and the revenue loss is likely to be substantial. Depending on the degree of diversion there could be significantly adverse effects on UK retail and distributive trades. The proposal in general would also impose a marked constraint on future increases in UK excise duty rates. Indeed, the pressure would be all the other way, with unwelcome implications for health and social policies.

5. As far as VAT is concerned, we consider that because UK rates are currently low in relation to most other Member States the proposal would have only a limited effect. In any case, as already mentioned, other factors (e.g. exchange rates, pricing structures) appear to be more important than VAT rates in price differentials. We think it unlikely, that there would be a substantial benefit to the UK to offset the revenue losses on the excise duty side.

IMPLICATIONS FOR OTHER MEMBER STATES

6. As far as other Member States are concerned, reactions would depend largely on the implications for loss of revenue and distortion of competition. Member States likely to lose revenue - notably Denmark, Ireland, France and probably Belgium and the Netherlands - could be expected to be vehemently opposed to such a proposal. The French, for example, have argued against the Commission's proposals for VAT rate bands as being too wide because they would permit unacceptable distortions of competition. This proposal would be worse from their point of view.

7. There would be a severe problem about setting minimum rates of excise duties (your proposal iii). If they were set slightly below the present averages they would involve increases for the low excise Member States which would be seen as involving a one-sided approach to the approximation issue. There would be particular impact on Greece (spirits, wine and tobacco); France (wine, beer and tobacco); Spain (spirits, wine, beer and tobacco); Italy (wine and spirits); Portugal (wine and spirits); and Germany (wine). Even if the minima were set so low as to do little more than underpin the present structures, Germany and Italy would be forced to impose excise duties for the first time on Table wines. This could be contrasted with the UK's retention of the VAT zero rate.

DUTY FREE CONCESSIONS

8. If duty free concessions on intra-community travel were ended, we believe that whilst there would be some substitution of duty-paid goods, both in the UK and in other Member States, a significant proportion of duty-free sales of spirits (demand is very sensitive to price) and some tobacco (demand is much less price-sensitive) would be lost. This reduction in demand would adversely affect both the Scotch whisky industry and the UK tobacco industry but we do not have sufficient data to enable us to make estimates of these effects. Recently the General Council of British Shipping told us that they would expect ferry prices to rise by about 25% if duty free sales were ended. We would expect a similar response from the British Airports Authority and other

beneficiaries of the current concession. Of course, abolition of duty free sales is a logical element in the achievement of the Single Market, but, as you suggest, it is not something on which the UK should take the lead. Indeed, to do so seems unlikely to assist in persuading the British public of the benefits of the Single Market.

CONCLUSION

9. Overall, we consider that the proposals are unlikely to gain much support from other Member States and some could be expected to oppose them strongly. Certain of these, notably the Danes and to a less extent the French, can be expected to be our allies in opposing the Commission's tax approximation proposals. In addition, the main consequence for the UK would be a loss - conceivably a very substantial loss - of revenue from the alcohol and tobacco duties and considerable potential damage to the retail and distributive sectors concerned. Unless the minimum rates were set very high, the UK would be seen to be proposing a major constraint on its tax raising capacity.

10. In view of this analysis we doubt whether there would be any advantage in tabling proposals on these lines - at any rate at this stage. But perhaps we could discuss this further at your meeting on 9 May.

P JEFFERSON SMITH

The table below compares approximate EC arithmetic average rates of excise duty for alcohol and tobacco at April 1987 with the 1987-88 UK duty rates.

Product	EC arithmetic average (April 1987)	1987-88 UK duty rate	Approximate % rate changes
ALCOHOLIC DRINKS			
Spirits	12.71 ECU (£8.54) per litre of alcohol	£15.77 per litre of alcohol	-46
Beer	2.3 ECU (1.54)per hectolitre/degree Plato of finished product at 15°c (14.8 for average beer)	£25.80 per hectolitre plus 86p for every degree of original gravity over 1030° (£31.82 for average beer)	-53
Table wine	57.83 ECU (£38.87) per hectolitre	£98.00 per hectolitre	-60
Fortified wine (15-18%)	200 ECU(£134.4) per hectolitre	£169.00 per hectolitre	-20
(18-22%)	200 ECU(£134.4)	£194.90 per hectolitre	-31
TOBACCO PRODUCTS			
Cigarettes	19.5 ECU (£13.11) plus 53% of retail selling price	£30.61 per 1000 plus 21% of retail selling price	-11
Pipe tobacco	Excise duty + VAT to comprise 55% of retail selling price	£24.95 per kilogram	-17
Cigars	Excise duty + VAT to comprise 35% of retail selling price	£24.95 per kilogram	-54
Hand Rolling tobacco	Excise duty + VAT to comprise 55% of retail selling price	£24.95 per kilogram	-53

(1 ECU = £0.672099)

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FRAME ECONOMIC

(FROM UKREP BRUSSELS)

ECOFIN COUNCIL : 18 APRIL 1988

INDIRECT TAX APPROXIMATION

SUMMARY

1. CHAIRMAN OF THE ECONOMIC POLICY COMMITTEE (EPC) PRESENTS A PRELIMINARY REPORT ON THE ECONOMIC ASPECTS OF INDIRECT TAX HARMONISATION. COMMISSION EMPHASISES THAT ABOLITION OF FISCAL CONTROLS IS AN ESSENTIAL ELEMENT FOR OBTAINING THE BENEFITS OF THE INTERNAL MARKET AND URGES EARLY DEBATE AND DECISIONS ON THE MAJOR PROBLEMS. ALL DELEGATIONS FLAG UP THE DIFFICULTIES INHERENT IN THE PROPOSALS WITHOUT CHALLENGING THE UNDERLYING PRINCIPLES. THE CHANCELLOR OF THE EXCHEQUER UNDERLINES THE NEED TO TAKE MEASURES TO REDUCE BUSINESS COSTS IN CROSS BORDER TRADE AS QUICKLY AS POSSIBLE, TO STUDY MORE CLOSELY THE ''MARKET FORCES'' APPROACH, AND TO SET MINIMUM EXCISE DUTY RATES FOR ALCOHOLIC DRINKS AND TOBACCO PROBABLY AT QUITE A HIGH LEVEL. IN-DEPTH POLITICAL DISCUSSION AT THE INFORMAL MAY ECOFIN COUNCIL.

DETAIL

2. MOLITOR (CHAIRMAN) OF EPC) NOTED THAT A QUANTITATIVE ANALYSIS HAD NOT BEEN POSSIBLE, BUT HIGHLIGHTED THE MAIN THEMES OF THE COMMITTEE'S PRELIMINARY REPORT (DOCUMENT 5573/88), CONCLUDING THAT THE ELIMINATION OF BORDER FISCAL CONTROLS WAS AN IMPORTANT, BUT NOT SUFFICIENT CONDITION FOR COMPLETING THE INTERNAL MARKET. THE TAX CHANGES PROPOSED BY THE COMMISSION WERE ON THE WHOLE LIKELY TO BE LESS DIFFICULT IN ECONOMIC TERMS FOR MOST MEMBER STATES THAN SOME OF THE STEPS TAKEN IN THE PAST, EG WHEN VAT WAS FIRST INTRODUCTED.

3. LORD COCKFIELD (COMMISSION) WELCOMED THE REPORT AS BROADLY ENDORSING THE COMMISSION'S APPROACH. THE CECCHINI STUDY ON THE LIKELY ECONOMIC IMPACT OF COMPLETING THE INTERNAL MARKET HAD EMPHASISED THAT THE BENEFITS WOULD ACCRUE ONLY IF THE WHOLE

PROGRAMME WERE COMPLETED. THE PURPOSE OF FISCAL APPROXIMATION WAS TO SWEEP AWAY FRONTIER CONTROLS AS AN ELEMENT OF THE OVERALL APPROACH. NONE OF THE ALTERNATIVE SOLUTIONS MENTIONED IN THE EPC REPORT SEEMED LIKELY TO BE ACCEPTABLE, EVEN TO MEMBER STATES. THE DIFFICULTIES OF INDIVIDUAL MEMBER STATES WOULD NEED TO BE RESOLVED ON A COMMUNITY LEVEL.

4. LORD COCKFIELD WELCOMED THE LUNCH TIME DECISION TO HOLD AN IN-DEPTH DISCUSSION AT THE INFORMAL MAY ECOFIN COUNCIL, AND SUGGESTED THE FOLLOWING QUESTIONS NEEDED TO BE RESOLVED:

I) IS FISCAL APPROXIMATION NECESSARY - HE HAD SYMPATHY WITH THE ''MARKET FORCES'' ARGUMENT, BUT DID NOT BELIEVE IT WAS ACCEPTABLE TO MEMBER STATES: THE COMMISSION WAS FLEXIBLE AND COULD AGREE TO ANYTHING WHICH ABOLISHED FISCAL FRONTIERS:

II) HOW SHOULD HEALTH, ENERGY, ETC ISSUES BE TAKEN INTO ACCOUNT - THE COMMISSION COULD ACCEPT HIGHER TAXES ON TOBACCO, FOR HEALTH REASONS, BUT COULD NOT ALLOW THESE RELATED ISSUES TO DELAY PROGRESS:

III) CAN MEMBER STATES LIVE WITH DEROGATIONS TO SOLVE INDIVIDUAL POLITICAL PROBLEMS, EG ZERO RATES AND EXCISE DUTIES - THE INTEGRITY OF THE INTERNAL MARKET HAD TO BE PRESERVED.

5. IN THE ENSUING DISCUSSION ALL MEMBER STATES SPOKE EXCEPT GERMANY, REPEATING MANY OF THE WELL-KNOWN DIFFICULTIES, WHILE NOT CHALLENGING THE PRINCIPLES UNDERLYING THE COMMISSION'S PROPOSALS. THE MAIN POINTS WERE AS FOLLOWS:

I) ENGGAARD (DENMARK) - NO COST/BENEFIT ANALYSIS YET BUT WOULD ANY BENEFIT BE WORTH THE PAIN: REVENUE LOSS WOULD BE ENORMOUS: VAT AND EXCISE DUTIES ARE THE PRINCIPAL TOOLS FOR FINE TUNING THE ECONOMY, AND THEIR LOSS WOULD DAMAGE THE POSSIBILITY OF ACHIEVING CLOSER COOPERATION IN BUDGETARY POLICIES.

II) EYSKENS (BELGIUM) - TAX APPROXIMATION CONTAINS DIFFICULTIES, BUT WITHOUT IT THERE WOULD BE NO INTERNAL MARKET: THE BENELUX EXAMPLE SHOWED THAT MARKET FORCES ALONE DID NOT RESULT IN TAX APPROXIMATION: IT WAS TIME TO BITE THE BULLET.

III) RUDING (NETHERLANDS) - URGENT NEED FOR FISCAL HARMONISATION: 6 PERCENTAGE POINT BAND FOR VAT IS TOO WIDE AND COULD RESULT IN DISTORTIONS OF TRADE BETWEEN NEIGHBOURING COUNTRIES: THE VAT

CLEARING SYSTEM DID NOT LOOK WORKABLE.

IV) SOLCHAGA (SPAIN) - THE VAT CHANGES COULD PROBABLY BE MANAGED: HARMONISATION OF THE VAT BASE WAS ALSO IMPORTANT: EXCISE DUTY PROPOSALS MUCH MORE DIFFICULT, AND A FLEXIBLE APPROACH WOULD BE NEEDED FOR TRANSITIONAL ARRANGEMENTS.

V) JUPPE (FRANCE) - THE MARKET FORCES APPROACH WOULD BE TOO DISRUPTIVE: THE VAT BANDS WERE TOO WIDE AND THE VAT CLEARING SYSTEM NEEDED RE-EXAMINATION: ONLY A GLOBAL, PROGRESSIVE, PRAGMATIC AND BALANCED APPROACH WOULD BE ACCEPTABLE.

VI) KARATZAS (GREECE) VAT CLEARING SYSTEM AND EXCISE DUTIES PRESENTED MAJOR PROBLEMS: CAUTIOUS APPROACH NEEDED.

VII) CAMPBELL (IRELAND) - VERY SERIOUS REVENUE LOSS WHERE WIDER SOLUTIONS THAN DEROGATIONS WOULD BE NEEDED.

VIII) SANTER (LUXEMBOURG) - QUANTITATIVE ANALYSIS NEEDED: THE OBJECTIVE OF REDUCING COSTS WAS AGREED BUT NOT HOW IT SHOULD BE ACHIEVED: ALTERNATIVES SHOULD BE EXAMINED.

IX) CHANCELLOR OF THE EXCHEQUER - IMPORTANT TO TAKE MEASURES AS SOON AS POSSIBLE TO REDUCE CROSS FRONTIER COSTS FOR BUSINESSES: THE MARKET FORCES APPROACH NEEDED FURTHER STUDY, AND COULD BE SUPERIOR TO A BUREAUCRATIC APPROACH: THE GROWING BURDEN OF ALCOHOL AND TOBACCO RELATED DISEASES ON HEALTH CARE RESOURCES POINTED TOWARDS A HIGH MINIMUM LEVEL OF TAX ON DRINK AND TOBACCO PRODUCTS.

X) AMATO (ITALY) - MARKET FORCES NOT SUFFICIENT: MOST DIFFICULTIES WITH EXCISE DUTIES.

XI) CADILHE (PORTUGAL) - GREAT CAUTION NEEDED: RETENTION OF ZERO RATES ESSENTIAL: PROBLEM WITH EXCISE DUTY ON TABACCO.

6. LORD COCKFIELD INTERPRETED THESE COMMENTS AS SHOWING THERE WAS NO DISSENT FROM THE COMMISSION'S GENERAL APPROACH. THERE WERE MANY PROBLEMS TO BE RESOLVED, AND THE COMMISSION WISHED TO BE AS FLEXIBLE AS POSSIBLE. STOLTENBERG (PRESIDENCY) CONCLUDED THAT THESE ISSUES WOULD BE CAREFULLY EXAMINED AT THE INFORMAL MAY ECOFIN COUNCIL.

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Waiting for PPS from C&E

BF 2/5 Monday 5/5

ACSA TAX APPROX. ETC 18/4

FROM: A C S ALLAN
DATE: 18 April 1988

MR JEFFERSON SMITH - C&E

cc PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr A J C Edwards
Mr Cropper
PS/C&E

pse check with C+E that we will be getting X for March.

TAX APPROXIMATION ETC

The Chancellor was grateful for your minute of 15 April, which he will want to discuss at the meeting fixed for 9 May.

2. He noted that the minimum excise duty rates for alcohol and tobacco could, of course, be higher. He would be grateful for a list of what the various duty rates are in each country.

ACSA

A C S ALLAN

AE10/021

RESTRICTED

PMP

FROM: A J C EDWARDS
DATE: 19 April 1988

MR ALLEN (C&E)

cc PS/Chancellor
PS/PMG
PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Mortimer
Mr Parkinson

Sir D Hannay (UKREP)
Mr Unwin (C&E)
Mr Jefferson-Smith (C&E)
Mr Shepherd IR
Mr Pratt) T Sol
Miss Wheldon)

EDWARDS TAX APPROX 19/4

TAX APPROXIMATION

You will wish to know about various developments yesterday, in and around ECOFIN, on tax approximation. UKREP telegram no. 58 of 18 April reports the discussion in ECOFIN itself.

Chancellor's Market-Based Approach

2. On the aeroplane to Luxemburg, the Chancellor confirmed that he was still minded to argue for a market-based approach whereby the Community would substantially remove the tax barriers and national governments would then have to decide where to set their rates. He wanted to argue for retaining the existing, country of origin system for VAT so as to avoid the problems of revenue diversion and clearing houses. The problems of revenue diversion and competitive downward bidding of rates would then arise only in relation to the excise duties. The downward bias problem could be solved by setting Community-wide minimum rates of excise duty for alcohol and tobacco in particular - a course which was desirable anyway on social grounds.

3. The Chancellor made clear that he had no illusions about the general acceptability of such an approach. It was clear that several other member states would reject it. In a negotiating situation, however, where time was important, there was often good tactical sense in putting forward proposals which others would not accept.

EPC Report

4. The Chancellor made four points about the report on the outward journey.

5. First, the reference to corporation taxes on page 3. The Chancellor expressed some dismay about the proposition in the final sentence of paragraph 2 on this page that the internal market required further harmonisation measures in the field of corporation taxes. He thought that this would encourage the Commission to bring forward ambitious and unwelcome plans. I noted that the wording "further harmonisation measures" was helpfully vague and that the Commission would certainly return to the subject anyway: they had a draft communication about the corporation tax base in preparation already. The Chancellor commented that the UK had the lightest company taxation burden in the Community. This gave us a useful competitive edge which he did not want to lose.

6. Second, Greek objections. The Chancellor noted that the paragraph of Greek reservations in the annex to the report seemed to pave the way for demands by Greece for compensation. It would be useful to draw the Germans' attention to this point.

7. Third, the report stated in paragraph 28 that the Benelux system "could lead to distortions between firms and differing effects on their profits". The Chancellor thought that this was no more than a pejorative way of referring to possible redistributions of productive and other resources.

8. The Chancellor's fourth point related to the Single European Act: see next section.

S[redacted]gle European Act (SEA)

9. The Chancellor pointed out that, in the footnote on page 15 of the EPC Report, the Commission stated that in their view the Benelux system would be incompatible with the Single European Act. A similar footnote of page 16 claimed that a system under which frontier formalities were eliminated for commercial trade but member states retained the right to control movements of goods across frontiers by households would likewise not be compatible with the aim of the Single European Act. The Chancellor said that we should take legal advice, including an opinion from the law officers, on what the Single European Act did and did not oblige us to do. Were the Commission's contentions justified? What would be the legal position on a market-based approach?

10. I discussed these Commission footnotes subsequently, in the margins of ECOFIN, with Sebastian Birch in Lord Cockfield's Cabinet. Birch said that the Commission's point was that article 8A of the SEA defined the internal market as an area without internal frontiers. The requirement to abolish frontiers was of fundamental importance for the Commission. A Benelux type system would not achieve this. The commitment of the Council in the revised Article 99 to harmonise indirect taxes to the extent necessary to ensure the establishment and functioning of the internal market had to be read in the light of this definition of the internal market.

11. Birch added that the Community's long-standing sixth VAT directive envisaged progress towards a single VAT system for the whole of the Community which would enable traders to trade as easily with other EC countries as in their own. The removal of frontiers was part of this process. The existing VAT system depended on having frontiers. Since these frontiers had to be removed, an alternative VAT system was inevitable unless member states were willing to accept the potentially large diversions of revenue. The clearing system was the only possible means which the Commission had been able to identify for correcting the revenue diversion problem.

ECOFIN Discussion

12. As recorded in the telegram, Lord Cockfield noted at ECOFIN that there were some who argued that tax approximation was unnecessary and that the better course would be to abolish frontier controls and let finance ministers decide what rates to set (" whether to sink or swim"). He said (doubtless somewhat disingenuously) that this free-market solution would have considerable attractions for the Commission and would be a suitable topic for discussion at the informal ECOFIN on 13-15 May. He could not believe, however, that member states would accept it.

13. The Chancellor picked up Lord Cockfield's point at the end of the discussion and endorsed the need to explore the free market approach further. He noted that minimum rates of tax for tobacco and alcohol might be needed for health and social policy reasons.

Tactics for Informal ECOFIN

14. The cognoscenti in Brussels still take the view that a number of member states will gladly conspire to delay substantive progress towards tax approximation, without however overtly opposing it. Against this background, the Chancellor told us on the return journey that he was minded to argue at the informal ECOFIN on 13-15 May for a further study (presumably by the EPC) on the pros and cons of a market-based approach. He accepted Sir D Hannay's view that we would not get away with this alone. Further work on other aspects would doubtless need to be commissioned as well. An obvious candidate would be the clearing house system and possible alternatives.

Next Steps

15. The Chancellor hopes to discuss those matters further at his 9 May meeting. May I assume that you will take the lead in obtaining the legal advice which he has requested (see paragraphs 9-10 above)? The Chancellor made clear that he would like to have this advice before the informal ECOFIN meeting and indeed before the proposed Debate on Tax Approximation. If it were available before the 9 May meeting that would, I think, be better still.

AJCE

A J C EDWARDS

Inland Revenue

Policy Division
Somerset House

FROM: J B SHEPHERD
DATE: 21 APRIL 1988

1. MR HOUGHTON Mr 21/4.

2. FINANCIAL SECRETARY

EC: DIRECT TAX HARMONISATION PROPOSALS

SHEPHERD EC-DIRECT TAX 21/4

1. The purpose of this note is to report to you that the Inland Revenue have been invited to send senior officials to a meeting in Brussels on 14 June 1988 of the Heads of Tax Administrations. This meeting has been called by the Commission (specifically by the Director General of Financial Institutions and Company Law) to discuss:-

"Preliminary Draft Proposal for a Directive on the Harmonisation of Rules for determining the taxable profits of undertakings" (doc. XV/27/88 of March 1988).

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cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir G Littler
Mr Scholar
Mrs Lomax
Mr Peretz
Mr A J C Edwards
Miss Sinclair
Mr Cropper
Mr J Arrowsmith (Bank of Eng.)
PS/Customs & Excise
Mr Isaac
Mr Painter
Mr Houghton
Mr Beighton
Mr McGivern
Mr Pitts
Mr Shepherd
Mr Spence
Mr Reed
Mr Elliott
Mr Keith
Mr Cayley
Ms Brand
Mr Alpe
PS/IR

Nature of Proposals

2. The draft directive runs to 35 Articles and is concerned with various aspects of the base for taxation of business profits. Since it needs to cover the profits of individuals in business as sole traders, and individuals trading in partnership as well as companies, it would affect so far as the UK is concerned the basis of computation for Income Tax, Capital Gains Tax and Corporation Tax.

3. The Commission is putting forward proposals in the following areas:-

(a) Rules for the depreciation of business assets

(b) Tax treatment of capital gains and capital losses in respect of items forming part of the fixed assets of a business

(c) Tax treatment of provisions for liabilities and charges made in the accounts

(d) Rules concerning the basis of valuation of trading stock

(e) Tax treatment of certain business expenses.

Previous history

4. Some of these proposals have been around since the early 1980's and there has been spasmodic discussion at working level at meetings of groups of tax experts in Brussels. They have also been the subject of working level discussions between the Commission and professional groups representing the accountancy bodies and the Institute of Taxation. Certain aspects (for example, (d) stock valuation and (e) business expenses) are relatively recent initiatives (end of 1986) and there has so far been only one exploratory round of working level discussion by tax officials early in 1987.

Commission's present Objectives

5. We understand informally from recent direct contacts with the Commission that tabling a draft directive on this group of topics for discussion by Heads of Tax Administration in June 1988 signals a tactical shift in their approach to harmonisation in the direct tax field. The long awaited "White Paper" on business direct taxation has now been abandoned. Instead, the present intention is that this group of related proposals on harmonisation of the business tax base will constitute the centrepiece of the Commission's direct tax policy. In the light of the discussion by officials in June 1988 it is proposed that the draft directive on the tax base should be sent to the Council "before the Summer holidays" together with a "communication". This will be a covering note which sets the tax base proposals in the context of other proposals in the direct tax area such as the draft directive setting out a common system of taxation for parent and subsidiary companies, and the draft directive concerning cross-border company mergers within the EC. These proposals have been around since the late 1960's. In particular, the "communication" is expected to comment explicitly on the Commission's latest thinking about how, following harmonisation of the tax base, there might be an approximation of business tax rates. The last thoughts on this subject, dating from as long ago as 1975, proposed that Member States Corporation Tax rates should be harmonised between 45 per cent and 55 per cent. It is understood that they are likely to revise this band in the light of moves in the interim period by certain Member States to lower their rates below 45 per cent and to eliminate tax shelters.

Handling: the next steps

6. When we have completed our analysis of the text of the latest draft proposals on the tax base, we shall let you have a further note, setting out the implications of following the Commission's thinking and inviting your endorsement of a proposed line to take. In preparing this we shall take account of the views of the official Treasury and the Bank.

Conclusion

7. You are invited to take note of this interim report of the Commission's most recent direct tax initiative in the matter of proposals to harmonise the base for business taxation. A more detailed submission incorporating a proposed line to take will follow when we have completed our technical examination of the draft directive which has been tabled for discussion on 14 June.

J B SHEPHERD

06/01/1k

CONFIDENTIAL

FROM: J MacAUSLAN
DATE: 21 April 1988

1. MR MONCK
2. CHANCELLOR

cc Paymaster General
Sir P Middleton
Mr Lankester
Mr A J C Edwards
Mr Burgner
Mrs Lomax
Mr Ilett
Miss Noble
Miss Barber
Mr Bent
Mr Kroll
Mr Parkinson
Ms Roberts
Mr Wynn Owen

EC MERGER CONTROL

You are going to OD(E) on 28 April to discuss EC merger control. This note offers a draft of a paper which you could consider putting to OD(E), and responds to your question about tactics in Moira Wallace's note of 7 April.

2. The last meeting of OD(E) on 25 February asked officials to examine some questions further. There is now a memorandum by DTI officials on those questions; the Cabinet Office intend to put a short summary on top, bringing out the main issues. This work has not done much to alter the substantive arguments. The Commission proposal seems to us to be based on a false approach. Other departments think the current draft regulation unacceptable, but are not convinced that a proposal is irredeemable.

3. Lord Young gives weight to industrialist's preference for a regulation; they think it would remove the threat of double jeopardy and reflect the fact that they operate in a community-wide market. We think them mistaken on both counts.

4. Lord Young may put in a paper next week, stressing that

there is no danger of significant progress by June, nor indeed by December, when Sutherland may move; we can therefore afford to see how negotiations go without seeking to kill the regulation now. In the meantime, there is a dispute in DTI whether we should negotiate towards as narrow a regulation as possible, or towards a broader one to help UK firms expand on to the Continent.

5. There is therefore a case for putting in a paper arguing for a decision at OD(E) against the principle of a regulation. Cabinet Office would accept a paper on Monday. I attach a draft, which tries to set out clearly the case against a regulation. That case does not come through clearly enough in the DTI and Cabinet Office papers.

6. The draft also has a brief section on tactics. The reason for this approach to tactics is that others will argue

(a) that there is no need for a decision now; and

(b) that it would be foolish to try to kill off the idea of a regulation before the Rover issue is settled.

7. A decision now that the regulation is wrong in principle would be a major gain for the Treasury. It would also help UK representatives to play their hand in the continuing exchanges in Brussels - in particular, to lobby for support, and to keep the issue off the agenda of the June Councils.

8. But even if there were a decision now, we might not want to go for a kill before Rover is settled. On the other hand, there is a risk that any acceptance by you in OD(E) of a link between the Rover and EC mergers issues might encourage Lord Young to concede something to Sutherland on EC mergers in exchange for clearance of the Rover deal. He is less likely to do so if you have argued against any explicit link, and attacked the draft mergers proposals vigorously. Holding back for the sake of Rover may also risk a bounce at the Internal Market Councils or the Hanover Summit in June; and no doubt the FCO would argue in due course that we had negotiated for too long to be able

to turn round and kill the proposal. So even if there is force in the Rover argument, you will not want to volunteer that at ODE(E). The crucial thing is to press for agreement now that a regulation is wrong in concept.

9. One other tactical question is outstanding; whether to say at OD(E) that the flaw in the Commission proposal is that it is based on centralisation of power in Brussels rather than mutual recognition based on minimum standards. Such an approach is **attractive**, because it is consistent with the line we take on other single market issues; it implies that the Commission should divert its energy in to ensuring that other member states have respectable national systems of merger control (which offers the Commission a way forward without total loss of face); and we can also use it to argue against any extended use of Articles 85 and 86.

10. The main **weakness** is that such an approach could induce the Commission to criticize the UK competition arrangements, especially the public interest test; that the Commission might see it as first recognition of their right to a role in merger policies; and that others at OD(E) may argue that mutual recognition does not get round the difficulty that Member States may take conflicting attitudes to the same merger. Nevertheless, you could deploy the point either as a defensive response to claims that the Treasury's position is entirely destructive, or even as a positive point.

11. You had it in mind (Jonathan Taylor's minute of 1 March) to raise the general issue with the Prime Minister. Your next bilateral with her is on 27 April, the day before the OD(E) meeting.

12. We will supply briefing next Wednesday for OD(E).

J MacAUSLAN

06/03/lk

CONFIDENTIAL

DRAFT PAPER FOR OD(E) ON 28 APRIL

EC MERGER CONTROL

1. It is time we decided our strategic objective in the exchanges about the proposed Regulation about Commission control of EC mergers. The memorandum by officials, and recent telegrams, confirm my view that the regulation reflects a mistaken approach, and that there are no achievable amendments which would make it acceptable. I believe that we should decide now on the objective of killing the Regulation, and that we can expect to win sufficient support from other member states.

Substance

2. The present and prospective position under Articles 85 and 86 is of course not ideal. But under a regulation, the Commission would have greater powers to authorise mergers that are unwelcome or politically sensitive, whether on competition or other grounds, and to run a European Industrial Strategy; and it would have powers over a wider field than under Articles 85 and 86. A regulation would not (in any way) remove the double jeopardy faced by firms, nor offer any significant benefits to UK firms. The concept of a regulation implies a shift to centralised control from Brussels that is unnecessary, runs counter to our general approach to single market issues, and offers no advantages to offset its inherent major drawbacks.

3. We have recently reviewed and improved our powerful and sensible national system of merger control. A regulation would give the Commission more power than Articles 85 and 86 to override our system to the detriment of competition;

(a) we could not stop anti-competitive mergers if the Commission (or future, less market oriented Commissions) authorised them in the interest of a European Industrial Strategy;

(b) we might not be able to stop mergers with significant local anti-competitive effects if the Commission thought their effects on competition at Community level minor;

(c) we could not stop bids for UK companies by state-owned or state-aided Community companies (eg the SAS bid for BCal) if the Commission authorised them;

(d) with a regulation, the Commission would formally exercise prior control, and could stop us blocking damaging mergers; whereas now we retain our sovereignty to block such mergers before the Commission can stop us.

4. A regulation would catch more mergers than the Commission could under Articles 85 and 86, even if there were a more vigorous attempt to apply the treaty articles and even if the turnover thresholds for the regulation were set higher than currently. Moreover, the Commission appears to intend that where mergers

outside the regulation's scope are within the scope of Articles 85 and 86, they should remain subject to control; the present unsatisfactory arrangements would remain, and the regulation would merely add an extra layer of control.

5. The benefits to UK firms from a Regulation would be far less than sometimes alleged, and would in any case be attenuated further if we succeeded in narrowing the Regulation to protect essential interests.

6. A Regulation necessarily implies some continuing double jeopardy. Member states will need to initiate investigations into cases where it is not clear or is disputed whether a merger has occurred and falls within the scope of the regulation (and indeed other cases covered by the Regulation in case the Commission eventually take no action). Firms will need to consider pre-notification both to the Commission and national authorities. The scope for dispute, and for double jeopardy, would be exacerbated if we sought to reserve certain sectors for national control (banking, newspapers, etc) or to ensure a double filter. A regulation would therefore muddy, not clarify, the role of national authorities in merger control.

7. UK firms already stand to gain little from a Regulation, since the UK has an open capital market, whereas in other countries there are barriers to foreign takeovers which a regulation alone could not be expected to combat. Changes to the draft regulation to safeguard essential interests would reduce any possible benefits to UK firms still further.

(1) our stengths are in eg financial services, but exemptions from the Regulation (eg to enable us to block banking mergers on non-competitive grounds such as the interests of depositors) are crucial to us but would eliminate any benefits from the regulation in this field

(2) reducing the number of mergers covered by the Regulation would also reduce any benefits

[(3) the main benefits would come if the Commission authorised mergers as contributing the basic objectives of the Treaty and so prevented other states from blocking takeovers by UK firms; but this provision for authorisation is one which we want to narrow or elimiate (see 3(a)).]

Tactics

8. We will need to discuss the tactics; but the key requirement now is to reach firm agreement on a strategic objective.

CABINET OFFICE MOE

cc Mr R. Allen, GP, DTI
Ms L. Duffield, FCO
Mr J. MacAuslan, HMT
Mr S. Parker, LOD
Mr G. Hobbingh MAFF
Mr S. Whiteley DTp
Mr B. Bender UKREP
(via FCO fax)

Final draft of Secretaries' paper on EC Merger Control

John Alty
21/4/88

cc Mr Monck
Mr Burgner
Mr Wynn Owen

EC MERGER CONTROL REGULATION

Note by the Secretaries

1. At its meeting on 25 February, OD(E) instructed officials to give further consideration to our proposed negotiating stance towards an EC merger control regulation. The attached Annex prepared by the Department of Trade and Industry in consultation with other Departments provides additional information on the key issues raised by the proposed regulation. This cover note seeks to draw out possible implications of this additional factual material for our overall attitude towards the regulation.

2. The two basic policy options are those identified in paragraph 1 of the Annex, namely:

a. opposition in principle to a Regulation, and acceptance that in its absence the Commission will seek to make greater use of its powers under Articles 85 and 86;

b. readiness to negotiate a regulation against a series of objectives designed to ensure it is an improvement on the position under Articles 85 and 86.

3. Under (b) we could of course still ultimately oppose the regulation if our objectives were not met. Conversely, under (a) tactical considerations might lead us to avoid declaring our hand immediately.

4. The arguments for and against a regulation can be considered as follows:

- would a regulation mean increased access to the continental market for British companies? If a liberal regulation were a useful market opening tool, that would be a significant gain to balance against any increased Commission powers which might result. If however the commercial benefits are small or uncertain then the main issue would be whether a regulation could be devised which would be more attractive to the UK than use of Articles 85 and 86 alone, in terms of such factors as scope, clarity of criteria, interaction with our own national controls and competitive impact.

- How far would a regulation actually substitute for Articles 85 and 86, and how far could we expect these Articles to remain a practical threat? If they remained so, this would constitute a powerful argument against a regulation: the present unsatisfactory arrangements would remain and the regulation would merely add an extra layer of control.

- If however in practice a regulation went a long way towards neutralising the powers in Articles 85 and 86, could a regulation be devised which would be more attractive to us than the Treaty Articles? A regulation should be able to clarify the respective roles of national and EC competition authorities, and its procedures could be more attractive to industry; but much depends on whether it is possible to draw a boundary line between national and EC powers which compares favourably with the (somewhat ill defined) scope for action under the Treaty Articles and for instance keeps within bounds the Commission's proposed right to override competition criteria in certain circumstances.

Commercial benefits (paras 33-39 of the Annex)

5. To date it does not appear that overt systems of merger control in other member states have proved a major obstacle to British companies

seeking to expand onto the continent. It is difficult to quantify the deterrent effect of covert means of national control, which certainly exist (cf Pearsons/Les Echos). As 1992 approaches large United Kingdom companies may well seek to expand more aggressively, thus putting national authorities more on the defensive. If this were the position, a regulation could be helpful in preventing British bids being blocked. (In doing so it could also facilitate continental bids for UK companies.) But there is a questionmark over how effective the regulation would be in preventing covert action by national authorities - possibly more valuable in overcoming administrative obstruction (as in France) than institutional problems (Germany). The more we seek to exempt sensitive sectors (eg newspapers, financial services, aviation) from the scope of the regulation, the more restricted will be the scope of any benefit. In general the potential commercial benefits may not be sufficiently clear to represent a major argument for a regulation.

Relationship between a regulation and application of Articles 85 and 86 (paras 26-32 of the Annex)

6. In the case of mergers within its scope, the Commission's intention is to take action under the regulation rather than Articles 85 and 86. To this end the draft regulation amends the regulations implementing Articles 85 and 86 so that they do not apply to the relevant mergers. In practice this means that the only likely challenge under Articles 85 and 86 to mergers covered by the regulation is from private action in national courts. To this extent the regulation would overlap with the Treaty Articles.

7. Whether the Commission will wish to investigate mergers outside the regulation under Articles 85 and 86 depends in part on the regulation's scope. It might be possible to secure their agreement that these mergers too should be excluded from the regulations implementing these Articles, although this could put the Commission in a difficult position if they received a complaint from a third party that the Articles were infringed by a merger. The right to take private action would remain as at present.

8. The overall picture is not altogether clear cut, but simply by repealing the application to mergers of the regulations implementing Articles 85 and 86 the Commission would be making it difficult for themselves to take action except under the regulation. For cases within the scope of the regulation, we can be fairly confident that the regulation would in practice substitute for the Treaty Articles. Whether the Treaty Articles would continue to be used for cases outside the scope of the regulation is more uncertain. This would not of course lead to the regulation and Treaty Articles applying to the same case, but means that cases left to member states under the regulation would not be wholly free from the risk of action under the Treaty.

Impact of a regulation compared with Articles 85 and 86 (paras 5-25 of the Annex)

9. The picture is uncertain given wide differences of view between member states about the final form of the regulation and uncertainty about how far the Commission could push Articles 85 and 86 (as they would undoubtedly seek to if we blocked a regulation). This note accordingly tries to identify what our requirements might be in order to achieve a more satisfactory regime under a regulation than under the Treaty Articles.

10. In principle we might wish to secure the procedural advantages of prior clearance and reduce the current extent of double jeopardy; but keep to acceptable proportions the numbers of cases caught by a regulation and maintain a continuing role for national authorities to prevent mergers in sensitive sectors. In addition, we may need to question the Commission's proposal that competition criteria might in some circumstances be overridden on industrial policy grounds. The question is whether such objectives can be made mutually consistent and if they are attainable.

(a) **Scope**

11. Under the Commission's present proposal there seems little doubt that more cases would be caught by the regulation than by use of the Treaty Articles. There is evidence that the Commission themselves are worried about their ability to cope with the number of cases which might arise. The increased scope for Commission interventio could be reduced in two main ways: by amending thresholds so as to exclude more cases; or by defining the application of the regulation in ways which envisaged a continuing role for national authorities. The second method would in some cases involve "double jeopardy".

(b) **Relationship with national controls**

12. The main procedural advantage of a regulation is that a company would have its proposed merger examined by the Commission before rather than (perhaps) have to have it unscrambled after the event. Depending on how the regulation was framed, this could reduce the problem of "double jeopardy" quite significantly. If the Commission found against the merger, it could not proceed, and national controls would have no role to play. The position would be more complicated if the Commission found in favour; the draft regulation envisages two possibilities: "authorisation" - in which case national authorities could not prevent the merger; and "clearance" - in which case national authorities would be left with a veto. The more mergers are "authorised" (as opposed to "cleared"), the more double jeopardy would be reduced. But the implications for our ability to block mergers could be serious: the regulation envisages the right to authorise mergers not only on competition grounds but also because they contribute to the "basic objectives of the Treaty". This could mean that we were powerless to prevent mergers that we regarded as anti-competitive which the Commission had approved either as pro competitive at an EC level or on industrial policy grounds. We could probably gain some support amongst other member states for a watering down of this provision: the Commission might be open to retention by national authorities of a right to block mergers in a limited number of sensitive sectors. We could also seek blocking rights for national authorities according to a wider definition of the public interest.

Conclusions

13. In broad terms a regulation appears likely to clarify criteria and procedures for merger control (and thus the respective roles of national and EC authorities), but at some cost in increasing the number of cases subject to Commission oversight (and thus in enhancing their role vis a vis that of member states). If that cost looks bound to be too high, this would point to Option 1 in para 2. The alternative would be to set ourselves negotiating objectives designed to minimise the cost. This might be achieved by amending thresholds to reduce, as far as practicable, the number of cases caught by the regulation, and seeking to secure clear conditions in the regulation governing the circumstances in which the Commission would have the power only to "clear" rather than "authorise" a merger. One might thus produce a clearer definition than presently exists of

(i) which cases would be solely for Commission consideration

(ii) in which cases both the Commission and national authorities would retain a veto

and (iii) which cases would be left for national consideration alone.

Ministers would then need to judge whether, in the light of progress in negotiations, the virtues of clarification were outweighed by the increase in Commission powers.

14. Ministers are invited:-

(i) to consider further which of the policy options set out in paragraph 2 should be pursued;

(ii) to decide what tactics to adopt in doing so.

Cabinet Office
21 April 1988

mjd 2/76Jn

CONFIDENTIAL

JMGT EC Merger Control 25/4

FROM: J M G TAYLOR
DATE: 25 April 1988

for PM bilateral

MR MACAUSLAN

cc PS/Paymaster General
Sir P Middleton
Sir G Littler
Mr Anson
Mr Lankester
Mr Monck
Mr A J C Edwards
Mr Burgner
Mrs Lomax
Mr Ilett
Miss Noble
Miss Barber
Mr Bent
Mr Kroll
Mr Parkinson
Ms Roberts
Mr Wynn Owen

EC MERGER CONTROL

The Chancellor has seen your minute of 21 April. He is content to circulate a paper along the lines you propose, thought he has noted that the draft does not address explicitly a key issue. This is whether it is worth trading EC power to override UK merger legislation (in an unpredictable way) for EC power to override other national merger legislation in the EC in a way which we hope will benefit UK firms wishing to make Euro-acquisitions.

2. He has a number of drafting amendments to the paper. I have passed these on to Mr Wynn Owen.

J M G TAYLOR

FROM: P WYNN OWEN
DATE: 27 April 1988

1. MR MACAULSAN
2. CHANCELLOR

cc PS/Paymaster General
Sir P Middleton
Mr Lankester
Mr Monck
Mr Burgner
Mr A J C Edwards
Mrs Lomax
Mr Ilett
Miss Noble
Miss Barber
Mr Bent
Mr Kroll
Mr Parkinson
Mr Flanagan

OD(E) - EC MERGER CONTROL REGULATION

You are attending OD(E) at 9am on Thursday 28 April. The EC Merger Control Regulation is the only item.

THE PAPERS

2. You have tabled a short paper, OD(E)(88)8. If you have time, you might also read Lord Young's short note, OD(E)(88)7, and the Cabinet Office cover note, OD(E)(88)6, to a longer paper by DTI officials.

3. Lord Young's note prevaricates. He does not at this stage recommend endorsing the principle of a regulation, nor does he rule out the possibility that it could be amended so as to serve UK interests. He notes the Commission see the UK position as crucial; argues the current position under Articles 85 and 86 is unsatisfactory; and suggests that his Steering Group of senior businessmen on the Internal Market support his approach. He ends by proposing continuation of constructive discussion, without commitment, against a set of objectives. These differ from those he suggested for the OD(E) in February, but are equally weak, contradictory and unattainable. They include seeking a regulation

which should apply to "a relatively small number of Community-wide mergers", over which the Commission would have exclusive jurisdiction; the removal of Commission powers under Articles 85 and 86 elsewhere "as far as possible"; and a narrow definition of the Commission's powers to "authorise" mergers. He offers to report again to OD(E) before the June Internal Market Council (IMC) - either 7 or 22 June; and suggests that in the meantime we "reserve our position on the merits of a regulation, while continuing to contribute constructively to discussions".

4. The Cabinet Office paper is far from ideal, but attempts to weigh up the pros and cons in an even-handed way. It usefully identifies two basic policy options of "opposition in principle" and "readiness to negotiate". It also helpfully outlines the significant powers the Commission currently envisage for themselves - involving "finding against" mergers, or "authorisation" - both of which would wholly rule out the involvement of national authorities. Only "clearance" might leave national authorities with a veto. In conclusion most of para' 13 plays for time, suggesting that a clearer definition be obtained on several points, which Ministers would subsequently need to judge on. But the note includes a final paragraph which helpfully flags up decisions on **substance** and **tactics** separately. You will want to draw this distinction throughout.

5. The note by DTI Officials was discussed in draft at EQS, as reported in Mr MacAuslan's minute of 30 March. It describes in detail the considerable scope the Commission still envisage for the Regulation and the uncertainties over overlap with national systems and overlap with Articles 85 and 86 .Section D is particularly weak in assessing the benefits of a Regulation. Its appendices, on the other hand, are quite useful - eg **Appendix 3** notes that, under the current 1,000 MECU world turnover threshold, 81 UK mergers qualifying under the Fair Trading Act in 1987 would have qualified for Commission investigation. **Appendix 4** takes 12 recent merger cases and notes how the Commission might have interfered (note that both GEC/Plessey and SAS/B.Cal might well have turned out differently under the Commission). **Appendices 6 and 7** on merger control regimes and the attitude of other member states are both fairly thin.

ASSESSMENT

6. On **substance** the DTI officials' minute catalogues difficulties with the current draft Regulation, from which your paper lays out the main criticisms succinctly. Press Lord Young to acknowledge that the current draft Regulation is clearly unacceptable as it stands and is little improved since the last OD(E) meeting. Official Working Party meetings held by the Commission have been disastrous - eg see Telno 1048 of 29 March (attached). It is highly unlikely that DTI officials genuinely believe they could achieve the objectives set out in Lord Young's note. They are playing for time.

7. The key question (as in Mr Taylor's minute of 25 April) is whether gains to UK firms from letting the Commission override national merger controls outweigh the drawbacks of this approach. We think the answer is clearly "no". The regulation is not well targetted to get the best trade-off here. It does not combat all those cases where national authorities may unjustifiably block a merger on nationalistic grounds (eg those below the thresholds); but it allows the Commission to undermine national merger policy in other unnecessary (and sometimes uncompetitive) ways as well. An approach designed to get the best trade-off here would look very different from the Regulation (and indeed from Articles 85 and 86). It would arguably start from mutual recognition and minimum standards. But some double jeopardy and loss of sovereignty would be inevitable to the extent one gave the Commission any role beyond simply assisting in the establishment and mutual recognition of national powers.

8. On **tactics**, the position is more tricky. Not only will Lord Young claim he does not wish to offend Sutherland while the Commission line on BAe/Rover is undecided, but the FCO may argue that it is unwise to decide on a position until after the French elections. By offering to return to OD(E) before the June IMC Lord Young is tempting OD(E) to postpone any decision for another month. What he does not say is that Commissioner Sutherland intends to visit London to see him before the June IMC (but after the French Presidential elections) to discuss this issue. So this delay simply

runs the risk of a Young/Sutherland deal on EC mergers, perhaps in exchange for something on BAe/Rover. As explained in Mr MacAuslan's minute of 21 April, you will not want to volunteer any acknowledgement of the linkage with BAe/Rover at OD(E), or Lord Young might be encouraged to move towards such a trade-off.

9. Realistically, the likely **outcome** at OD(E) is that the Foreign Secretary, in the chair, will attempt to delay a decision for another month. If so, you might:

(i) aim to get agreement that the regulation embodies a fundamentally flawed approach in **substance**, and that no amendments have been suggested which would avoid the basic flaws.

(ii) ensuring on **tactics** Lord Young and his officials are not invited to negotiate towards Lord Young's half-baked objectives. Instead, Sutherland should be told the UK wholly maintains its reserve on the principle and has fundamental objections to the draft.

LINE TO TAKE

10. **Opening Remarks** you might briefly rehearse points from your paper, listing the fundamental flaws in the whole approach of a Regulation:

- two layers of regulation bound to mean some double jeopardy, involving plenty of dispute;

- Commission may pursue EC industrial strategy, while ignoring locally anti-competitive effects of mergers;

- Use of Commission's authority will necessarily entail overrides on national competition authorities/decisions;

- allowing Commission first bite poses serious danger to sovereignty in major, politically sensitive cases;

- no way you can disapply Articles 85 and 86, so Regulation simply adds to your worries;

- the higher the thresholds, the more the loss of potential benefits to UK firms, since smaller mergers can still be blocked nationally.

11. Then draw on the following:

- Decision needed now - intolerable for OD(E) to continue wasting meetings on this issue; no one here truly thinks a Regulation is essential to the Internal Market; ridiculous to keep proposing negotiating objectives which are weak, contradictory and unobtainable; we are the principle player in this field - high time we took a decision and made it known. Only fair to all parties, including Commission.

- Commission's aim clearly for something much more wide-ranging than Articles 85 and 86, involving primacy (distinct from simply going first) over all significant EC mergers. No way they will realistically shift to anything like Lord Young's negotiating objectives. So maintenance of Articles 85/86, however unsatisfactory, much better than any Regulation.
- Scare-mongering over Articles 85 and 86 over-done. Philip Morris case open to very different legal opinions. Quite clear Commission can do nothing now to stop us acting first to block a merger.

- Lord Young's aims are:

(i) avoid double jeopardy;

and (ii) remove obstacles to UK firms wishing to expand into EC.

- Lord Young's negotiating objectives are inherently flawed and contradictory, when judged against these criteria:

(1) Lord Young suggests Commission primacy over a "small number" of EC-wide mergers. What does he mean by "small number"? Annex to his own officials paper shows 81 UK mergers would have been caught by current draft regulation in 1987. Current regulation could affect the top 260 companies in UK (assuming they merged with company of broadly equal size, each with annual turnover of £330m, or greater). Reducing scope in this way also frustrates aim (ii).

(2) Lord Young suggests Commission "exclusive jurisdiction" within (1). But this only achieves aim (i) if there is no scope for doubt or dispute, which is impossible to negotiate and to enforce in practice. To the extent you win exlusions for specific sectors, you frustrate aim (ii)

(3) Lord Young suggests removal of Art's 85+86 Commission powers "as far as possible". Para'29 of his own officials' paper shows this is impossible.

(4) Lord Young aims to define Commission's "authorisation" powers as narrowly as possible. Impossible to achieve much in negotiation. To the extent you do, it frustrates aim (ii).

- Set no store by clearly indistinct views of Lord Young's Advisory Groups of businessmen. But gather they equally stressed:

(i) "The need to avoid "double jeopardy", which in practice would not be removed by current draft Regulation.

(ii) The fact that our companies are perhaps the most easily acquired and the least regulated and thus provide a convenient entry ticket to the EC for non-EC nations. They saw EC Mergers Regulation as a means of protection against non-EC predators - surely unacceptable?

(iii) Present UK mergers policy was too insular - surely an argument Lord Young must refute?

- Moreover, gather **merchant banks**, who speak as advisers on takeovers throughout the economy, not just for their own commercial sector, were extremely wary of a Regulation.

- **British Airways** have not followed their time-wasting discussions with the Commission by calling for more powers for the latter - quite the reverse. BA said throughout it saw no basis for Commission's action and made it clear that the cosmetic package of concessions, which it offered to make the Commission go away, amounted to little or no cost.

- The Bank of England have made it clear [see Bank letter attached] that they would not wish any decision by the Commission that a proposed merger was not anti-competitive to remove the scope for national level blocking on non-competition grounds, such as the interests of depositors. We have to protect our own non-competition powers in areas such as banking. But, to the extent we do, we would simply erode any benefits a Regulation might conceivably bring us, since other countries will follow suit.

flagged (Osborne/Kuhn 13/4)

- Other EC countries capital markets and company structure a long way removed from our own. For instance, Germans vest control of most major companies' shares not in stock market but in major German banks, who would concert to block any foreigner's bid, should anyone be foolish enough to mount one. This proposed Mergers Regulation does absolutely nothing to break down these non-competition barriers to taking over a major German firm. Instead, it simply lowers our safeguards further. Lord Young should be focussing on opening up other capital markets and company structure within EC, to match our own free market approach. So whole approach of Regulation fundamentally flawed - approaches the problem from wrong end.

The annex to this note contains useful quotations from others' papers which you might use in debate in OD(E) to back up your case.

Fallback

- **Mutual recognition,** combined with liberalisation and deregulation, should be at heart of creation of Internal Market on all fronts, not harmonisation and enhanced Commission intervention (which simply undermine sovereignty).

- Only role for Commission in achieving Internal market in mergers policy should be in promoting "Mutual Recognition".

Tactics

12. This section deals in turn with each of the main tactical argument that will be deployed against taking any decision tomorrow, and provides a line on each.

13. BAe/Rover - avoid acknowledging any explicit linkage between this and EC Mergers issue if you can. If pressed say each should be fought on its merits. If Sutherland were so rash as to even suggest any trade-off between our views on such unrelated issues, that would simply show how unfit he and the Commission would be to run a competition policy - we would constantly be plagued by such wheeler-dealing on specific mergers cases, wholly unrelated to the competition benefits or otherwise to the companies concerned.

14. French Elections - understand Balladur dead against any Regulation. We are not reliant on their support, since this Regulation needs unanimity, but with them we can easily kill it, not least because Working Parties have been marked by several other countries expressing serious reservations. Understand even French diplomats have serious reservations - they doubt Commission would be suitable to run any competition policy. No harm in making our position known now. Would expect new French administration to follow.

15. QMV threat under Art' 87 if we reject Regulation now - scare-mongering. To block QMV only needs 23 votes out of 76 - UK has 10 and doubtless France (or Italy) would provide another 10, leaving need for only one other country's (excluding Luxembourg who only have 2 votes). In any case, lawyers by no means clear what Commission could achieve by way of further defining current Art's 85 and 86 under Art' 87. Appears they would have to stretch a point and take matter to ECJ to pursue any claim for powers to act before mergers.

16. Commission making no significant progress, so play long - no excuse for not reaching a decision on substance **now**. Only fair and efficient for all parties to do so. Otherwise risk Commission attempting embarrassing bounce at June IMCs or Hanover Summit (worst possible fora in which to opt out, though we would have to at the crunch).

17. Treasury's position inconsistent - [at EQS Mr Kerr (FCO) acknowledged that the argument that the Commission would operate the regulation anti-competitively was strong, but said this contradicted our argument that it would infringe UK power to control mergers in its own public interest.]
Absurd to argue that our existing right to have a public interest test in any way disqualifies us from arguing that it would be wholly inappropriate for the Commission to introduce its own version of a public interest test (EC Industrial Strategy). Key point is that the Commission's strategy could well **conflict** with our own public interest test. Indeed, understand Commission have made it clear that they would use it to overrule national public interest decisions. So there is no contradiction in Treasury position, but there is potential for conflict in Commission proposals. You cannot have both parties running different versions of public interest tests.

Fallbacks

18. Given Lord Young's willingness to return to OD(E) for the June IMC, there must be a strong chance of another stand-off at this ODE(E). In that case, seek to:

(i) Get agreement that the Regulation embodies a fundamentally flawed approach.

(ii) Argue that Lord Young's negotiating objectives are weak and unrealistic and therefore stop them being used actively in negotiations prior to the next OD(E)

(iii) Gain agreement that the UK will maintain and reiterate its reserve on the whole principle of a Regulation (Lord Young's paper concludes by suggesting "we reserve our position on the merits of a regulation, while continuing to contribute constructively to discussions." Seek at the very least to delete "merits" and replace it by "principle").

(iv) Ensure Lord Young is instructed to tell Sutherland, when Sutherland comes to London during the next month, that the UK wholly maintains its reserve and that we continue to have major difficulties with the whole approach enshrined in the Regulation. So Sutherland can forget the prospect of any Regulation this year (at the end of which he leaves his post).

(v) Avoid, if possible, signing up to any explicit recognition of linkage with the BAe/Rover problem..

Philip Wynn Owen.

P WYNN OWEN

QUOTES FROM DTI AND CABINET OFFICE PAPERS

Benefits to UK Firms

"In general the potential commercial benefits may not be sufficiently clear to represent a major argument for a regulation" (Cabinet Office, paragraph 5).

Scope of regulation

"More cases would be caught by the regulation than by the use of the Treaty articles" (Cabinet Office, paragraph 11).

"The scope for action under the Treaty articles ... is ... undoubtedly more limited than under a regulation" (DTI, paragraph 9).

Double jeopardy

"The Commission's proposal does not eliminate the potential for double jeopardy" (DTI, paragraph 14).

Competition effects

"a merger with significant anti-competitive effects in the UK could proceed unchecked". (DTI paragraph 21).

"Exclusive jurisdiction for the Commission opens up the possibility that the UK would not be able to stop a merger ... on competition grounds" (Lord Young, page 2).

"A possible area of concern ... is that of bids for UK companies by Community companies which were state-owned and possibly state-aided" (DTI, paragraph 22).

Remaining use of Articles 85 and 86

"Commission ... intend that where mergers outside the Regulation's scope are within the scope of articles 85 and 86, they should remain subject to control" (DTI, paragraph 29)

"Cases left to members states under the regulation would not be wholly free from the risk of action under the Treaty" (Cabinet Office, paragraph 8).

"[If the Treaty Articles] remain a practical threat ... this would constitute a powerful argument against a regulation: the present unsatisfactory arrangements would remain and the regulation would merely add an extra layer of control" (Cabinet Office, paragraph 4).

10/28

FROM: A J C EDWARDS
DATE: 29 April 1988

PAYMASTER GENERAL

cc Chancellor
Sir P Middleton
Sir G Littler
Mr Anson
Mr Lankester
Mr Bonney
Mr Mercer
Mr Mortimer
Mr C B Evans
Mr Tyrie

NEW EC OWN RESOURCES DECISION:

The negotiations in Brussels on the new Own Resources Decision, implementing the revenue aspects of the Brussels European Council conclusions, have been going fairly smoothly. The main issues outstanding are:

i. the Italian problem,

ii. our problem on the treatment of relief for Spain and Portugal, and

iii. definition of the own resources ceiling.

Since the COREPER discussions on these issues may reach a critical stage on Tuesday of next week, I should be grateful if you could approve (or otherwise) the line which we propose to ask Sir David Hannay to take.

Italian and Iberian Relief problems

2. As you will recall, the small amendment to the conclusions text which the Prime Minister secured at the end of the Brussels European Council will save the UK during 1988 a sum which

EC Own Resources
Decision impact on
UK contribution
6 pages

Mr Mortimer now estimates at some £350 to £400 million. This will offset what would otherwise have been an unseemly blip in 1988 in our net contribution after abatement. From 1989 onwards the gain to the UK from having a smaller net contribution initially will be roughly offset by a corresponding reduction in the abatement due to us from the previous year.

3. We were not sure at the Brussels European Council exactly how the Commission would propose to implement the agreement to score the UK abatement against the new VAT ceiling. By the same token, we were not sure exactly what the division between VAT and GNP contributions in the Budget would be. The country most affected by this important technical detail is Italy, whose share of Community GNP is some three percentage points greater than its share of the Community VAT base. The UK is affected in the opposite direction because our share of Community GNP tends to be below our share of the VAT base, though in our case this effect will be offset in accordance with the European Council conclusions by an equal change in our abatement in the following year.

4. The scoring method proposed by the Commission was as unfavourable as it could possibly have been for Italy (and the most favourable possible for the UK). The Italians countered by proposing a different methodology which would be as favourable as it could possibly be for Italy (and as unfavourable as it could possibly be for the UK).

5. So far as the text of the European Council conclusions is concerned, we are in no doubt that the Italian interpretation cannot be sustained. On the other hand, we have some sympathy with the Italians because (a) they clearly did not realise the implications of what was proposed and (b) the figures circulated by the Commission at the European Council probably helped to mislead them.

6. In recent days the Council Secretariat have come up with a compromise proposal. This is just about reconcilable with the European Council conclusions and effectively splits the

difference between the Italian and Commission interpretations: it is in fact somewhat closer to the Commission's interpretation than the Italians'.

7. Compared with the Commission's interpretation, and on certain assumptions about what exactly the Council Secretariat's interpretation is, the estimated effects on Italy and the UK in 1988 (gains, plus) are:

Mecu

	Italian Interpretation	Council Secretariat's interpretation
Italy	+120	+47
UK	-40	-25

8. The effect on Italy would be a continuing one each year. The UK would recover the sums shown in the form of extra abatement in 1989. But we should never catch up with the loss sustained in 1988 (at least until such time as the whole system is changed).

9. The other issue concerns the method by which Spain and Portugal are relieved from contributing in full to our abatement. We are in no doubt that our interpretation of the European Council conclusions is correct. We attach particular importance to winning agreement for our interpretation because the Commission's alternative method would breach the established principle that the UK receives the full abatement due to it regardless of the financing method used. The Commission's method would also, as you recall, qualify in some small measure the key proposition that the new system preserves the Fontainebleau abatement in its entirety.

10. In this case, the UK would make continuing losses from the Commission's interpretation, though the amounts would diminish over time as the Spanish and Portuguese transitional refunds are phased out (by 1992). The loss to the UK from conceding the Commission's interpretation would be some 10 mecu in 1988 (after allowing for the reduced abatement which we would receive in 1989) and some 23 mecu over the period to 1991. The other gainers from our interpretation would be Germany, Spain and Portugal. The main losers would be Italy (2½ times the UK gain) and France (over 1½ times the UK gain).

11. The French will probably not be in a position to resolve any of these issues until after the second round of the Presidential election. But there is clearly a chance that either next week or a little later on we shall have to indicate in Brussels whether we could accept the Council Secretariat compromise on the Italian problem.

12. In my opinion, we <u>should</u> win our point on the Spanish and Portuguese relief if the Council Secretariat compromise is adopted for Italy. There are two reasons for this:

(a) Spain and Portugal would be among the losers from the Council Secretariat compromise. There would thus be a general perception in the Community that they deserved to have some compensating gains, in the early years at least, from our solution to the relief problem; and

(b) Italy, as the biggest loser from our interpretation of Spanish and Portuguese relief, would vehemently oppose this if they received nothing in relation to their own problem.

For the UK, the amounts involved in the two cases are fairly similar: a permanent gain amounting to some 23 mecu after abatement from our interpretation of the Spanish and Portuguese relief as against a loss in 1988 (unlikely to be unwound except in the context of an overhaul of the own resources system)

of some 25 mecu from the Council Secretariat compromise on the Italian problem.

13. If no concession is made to the Italians, it will I think be extremely difficult for us to win our case on Spanish and Portuguese relief. There would be a general perception that, if the Italians had agreed to eat humble pie on their main preoccupation, at least they should not be penalised by having to accept the penalties for them involved in our interpretation of Spanish and Portuguese relief.

14. Against the above background, I suggest that we should authorise Sir David Hannay, whenever the negotiating time is ripe, to indicate willingness in principle to go along with the Council Secretariat compromise on the Italian problem, but only on the basis that our interpretation of the Spanish and Portuguese relief problem is accepted. There should, I believe, be scope for a deal here. The most difficult member state to persuade will be France, who will loose from both elements in the deal. But France would at least pay much less under the Council Secretariat compromise than under the Italian's preferred solution and the French may well have other points which they wish to ~~accose~~ trade in the negotiation.

Definition of Own Resources Ceiling

The issue here is simpler. The Brussels European Council conclusions speak, somewhat inconsistently, of setting a new own resources ceiling on payment appropriations.

There are however two differences between the total of own resources and the total of payments appropriations. The Community has a small amount (around 200 mecu a year) of 'other revenue' - that is, revenue other than own resources - and Budget surpluses carried forward from previous years can substantially increase the funds available for spending (that is for payment appropriations) in any particular year.

16. Against this background, we argued initially in Brussels that the ceiling should apply to own resources and payment appropriations. Neither total should be allowed to exceed 1.2 per cent of Community GNP or whatever lower figures may be agreed for sub-ceilings in the intervening years. This approach does however raise the legal difficulty that the own resources Decision is concerned with revenue and not expenditure. We therefore switched our support to a French proposal that Budget surpluses should be scored alongside the Community's ~~for~~ four own resources in determining the total revenue available within any given ceiling. This approach, if agreed, would be similar to having a ceiling on payment appropriations. The only difference would be the relatively small "other revenue" items mentioned above.

17. There are two reasons why this issue is potentially important:

- First, in years when the dollar appreciates significantly against the ecu (something which may well happen over the period to 1992) there could be surpluses of up to 1 billion ecu a year carried forward under the new "monetary reserve" provisions: these extra funds would be an enormous temptation to the big spenders in the Council and the European Parliament.

- Second, there could well be substantial underspending on the structural funds compared with the plans agreed by the Brussels European Council, generating extremely substantial cash surpluses over time. We would much prefer an arrangement in which money not spent would be effectively returned to member states rather than left to build large surpluses.

18 Members states are predictably divided in their views on this. The compromise solution which has been mooted is that any Budget surpluses resulting from the monetary reserve should be counted against the own resources ceiling but not Budget surpluses which arise from other causes.

19 We would propose, if you agree, to ask Sir David Hannay to continue arguing strongly for all Budget surpluses to be scored against the ceiling, since a rigorous Budget discipline clearly demands nothing less. If however we find ourselves isolated on this issue (but not otherwise), I think we shall have to be prepared to accept the compromise proposal in the preceding paragraph. We should however insist on writing this into the Own Resources Decision.

Conclusions

20. If you agree, we would propose to brief Sir David Hannay on the Italian problem/Spanish and Portuguese relief issues as in paragraph 14 above, and on the definition of the own resources ceiling as in paragraph 19 above.

AJCE

A J C EDWARDS

JEFFERSON SMITH - REQUEST FOR LEGAL ADVICE 29/4

RESTRICTED

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

FROM: P JEFFERSON SMITH
DATE: 29 April 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Edwards
Mr Culpin
Miss Sinclair
Mr Riley
Mr Mortimer
Mr Parkinson

JEFF-SMITH 29/4

Ref. ox.

1. Mr Edwards' note of 19 April to Mr Allen passed on your request for legal advice, including that of the Law Officers, on what the Single European Act did, or did not, oblige us to do; whether the Commission's contentions in the footnotes on pages 15 and 16 of the EPC report were justified; and what would be the legal position on a market-based approach.

2. Mr Edwards explained that you wanted this advice before the debate on tax approximation (expected to be in the week beginning 9 May) and the informal ECOFIN on 13-15 May. It was also hoped that the advice could be available before your meeting on this subject on 9 May.

Internal Circulation:	CPS	Mr Nissen	Mr Kent
	Solicitor	Mr Allen	Mr Cockerell
	Mr Nash	Mr Fotherby	Mr Knox
	Mr Wilmott		

3. The general question of how far the Single European Act can or cannot compel tax harmonisation has of course been addressed before. But the way the question is being put now raises potentially very difficult issues and could result in the Law Officers giving answers which would be definitive but possibly unwelcome. We have therefore discussed the questions with a group of lawyers from the Law Officers' Department, Treasury Solicitor's Department, FCO, DTI and Cabinet Office before agreeing a paper to be submitted to the Law Officers.

4. A number of points emerge from this preliminary meeting:-

(i) the issues raised are so fundamental, complex and wide-ranging that it is essential that the questions to be put to the Law Officers are very carefully formulated and explained and that the Law Officers do not give their opinions in haste. In practice, this means that the Law Officers could not give an opinion before ECOFIN on 13-15 May.

(ii) because the issues are so difficult, it would be unwise to rely on preliminary indications of the legal position as expressed by legal experts at official level. (For what it is worth, however, there appeared to be a body of opinion among the lawyers at the preliminary meeting that a credible legal defence could be made for retaining light frontier cntrols - but the lighter the better and preferably not at the frontier at all).

(iii) consideration of your questions is inextricably linked to examining what grounds there would be for legal action against Member States if tax harmonisation was not achieved and any barriers still in place in 1993.

4. Although the delay is unfortunate, we believe that it would be preferable to get a fully considered opinion in an area as critical as this. Also, if it becomes apparent as the questions are being formulated that the answers are likely to be unhelpful or positively unwelcome, we can seek your view again on whether you wish to proceed.

5. I realise that this will hamper a positive approach at ECOFIN. Perhaps we could discuss its implications at your meeting on 9 May.

P JEFFERSON SMITH

ps3/4T

UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 3 May 1988

PS/PAYMASTER GENERAL

cc Sir P Middleton
Sir G Littler
Mr Anson
Mr Lankester
Mr A J C Edwards
Mr Bonney
Mr Mercer
Mr Mortimer
Mr C B Evans
Mr Tyrie

NEW EC OWN RESOURCES DECISION

The Chancellor has seen Mr Edwards' minute of 29 April.

2. He has commented that it is most important that we maintain the linkage, and do not move on the Italian problem unless we are assured of success on the Iberian question.

J M G TAYLOR

mjd 2/93Jn

CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 3 May 1988

MR MCAUSLAN

cc Mr Monck
Mr Burgner
Mr Wynn-Owen

EC MERGER CONTROL REGULATION

You should by now have seen the minutes of OD(E) of 28 April.

2. The Chancellor has commented that the difficulty he had here was with the Attorney General. The Attorney General maintained: (a) that Articles 85 and 86 could be used in advance of a merger and (b) that Articles 85 and 86 could be used to allow a merger we had sought to block under UK legislation.

3. The Chancellor would be grateful for confirmation that these assertions are correct.

J M G TAYLOR

ps3/11T

RESTRICTED

FROM: J M G TAYLOR
DATE: 4 May 1988

MR JEFFERSON SMITH - C&E

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Edwards
Mr Culpin
Miss Sinclair
Mr Riley
Mr Mortimer
Mr Parkinson
Mr Unwin - C&E
Mr Nash - C&E
Mr P R H Allen - C&E

SINGLE EUROPEAN ACT

The Chancellor has seen your minute of 29 April. He agrees that we should discuss the implications of the need to proceed cautiously, as you propose, at his meeting on 9 May.

J M G TAYLOR

42/2.BTW.1234/38 CONFIDENTIAL

PS/IST ec DIRECT TAX 4/5

FROM: J J HEYWOOD
DATE: 4 May 1988

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Culpin
Mr A Edwards
Mr Cropper
Mr Houghton IR
Mr McGivern IR
Mr Shepherd IR
PS/IR

EC: DIRECT TAX HARMONISATION PROPOSALS

The Financial Secretary had a word with officials today about Mr Shepherd's minute of 21 April.

2. Although the "preliminary draft proposals" the Commission is putting forward are by no means as far-reaching or as comprehensive as Lord Cockfield originally had in mind, the Financial Secretary believes that most of them would be wholly unacceptable to us. Inter alia, they might involve:

OK

(i) Capital allowances extended to commercial buildings;

(ii) 25% writing down allowances for plant and machinery and the 4% allowance for industrial buildings replaced by the depreciation rates adopted in the commercial accounts;

(iii) Greater scope for deferral of CGT (and it is not clear whether indexation relief would be permissible);

(iv) More generous treatment of bad debt provisioning and business expenses (probably allowing companies tax relief on the full amount of any provisions or business expenses declared in the commercial accounts).

3. The Revenue are preparing fuller analysis of the proposed draft Directive on the tax base and aim to put a paper to Ministers by the middle of the month. The Financial Secretary will be keeping further developments under close review, but wanted to draw the Chancellor's attention to the present proposals.

JEREMY HEYWOOD
Private Secretary

LINWIN - SINGLE EURO MARKET 4/5

8/5 for reg folder (9/5)

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

CHAIRMAN C&E 4/5

CONFIDENTIAL

FROM : THE CHAIRMAN
DATE : 4 May 1988

CHANCELLOR OF THE EXCHEQUER

cc Paymaster General
Economic Secretary
Sir P Middleton
Sir S Littler
Mr Byatt
Mr Scholar
Mr Culpin
Mr Edwards
Miss Sinclair
Mr Cropper

THE SINGLE EUROPEAN MARKET

There is a lot of paper already for your meeting on 9 May, but I wonder if I might register a few key points on which I should find it very helpful to have your steer over the coming weeks.

2. The UK's response to the Commission's proposals will have far reaching administrative implications for Customs and Excise and the trading community. Lord Young's campaign is already arousing expectations and increasing the pressure to explain how intra-Community trade will be dealt with after 1992. It is also beginning to impinge on our own departmental planning - next year, 1 January 1993 will enter the PES frame.

Internal Circulation: Mrs Strachan
Mr Jefferson Smith
Mr Nash
Mr Allen
Mr Knox

3. I should like, therefore, to consider briefly whether we can establish any "anchor points" for purposes of practical policy planning.

Our present system

4. A brief reminder on this first. VAT and excise duty on imports become payable at the frontier (though much excise trade is transferred under Customs control to bonded warehouses inland). Our frontier systems bring the goods under control, document them and secure the revenue. We also enforce at the ports a range of prohibitions (mostly for other Departments) and collect the data for trade statistics. Thus, while some work is done inland, most is concentrated at the frontiers and we still think this is the most efficient way of doing our job; in effect, we turn to advantage our island frontiers in a way the continentals cannot.

5. Export controls are very light. For intra-Community trade, our main chore is to certify transit documents, to establish Community status on importation into other member states. But there are some export controls, eg for the CAP and for COCOM.

Policy choices

6. Although the two sets of issues are interrelated, for purposes of analysis it might be simpler to look at tax and frontier controls separately.

Tax approximation

7. The key issue is how far you think the Government will be able to sustain the present "market-based" approach, which denies the need for tax approximation. The answer has significant implications both for the revenue and the competitive position of UK traders as well as for tax administration.

8. To take an extreme hypothesis, if the approach was sustained, but we moved at the same time to a US type system with no internal frontiers, there would be severe problems. This is not to say that, if required, we could not devise a system to meet such circumstances. For example, our internal VAT system could be made to pick up most of the VAT due on imports for resale by registered traders; and zero rating of exports could go on without frontier controls. It would also be possible in principle to extend excise control down to the retail shop in order to pick up excise duties on goods that stayed outside our warehousing system. But this would be very costly (it would require more staff); and until taxes reached their market levels, high excise rates would be undermined by low ones and there could be serious damage to the distributive trades. Some of the costs and problems would still arise even with tax approximation; but without that they would be much greater. There would certainly be great concern among a number of UK industries if they thought this was the direction in which we are heading.

Frontier Controls

9. A more orderly system - assuming no imposed tax approximation - would involve continuing to bring imports and exports under Customs and Excise control, preferably at the frontier where we shall in any case need to retain controls in respect of non-EC passengers and goods and for other purposes. This is not to say that we should want to retain the present controls; we should aim at substantial simplification and redirection of effort inland wherever operationally feasible and cost effective. But this would still fall well short of the Cockfield vision and great care would need to be taken to ensure that the regime was seen as a balanced counterpart of the regime for domestically based taxpayers. Subject, however, to the advice to be obtained from the Law Officers, this seems to us the line best suited to avoiding legal challenge.

10. If you think the Government will be prepared to sustain this 'alternative' approach, we shall press on hard with developing the options for facilitating E.C. cross border traffic on which we are already working. Two main possibilities are a "fast lane" EC clearance and an extension of the simplified "period entry" system for freight. The essence of these ideas is that straight forward importations from other member states (that is, the vast bulk in which our only concern is VAT and trade statistics) will be advised to us at the ports; but subject to the occasional check, any follow up will come after importation. This would be a significant lifting of the frontier barrier without incurring the undoubted extra cost and probable loss of effectiveness of the more radical alternative.

11. To go much beyond this would also present serious problems for the other controls we currently operate at the frontier. The main ones relate to:-

(i) Drugs, firearms and terrorism;
(ii) Animal, plant and related health controls;
(iii) CAP requirements;
(iv) COCOM requirements;
(v) Collection of trade statistics.

12. I will not discuss these in detail here. The problems are obvious, and most of them are the responsibility of other Departments. In most cases it is possible to envisage control arrangements inland and, if the Government so willed, we could no doubt devise them. But - particularly on drugs - it is difficult to imagine that any alternative inland system could be as effective or economical as the present one; and the resource implications (which we are examining) could be considerable. For example, a simple analogy with the German Customs service (which exercises nearly all controls away from the frontier) suggests that 3 times as many staff as we currently employ on Customs work would be required.

13. All this can, and will, be explored in detail by us and the other Departments concerned. What I should welcome a steer on now, however, is how far you think that an alternative "simplification" approach on these lines will be sustainable; or how far you think we shall, under pressure as 1993 approaches, have to be prepared to think and plan much more radically. I am becoming increasingly concerned that Lord Young's campaign is misleading the business community into expecting a more extensive demolition of frontier controls after 1992 than is likely to be the case.

Conclusion

14. We have a major planning task ahead of us and it is too much to expect all the answers now. But we need some reasonably firm points on which to plan, and to start informing both our staff and the trading community, and I wonder whether you will feel able to endorse the following:-

(a) VAT and excise duties will not be approximated or harmonised;

(b) Subject to any rethinking on the part of other Departments, the UK will keep, and we will enforce at the frontier, our import prohibitions on drugs, weapons and other items of serious "social" concern; we may also need some export controls for COCOM purposes;

(c) For the rest, we will not assume a radical abandonment of control of intra-Community freight and passengers but prepare and launch an attractive simplification package, based on the concept of information at the frontier, with minimal checking, in place of routine frontier control.

J B UNWIN

JEFFERSON SMITH EXCISE DUTY ON ALCOHOL & TOBACCO 5/5

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

1) ACSA. to see that this now here

2) Bring mtg folder.

FROM: P JEFFERSON SMITH
DATE: 5 May 1988

PS/CHANCELLOR

cc PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burn
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr A J C Edwards
Mr Cropper

TAX APPROXIMATION

EXCISE DUTY RATES ON ALCOHOL AND TOBACCO PRODUCTS

1. Your note of 18 April requested a list of the various duty rates in each Member State. The attached tables contain the relevant information. For convenience, we have also shown the VAT rate applicable since these would of course affect the final selling price.

2. The figures derive from tables published by the Commission in October 1987 and reflect the position as at 1.4.87 - the most recent date for which figures are currently available.

PJ

P JEFFERSON SMITH

TABLE 1 : ALCOHOLIC DRINKS

DUTY RATES IN EC COUNTRIES (CONVERTED TO STERLING AT 1.4.87)

	SPIRITS(1) (PER HECTO-LITRE OF PURE ALCOHOL)	STILL TABLE WINE (2)(PER HECTOLITRE OF PRODUCT)	FORTIFIED WINE (3) (PER HECTO-LITRE OF PRODUCT)	BEER AT 1037° (4) (PER HECTOLITRE OF PRODUCT)
BELGIUM	942.44	14.53-24.54	24.53	4.38-6.90
DENMARK	2560.00	74.51-115.20	213.94	23.93
GERMANY	881.03	-	881.03	3.62-4.49
FRANCE	810.01	2.28	5.60	1.14
GREECE	30.30	-	0.06-1.81	6.51
IRELAND	1800.01	184.41	267.39	55.35
ITALY	164.78	-	65.91-164.78	8.89
LUXEMBOURG	633.85	10.00	10.00	2.05-3.36
NETHERLANDS	972.58	25.33	25.33	10.13-12.82
UNITED KINGDOM	1577.00	98.00	169.00-194.90	31.82
SPAIN	270.19	-	-	1.60
PORTUGAL	155.91	-	-	5.35

Source: EXCISE DUTY TABLES AT 1.4.1987 ISSUED BY DG XX1, CUSTOMS UNION SERVICE

(1) Alcohol & spirits from other materials (eg whisky, gin, vodka)
(2) Still wine n.e. 12%
(3) Fortified wine greater than 15% but not exceeding 22%
(4) Beer at UK average strength

TABLE 2 : ALCOHOLIC DRINKS

VAT RATES IN EC COUNTRIES

	SPIRITS (1)	STILL TABLE WINE (2)	FORTIFIED WINE (3)	BEER AT 1037° (4)
BELGIUM	25%	25%	25%	19%
DENMARK	22%	22%	22%	22%
GERMANY	14%	14%	14%	14%
FRANCE	18.6%	18.6%	18.6%	18.6%
GREECE	6% (5)	6%	6%	-
IRELAND	25%	25%	25%	25%
ITALY	18%	9%	9%-18% (6)	9%
LUXEMBOURG	12%	6%	12%	12%
NETHERLANDS	20%	20%	20%	20%
UNITED KINGDOM	15%	15%	15%	15%
SPAIN	12%	12%	12%	12%
PORTUGAL	30%	8%	16%	16%

SOURCE: EXCISE DUTY TABLES AT 1.4.87 ISSUED BY DGXXI, CUSTOMS UNION SERVICE

(1) Alcohol and spirits from other materials. (eg. whisky, gin, vodka)
(2) Still wine n.e. 12%
(3) Fortified wine greater than 15% but not exceeding 22%
(4) Beer at UK average strength.
(5) With the exception of ouzo, Brandy and liquors subject to a rate of 18%
(6) The higher rate VAT applies to product of CCT 22.07

TABLE 3: CIGARETTES (1)

DUTY RATES IN EC COUNTRIES (CONVERTED TO STERLING AT 1.4.87)

	RETAIL PRICE(2) PER 1000 CIGARETTES	SPECIFIC EXCISE PER 1000 CIGARETTES	AD VALOREM EXCISE DUTY (3)	VAT AS A % OF RETAIL PRICE
BELGIUM	48.70	1.78	60.70%	5.66%
DENMARK	115.65	55.48	21.22%	18.03%
GERMANY	69.10	19.52	31.50%	12.28%
FRANCE	25.41	0.95	45.46%	25.60%
GREECE	15.50	0.44	33.95%	26.47%
IRELAND	87.13	35.04	13.61%	20%
ITALY	38.78	1.31	53.39%	15.25%
LUXEMBOURG	36.70	1.23	57.55%	6%
NETHERLANDS	52.03	18.61	19.06%	16.67%
UNITED KINGDOM	76.00	30.61	21%	13.04%
SPAIN (4)	24.56	0.49	40%	11.94%
PORTUGAL	22.83	1.60	51.03%	13.79%

SOURCE: EXCISE DUTY TABLES AT 1.4.87 ISSUED BY DGXXI, CUSTOMS UNION SERVICE

(1) Excise duty rates based on 1000 pieces.

(2) Retail price includes all duties and taxes.

(3) The percentage rates are percentages of the retail price.

(4) Spain has a temporary derogation for certain cigarettes which allows for lower rates of Ad Valorem duty.

TABLE 4:OTHER MANUFACTURED TOBACCO

DUTY RATES IN EC COUNTRIES (1) (CONVERTED TO STERLING AT 1.4.87)

	CIGARS (2) EX 3 Kg/1000	CIGARILLOS (3)	PIPE TOBACCO	HAND ROLLING TOBACCO (4)	VAT AS % OF RETAIL PRICE
BELGIUM	16.50%	21%	31.5%	31.5%	5.66%
DENMARK	10% + £18.10/1000	10% + £18.10/1000	£11.78 /Kg	£48.55 /Kg	18.03%
GERMANY	14% (min £8.98/1000)	17% (min £10.71/1000)	20.70%+ £1.45 Kg (min £5.18 /Kg)	31.8%+ £2.90/Kg (min £8.90 /Kg)	12.28%
FRANCE	24.5%	24.5%	39.5%	39.5%	25.60%
GREECE	5%	5%	37%	37%	26.47%
IRELAND	£51.90 /Kg	£51.90 /Kg	£52.44 /Kg	£52.45 /Kg	20%
ITALY	24%	24%	56%	56%	15.25%
LUXEMBOURG	16.5%	21%	31.50%	31.5%	6%
NETHERLANDS	2.93%	8.11%	10.60%+ £6.12 Kg	10.60%+ £6.12 Kg	16.67%
UNITED KINGDOM	£47.05/Kg	£47.05/Kg	£24.95 /Kg	£49.64/Kg	13.04%
SPAIN	10%	10%	20%	20%	10.70%
PORTUGAL	26.21%	26.21%	26.21%	26.21%	13.79%

SOURCE: EXCISE DUTY TABLES AT 1.4.87 ISSUED BY DG XXI, CUSTOMS UNION SERVICE

(1) The excise rates in % apply on the retail price.

(2) Cigars entirely of natural tobacco

(3) Entirely of natural tobacco

(4) Defined in the excise duty tables as "Smoking tobacco fine cut"

SINCLAIR - SINGLE MARKET & TAX APPROX. 5/5

4485/2

CONFIDENTIAL

BP for TAX APPROX FOLDER

SINCLAIR SINGLE MARKET & TAX APPROX 5/5

FROM: MISS C E C SINCLAIR
DATE: 5 May 1988

CHANCELLOR

cc Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Lankester
Mr Byatt
Mr Culpin
Mr A Edwards
Mr Riley
Miss O'Mara
Mr Michie
Miss Hay
Mr Ford
Mr Cropper
Mr Tyrie

PS/IR
Mr McGivern - IR

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

THE SINGLE MARKET AND TAX APPROXIMATION

In my minute of 30 March on the Boiteux Commission Report, I said that we would let you have a more considered piece on the wider implications of proposals for direct and indirect tax approximation. This is attached. It has been discussed with Customs and Excise and the Inland Revenue.

2. Since my earlier minute the Commission have unveiled draft proposals to harmonise business taxation. The Inland Revenue are still studying these, and will let you have a detailed note in due course. But their preliminary view is set out in the attached paper.

3. The aim of the paper is to explore, in broad terms, what might be involved in going down the Commission's route. It is

for you and colleagues to decide how far these ramifications would be acceptable in the context of our policy on the single market. The paper tends to the conclusion that you will find the ramifications unacceptable; and discusses the implications for tactics both in Whitehall and Brussels.

CAROLYN SINCLAIR

THE SINGLE MARKET AND TAX APPROXIMATION

This paper looks at the broad issue of tax approximation, both direct and indirect, in the context of a single European market. It discusses the implications for the UK and other member states; and outlines possible tactics for dealing with Whitehall and Brussels respectively.

Background

2. Up till now the debate in the EC on tax approximation has focussed on Lord Cockfield's proposals to harmonise rates of VAT and excise duties. But the Commission have now come forward with proposals to harmonise the rules for determining the taxable profits of undertakings. This would affect our rules for income tax (sole traders and partners), capital gains tax and corporation tax. In addition, the French are arguing that complete liberalisation of capital markets should be accompanied by harmonised taxation of investment income.

3. The single European market aims to increase competition and improve economic efficiency. Among other things, this will involve opening up markets, such as capital markets, which in some member states have been protected from foreign competition. It also involves facilitating trade in goods within the EC by harmonising technical standards, and by removing or reducing as far as possible the costs imposed by border controls.

Indirect tax harmonisation

4. The pressure for tax approximation is two-fold in origin. Indirect taxes such as VAT and excise duties and stamp duties are in principle neutral in their effect on competition in a single market. Under the destination principle which applies in the EC, goods bear the same rate of VAT within a given country regardless of where they are produced. But different tax rates in different countries may encourage cross-border shopping. The

Commission argue that indirect tax approximation is a precondition for removing internal EC frontiers without all the problems of cross-border shopping that would otherwise arise.

Direct tax harmonisation

5. 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). Intellectually, a stronger argument can be mounted for harmonising these taxes on grounds of competitive neutrality than in the case of indirect taxes.

Implications for member states

6. The imposition of a partially harmonised structure of tax would have different effects on different member states. Those countries which found they had scope to increase their indirect taxes (the UK) would be able to reduce other taxes, such as income tax. On the other hand, countries obliged to reduce their indirect taxes (France) would find themselves forced to increase other taxes; and/or increase borrowing; and/or reduce public expenditure. Although indirect taxes, which do not distort competition would come closer together, other taxes which do distort competition, may well not.

7. This illustrates the random effect the Commission's proposals would have on different member states. Although arguments about sovereignty as such find little sympathy, we can expect other member states to be reluctant in practice to see important policy objectives frustrated as a consequence of tax approximation. The French are worried about this, and have made it clear that they are not prepared to harmonise VAT at the expense of increasing direct taxes on business and individuals. This suggests that while they do not challenge the need for centrally agreed approximation of VAT rates, they could only move towards this slowly if they are not to jeopardise their direct tax priorities.

Implications for UK

8. The UK is now a low tax country by EC standards (see Annex). If social security contributions are included, tax as a percentage of GNP is lower in the UK than in the other major EC countries.

9. In the unlikely event that the UK were to accept VAT harmonisation on the lines currently proposed by the Commission, there would be scope for reducing taxes elsewhere. But if there are simultaneous proposals to harmonise certain areas of direct taxation, room for manoeuvre would in practice be limited. Inevitably harmonisation proposals would tend towards a middle position in terms of prevailing tax rates and tax bases in the member states. Just as the rate bands proposed for VAT and excise duties have no particular economic logic about them, so proposals for tax harmonisation in other areas could be expected to reflect political feasibility rather than economic desirability.

10. All this poses difficulties for a country such as the UK which has in recent years put a good deal of effort into reforming its tax system. Even where tax harmonisation did not oblige us to increase rates of direct tax, proposals which would involve unpicking parts of carefully balanced reforms, such as the 1984 reform of corporation tax, would be unwelcome to say the least.

11. The Inland Revenue's preliminary assessment of the proposals to harmonise the business tax base suggests that these would require us to modify our business tax regime (certainly for companies and also for some unincorporated businesses) in the following ways:

a. a fundamental re-shaping of capital allowances to link tax relief directly to commercial depreciation (affecting both rates and scope, eg commercial buildings);

b. on capital gains, extending tax deferral on the sale of assets very much more widely than UK law currently allows. In some cases the proposed Directive could mean a significant change to the way gains are computed.

It would also require the UK to allow capital losses to be set against income. It is also far from clear whether indexation relief would be permissible;

c. More generous relief for provisions (eg for bad debts and sovereign debts); the relief would cover a wider range of items than now, and on more generous terms;

d. significant changes (mainly relaxations) in rules for deductibility of business expenses and valuation of trading stock - giving a reduced measure of taxable profits.

All this would involve radical changes to the present UK regime with, it would appear, very significant Exchequer costs.

12. French pressure to harmonise the taxation of investment income will not go away, although it has now been accepted by the French in ECOFIN that it is not a pre-condition for the complete liberalisation of capital movements. Such proposals make no sense unless they were to be adopted on world wide basis, which is probably non-negotiable. The UK, as a world financial centre, stands to lose more than other member states from the adoption of an EC withholding tax which would drive third country investment elsewhere.

UK position on tax approximation generally

13. The main question is whether any form of centrally agreed and imposed tax approximation is acceptable. There is no doubt that surrendering national freedom in this area would severely limit our ability to use a key tool of economic management. This issue goes much wider than retaining our ability to impose zero rates of VAT or high levels of excise duties on cigarettes and alcohol. In considering the Commission's proposals for indirect tax harmonisation the Chancellor has taken the view that the Commission's approach is not a realistic starter. A market-based approach, leaving member states free to determine rates of VAT and excise duties, would hold open the possibility of removing

tax-related controls in the longer term. This view was broadly endorsed by OD(E) last October.

14. Accepting the principle of centrally agreed tax approximation is likely to make a rational approach to tax reform in areas where tax is harmonised very difficult indeed. Even if the Commission base proposals for tax harmonisation on widely accepted economic principles (eg broad base, low rates, few/no special reliefs), the outcome of negotiations in Brussels is likely to be random, reflecting what can be accepted by 12 different countries.

15. Moreover, it is harder to argue against the need for harmonisation of taxes which distort international competition than it is to argue against the need for harmonisation of indirect taxes. So if the pass is sold on the latter, this could be the beginning of a very far-reaching process. There would be considerable risk that fiscal flexibility in individual countries would be progressively eroded, tending to complete loss of fiscal sovereignty in the long run. The UK would effectively be tied in to levels of public expenditure and borrowing in other countries - 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.

Tactics in Whitehall

16. Assuming it is thought essential to retain national control over the levers of tax policy, it would be helpful to get this clearly established in Whitehall as a background to consideration of proposals for harmonising areas of direct as well as indirect taxation. Clarity on the point would avoid the danger of being edged into a position where, as part of a political package, we gave up our freedom to determine rates and structures of tax in the future, because the Commission's proposals in a given area happened to allow us to retain our present rates and structures.

17. Other Departments in Whitehall are as yet barely aware of the implications of proposals for direct tax harmonisation; and

may be under the impression that these would pose fewer problems for the UK because of the absence of political commitments comparable to those on VAT zero rates (other than the 20p rate for income tax). Tax is a matter for the Chancellor. But it will be easier to get it accepted in Whitehall that centrally imposed tax approximation is unacceptable to the UK in any area if we can demonstrate that this is not incompatible with progress towards the single market, to which we are committed.

Tactics in Brussels

18. We are not likely to get far in the EC by declaring flat opposition to tax approximation on grounds of economic sovereignty. But proposals in this area will be immensely difficult for any member state required to change its existing system. There is plenty of scope for highlighting practical problems just in case anyone has failed to notice them. And we will want to remind other member states of the wider implications eg for direct tax if they give up freedom of manoeuvre on indirect taxes; and for the control of inflation etc. We could point out, in parallel, the attractions of allowing market forces to bring about the degree of tax approximation which is necessary to the successful functioning of a large single market.

19. One point to be considered is whether opposition to centrally imposed tax approximation is compatible with suggestions for minimum rates of duty within the EC. Logically it is not. This need not prevent us from arguing for minimum rates of excise duty as a tactical ploy where we can be confident that it will not be accepted by the other member states anyway. But we will need to develop such a line with care, lest it be turned to demonstrate that we are not opposed to centrally determined bands of tax rates.

20. However we play our hand, it must be recognised that the position outlined above could lead the UK into a position of total isolation in the Community. The danger of this needs to be balanced against the danger of losing economic sovereignty (paragraphs 12-14 above).

Conclusions

21. It is very difficult to predict the outcome. Certainly tax approximation in any area by 1992 looks most unlikely. In the longer run, however we should not underestimate the 'water on stone' effect of the Commission's unflinching attachment to centrally imposed solutions, especially when combined with the unwillingness of other member states to be seen to be "un-European".

22. But the immense difficulty of reaching agreement on tax approximation does hold out hope that over time it may be quietly accepted that the centrally agreed route is not feasible.

23. The UK's best course would seem to lie in resisting any commitment to accept central determination of tax rates and structures; ensuring that the difficulties of a centrally determined approach are fully understood; elaborating the case for a market solution to the problem of different tax rates in EC member states; and emphasising that tax harmonisation is not an end in itself.

TABLE

Taxes and Social Security as a percentage of GNP at factor cost, 1985

	Including social security contributions	Soc Sec	Excluding social security contributions	Indirect taxes (VAT only)		Excl Soc Sec
Denmark	61	2	59	23	(12)	11
France	53	23	30	18	(10)	8
Belgium	51	16	35	13	(8)	5
Netherlands	50	22	28	13	(8)	5
FRG	46	18	28	14	(7)	7
Italy	45	15	30	13	(7)	6
UK	44	8	36	18	(7)	11

Source: Economic Trends December 1987

iae3.ip/docs/Chx

CONFIDENTIAL

FROM: J MACAUSLAN
DATE: 5 May 1988

CHANCELLOR

cc: Mr Monck
Mr Burgner
Mr Wynn Owen o/r

EC MERGER CONTROL REGULATION

1. Jonathan Taylor's note of 3 May to me records that the Attorney General maintained at OD(E) on 28 April

a. that articles 85 and 86 could be used in advance of a merger and

b. that they could be used to allow a merger we had sought to block under UK legislation.

You asked for confirmation that these assertions were correct.

2. The Attorney's assertions seem to go beyond the views taken by DTI (and reflected in their paper and in our brief for you). The reason may be that the Attorney is uncertain how far the Court of Justice might push the interpretation of the Articles; he may be trying to identify the worst possible outcome, even if it is an unlikely one. (We would need to bear in mind that the provisions of a Regulation might be similarly stretched over time).

3. The Cabinet Office too were surprised at the assertions; Roger Lavelle will therefore write to the Law Officers Department to ask them to set out the reasoning behind the assertions; other Departments will then have an opportunity to discuss the issues.

4. We will let you know the outcome of this work.

5. Sutherland will be meeting Lord Young in late May to discuss Rover, and is keen to discover at the same time the UK position on the draft Regulation. The Cabinet Office intend to ask DTI to circulate a draft brief for that meeting for discussion between Departments. But it may be helpful for you to write to Lord Young to try to keep him on the straight and narrow. We will consider this further and may submit a draft.

J MACAUSLAN

Nh8/20Jo

UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 6 May 1988

MR MACAUSLAN

cc Mr Monck
Mr Burgner
Mr Wynn Owen

EC MERGER CONTROL REGULATION

The Chancellor was grateful for your minute of 5 May.

J M G TAYLOR

RESTRICTED

FROM: MISS C E C SINCLAIR
DATE: 6 May 1988

CHANCELLOR

cc Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr A Edwards
Mr Riley
Mr Michie
Mr Ford
Mr Cropper
Mr Tyrie

Mr McGivern - IR

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

THE SINGLE EUROPEAN MARKET: MEETING 9 MAY

You are having a meeting to discuss the tax aspects, both direct and indirect, of the Single European Market.

2. Papers for the meeting are:

Miss Sinclair's minute of 30 March: EC Fiscal Harmonisation: French Boiteux Commission Report.

Mr Jefferson Smith's minute of 15 April: Tax approximation etc.

Mr Jefferson Smith's minute of 29 April: Request for legal advice.

Mr Unwin's minute of 4 May: The Single European Market.

Miss Sinclair's minute of 5 May: The Single Market and Tax Approximation.

3. The attached annotated agenda falls into 2 parts: the general principle of centrally-determined tax approximation; and the tactics to be deployed in Brussels and Whitehall.

CAROLYN SINCLAIR

RESTRICTED

Substance

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

2. Is this a question which can be settled by legal advice; or is it essentially political?

3. What are the pros and cons of consulting the Law Officers?

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

5. Would acceptance of a degree of indirect tax approximation make it more difficult to oppose proposals for direct tax approximation?

6. 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?

2 candidates

Tactics - Brussels

7. Can we hope to secure any major allies - eg the French or Germans - if we oppose centrally determined tax approximation in principle?

8. 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?

get r shirt

9. 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?

10. 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 - not withstanding difficulties over drugs, terrorism etc - and presented our simplification alternative as a step on the way?

11. If a high profile results in isolation, what do we stand to lose?

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

13. Would it be tactically helpful to do so, given that even minima low enough to allow most member states to retain their present structures would oblige Germany and Italy to tax table wine?

Tactics - Whitehall

14. Proposals for direct tax approximation are now beginning to emerge. Should we take the initiative in putting an early paper to OD(E) - which will be looking at preparations for the Hanover Summit - setting out your position on direct and indirect tax approximation?

LAW OFFICERS' DEPARTMENT
ROYAL COUPTS OF JUSTICE
LONDON, WC2A 2LL

M.L. SAUNDERS
LEGAL SECRETARY

Roger Lavelle Esq
Cabinet Office
70 Whitehall
LONDON SW1A 2AS

20 May 1988

EC MERGER CONTROL REGULATION

The Attorney General has considered your letter to me of 10 May requesting further elaboration of his comments at the OD(E) meeting on 28 April.

The extent to which Articles 85 and 86 apply to mergers was of course explored by the Attorney General in his letter of 15 February 1988 to the Chancellor of the Exchequer. As to the extent of the Commission's powers under these Articles before a merger takes place, the Attorney's views are as follows:

The Commission may intervene by taking interim measures. The Attorney General noted in his letter that Regulation 17 is not suited to being used as an instrument of merger control. It provides the procedural basis for the application of Articles 85 and 86 by the Commission. But the time scales involved for formal rulings are too long and the Commission's ex post facto consideration of a merger puts the companies involved in the hazardous position of having the merger unscrambled or having heavy fines imposed on them.

However, whilst Regulation 17 does not expressly provide a power to take interim action, it was acknowledged by the ECJ in Camera Care v Commission [1980] ECR 119 that:

"The powers which the Commission holds under Article 3 of Regulation 17...includes the power to take interim measures which are indispensable for the effective exercise of its functions and, in particular, for ensuring the effectiveness of any decisions requiring undertakings to bring to an end infringments which it has found to exist."

It would appear the Commission has used these powers on three occasions, but none of these has involved a merger. The Commission has set out some of the principles which apply in the exercise of the power to take interim measures. These principles are set out in a statement given to the parties to the Camera Care action. Inter alia, "it must appear that there is a reasonably strong prima facie case that there has been a violation of the rules of competition set out in the Treaty..." In Ford v Commission [1984] ECR 1129 at 1168, the Advocate General said:

"It is .... of the essence of the power to grant interim relief that at least a prima facie case is shown to justify the exercise of the power. There must be a sufficient sub-stratum of fact, and a sufficiently clear case in law to justify the Order".

Although there has been no case involving a threatened infringement rather than actual infringement it is thought that if the Commission could show that the action proposed to be taken would, prima facie, infringe Article 85 or 86 and if all the other conditions for interim measures were satisfied, interim measures could be taken notwithstanding the fact that the action was only threatened.

The other conditions for interim measures emerged from the Camera Care case itself and from the Commission's statement. In Camera Care the Court said that it was essential that interim measures should be taken only in cases proved to be urgent in order to avoid a situation likely to cause serious and irreparable damage to the party seeking their adoption or a situation which is "intolerable for the public interest". In relation to a merger the requirement that the measures were needed to avoid serious and irreparable damage to the complainant is more difficult to satisfy than, for example, in relation to predatory pricing or refusal to supply. However, it might in some cases be argued that the difficulties and

delays involved in unscrambling a merger would give rise to serious and irreparable damage to a competitor.

It appears that there has been no case where interim action has been taken to avoid a situation which is "intolerable for the public interest". Elsewhere in its judgment in Camera Care the Court said that interim measures might be suitable "when the practice of certain undertakings in competition matters has the effect of injuring the interests of some Member States, causing damage to other undertakings or of unacceptably jeopardising the Community's competition policy". In its statement on interim measures the Commission indicated they would take into account all the circumstances and, as far as possible, balance all the interests involved. Measures which irrevocably altered the position of the enterprise and the subject of the interim measures would not be adopted. The Commission also said that in appropriate cases it would require the party requesting interim measures to provide a bond or guarantee to indemnify the person against whom interim measures are ordered.

The Commission's statement indicates that the Commission might take action on its own initiative and without formal complaint. However, the Commission will clearly find it easier to show urgent need to avoid serious damage if it has received a complaint.

In the Camera Care case the Court said that a person subject to interim measures should enjoy the benefit of the essential procedural safeguards of Regulation 17. It is thought that the person against whom the measures are to be taken must be informed of the Commission's objections and given a short time to provide a written response and that there must also be an oral hearing. The Advisory Committee must be consulted. In the AKZO case [1987] 1 CMLR 231, interim measures were not adopted until more than two months after the complainant had made a formal request for interim measures. Whilst the Commission could no doubt act faster if it chose, it is expected that the Commission would find it difficult to take interim measures against mergers on a routine basis.

It appears therefore that while the Commission has the formal powers to adopt interim measures it has yet to exercise such powers in the case of a merger and the mere threat of fines or other action is a sufficient weapon for the Commission to have no need to resort to its formal powers.

As to your question about the circumstances and grounds on which the Commission might be able to intervene to overrule a national decision on a merger proposal, the Attorney advises that the basic principle was stated in Walt Wilhelm v Bundeskartellamt [1969] ECR 1:

> "in principle the national cartel authorities may take proceedings also with regard to situations likely to be the subject of a decision by the Commission. However, if the ultimate general aim of the Treaty is to be respected, this parallel application of the national system can only be allowed insofar as it does not prejudice the uniform application throughout the Common Market of the community rules on cartels and of the full effect of the measures adopted in implementation of those rules.
>
> "national authorities may take action against an agreement in accordance with their national law, even when an examination of an agreement from the point of view of its compatibility with community law is pending before the Commission, subject however to the condition that the application of national law may not prejudice the full and uniform application of community law or the effects of measures taken or to be taken to implement it."

Apparently it was envisaged that national law might be more lenient than community law. Since the basis of the principle is that "the ultimate general aim of the Treaty is to be respected", an exemption granted by the Commission which was regarded as being essential to establishing the Common Market could be held to override a national prohibition. This would be a rare but theoretically possible case.

Exemption under Article 85(3) will not cure any and every defect in an agreement. An agreement might be void in domestic law for reasons apart from a competition law prohibition or may be prohibited on other grounds such as prudential controls or control of the media.

The position therefore appears to be that there is a possibility that the Commission could unblock a merger but the extent of this power is unclear. It also perhaps dubious for practical reasons whether the Commission would ever seek to use this power. Unless the matter were pursued purely to establish the principle, it is unlikely that a merger could proceed after the protracted delay which would inevitably occur between the time that national authority had blocked a merger and the proceedings before the Commission (and no doubt the ECJ) had been concluded.

Finally, it is possible that if the present proposed Merger Control Regulation were to fail, the Commission might propose an amendment to Regulation 17 so far as it applies to mergers. This could be adopted by qualified majority voting rather than unanimity. Such a regulation could set up a procedure enabling formal prior notification of mergers to which Articles 85 and 86 applied, and clearance or exemption (in the case of mergers subject to Article 85). It would enable the Commission to impose conditions on mergers where the merger proposal would otherwise contravene Article 86.

I am copying this letter to the recipients of yours.

Yours sincerely,

Michael Saunders.

MICHAEL SAUNDERS

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: T J PAINTER
DATE: 23 May 1988

FINANCIAL SECRETARY

EC HARMONISATION: DRAFT DIRECTIVE ON THE BUSINESS TAX BASE

1. The attached papers reflect the first attempt to take stock of the Commission's new initiative on direct tax harmonisation - their 'preliminary draft directive' for harmonising the direct tax base - and seek your approval for the line Mr McGivern and I suggest we should take first at a meeting of the 'Group of Six' heads of tax of administrations in the Hague on 7 and 8 June, and at a meeting of heads of tax administrations at the Commission on 14 June.

---

cc Chancellor of the Exchequer
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Geoffrey Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr Riley
Miss Sinclair
Mr Ford
Mr Cropper
Mr Tyrie
Mr Unwin (C/E)
Mr Jefferson Smith (C/E)

Chairman
Mr Isaac
Mr Painter
Mr Houghton
Mr McGivern
Mr Pitts
Mr Calder
Mr Cleave
Mr Johns
Mr Fitzpatrick
Mr Spence
Mr Cayley
Mr Shepherd
Mr Keith
Mr Elliott
Mr Weeden
Dr Keenay
Miss Brand
PS/IR

2. Mr McGivern's note describes the background. It looks as if the Commission have found a single new comprehensive approach to direct tax harmonisation (the long - threatened Cockfield White Paper) too difficult or, perhaps, tactically unpromising. The present draft directive focuses on the business tax base. The Commission can, and no doubt will, argue that is where member countries said the starting point should be, assuming there was a case for harmonisation at all, when the subject was last live in the early 1970's. But the introduction to the draft also seeks to put the earlier (1975) draft directive on CT structure and rates back on the table.

3. There is a touch of the Bourbon about the Commission's proposals, with its belated tackling of the tax base base issue and the revival of the rate and structure proposals. They take no account of the fact that since the early 1970's, and particularly in the last 4 to 5 years, the move, with the UK and US in the lead, has in any case been very much away from special incentives, and distortions, which were troubling them, and the extent to which, therefore, experience and market forces can already be said to be evening out major distortions in advance of 1992.

4. Strategy

The strategy I think is clear from the Chancellor's recent meeting: to tackle the issue of principle and refute the need for tax harmonisation. Market forces can be relied on to bring about any necessary degree of approximation of tax systems after 1992, so as to reduce or obviate differences which genuinely hinder competitiveness and the free movement of capital. The community must also look outwards as well as inwards. The clear movement in the external world especially the US, is towards broader - based tax regimes for business with lower tax rates. The UK has been in the forefront of this development with the elimination of all the major specific investment incentives, and a 17 point reduction in corporation tax rate (now the lowest in the present

Community except for Spain). Moreover, at first blush, the Commission's proposals on the tax base imply greater flexibility for businesses than does our system in the deductions allowable in arriving at profits, if only because of greater reliance on less than-uniform national accounting practice; and the 1975 proposals on corporation tax rates assume a permissible rate band which starts well above the United Kingdom's (and that of the United States). In short, even if the need for centrally-imposed harmonisation in this area had been established, the Commission's proposals appear to imply in the case of the UK a significant retreat from the broad based, low-rate structure which is of the essence of facilitating competitiveness including especially the competitiveness of member states in the outside world.

5. Tactics

As Mr McGivern's note records, we have little to go on at this stage as to the possible approach of other member states. The preliminary discussion at the informal group 6 meeting at the Hague (the UK, France, Germany and the Benelux countries) may give a first indication before the meeting of heads of tax administrations in Brussels the following week.

6. In such discussion as there has so far been in the Group of Six the Germans at official level have shown some academic, support, going so far as to suggest last year that officials of the Group should draw up their own proposals in view of the Commission's delay in producing what was then to be a comprehensive White Paper. (We declined the invitation, which was not pursued.)

7. I can only speculate about the French approach. But it would not be wholly surprising if their attitude were shaped by a combination of anxiety about the implications of possible VAT harmonisation for their revenue raising capacity, coupled with fears for their competitive position after 1992. In other words they may feel they cannot afford a relatively low corporation tax rate like the UK's and that they would quite like to tie the UK

and others into a relatively high rate business tax regime on a base which, prima facie, is more akin to their existing system than ours. They may, too, see long-term work on direct tax harmonisation as a diversionary tactic given their worries on the indirect tax front.

8. The main tactical issue seems to be the line we should take in these, very early, discussions on the question of (a) whether the preliminary draft should go to the Council of Ministers 'before the summer holidays' as the Commission propose and (b) the more general question of further detailed work.

9. On (a) it would be consistent with the strategic assumption outlined above to take the line that there is really nothing to go to the Council, certainly at this stage. The real issue is that there is no real case for harmonisation of this sort. The draft directive would first need to establish a case, instead it moves straight into very sketchy proposals for implementation which in any case leave more questions unanswered than answered.

10. A possible alternative would be for the UK not to take a high profile in opposing an early reference to the Council, provided we indicated clearly what we expected Ministers' fundamental objection to the proposal to be, on the footing that if other members wanted it to go there it would provide an early opportunity at political level to make the UK view clear.

11. This is clearly very much a political choice.

12. As to (b), the essential requirement is to avoid being drawn into discussion with other members and the Commission on the shape and detail of a possible harmonised régime even on a without-commitment basis. That would inevitably compromise the clarity of the UK's objection to the idea in principle, quite apart from tying up substantial resources on unproductive work. The same argument could be deployed against a joint expert study to establish whether there was a need for a Directive, though that would be a more difficult line to run because the UK would be

seen to be wholly negative even at this very early exploratory stage.

13. I suggest therefore that if, as we expect, the Commission or other Members propose further study by tax experts of the countries concerned, we take the line that that would not seem productive, given the objections in principle to across-the-board harmonisation by way of Directive. We could say that subject to our Ministers' views we would be happy to look, without commitment, at any specific features of the business tax regime within the Community where the Commission felt they could make out a case that distortions were serious, and where they argued that market forces could not, post 1992, be expected to achieve acceptable approximation. But as a fall-back we should be prepared to join in any broader study of the overall need for a Directive if other members supported it.

14. We must of course expect to meet pressure on specific issues of this kind from parts of the UK business sector in any case as 1992 approaches. One example where representations are already being made is in the general insurance field where the UK industry (and Lloyds) are claiming that they will increasingly be at a competitive disadvantage in part because of the more relaxed attitude of other member states towards provisioning.

15. We shall of course report back after the Group of Six meeting in the Hague. But there will be very little time between then and the Brussels meeting, and it would be helpful to know whether you are content with the broad line we are suggesting.

T J PAINTER

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

From: E McGIVERN
Date: 23 May 1988

1. MR PAINTER Note attached [illegible]

2. FINANCIAL SECRETARY

SINGLE MARKET: PROPOSED DRAFT DIRECTIVE ON HARMONISATION OF THE BUSINESS TAX BASE

1. The attached paper explains the detailed proposals in the Commission's "preliminary draft Directive" on the harmonisation of the business tax base and the changes which, as we understand the (in parts, unclear) proposals, would be necessary to the UK system if we were to comply with the Directive.

2. This covering note sets out what we believe are the Commission's intentions, summarises the major implications for the UK and seeks your agreement on the line we should take in forthcoming meetings with some of our European tax colleagues (on 7 June) and with the Commission on 14 June.

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr Riley
Mr Gilhooly
Mr Ford
Mr Cropper
Mr Tyrie
Mr Unwin (C/E)
Mr Jefferson Smith (C/E)

Chairman
Mr Isaac
Mr Painter
Mr Houghton
Mr McGivern
Mr Pitts
Mr Calder
Mr Cleave
Mr Johns
Mr Fitzpatrick
Mr Spence
Mr Cayley
Mr Shepherd
Mr Keith
Mr Elliott
Mr Weeden
Mr Keenay
Miss Brand
PS/IR

Background

3. As Mr Shepherd explained in his note of 21 April, the Commission's intention is that, subject to what emerges from a meeting of Heads of Tax Administrations in Brussels on 14 June, the draft will be forwarded to the Council "before the Summer holidays". In a "communication" (a covering note) the Commission will set the proposed draft in the context of other proposals in the direct tax area which have been around for some time (eg the draft Directives on cross-border mergers, the taxation of parent and subsidiary companies and a common system of relief for trading losses - see Annex). The Parliament will be invited - possibly in parallel with the discussions on harmonisation of the tax base - to resume its consideration of the 1975 draft Directive on harmonised CT rates and structures. The whole package of existing drafts and the proposed new one on the tax base, will constitute the Commission's policy for business direct taxation and will replace the long-threatened White Paper which has now been abandoned.

Purpose of the proposed Directive

4. This is how the Commission see it.

> "The objective of establishing the internal market cannot be fully realised unless a number of measures are taken considering company taxation. .... In the interests of tax neutrality, the closer alignment of firms' tax burdens is a necessary exercise that must be successfully carried through over the next few years.
>
> "The purpose of this proposal for a Directive is to harmonise the tax base .... Its adoption will not entirely resolve the problem of closer alignment of the tax burden, for which tax rates also need to be harmonised. However [it has] a two-fold objective. First

it will make for transparency of the systems of company taxation ... an indispensable first step towards harmonising tax rates. Second, by ensuring that the same rules apply throughout the Community, it will help create a more favourable tax environment which will not only be less complicated, but in which tax legislation will be placed on more stable foundations. In this way, it will be much easier for firms, especially small and medium sized ones, to set up in other member states.

"Once the proposal has been adopted, member states will no longer be able to introduce incentives by way of the tax base .... However, member states will be free [provided they comply with the EEC Treaty concerning state aids] to take such measures by employing other techniques such as grants, tax credits, etc."

Timing for implementation

5. Member states would be obliged to implement the necessary legislation to give effect to the Directive not later than three years after the end of that in which it is adopted. On any realistic assessment of likely progress on such a major and controversial measure, implementation - if it were ever to come about - is clearly many years off. Nevertheless, and notwithstanding the past track-record of delay and total failure to secure agreement on other tax Directives, the Commission can be expected to try to press forward with greater vigour than hitherto, relying upon other moves towards the single market as leverage.

Implications for UK Business Tax System

- General

6. Following the Commission's proposals for indirect tax approximation, a centrally imposed system of business direct

taxation would seriously limit the Chancellor's ability to determine fiscal policy. This loss of freedom would be a cause for serious concern even if the Commission's proposals did not require any changes to the UK's existing business tax system.

7. The extent to which the Chancellor's hands would be tied if he wished to make further significant changes in the business tax regime would depend on -

a. crucially, the width and starting point for the proposed band of CT rates;

b. how broad the Commissions' tax base turned out to be at the end of the inevitable bargaining process; and

c. whether member states would be free to broaden that base further by withdrawing special reliefs. But even if the rules did permit this, in practice it would be difficult to remove from UK businesses reliefs which their European competitors were getting in the harmonised base, particularly if the Commissions' rate band limited the scope for trading off CT rate reductions against the removals of tax relief. (It would be even more difficult to trade-off adjustments in reliefs and income tax rates for businesses in the unincorporated sector).

8. What is clear is that if the proposed Directive had been in force in 1984 together with the (now outdated and to be revised) 1975 proposed CT rates of between 45% and 55%, it would not have been possible for the Chancellor to achieve the 1984 reforms. Nor, we suspect, would it be possible in the future to align the target 20% basic rate of income tax with the main CT rate (if that was an option the Chancellor wanted to keep open) as our guess is that any new band of rates the Commission might propose is likely to start well above the 20% point, probably in the low thirties.

9. It is perhaps worth mentioning that, in principle the Commission's proposals move partly in the direction of the Chancellor's business tax reforms - by removing special reliefs and incentives and so broadening the tax base. But from where the United Kingdom now stands, the proposals would be a backwards step in the direction of a narrower tax base which would follow from the Commissions' proposals for bringing the measure of taxable profits closely into line with the profits shown in the commercial accounts. And if Ministers did ever want to move in the other direction, perhaps for some specific economic need of the moment, this would no longer be possible.

- The main proposals

10. A more detailed study of the proposed draft - see the attached note - confirms our preliminary assessment which was set out in Carolyn Sinclair's paper of 5 May for the Chancellor's meeting on 9 May. Although many areas need clarification, it is abundantly clear that - quite apart from the fundamental objection of principle to centrally imposed harmonisation - the United Kingdom would have to modify its business tax regime substantially (certainly for companies and also for some unincorporated business). PRT would not be subject to the Directive but it would affect ring fence CT. The main changes would be:

a. a fundamental re-shaping of capital allowances to link tax relief directly to commercial depreciation (affecting both rates and scope, eg extension of relief to commercial buildings and withdrawal of 100% first year allowances in Enterprise Zones);

b. on capital gains, extending tax deferral on the sale of assets very much more widely than UK law currently allows. In some cases the proposed Directive could mean a significant change to the way gains are computed. It would also require the UK to allow

capital losses to be set against income. It is also far from clear whether indexation relief would be permissible;

c. more generous relief for provisions (eg for bad debts, sovereign debts and abandonment/ decommissioning costs); the relief would cover a wider range of items than now, and on more generous terms;

d. significant changes (mainly relaxations) in the rules for deductibility of business expenses and the valuation of trading stock - giving in most cases a reduced measure of taxable profits. The rules could also weaken the North Sea ring fence provisions significantly.

11. All of this would involve radical changes in the present system. In particular it would mean unpicking the 1984 tax reforms. And unless these changes were to be made on a revenue-neutral basis - with the sectoral effects that that would imply - there would be very significant Exchequer costs (see paragraphs 12-19 below). In addition we believe that the greater reliance on commercial accounts - which do not in practice produce a fully harmonised base for commercial profits - would lead to much greater variability of taxable profits, depending on largely subjective factors. This may in one sense be simpler as the Commission suggests, but it must be questionable whether it would be, as they imply, a stable tax base, or even true harmonisation.

Exchequer costs

12. The draft draws heavily on the provisions of the Fourth Directive on company accounts and, as indicated, would bring the tax base very much closer to the commercial profits shown in the accounts. It is clear this would produce heavy costs

for the UK Exchequer. We can only guess at the scale of them. We do not have the database to handle the costs of the change. In any event, it is far from clear just what the Commission's proposals would mean in certain areas, in particular (but not only) for company capital gains and losses. And it could well be that some of the proposals might be dropped in the light of reactions from member states. So the costings which follow are highly speculative.

13. Subject to that major qualification, we have had a shot at putting figures on the possible costs at three broad levels.

14. First, the major changes where although there is still uncertainty, the possible effects on CT yield can be broadly foreseen and move in a consistent direction over a long period. The orders of magnitude here seem to be -

	£m	
Capital Allowances on commercial buildings	1500	
Changes in treatment of trading stocks	100	
Business expenses	100	
Trading losses	250	
Say	2000	cost

On a crude estimate, the main CT rate would need to be increased to 40% over time to make good that loss. The main gainers would be the financial and commercial sectors at the expense of manufacturing.

15. Second, there are areas of the Directive where the Commissions' proposals are in such general terms that we have little or no idea of what they would mean in practice. There could be very substantial costs involved here, particularly in the CGT field where, if our assessment is correct, extension of the deferral rules and relief for capital losses against income, could mean Exchequer costs well in excess of £m1000 per annum. On a revenue-neutral change, that would require a

further 2% increase in the CT rate, the main gainers would be property owning companies and the insurance sector, at the expense of the manufacturing sector.

16. Third, there are those changes which would involve major impact costs and a smaller (though significant) continuing cost. Provisions in company accounts are the main items affected here because:

a. specific provisions will apparently be tax deductible in full on the commercial accounts figures (eg bank sovereign debts, insurance company provisions and Lloyd's RIC);

in addition

b. there will apparently be a new relief for general reserves (expressed as a fixed percentage of claims etc which, on past experience, are unlikely to be recovered) - this will give a further layer of relief (on top of (a) to banks, insurance companies* Lloyds and commercial concerns;

plus

c. a new relief for provisions for future expenditure - this would benefit industry/commerce generally (and in particular would apparently give relief for North Sea abandonment costs and the de-commissioning costs of Nuclear Power stations).

17. The impact cost on provisions would come from banks, insurance companies etc, getting a once and for all benefit from the new, more generous, scale of relief for existing

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* We have tried to take account of insurance company provisions and reserves in this section. Such companies are excluded from the proposed draft Directive - as the EC accountancy treatment has not yet been agreed - but it seems a safe bet that, for them too, the end result will be increased tax relief.

provisions. The cost is highly uncertain, but likely to be large. We estimate that it would be at the upper end of the £1/2 billion to £1 billion range.

18. We estimate the ongoing cost of relief for provisions would be at least £100 million per year. (The one-off cost of relief for existing provisions represents a bringing-forward of relief. So it should produce a compensating yield in future years. But we think this would be more than counter-balanced by the cost of extra relief for new provisions).

19. Costs: Summary. As we emphasised, these cost estimates are highly speculative. The £3 billion extra cost figure - and the resulting 42% CT rate on a revenue-neutral basis - may be too high or too low by substantial margins. Our estimate of the impact cost of provisions (say £1 billion) may also be a long way out either way. But it is worth emphasising that we have not tried to take account of substantial behavioural changes. It seems probable that companies would react to the changes in the tax regime by altering their behaviour (accounting and/or commercial) to maximise the tax advantage of the new regime. So we feel that for long-term costs, the estimates we have given are more likely to be on the low side than the high side.

20. The scale of the potential Exchequer costs, and the uncertainty about the Commission's intentions, reinforce a thought which has come to us increasingly strongly as we have considered the Commission's proposals. This is that the proposals have not been properly considered by the Commission, let alone by the member states, and are nowhere near ready for submission to Parliament or the Council of Ministers.

Views of other EC members

21. We should be better placed to report on this after our meeting with our opposite numbers in the Group of Six (France, Germany, Netherlands, Belgium, Luxemburg) on 7/8 June.

22. We suspect from past discussions on existing draft Directives that, to put it no higher, no country will be enthusiastic about the Commission's proposals as a whole; and that some will have fairly strong reservations on certain major aspects. But our feeling is that, particularly as some EC countries have a tax base which more closely reflects commercial profits than the United Kingdom's, the proposals as a whole may present greater difficulty for the UK than for most other member States. Nevertheless, our preliminary assessment is that the Commission will face a very long and steep uphill struggle on these proposals, and that the UK may not be alone in opposing centrally imposed harmonisation. Lord Cockfield appears to have got nowhere in his attempts at the Presidency meeting on 10 May to persuade Chancellor Kohl to press for movement on a package of CT issues which have been stalled for some time as a result of German - Dutch (and we suspect others') disagreement. We believe this is the package of measures described in the Annex.

Views of UK industry

23. We have not yet seen any comments from representatives of UK industry on the proposed new Directive, but it is possible that they might support the idea of a harmonised base if it achieved a level playing field. Some businesses will object to the less generous rates of tax depreciation (implicit in adopting commercial rates for plant and machinery). But none of the bodies will want to commit itself until the position on the CT rates is clearer. A representative of the Institute of Chartered Accountants was reported in Accountancy Age as saying that "One has to be serious about it but it is difficult to be seriously inspired when there are so many anomalies".

24. The CBI have, however, told us that they fully support an initiative in March of this year, by the Union of Industrial Employers' Confederation of Europe in calling for the early adoption (if needs be on a piecemeal approach) of the three

existing draft Directives which the Commission have up to now been considering as a package (items 1 to 3 in the Annex).

Line to take

25. In the light of the discussion at the Chancellor's meeting of 9 May, the line we propose to take in discussion with the Commission (and which we would indicate in broad terms in the Group of Six) is as follows:

a. the UK cannot accept that successful operation of the single market requires the adoption of a centrally imposed harmonisation of the business tax system;

b. market forces will indicate what tax changes are necessary to secure a proper working of the single market. Market forces will reflect member Governments' economic policies as a whole and not just fiscal policies which, although important are only one factor in achieving a sound and successful business sector;

c. market forces will always push rates downwards if there are member states or important third country competitors with lower taxes. The Community would not benefit from a cumbrous uniform system of taxation, with adjustments constrained by the need for unanimity among twelve countries, while, for example, the US and Japan remain free to alter taxes subject only to their own domestic political constraints;

26. This would mean that we could, if Ministers wished, argue that the proposed draft Directive should not be referred to the Council of Ministers and the European Parliament at this stage. The main justification would be that the case for centrally imposed harmonisation has not been made out, but if we had to

we could reinforce this line with the argument that the draft Directive is, in any event, in no fit state to be considered by Ministers and the Parliament.

27. Alternatively, we could avoid taking the lead in opposing early submission and, while reserving the UK's position, let it go forward if other member states pressed strongly for this to happen.

28. As regards further detailed study of the proposed draft Directive, we could take the line that this seems unnecessary as there is no clearly established need for a Directive; but we could offer to consider a study of any particular aspects of member states' tax regimes which the Commission believe are distortionary and which are not likely to be modified or removed by the competitive pressures of the single market.

29. As a fall-back position, we could argue that before any detailed work is done on the Directive, the Commission need to show, on the basis of a detailed study why they consider a harmonised tax system is essential to the successful operation of the single market. Such a study would need to demonstrate that a centrally imposed system would achieve greater benefits than would arise from the operation of market forces. It would need to take into account not only the effects of changes in corporate taxes, but also the implications for other taxes and the possible constraints on economic management. If Ministers agree, we could offer to join in a broader study of this kind if other member states went along with the idea.

Consultations with industry

30. At some stage it may be necessary to consider how best to consult industry on such proposals as eventually emerge but, this can be pursued later.

31. Are Ministers content with the line we propose to take? In particular would you wish us to oppose the submission of the draft Directive to the Council at this stage? And if it should prove necessary, may we adopt the fall-back position in paragraph 29? We will of course report further on the views of other members of the Group of Six after the meeting on 7/8 June.

E McGIVERN

ANNEX

OTHER RELEVANT DIRECTIVES ON THE TABLE

Arbitration procedure for transfer pricing

1. A draft Directive, now in the form of a draft Convention, proposing an international arbitration procedure for disputes about the adjustment of transfer prices between connected businesses. The UK attitude is to ensure that whatever instrument is produced is workable, to avoid giving the Commission an unjustifiable competence in this matter and to be sure that the need for such a procedure is adequately examined. The draft has been on the table since 1976 and was last substantively discussed in May 1984.

Mergers

2. A draft Directive proposing a common system of taxing mergers has been on the table since 1969. The UK line has been to accept the broad outline of the proposals, but there are several major points of difficulty and more may emerge. The draft was last substantively discussed in July 1985 but several Member States still have considerable reservations.

Parents and Subsidiaries

3. A draft Directive proposing a common system of taxing parent and subsidiary companies has been on the table since 1969. The UK has so far taken the line that we could accept the proposal, but until recently it has been blocked by the Germans and the Dutch. Again, this draft was last discussed substantively in July 1985; the Commission wants to take it forward together with the Directives on arbitration and on mergers (see above).

4. The above three Directives were on the agenda for a meeting in March this year, held to take stock of the position of Greece, Spain and Portugal. There was very little substantive discussion except on the parents and subsidiaries Directive; the Germans were able to shift a little on this but Dutch objections were not overcome.

Trading losses

5. A draft Directive to harmonise the tax treatment of losses has been on the table since 1984. It would allow indefinite carry-forward and three-year carry back of losses (two years more than in the UK); and it would also allow losses carried forward or back to be set against income other than trading profits. This is incompatible with the UK scheduler system, and the Commission recognise this. (Other Member States also have difficulty with the proposals). It could also have substantial implications for the Exchequer (we guess that the cost might be in the region of £m250 per annum but this is a very tentative estimate). There has been no movement on the draft for the past four years.

EUROPEAN COMMISSION DRAFT PROPOSAL FOR A DIRECTIVE ON THE HARMONISATION OF RULES FOR DETERMINING THE TAXABLE PROFITS OF UNDERTAKINGS

SECTION 1: SCOPE OF THE DIRECTIVE

1. The scope of Article 1 is unclear. It appears to envisage that the provisions of the Directive would only apply to certain kinds of business. This would apparently mean that different sets of tax rules would apply eg to companies as opposed to the unincorporated sector, or perhaps to unincorporated firms trading only within their home country as opposed to those doing business abroad. This is clearly impractical.

SECTION II: DEPRECIATION: ARTICLES 2-12

Objectives

2. This group of articles contains the Commission's proposals for harmonising the rules for depreciation of business assets. Their general thrust is to -

a. Exclude investment incentives from tax depreciation systems.

b. Give tax relief on all depreciable fixed assets (which would include commercial buildings).

c. Link tax relief directly to commercial depreciation with costs systematically written off over the probable useful life of an asset.

d. Allow taxpayers the option of the straight line or reducing balance methods of write off for tangible assets such as buildings, plant and machinery.

3. The proposals do not deal with leasing because the Commission have concluded that differences in commercial

accounting treatment must first be settled at the Community level.

Investment Incentives

4. Following the 1984 business tax reforms, the surviving incentives are the 100% allowances in the year incurred for expenditure on the construction of industrial and commercial buildings in enterprise zones and for capital expenditure on scientific research. The EZ incentives would have to be withdrawn, with some Exchequer savings but declining after 1991. It is probable that the scientific research allowances would be covered by the Commission's proposal for "R & D" costs but we would have to confirm that our treatment of all oil expenditure as "R & D" could continue.

Other major implications

5. Other major implications stem from the Commission's determination to link commercial and tax depreciation and to base tax rules on the provisions of the Fourth Council Directive on Company Accounts which have been incorporated into national law here (Companies Act 1981) and in most other Member States. Company law requires the cost of a depreciable fixed asset to be written off systematically by depreciation over the period of its useful economic life. The main effects would be -

a. Linkage to commercial depreciation would require a fundamental reshaping of the capital allowance system. The simple approach of giving writing down allowances at 25% on all plant and machinery and at 4% on qualifying buildings would be replaced by relief at different rates based on rates of commercial depreciation.

b. There would be a considerable element of subjectivity and in the short term uncertainty over the Exchequer cost of tax relief because determination of the useful life of each asset and therefore the rate of write off for tax purposes

would depend on the judgement of a company's officers and advisers.

c. Relief would have to be given on commercial buildings and probably on residential property let by property companies.

6. An extension of relief to commercial buildings and rented residential property would be very expensive. If for example 4% writing down allowances were given on all new commercial buildings there would be a build up of cost - at present levels of expenditure - to around £300 million after 5 years, with a potential long term cost of £1.5 billion per annum. Up to one half of that long term cost could arise immediately if existing buildings were included.

Less fundamental issues

7. Other important aspects are -

a. For second hand buildings there appears to be no restriction of relief by reference to the original construction costs (so Exchequer costs would rise as property values increased).

b. The proposal that allowances should begin when an asset is supplied or its production completed would be less favourable than the UK rule (date expenditure incurred); and would be unwelcome to those industries, such as shipping and aircraft, which invest in long-lead assets where stage payments during course of construction are customary.

c. The option of the straight line or reducing balance methods of calculation for tangible assets is an unnecessary complication.

d. The application of the straight line method to intangible assets runs directly counter to the new framework of allowances introduced from 1 April 1986 for capital

expenditure on purchase of patent rights and acquisition of know-how.

e. Relief would have to be given for company formation expenses and for capital expenditure on purchasing goodwill and trademarks (formation expenses are "nothings" in UK system: constant pressure for relief).

f. The rules for calculating the base cost for depreciation allowances might not be compatible with the UK rules which prevent a loss of tax on oil company farm-outs.

8. Proposals on depreciation have been around since 1979. When last discussed officials of most Member States questioned the value of a draft directive which took little or no account of political and administrative realities. The present draft shows little change of substance and, on past experience, we would not expect it to command much support.

SECTION III: CAPITAL GAINS: ARTICLES 13-19

9. The general proposal in this section is:-

(i) indexation may be possible, but this is far from certain;

(ii) same rates for gains as for income;

(iii) sideways relief for capital losses;

(iv) rollover extended to all fixed assets;

(v) the possibility of an exit charge if assets are shifted abroad (and this would extend to stocks also);

(vi) no provision for transfers within a group.

Scope

10. Article 13 provides that the harmonised rules are to apply only to fixed assets of the business. These are not defined; presumably they would be defined under accountancy conventions and EC accounting Directives, which give a good deal of flexibility. Clearly there is a danger of distortions if there is one (European) set of rules for fixed assets and another (national) set for other assets. Also, the rules will not apply in abnormal situations - eg a winding-up, and this could make for distortions.

11. Article 14 sets the circumstances in which capital gains are to be charged. From our viewpoint, there are three particular things to note:-

(i) there are no provisions to enable assets to be transferred tax-free to another company in the group. This of course contrasts with UK law and would hamper group activity;

(ii) countries are allowed, if they wish, to impose a charge on assets moved abroad (see Articles 18 and 19);

(iii) there is no provision to enable a charge to be imposed on a company in respect of its chargeable assets when it moves its residence abroad, whether under domestic law or a double taxation convention. Such a charge is being introduced in this year's Finance Bill. In addition, in this context "capital gains" seem to include gains on depreciating assets, such as balancing charges which are imposed when a company ceases to be resident in the UK.

12. Article 15 sets out the rules for computing capital gains. Or to be more precise, it sets out rules for determining the disposal value - but leaves the determination of cost to national law. It is, though unclear whether indexation could continue.

13. Article 16 provides for tax on gains to be at the same rates as on income, with no preferential rates for long-term gains. It would thus rule out the regime for long-term gains in some other EC States. It also provides for capital losses to be available against general profits, and this would run counter to our rules and have a potentially high cost.

14. Article 17 allows rollover where there is reinvestment in other fixed assets. Because the concept of fixed assets is flexible and extensive (including at least some shares), this goes much wider than existing UK business rollover. Among other possible objections, it is doubtful whether this provision is compatible with the UK rules for preventing loss of tax on oil company farm-outs.

15. Under Article 18, where a country imposes an exit charge, it has to be spread in equal instalments over the estimated life of the asset. This would be an administrative nightmare - and unenforceable if the enterprise had no residual presence in the taxing country. And under Article 19, where an exit charge is imposed the country to which the asset is moved must exclude from its charge gains before the asset was transferred to it. Countries can make an exception for companies resident in their territory - but, if they do so, must prevent double taxation.

16. These rules do not cater for cases where an asset is transferred from EC Member State A via a third country to Member B. More generally, they would mean significant changes in UK law.

SECTION IV: PROVISIONS: ARTICLES 20-22

17. There could be extensive Exchequer costs in this area: mainly one-off costs, possibly towards the top of the £0.5bn-£1bn range. Like most of the costings, this is a very tentative figure. It is also a once for all additional cost of moving to a system of relief for commercial provisions. But with tax driven behavioural changes there could also be costs in the future, amounting to at least £100m per annum. These figures take

account of the proposed relief for general reserves (Article 31 - paragraph 34 below) as well as the terms of Articles 20-22.

18. The directive would - apparently - give relief for future commitments (eg future expenditure on repairs to buildings, aircraft etc) which get no tax relief at all at present. And the rules on provisions that can now qualify for relief (eg bad debts, including sovereign debts) would probably be so weak that the whole of the commercial provisions would be tax deductible. In all probability this would apply to insurance companies and Lloyds, as well as to banks and other businesses. The directive does not at present cover provisions by insurance companies (because the accounting directive is under review). But there seems little doubt that eventually the same (lax) tests would apply for insurance as for other provisions.

19. One important consequence is that we would apparently have to allow provisions in respect of oil companies' abandonments costs. Oil companies would then get CT relief for these costs during the life of the field instead of after the expenditure was incurred and there would be a considerable timing effect. Another (expensive) consequence would be that relief would be available for provisions for the decommissioning costs of nuclear power stations.

SECTION V - ARTICLES 23-25: STOCKS

20. This very technical section sets out a proposed regime for the tax treatment of trading stock. The main objections to this regime, as we understand it (considerable clarification of the Commission's intentions will be necessary), are -

- it would necessitate a much more detailed statutory code than we have, or need, at present in this area; and

- it would allow traders to value stock for tax on a more advantageous basis than happens at present, entailing significant Exchequer costs.

Stock valuation: general background

21. Under general accountancy principles, a trader must enter each year in his profit and loss account an opening and closing figure for his trading stock. If the closing stock figure is higher than the opening stock figure, the difference effectively increases his taxable profits. If it is lower the difference effectively reduces the profit.

22. It is therefore necessary for trading stock to be valued each year. Accountancy principle requires that it be valued, for prudential reasons, at the lower of historic cost or net realisable value.

Present UK tax treatment

23. UK tax law allows for considerable flexibility in this area, because we are generally content to follow accountancy principles as they apply to determine historic cost or net realisable value. There is no particular difficulty in arriving at net realisable value, where that gives a lower figure than cost. For historic cost, the accountancy profession have a set of guidelines.

Proposals in the directive

24. The directive appears to part company from our present arrangements by stipulating certain specific rules which would seem to mean that -

(a) in certain circumstances, to calculate historic cost, traders could use what is known as the "base stock" method or the "LIFO" (last in, first out) method. This would be undesirable because neither of these methods would result in a realistic valuation, because both mean that earlier (lower) costs rather than later (higher) costs are reflected in the "historic cost" figure; and a figure made up in that way is likely to be out of date. Neither method is at present approved by the UK accountancy profession. Both could result in

lower profits being returned and hence in some loss of tax. Moreover the LIFO method is particularly advantageous to a business when prices are rising and is, we understand, permitted in some countries as a

form of inflation adjustment for tax purposes (provided it is also adopted in the commercial accounts);

(b) A measure of current value of stocks different from that currently adopted for UK tax purposes would be used in determining whether that value had fallen below cost. That could result in our having to allow tax relief on a greater measure of anticipated loss on the stocks than we do under our present system.

(c) traders who had reduced their stock valuations to the current value basis would be able to retain that figure in their accounts even after the value had risen again. So they would enjoy the benefit of the earlier reduction in valuation, and the corresponding reduction in taxable profits, even though it was no longer justified.

Conclusion

25. All this means, as we see it, that

(a) there would be some scope for traders to value their stocks on a more tax advantageous basis than they can at present. The revenue effect of this would depend on the behaviour of taxpayers in the light of the new rules, but there could be an initial cost of £100m-£200m, reducing thereafter to a long-term cost of £100m per annum;

(b) quite a lot of legislation would have to be introduced - where there is none at present - to give these new rules statutory effect; and

(c) some of the proposed valuation methods are not acceptable for UK accountancy purposes and it is not immediately clear therefore what their status should be for tax purposes under the directive.

ARTICLE 26

26. This Article has provisions for stock in trade similar to those in Article 14 for fixed assets. Again, there appears to be no provision for a charge on a company's ceasing to be resident in the UK. There is a UK charge in these circumstances bringing in stock in trade at market value on migration.

SECTION VI: ARTICLES 27-29: DEDUCTIBLE CHARGES AND EXPENDITURE

27. These three articles propose a general rule, with two specific riders, for determining what expenditure is to be allowed as a deduction in calculating taxable profits. Expenditure is to be allowable "in so far as [it] contributes to the formation of taxable income". The two stated exceptions to this rule are -

- penalties and fines are not to be deductible at all

- Member States are to be allowed to make their own rules for "gratuitous acts and payments" (this apparently refers to donations to charities, arts or sports bodies).

Implications for UK

28. This set of proposals - which would reintroduce relief for entertainment expenses (see paragraphs 32-33) - represents a significant relaxation of the existing UK tax rules about deductibility of business expenditure. The basic rule at present is that expenditure, to be deductible, must be incurred "wholly and exclusively" for the purposes of the business; and there are a number of more specific provisions which both deny, and allow, deductions in special circumstances. The basic rule is as old as

the income tax itself and there is a considerable body of case law on the way it applies in particular circumstances.

29. The main points where the Commission's proposals would introduce relaxations are:

(i) The new basic test itself - contribution to the formation of taxable income - is much looser than the "wholly and exclusively" test. The explanatory notes to the main article make it clear that a Revenue authority should not be able to challenge a claim to deduct a particular item of expenditure, under the proposed general rule, on the grounds that it was "inexpedient", "unusual", or "excessive" in amount. So the Revenue would have to take the trader's word for it that he had made a bona fide commercial judgment in incurring all the expenditure. Under the "wholly and exclusively" rule, an Inspector can challenge a claim to deduct expenditure some of which he suspects may have been incurred for other than business reasons.

(ii) There would need to be apportionment of expenditure between business and private use, where the expenditure was incurred partly for business and partly for private purposes - this would arise mainly in the case of unincorporated businesses but there could also be problems with small closely controlled (e.g. "husband and wife") companies . Our "wholly and exclusively" rule means that, in strictness, where there is duality of purpose, none of the expenditure should qualify for a deduction. In practice, we do in fact apportion some types of expenditure, e.g. rent and rates where a trader uses his home partly for business, or petrol and other motoring expenses. But this treatment is concessionary and is confined to items where the business element is reasonably easily quantifiable. There would be tremendous scope for dispute and litigation, and correspondingly increased compliance

costs, if an apportionment had to be made in all cases where there was duality of purpose.

30. On the two more specific articles -

(i) Fines and penalties would not be deductible. The notes suggest that these expenses are "highly personal", though it is difficult to see how that can be so in the case of fines imposed on a company. Under our present rules some fines/penalties do rank for a deduction - e.g. libel awards against a newspaper.

(ii) The rules here (as expanded in the explanatory notes) seem to envisage that business gifts (and, presumably, business entertaining) would be deductible. But business entertaining and gifts are not allowable deductions under present UK law, and the current Finance Bill includes a proposal to extend this disallowance to the entertainment of foreign customers. If all entertainment expenses were made allowable, the cost would be some £m25 per annum.

31. The proposed rules on business expenses - as they apply to entertaining - give particular cause for concern. The basic proposition is that the trader's decision on the nature and amount of expenditure in the business should be accepted by the Inspector. This treatment is to apply "to so called luxury expenses (e.g. yachts, hunting trips, luxury cars) where deductibility should be refused only if they are incurred in a private capacity". Apart from the endless scope for argument about the private element, this rule would appear to open the way to the kind of abuses which led in 1965 to the withdrawal of tax relief for all entertaining expenditure apart from that on foreign customers. We would also have to give relief for some interest costs which at present do not qualify. This could open the way for abuse in some areas.

32. It should also be noted that an article in the depreciation section of the directive (Article 10) stipulates that "formation

expenses" may be set off against tax. These are expenses which we regard as being of a capital nature, and we give no relief for them. The costs of doing so could be considerable. Furthermore, once relief were given for one item of capital expenditure it would be difficult to hold the line there - for example, against allowing relief for the costs of raising new equity capital, a proposal which we have most recently costed at £m90 (but the recent fall in the stock market means that this figure should probably now be reduced to £m75).

SECTION VII: OTHER ASSETS: ARTICLES 30-31

33. The provisions in this section are extremely obscure. On the face of it they appear to provide that capital gains will normally be computed by reference to actual costs. But there is a special rule which would impose a revaluation where an asset falls in value, which on the face of it would enable Member States to deny all relief for capital losses - a nonsense and in conflict with the earlier capital gains section. The same rules would apply to financial assets held by banks and other financial trading companies. This may not be what the Commission intend, but it is what the draft as it stands appears to achieve. This section would need a great deal of clarification.

34. Article 31 would also apparently give income tax/CT relief for general reserves for bad debts and other claims. The present UK system gives no relief for general reserves: it is only available for specific provisions (an area where the Commission's proposals would be more generous than the current UK rules). The Commission's proposal would give relief on a "market" basis for reserves for claims etc which, on the basis of past experience, are unlikely to be recovered. This would give an extra layer of relief for provisions, on top of the (generous) rules in Articles 20-22. Banks, insurance companies and Lloyds would be substantial beneficiaries. The costs of this relief are included in the cost of relief for provisions (paragraph 17 above).

V33.09

FROM: J E MORTIMER
DATE: 23 May 1988

PAYMASTER GENERAL

cc Chancellor
Sir G Littler
Mr Lankester
Mr Edwards
Mr Bonney
Mr Mercer
Mr Evans
Mr Kaufmann
Mr Addison

NEW EC OWN RESOURCES DECISION

In his note to you of 29 April, Mr Edwards sought your views on two problems:

(i) the Italian problem, involving the proportions of the Community budget to be financed by VAT and GNP contributions;

(ii) the Spanish and Portuguese problem, involving the question of whether transitional relief to Spain and Portugal on their contributions to the UK abatement should be given by revenue side abatements or expenditure side refunds.

2. In response, you and the Chancellor agreed that we could accept a compromise on the Italian problem (the so-called "Ersboell formula" which would involve an increase in the proportion of the budget financed by VAT, but not by as much as the Italians would like) provided that it was agreed that the Spanish and Portuguese problem was solved by revenue side abatements and not expenditure side refunds.

3. The Italian and Spanish and Portuguese problems are likely to be discussed at the Foreign Affairs Council (FAC) tomorrow. Mr Edwards (possibly) and I will be in attendance. This note brings you up to date with recent developments and seeks confirmation of the line the Foreign Secretary should take. It also touches upon a third issue likely to be discussed, concerning the treatment in the five year expenditure forecast of the 600 mecu provision for set aside and income aids agreed at the Brussels European Council.

The Italian and Spanish and Portuguese Problems

4. At COREPER last Tuesday, the Presidency proposed a compromise on the Italian and Spanish and Portuguese problems. In 1988, the Commission proposal for dealing with the Italian problem (ie the approach which we and nearly all other member states believe is consistent with what was agreed at the Brussels European Council) would apply, and Spain and Portugal would be given transitional relief by expenditure side refunds. In 1989 and later years, however, the Ersboell solution to the Italian problem would apply, and Spain and Portugal would be given transitional relief by way of revenue side abatements.

5. The thinking behind the compromise was that, by postponing till 1989 the introduction of the Ersboell formula and revenue side relief for Spain and Portugal, the relatively large cost of the changes to France would be reduced.

6. On instructions from us, Sir David Hannay opposed this compromise. While it makes little difference to us when the Ersboell formula is introduced (since we suffer a financial "penalty" of some 25 mecu in whichever year the change takes place), we are concerned about the suggestion that we should make a concession in 1988 on the Spanish and Portuguese problem. There are three reasons for this:

(i) with expenditure-side refunds, our effective rate of compensation would be less, and this would cast doubt on the validity of the Prime Minister's claim immediately after the Brussel's European Council that the Fontainebleau mechanism had been retained "intact";

(ii) there is an important principle at stake: we believe the European Council conclusions make quite clear that relief should be given by revenue side abatement, and this agreement should be faithfully reflected in the implementing arrangements for all years;

(iii) a concession in 1988 would cost a significant amount - nearly half (10 mecu) of the total benefit (23 mecu) that would arise from giving relief on the revenue side from 1988 onwards.

7. The Presidency have now formally withdrawn their compromise proposal. But it is likely that a proposal on these or similar lines will again be proposed at the FAC next week. If so, and subject to your views, we would propose to advise the Foreign Secretary that, while we could accept some change in the timing of the introduction of the Ersboell proposal (or even agree to the introduction of the Ersboell formula for a period with a return to the Commission approach at a later date), we could not accept any concession on the Spanish and Portuguese problem for the reasons set out in the paragraph above.

8. We are conscious that a resolution of the two problems at the FAC next week is unlikely. The French will be unwilling to agree anything until they have a new government. Moreover, the failure by the Parliament to give an opinion on the draft Own Resources Decision at its May plenary means that final agreement by the Council on the ORD cannot now take place until the middle of June at the earliest. This lifts the pressure to find an early solution to the outstanding problems.

Set aside and income aids

9. The European Council agreed that, in 1992, there should be a ceiling of 600 mecu on expenditure for set aside (to withdraw agricultural land from production) and income aids (payments to compensate for reduced levels of CAP support). Moreover, it was agreed that 150 mecu of the set aside should count as agricultural guarantee expenditure, and the balance would be financed out of agricultural guidance.

10. We have now more or less got it agreed that the 150 mecu that falls on agricultural guarantee should be financed from within the agricultural guideline (though there is still aFrench reserve on the point). We have argued that the whole of the

remainder (ie 450 mecu) should fall within the agreed 13 becu provision for the structural funds. But this has not been agreed. Indeed, only the Dutch are on our side. Neither the French nor the Germans have offered support even though it would be in their financial interests to have the 450 mecu fall within the 13 becu since the effect of doing so would be to reduce the provision for other structural fund expenditure, to which they will both be net contributors.

11. Unfortunately, the text of the European Council conclusions is not clear on whether the 450 mecu should be included within the agreed 13 becu for the structural funds. Moreover, Ersboell has circulated a note summarising the discussion at the European Council which, he argues, supports the view that the 450 mecu was intended to be on top of the 13 becu. He has also drawn attention to a working paper which went to the European Council and which contains a table of figures indicating that that part of the provision for set aside and income aids which was not included in FEOGA guarantee should be regarded as additional expenditure.

12. Although these considerations are by no means decisive - eg since the text of the European Council conclusions sets a ceiling for the structural funds without qualification - we think that, in practice, there is virtually no chance of securing agreement for our preferred treatment of the 450 mecu. The better course, it seems to us, would be to make a tactical concession at the appropriate time with a view to agreeing if possible that 300 mecu (relating to income aids) should be on top of the 13 becu for the structural funds, while the 150 mecu of set aside not included within the agricultural guideline should fall within and not on top of the 13 becu.

Conclusion

13. We would be grateful to know whether you agree with the suggested line to take set out in paragraphs 7 and 12.

J E MORTIMER

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New King's Beam House
22 Upper Ground
London SE1 9PJ
Telephone: 01-620 1313

CONFIDENTIAL

FROM : THE CHAIRMAN
DATE : 23 May 1988

CHANCELLOR OF THE EXCHEQUER

cc Paymaster General
Economic Secretary
Sir Geoffrey Littler
Mr Byatt
Mr Scholar

THE SINGLE EUROPEAN MARKET

I attended the annual meeting of the informal "Club" of Heads of EC Customs Administrations in Lisbon at the end of last week. Much of our discussion was, of course, about 1992.

2. I think it is worth reporting briefly that I found the general approach among my colleagues much more realistic than hitherto. The discussion at your informal ECOFIN the previous weekend had clearly had a noticeable effect. Drawing on it, I took the line that the obvious impossibility of realising the Commission's pure "no frontiers" vision by the end of 1992 should not impede us from taking practical steps in the meantime to simplify procedures. Both my German and French colleagues strongly supported this - the former in a marked change from his previous position, and the latter for the first time endorsing a "pragmatic" approach.

Internal Distribution: Mr Jefferson Smith
Mr Nash
Mr Allen
Mr Knox

3. The Commission were unusually restrained. They did not seek to blow the whistle when alternative possibilities were discussed. They also seemed to accept the overriding importance of ensuring the Community's external frontiers are properly safeguarded before internal border controls of sensitive items (drugs, firearms etc) can significantly be relaxed.

4. All in all, I thought it was a much more encouraging background for development of our "alternative" step-by-step approach, which we can now exhibit further in the proposed EPC paper. There was, incidentally, little discussion of tax harmonisation; it seemed to be accepted round the table that, as made clear at Lubeck, the difficulties are so great that early progress is unlikely.

J B UNWIN

NH8/61Jo

UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 24 May 1988

MR UNWIN - C&E

cc PS/Paymaster General
PS/Economic Secretary
Sir Geoffrey Littler
Mr Byatt
Mr Scholar

Mr Jefferson Smith - C&E
Mr Nash - C&E
Mr Allan - C&E
Mr Knox - C&E

THE SINGLE EUROPEAN MARKET

The Chancellor was grateful for your minute of 23 May. He has commented: "Good".

J M G TAYLOR

42/2/DCG/4370/9

FROM: **J J HEYWOOD**
DATE: **25 May 1988**

PS/CHANCELLOR

CC/ FST reaches the same conclusions as you. (Do you want to bring on to these pps. for your meeting with Sir J Nickson?)

I agree -

25 26/5

cc PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Sir Geoffrey Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr Riley
Miss Sinclair
Mr Ford
Mr Cropper
Mr Tyrie
Mr Unwin - C/E
Mr Jefferson Smith - C/E
Mr Painter - IR
Mr McGivern - IR
PS/IR

EC HARMONISATION: DRAFT DIRECTIVE ON THE BUSINESS TAX BASE

The Financial Secretary has seen the minutes from Mr Painter and Mr McGivern of 23 May.

2. The Financial Secretary thinks that our line should be as in Mr Painter's paragraph 9. He believes that we should strongly resist an early reference to the Council.

3. The Financial Secretary also agrees with Mr Painter's paragraph 13 that we should take the line that a further study by tax experts would be wholly unproductive given that the principle of across-the-board harmonisation by way of Directive is unacceptable in principle.

J J HEYWOOD
Private Secretary

ps3/75T

RESTRICTED

FROM: J M G TAYLOR
DATE: 27 May 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr Riley
Miss Sinclair
Mr Ford
Mr Cropper
Mr Tyrie

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

Mr Painter - IR
Mr McGivern - IR
PS/IR

EC HARMONISATION: DRAFT DIRECTIVE ON THE BUSINESS TAX BASE

The Chancellor has seen your minute of 25 May. He agrees with the Financial Secretary's conclusions. (He has commented, however, that this will be very tricky: there will be many in the CBI who will support these (Commission) proposals.)

J M G TAYLOR

Mr Wyn Owen

RESTRICTED

060010
MDHOAN 6986

1 - Steve
2 - Nigel
3 - EZ.

RESTRICTED
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AND TO DESKBY 281200Z UKREP BRUSSELS
INFO IMMEDIATE OTHER EC POSTS

FROM RESIDENT CLERK: CHANCELLOR KOHL'S LETTER ON THE SINGLE MARKET

1. FOLLOWING IS TEXT OF PRIME MINISTER'S REPLY TO THE CHANCELLOR'S LETTER ON THE SINGLE MARKET.

2. BEGINS

THANK YOU FOR YOUR LETTER OF 20 MAY ABOUT YOUR PLANS FOR TACKLING SINGLE MARKET ISSUES IN THE REMAINDER OF THE GERMAN PRESIDENCY. I VERY MUCH WELCOME YOUR DETERMINATION TO REACH AGREEMENT ON A SIGNIFICANT PACKAGE OF MEASURES. AS YOU KNOW, WE AGREE WITH YOUR PRIORITIES. WE MUST BE ABLE TO SHOW AT THE EUROPEAN COUNCIL THAT PROGRESS TOWARDS COMPLETION OF THE SINGLE MARKET IS NOW IRREVERSIBLE: AGREEMENT BEFOREHAND ON SUCH MAJOR ITEMS AS LIBERALISATION OF CAPITAL MOVEMENTS, MUTUAL RECOGNITION OF DIPLOMAS, AND FULL LIBLERALISATION OF INTERNATIONAL ROAD HAULAGE WILL BE THE BEST WAY OF DEMONSTRATING THAT OUR CONCLUSIONS ARE NOT MERE RHETORIC.

I ALSO WELCOME YOUR INTENTION AT THE EUROPEAN COUNCIL TO SET PRIORITIES FOR FUTURE WORK ON THE SINGLE MARKET. THIS WILL MAINTAIN MOMENTUM AND GIVE DIRECTION TO THE COUNCIL'S WORK. I HOPE WE CAN HIGHLIGHT FIVE AREAS FOR PRIORITY ACTION:

- FINANCIAL SERVICES (FURTHER PROGRESS BEYOND THE EXPECTED AGREEMENTS ON CAPITAL MOVEMENTS AND NON-LIFE INSURANCE) SEMI COLON

- STANDARDS, TESTING AND CERTIFICATION SEMI COLON

- PUBLIC PROCUREMENT - INCLUDING THE QUESTION OF COMPLIANCE SEMI COLON

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- FURTHER LIBERALISATION OF SEA, LAND AND AIR TRANSPORT SEMI COLON

- TELECOMMUNICATIONS.

ALTHOUGH MUCH GROUNDWORK HAS BEEN DONE ON THESE KEY QUESTIONS, AND SOME SIGNIFICANT PROGRESS HAS BEEN MADE, A LOT REMAINS TO BE DONE, AND WE SHOULD AIM TO GIVE THIS WORK A REAL IMPETUS. YOU ALSO MENTIONED THE QUESTION OF MERGER CONTROL. THE UNITED KINGDOM POSITION ON THIS WILL BE DETERMINED IN THE LIGHT OF DETAILED NEGOTIATIONS, TO WHICH WE HAVE SAID THAT WE WILL CONTRIBUTE CONSTRUCTIVELY.

I AM SURE YOU WOULD AGREE THAT OUR MESSAGE FROM HANOVER MUST BE A PRACTICAL ONE, SHOWING THAT WE ARE GETTING ON WITH THE JOB OF CREATING A SINGLE MARKET BASED ON THE LIBERALISATION OF MARKETS, THE LIFTING OF BURDENS ON BUSINESS, AND NOT ON HARMONISATION FOR HARMONISATION'S SAKE. WE WILL DO EVERYTHING WE CAN TO HELP YOU REACH THESE OBJECTIVES OVER THE NEXT FEW WEEKS.
ENDS

3. PLEASE ARRANGE FOR MESSAGE TO BE DELIVERED ON 30 MAY. ORIGINAL FOLLOWS BY BAG.

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Translation

Letter dated 20 May 1988 from the Chancellor of the Federal Republi of Germany, Dr. Helmut Kohl, to the British Prime Minister, The Rt. Hon. Margaret Thatcher MP.

Dear Prime Minister, dear Margaret,

The completion of the internal market is one of the most important goals the European Community has set itself for the years ahead. Without this large-scale market Europe will not be able to develop its full economic and political potential. In the Single European Ac we therefore not only committed ourselves unanimously to this goal but also set ourselves an ambitious date: the year 1992.

We thus triggered off a dynamic process which has meanwhile led to considerable progress. But we all know that there is still a lot of work to be done. Our concern must be to achieve it in the allotted period of time. We must therefore not relax our efforts.

In its decisions of 11/12 February 1988 the European Council created the pre-requisites for us to concentrate on the completion of the internal market in the remaining period of the German Presidency. My Government informed the Commission and the Member States of its programme for the internal market before taking over the Presidency. We are determined to implement this programme as far as possible in the time available.

In some sectors we are facing decisions which are of special impertance for the completion of the internal market. In particular I would mention:

- the liberalisation of capital movements,
- the directives on the recognition of diplomas and on the right of residence, which are particularly important for Citizens' Europe,
- the regulation governing market access in the road haulage sector,
- the further opening of the public procurement markets, also in the building sector,
- the proposals on trade mark law and the convening of a governmental conference on the European Patent Convention,
- directives in the field of the law relating to companies.

Agreement should also be reached soon on vital elements of merger control.

I enclose a complete list of the proposals which could be adopted by the respective Councils by the end of June if all those concerned make the necessary efforts.

I am writing to you personally today to ask you to ensure that your Government contributes, through constructive cooperation and a willingness to compromise, towards achieving the goal we are all aiming for. I am addressing this appeal in similar letters to the Heads of State and Government of the other Member States and the President of the Commission.

It should be our common political concern to do everything in our power to ensure that the European Council can draw a positive interi balance of the progress made towards the internal market and at the same time agree on the next priorities up to the half-way stage at the end of 1989. We will thus make it clear to the entire European public that rapid progress is being made on the chosen path and that we are willing to adhere to the agreed timetable.

Yours,

Helmut