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FRAME ECONOMIC

INDIRECT TAX APPROXIMATION: VAT CLEARING SYSTEM  
MEETING OF FINANCIAL QUESTIONS GROUP ON 21/22 JANUARY 1988  
SUMMARY.

1. ALL MEMBER STATES EXPRESS CONSIDERABLE DOUBTS ABOUT OPERATION AND EFFECT OF MAJOR ELEMENTS OF THE VAT CLEARING SYSTEM. UK ABLE TO TUCK IN BEHIND THE CRITICISMS OF OTHER DELEGATIONS. COMMISSION ARGUES THAT NATIONAL VAT SYSTEMS WORK ADEQUATELY ON BASIS OF TRADERS' TAX RETURNS, SO NO REASON IN PRINCIPLE WHY CLEARING SYSTEM SHOULD NOT DO THE SAME. SEVERAL AREAS NOT DISCUSSED AND FURTHER MEETING LIKELY BEFORE REPORT IS PREPARED FOR COREPER.

DETAIL.

2. COMMISSION EXPLAINED THAT THE CLEARING SYSTEM (CS), WHICH IS DESIGNED TO ENSURE THAT TAX CHARGED ON GOODS AND SERVICES UNDER THE PROPOSED ORIGIN BASED SYSTEM ACRES TO THE MEMBER STATES WHERE THEY ARE CONSUMED, WAS AN ESSENTIAL ELEMENT OF THE FISCAL APPROXIMATION PACKAGE. WHICH ITSELF WAS DIRECTLY BASED ON THE REQUIREMENTS OF THE SINGLE EUROPEAN ACT TO CREATE AN INTERNAL MARKET WITHOUT INTERNAL BARRIERS. THE LATEST OUTLINE PROPOSALS (DOCUMENT 8202/87) TOOK ACCOUNT OF THE WORK DONE BY THE HIGH LEVEL GROUP IN 1986, AND IN PARTICULAR OF THE CRITICISMS MADE BY THE UK AT THAT TIME. EUROPEAN BUSINESS ASSOCIATIONS (COMPROS) HAD WELCOMED THE SYSTEM AS PART OF THE ABOLITION OF FISCAL FRONTIERS.

3. IN OPENING REMARKS, PORTUGAL, IRELAND AND GREECE REGRETTED THAT THE INTERNAL MARKET ASPECTS OF THE SEA SEEMED TO BE TAKING PRECEDENCE OVER OTHER EQUALLY IMPORTANT OBJECTIVES (PRESUMABLY A REFERENCE TO COHESION) WHILE DENMARK TRIED, UNSUCCESSFULLY, TO SCUPPER DISCUSSIONS BY GOING BACK OVER THE GROUND CONSIDERED BY THE HIGH LEVEL GROUP, AND SUGGESTING CONSIDERATION OF ALTERNATIVE APPROACHES E.G. THE ZERO RATE NOTIFICATION SYSTEM AND MORE COMPUTERISATION. THE NETHERLANDS WERE POSITIVELY INCLINED, BUT WERE WORRIED ABOUT POSSIBILITIES OF FRAUD AND FAILURE BY TRADERS TO GIVE RELIABLE INFORMATION ON TAX RETURNS. FRANCE PROFESSED TO BE KEEN ON FISCAL HARMONISATION BUT HAD DISCOVERED DIFFICULTIES IN THE CS

CAUSED BY THE TREATMENT OF EXEMPT TRADERS. EXCHANGE RATE FLUCTUATIONS, RELIABILITY OF INFORMATION AND FRAUD. SPAIN WAS WORRIED BY THE COMPLEXITIES OF THE SYSTEM AND PROBLEMS OF CONTROL WHILE ITALY FELT THAT MEMBER STATES' DIFFERING VAT ACCOUNTING REQUIREMENTS, E.G. PERIODICITY OF TAX RETURNS. COULD PRESENT PROBLEMS.

4. ALL DELEGATIONS AND THE COMMISSION ACCEPTED THE UK'S APPROACH THAT THE FEASIBILITY OF THE CS HAD TO BE JUDGED IN RELATION TO THE FOLLOWING CRITERIA:

- (I) THE RIGHT MONEY MUST ACCRUE TO THE RIGHT MEMBER STATE AT THE RIGHT TIME:
- (II) IT SHOULD BE FULLY AUDITABLE TO SATISFY TAX AUTHORITIES ACCOUNTABILITY TO NATIONAL PARLIAMENTS:
- (III) IT SHOULD BE ADMINISTRATIVELY PRACTICABLE (I.E. NOT IMPOSE UNACCEPTABLE BURDENS ON TAX ADMINISTRATIONS OR TRADERS):
- (IV) IT SHOULD GIVE A REASONABLE GUARANTEE THAT TAXES ARE NOT EVADED.

SCOPE OF THE CS.

5. THE COMMISSION CONFIRMED THAT INTRA COMMUNITY SUPPLIES OF SERVICES WOULD BE TAXED IN THE MEMBER STATE WHERE THE SUPPLIER WAS ESTABLISHED (THE SAME RULE AS FOR GOODS) BUT THAT THEY WERE STILL CONSIDERING HOW TO DEAL WITH TRANSPORT OF PERSONS WHEN THE JOURNEY PASSED THROUGH SEVERAL MEMBER STATES. IN PRINCIPLE TAX WOULD BE CHARGED IN THE MEMBER STATE OF DEPARTURE.

6. SUPPLIES BY EXEMPT TRADERS (E.G. BANKS INSURANCE COMPANIES AND PUBLIC AUTHORITIES) WOULD NOT ENTER INTO THE CS, BUT TAX ON SUPPLIES TO SUCH BODIES WOULD BE PAID OVER TO THE CENTRAL ACCOUNT, AND WOULD PRODUCE A SURPLUS IN IT (SINCE NO EQUIVALENT INPUT TAX WOULD HAVE BEEN DEDUCTED). MORE CONSIDERATION WAS NEEDED ABOUT HOW TO DISTRIBUTE THIS SURPLUS, BUT THE COMMISSION HAD IN MIND EITHER A DISTRIBUTION KEY OR FINDING THE RELATIVE IMPORTANCE OF THE EXEMPT SECTOR IN EACH MEMBER STATE ON THE BASIS OF MACRO ECONOMIC FIGURES. FRANCE SUGGESTED THAT IF THIS RESEARCH FAILED THEN EXEMPT TRADERS MIGHT HAVE TO MAKE TAX DECLARATIONS. UK AND BELGIUM OPPOSED THIS IDEA BECAUSE OF THE ADDITIONAL BURDEN IT WOULD PLACE ON TRADERS BUT LUXEMBOURG FELT IT WAS ESSENTIAL TO ENSURE THAT TAX ACCRUED TO THE MEMBER STATE OF CONSUMPTION BECAUSE THE FINANCIAL SECTOR WAS VERY IMPORTANT TO THE LUXEMBOURG ECONOMY WHERE A LOT OF INPUT TAX COULD NOT BE RECLAIMED.

7. A LONG DISCUSSION OF THE COMMISSION'S PROPOSAL TO EXCLUDE

RETAIL SALES FROM THE CS, BUT TO INCLUDE MAIL ORDER SALES, PRODUCED NO CLEAR CUT CONCLUSION. MOST MEMBER STATES ACCEPTED THAT SINCE TAX REVENUE SHOULD REACH THE MEMBER STATE OF CONSUMPTION IN PRINCIPLE EVEN TAX CHARGED BY RETAILERS TO PRIVATE INDIVIDUALS RESIDENT IN ANOTHER MEMBER STATE SHOULD FIGURE IN THE CS. BUT THIS WOULD INVOLVE RETAILERS IN THE ALMOST IMPOSSIBLE TASK OF DISTINGUISHING BETWEEN CUSTOMERS. MAIL ORDER SALES COULD EASILY ENTER THE SYSTEM BECAUSE THE DESTINATION OF SUPPLIES WAS READILY APPARENT. BUT MORE THOUGHT WAS NEEDED ABOUT THE DEFINITION AND TREATMENT OF RETAIL SALES (ESSENTIALLY TO INDIVIDUALS, BUT ALSO POSSIBLY TO PEOPLE ACTING ON BUSINESS).

8. BELGIUM FEARED A HUGE LOSS OF REVENUE IF SALES TO PRIVATE INDIVIDUALS WERE EXCLUDED AND A DIFFERENCE PERMITTED OF UP TO 6 PERCENTAGE POINTS IN THE VAT RATES BETWEEN MEMBER STATES. THEY SUGGESTED THAT RETAIL SALES SHOULD BE EXCLUDED FROM THE CS ONLY WHERE IT WAS DIFFICULT TO IDENTIFY THE PLACE OF RESIDENCE OF THE CUSTOMER. PORTUGAL, LUXEMBOURG THE NETHERLANDS AND TO A LESSER EXTENT, FRANCE HAD SOME SYMPATHY FOR THE BELGIAN POSITION, BUT THE GENERAL FEELING WAS THAT SALES TO PRIVATE INDIVIDUALS WOULD HAVE TO BE EXCLUDED FROM THE CS BECAUSE OF TECHNICAL PROBLEMS, BUT MORE REFLECTION WAS NEEDED. THE COMMISSION FELT THE PROBLEM WAS RELATIVELY SMALL, SINCE ABOUT 95 PERCENT OF ALL CROSS BORDER TRANSACTIONS WERE BETWEEN TRADERS.

#### CONTROL PROBLEMS AND FRAUD.

9. THE COMMISSION ARGUED THAT NO NEW TYPES OF FRAUD WOULD BE PRODUCED BY THE CS, ALTHOUGH EXISTING FRAUDS WOULD BECOME WORSE. EXTENDED MUTUAL ASSISTANCE PROVISIONS WOULD BE NEEDED TO COMBAT THIS. BUT THE SELF-POLICING NATURE OF THE VAT SYSTEM WOULD WORK EQUALLY WELL ON A COMMUNITY BASIS AS ON A NATIONAL BASIS. FRAUD WAS NOT THE RESULT OF THE CS, BUT THE RESULT OF ABOLISHING FISCAL FRONTIERS.

10. DELEGATIONS WERE NOT CONVINCED. IT WOULD BE MUCH MORE DIFFICULT TO DISCOVER FALSE INVOICES, INFLATED INPUT TAX CLAIMS, SUPPRESSED SALES ETC WHERE TRADERS IN DIFFERENT MEMBER STATES WERE INVOLVED. ALL DELEGATIONS DOUBTED WHETHER THE GLOBAL TOTALS OF OUTPUT TAX AND INPUT TAX RELATING TO TRANSACTIONS WITH OTHER MEMBER STATES (WHICH WOULD BE PROVIDED BY TRADERS ON THEIR TAX RETURNS) WOULD BE ADEQUATE TO IDENTIFY POTENTIAL FRAUDS AND TO SHOW WHERE THEY WERE TAKING PLACE. IT MIGHT BE NECESSARY TO ASK FOR FURTHER DOCUMENTS TO ACCOMPANY THE TAX RETURNS OR TO RELY ON STATISTICAL METHODS FOR IDENTIFYING PROBLEMS.

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11. LUXEMBOURG, FRANCE AND THE UK FELT THAT THE COSTS OF ANY NEW CONTROL MEASURES, AND THE BURDENS PLACED ON TRADERS AND TAX ADMINISTRATIONS. WOULD HAVE TO BE CAREFULLY EVALUATED. NO FINAL VIEW COULD BE TAKEN ON THE CS UNTIL IT WAS CLEAR HOW ALL THE ELEMENTS WOULD FUNCTION. AND WHETHER THE COST OF MAKING THE SYSTEM FUNCTION WAS WORTH IT. THE COMMISSION ARGUED THAT THE NET TRANSFER OF REVENUE INVOLVED WAS ONLY ABOUT 2 PERCENT OF THE TOTAL VAT REVENUE IN THE COMMUNITY, SO CONTROL AND FRAUD PROBLEMS SHOULD NOT BE EXAGGERATED. BUT DELEGATIONS POINTED OUT THAT THE GROSS AMOUNTS DECLARED FOR THE CS WOULD BE VERY SUBSTANTIAL. THE PRESIDENCY SUGGESTED THAT WORKING PARTY NO 1 SHOULD EXAMINE, AS A SEPARATE MATTER, WHAT STEPS COULD BE TAKEN TO COMBAT FRAUD. THE COMMISSION WAS NON-COMMITAL. BUT COMPLAINED THAT DELEGATIONS WERE SIMPLY AVOIDING GIVING THEIR VIEWS ON THE PRINCIPLES OF THE CS. UNLESS THE COMMISSION SAW THAT THE BROAD IDEA OF THE CS WAS ACCEPTABLE IT WAS NOT WORTH DOING LARGE AMOUNTS OF DETAILED WORK.

CASH FLOW EFFECTS.

12. UK, FRANCE, GREECE, IRELAND AND PORTUGAL ASKED FOR FURTHER STUDY OF THE ADVERSE EFFECTS ON THE REVENUE OF NET IMPORTING MEMBER STATES AS A RESULT OF THE CS. WOULD THERE BE COMPENSATION FOR LOSSES: WOULD PERIODS FOR SUBMITTING TAX RETURNS BE HARMONISED: WOULD REPAYMENTS BE MADE QUICKLY: WHAT WOULD HAPPEN IF THE CS ENDED UP IN DEFICIT? THE COMMISSION NOTED THESE CONCERNS AND SAID THEY WERE BEING STUDIED.

OTHER PROBLEMS.

13. THE COMMISSION WAS REFLECTING ON PROBLEMS WHICH COULD BE CAUSED BY FLUCTUATION OF EXCHANGE RATES. DENMARK FELT THAT THERE MIGHT BE DISTORTIONS IN FAVOUR OF IMPORTS FROM THIRD COUNTRIES AND GREECE WAS CONCERNED THAT THEIR BALANCE OF PAYMENTS WOULD BE ADVERSELY AFFECTED. WHO WOULD BE LIABLE FOR OWN RESOURCES PAYMENTS ON GOODS SUPPLIED TO AND CONSUMED IN ANOTHER MEMBER STATE? WHEN WOULD THERE BE A DISCUSSION OF THE AUDIT AND ACCOUNTING REQUIREMENTS TO BE PLACED ON TRADERS AND TAX ADMINISTRATIONS?

CONCLUSION.

14. THE PRESIDENCY SUMMARISED THE GENERALLY CRITICAL REACTION OF ALL DELEGATIONS. A REPORT SHOULD BE SENT TO COREPER BUT DELEGATIONS FELT THAT A FURTHER MEETING WOULD BE NECESSARY BEFORE ANY USEFUL REPORT COULD BE PREPARED.

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*pmf*

FROM: J M G TAYLOR

DATE: 5 February 1988

NOTE FOR THE RECORD

**MEETING WITH SCOTCH WHISKY ASSOCIATION: 14 DECEMBER 1987**

The Chancellor saw a delegation from the Scotch Whisky Association on 14 December, to hear the SWA's Budget representations. The Chancellor was accompanied by the Financial Secretary, the Economic Secretary, Mr R I G Allen, Mr Cropper, Mr Whitmore (Customs and Excise), and Mr Bolton (Inland Revenue). The Scotch Whisky Association Delegation comprised Col. Bewsher, Mr McPhail, Mr Connell, Mr Straker and Professor Mackay.

2. The discussion was on the basis of the SWA's letter of 4 November.

3. The SWA argued on familiar lines for:

- (i) relief from Corporation Tax, particularly by the introduction of a Statutory Maturation Allowance;
- (ii) lower excise duties, to overcome the "discrimination" against spirits.

4. The Chancellor noted that the Government could not discriminate between Whisky and other spirits. He did not accept that there was discrimination against spirits and in favour of beer and wine. As far as Corporation Tax was concerned, the effective rate of tax depended on the level of stocks compared to the amount of sales. A Statutory Maturation Allowance would be seen as a device for getting around the abolition of stock relief. He



undertook, however, to consider the SWA's representations carefully in forming his conclusions on the appropriate level of taxation in the next Budget.

A handwritten signature in black ink, appearing to be 'J M G TAYLOR'.

J M G TAYLOR

CONQUEROR





FROM: S P JUDGE  
DATE: 8 February 1988

PS/CHANCELLOR

cc PS/Chief Secretary  
Mr Anson  
Mr Lankester  
Mr Edwards  
Mr Turnbull  
Mr Gieve  
Mr Mercer  
Mr Mortimer  
Mr Bonney  
Mr Kaufmann  
Mr Evans  
Mr Addison  
Mr Westcott - UKREP (by fax)

*Ch. Content with this  
line?*

*25 8/2  
YJS*

**OWN RESOURCES AND THE 1988 BUDGET**

The Paymaster General had only a few minutes to look at Mr Mortimer's submission of today, between leaving the Overview and catching his train from Victoria.

2. He is in general content with the line proposed in Mr Mortimer's paragraph 1: he thinks Mr Addison should be as low-key as possible, and should specifically note the procedural point (paragraph 12) that further discussion in the Budget Committee and the Budget Council will be needed.

3. Given the time the Paymaster was able to spend on this, he would be most grateful if the Chancellor could look at this between now and 0845 tomorrow, when UKREP will telephone me.

S P JUDGE  
Private Secretary

A remarkably good document. PJ

16 FEB 1988

16/2

FROM: P J CROPPER  
DATE: 15 February 1988

ECONOMIC SECRETARY

PS/C&E  
Mr Scholar  
Mr Tyrie  
Mr Call

ZERO RATES ETC

Alan Reid, tax expert in the EDG secretariat sends me this, saying:

"Something like this is being published by Ben Patterson in his own name, about 29 February, but the 'Sunday Times' at least has a copy."

If you think other Ministers should see it, will your office do the circulation.

P J CROPPER

ES/ I doubt that other Ministers will want to plough through all this, but the Chancellor may want to be aware.

P 16/2

*VAT: THE ZERO RATE ISSUE*

*by BEN PATTERSON, European Parliament Member for Kent West*

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## VAT: THE ZERO RATE ISSUE

by BEN PATTERSON, European Parliament Member for Kent West

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The controversy in Britain over Lord Cockfield's plan to "approximate" the rates of VAT within the European Community has so far centred on a single issue: the future of the zero rate. The prospect of taxes on food, on books and on children's shoes and clothes has stirred up a political hornets' nest; and a number of fundamental questions need answering. Among these are:

- Is zero a valid VAT rate ?
- Would a tax on food be passed on to the consumer ?
- Does zero rating somehow give British industry an unfair price advantage ?
- Is rating children's clothes at zero the best way to help poor families ?
- And what has the whole matter to do with eliminating internal frontiers anyway (zero-rated buildings don't cross frontiers) ?

### WHAT IS VAT ?

Value Added Tax, irritatingly, is not a tax on value added. It is generally collected as if it were: traders in the chain from raw material supplier to final consumer pay a tax bill based on the difference between input and output prices.

But VAT is intended to be a tax on final consumption. Since each trader recovers the tax content of inputs and charges full VAT on outputs, the accumulating bill is passed down the chain to be paid by the end purchaser (see table 1).

This becomes quite clear in the context of international trade. Under the current system, goods are exported from one country to another VAT-free (i.e. at zero rate). The Exchequer of the exporting country receives no revenue, even though the value of the export has been "added" in that country. Imports are then taxed at the rate of the importing country; and the final consumer pays into the Exchequer of that country the whole tax bill.

The Commission's proposals for a VAT "clearing system" maintains VAT as a consumption tax. In this case, VAT would be paid on exports at the rate of the exporting country. But the revenue would still accrue to the Exchequer of the country where the goods were finally consumed.

As it happens, treating VAT as a real tax on value added would greatly simplify the abolition of tax frontiers within the Community. As goods moved between countries, each Exchequer would receive a slice of the tax revenue based on export price less import costs. There would be no need for any "clearing system" to re-allocate the revenue to the country of final destination.

The effect, however, would be a considerable transfer of resources to net exporting countries. Put bluntly, the German Finance Minister would gain some £25 billion a year, and the Benelux Ministers some £22 billion a year, at the expense of the Exchequers (and paid by the consumers) of the other eight Member States.

#### WHAT IS ZERO RATE ?

From the point of view of anyone involved in the VAT system, a rate of zero has to be treated in exactly the same way as a rate of 1% or 5% or 15%. A form has to be filled in. Tax paid on inputs is recovered.

This is quite distinct from exemption. Here, no VAT forms are filled in, and no input tax is recovered. As a result, the

**A simplified model of a VAT system  
(assuming a standard rate of 10%)**

Table 1: NORMAL

Sale Price	Tax	Less rebate of input tax	Net tax that stage
20	2	-	2
40	4	2	2
60	6	4	2
80	8	6	2
100	10	8	2
Paid by consumer (effective rate)			10

Table 2: FINAL STAGE EXEMPT

Sale Price	Tax	Less rebate of input tax	Net tax that stage
20	2	-	2
40	4	2	2
60	6	4	2
80	8	6	2
100	-	-	-
Paid by consumer (effective rate)			8

Table 3: ZERO RATED AT FINAL STAGE  
(assuming all inputs taxed)

Sale Price	Tax	Less rebate of input tax	Net tax that stage
20	2	-	2
40	4	2	2
60	6	4	2
80	8	6	2
100	0	8	-8
Paid by consumer (effective rate)			0

final consumer does pay some tax: i.e. the tax on the exempt traders' inputs, which is passed on (see table 2). Indeed, exemption can sometimes mean tax on tax (where, for example, there is an exempt stage in the middle of a chain).

In the case of zero rating, by contrast, all the tax paid at preceding stages in the chain is rebated (see table 3).

The purpose of zero rating is to ensure that the final price to the consumer is entirely free of tax, either shown on the invoice or concealed.

#### VAT ON FOOD: WHO WOULD PAY ?

Is it true, though, that the benefit of zero rating is passed on to the consumer ? Put another way: to what extent would an increase in tax - say, from zero to 4% - be passed on ?

Micro-economic theory predicts that a tax increase is passed on, or must be absorbed by the supplier, according to the elasticity of demand for the product at that price level.

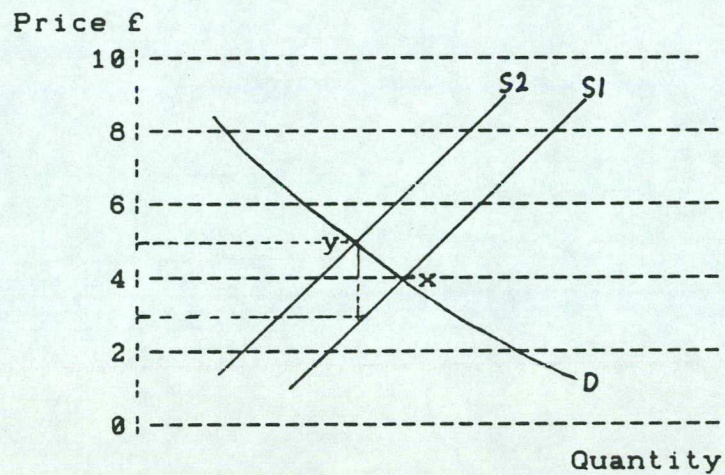
If demand is completely inelastic - that is, if people go on buying whatever the price - prices rise by the full amount of the tax. If demand is completely elastic - that is, if people stop buying altogether when the price goes up - prices do not rise at all. In between, prices rise by a proportion of tax.

What about food ? At first sight, this would seem to be a good example of perfectly inelastic demand. People have to eat. Moreover, demand for food consumed at home (zero rated) has not risen with incomes: in 1986 household food bills accounted for only 13.8 % of total consumer spending, compared to 18.4 % ten years earlier\*. By contrast, spending

---

\* *Household Food Consumption & Expenditure 1986 (Stationary Office f14)*

Table 4: The effect of a tax on prices



The market is in equilibrium at the intersection of supply curve  $S_1$  and the Demand curve  $D$  at point  $x$ , giving a price of £4. When a tax of £2 is imposed, the supply curve shifts vertically by the amount of the tax to  $S_2$ . But at a higher price, people buy less, and a new equilibrium is found at point  $y$ , giving a price of £5. A proportion of the tax (£1) is paid by the customer; the rest (£1) is absorbed by the supplier. It will be apparent that these proportions are determined by the slope of  $D$  between  $x$  and  $y$  (i.e. the elasticity of demand.)



on restaurant bills, which are subject to VAT, has kept pace with rising incomes!

Though demand for food in general may be inelastic, however, demand for particular food products can be very elastic indeed. In the short run at least, families tend to spend a fixed proportion of income on food. If one product rises in price, housewives quickly switch to a competing product "downmarket".

So, in the event of a tax being imposed on food, it is likely that the total spent on food would remain much the same. Higher-priced products (e.g. beef) would appear highly price-elastic, as purchasers switched to "downmarket" substitutes (e.g. pork or poultry).

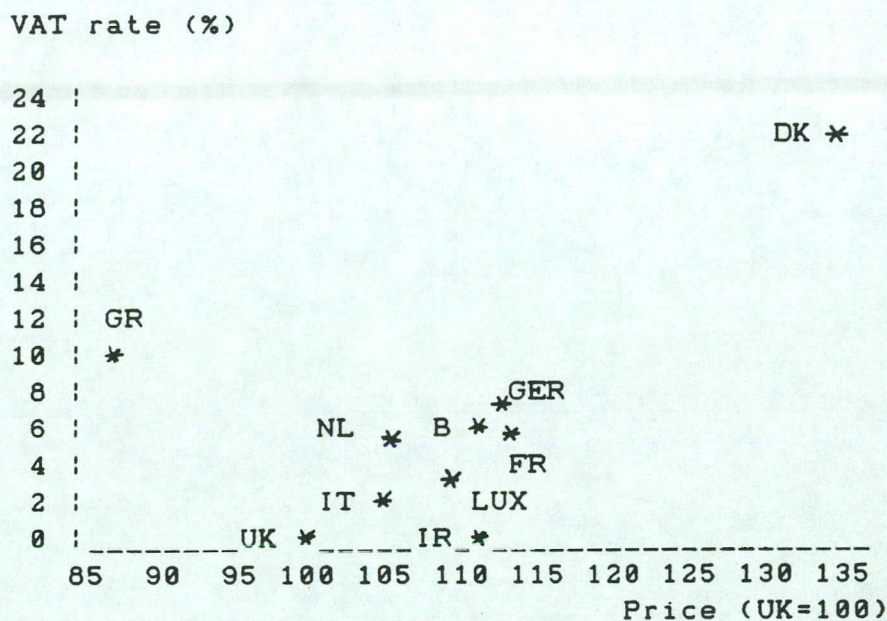
The matter is not, however, as simple as it seems. To begin with, micro-economic analysis of this kind depends on the assumption of perfectly competitive markets - reasonable in the case of most, but perhaps not all, food products. Where there is an element of monopoly, suppliers will be able to pass on a higher proportion of the tax to consumers.

There is also the long-term effect on supply: to the extent that profit-margins are eroded - i.e. to the extent that the tax is not passed on - marginal firms will go out of business, again shifting the supply curve.

Where does this leave the argument about zero rating? In the same way that a tax increase cannot usually be passed on completely, so a tax cut cannot all be retained by the supplier. The proportions depend on the elasticity of demand.

This theoretical analysis can be checked by empirical studies. If we look at food price levels in the twelve Community States, for example, there is a general positive correlation with the levels of VAT on food: the higher the VAT rate, the higher the price paid by the consumer (see Table 5).

Table 5: VAT rates and food prices (1985)



This relationship is not, however, true for all countries. Though a 10% VAT is imposed on food in Greece, prices are some 12% lower than in the UK. Ireland has a zero rate, but prices are at Belgian levels, where VAT is charged at 6%. Other factors here are more important than VAT differences.

Similarly, a survey of UK/Belgian/French price levels in 1986 by the Community consumers' organisation, BEUC, showed that for many individual products "differences in VAT cannot explain the actual price differences"\*.

It is logical to conclude that a large part of the benefits of zero VAT on food are indeed passed on to the consumer; but that some are not, and have the probable effect of keeping marginal suppliers in business.

---

\* "Consumers without Frontiers" (BEUC, Dec.1986)

### EEC VAT LAW

The current basic text on VAT within the European Community is the Sixth VAT Directive of 1977. Its introduction was linked to the financing of the EEC Budget from "own resources", one element of which was to include payments "obtained by applying a common rate of tax on a basis of assessment determined in a uniform manner according to Community rules". In 1986 "VAT own resources" accounted for 22.8 billion ECUs out of a 34.87 billion ECUs total revenue.

The main thrust of the 6th Directive was therefore towards harmonizing the taxable base: the same goods and services had to be inside or outside the VAT system in all Member States.

This link between VAT harmonization and "own resources" has, however, given rise to a number of misconceptions

To begin with, the "VAT element" of "own resources" is not based on the VAT actually collected in each Member State. Rather, each country's payments are calculated by applying a Community rate (upper limit currently 1.4%) to the harmonized VAT base, whatever the rate or rates actually existing in the country.

Moreover, the Community rate has been applied, not to each country's actual VAT base, but to a notional harmonized VAT base. The 6th Directive permitted a large number of derogations, with individual countries exempting transactions generally covered or taxing transactions generally exempt; and these variations have had to be allowed for in calculating payments. Even so, the system has been widely criticised for failing to take account of other variations between countries: notably the size of the "black", and therefore untaxed, economy. (Hence the "Delors" package currently under discussion which would relate national payments directly to GNP.)

As a result, and contrary to what has often been asserted, the existence of a zero rate in the UK and elsewhere has in no way affected the "own resources" paid by those countries.

Since zero-rated goods are within the VAT system, they have formed part, not merely of the notional, but of the actual VAT base.

How is it, then, that the UK's zero rate has been the subject of action in the Community Court ?

### THE TEMPORARY DEROGATION

To understand this, it is necessary to go back to the adoption by the Community of VAT as the principal common consumption tax. The national systems which preceded VAT were in some cases highly complex, often producing tax-on-tax and with various subsidising or penalising effects on trade.

The justification for bringing "into alignment" the national systems, according to the 2nd. VAT Directive of 1967, was therefore the need "to ensure neutrality of competition between Member States".

The general adoption of the VAT system made it possible, by the device of zero-rating exports and fully rating imports, to prevent different tax levels from directly distorting trade. Countries where the whole tax content of goods could be rebated on export (as is the case with VAT) had previously enjoyed a competitive advantage over countries where exports had a "hidden" tax content - as was the case, for example, with Purchase Tax in the UK.

The Second VAT Directive of 1967 also observed that "the system of value added tax makes it possible, where appropriate, for social and economic reasons, to effect reductions or increases in the tax burden on certain goods and services by means of a differentiation in rates.." Some Member States do indeed have "luxury" and/or "reduced" rates.

The Directive, however, went on to state that "the introduction of a zero rate gives rise to difficulties". What these might be were not specifically stated. But a clear

indication of the orthodox Community view is contained in the "Global Communication" on tax approximation of 1986.\*

"It should....be remembered that zero rating, by giving a price advantage to the products of one Member State, distorts competition within the Community; this is particularly true when applied to supplies which feed through into industrial and commercial costs".

However, a temporary derogation for zero rating was contained in Article 28 of the 6th Directive. This referred back to Article 17 of the 2nd which provides that "exemptions with refund" (i.e. the zero rate) can exist:

1. only "for clearly defined social reasons and for the benefit of the final consumer";
2. only until "the abolition of the imposition of tax on importation and the remission of tax on exportation in trade between Member States" ( which the Commission now proposes shall happen at the end of 1992); and
3. only "where the total incidence of such measures does not exceed that of reliefs applied under the present system" (i.e. no expansion of zero rating is permitted).

It is the first of these criteria which has resulted in the recent Commission actions against the UK. Specifically, some of our zeros have not been seen to be "for clearly defined social reasons" and "for the benefit of the final consumer - conditions which the Court's Advocate General Marco Darmon states are "not alternative but cumulative".

More fundamental, however, is the assumption underlying the Commission's case: that zero is not a proper tax rate at all, but a form of subsidy, the result of which is to give UK industry and commerce an unfair competitive advantage.

ZERO AS SUBSIDY

How might this come about ? Suppose, for example, we re-calculated Table 3, assuming that the first seller in the chain receives a tax rebate of 1.5 on inputs ?

Table 6: PRODUCT ZERO RATED AT FINAL STAGE

Sale Price	Tax	Less rebate	Net tax that stage
20	2	1.5	0.5
40	4	2	2
60	6	4	2
80	8	6	2
100	0	8	-8
Net tax:			- 1.5

Not only, it appears, has the consumer paid no tax. The revenue seems to have lost 1.5 !

Table 6 is an illusion. The "chain" of supply from first seller to final customer is likewise an illusion. Rather there is an endless web, with each supplier also a consumer. It is impossible, at any stage, to receive a rebate of VAT which has not already been paid at an earlier stage.

Nevertheless, both the 2nd VAT Directive and the more complete 6th Directive outlaw the zero rate in the long term. Any rate must be "high enough to permit in normal circumstances the deduction of tax paid at the preceding stage".

Three observations might be made.

1. The effect of the tax philosophy contained in the 2nd and 6th VAT Directives is that the consumer can never be entirely relieved of the tax which is passed on in the supply chain.

This, however, is a legitimate objective of tax policy.

2. The distinction drawn between exemption and a neutral rating (i.e., the lowest rate allowed under EC rules) is a narrow one (see tables 7 and 8, compared to tables 2 and 3).

**Exemption and neutral rating, calculated under EC rules**

Table 7: Exemption

Sale price	Tax	Less rebate	Net tax
20	2	-	2
40	4	2	2
60	6	4	2
80	8	6	2
100	-	-	-
Tax paid by consumer:			8

Table 8: Neutral rating

Sale price	Tax	Less rebate	Net tax
20	2	-	2
40	4	2	2
60	6	2	2
80	8	6	2
100	8	8	0
Tax paid by consumer:			8

3. This argument does not apply only to zero rating. Indeed, in the example above, it implies that any rate on the final product below 8% is not a "genuine" rate.

This is in fact what the 2nd Directive says: not only in the case of "exemptions with refund" (Article 17) but also in the case of reduced rates (Article 9) "the amount of value added tax resulting from the application of the rate shall normally permit the deduction of the whole of the value added tax which is deductible under Article 11".

There is nothing special, then, about zero - it is as good a number as any (as mathematicians will explain). The critical point is the view one takes about the full rebating of input taxes.

### ZERO AND INDUSTRIAL COSTS

In what ways might the Commission's arguments about industrial costs and competition be justified ?

First, at the most obvious level, zero rating might give "a price advantage to the products of one Member State" by taxing them directly at a lower rate. However, where a product is zero-rated, there is no difference of treatment between domestically-produced supplies and imports. The import will have already been exported at zero (i.e. all input taxes will have been recovered in the country of origin); and no VAT will be imposed in the country of consumption.

Secondly, some might enjoy a tax advantage on the input side because "supplies which feed through into industrial and commercial costs" are zero rated. At first sight, it might indeed seem that a company paying a zero tax on, say, its fuel bill enjoys an advantage over one whose fuel bill is taxed at a positive rate. But both firms are able to recover their input taxes. The different taxing of fuel should have no effect on the taxed, or exported price of the final product.

It is true, of course, that certain firms are outside the VAT system, either because their products are exempt or because they are too small. In these cases they will not be able to recover input taxes; and zero-rated inputs will give a competitive advantage.

It is also true that there can be cash-flow benefits to firms enjoying zero-rated inputs, since input tax can only be offset against tax due on sales. However, it is difficult to believe that these factors cause major distortions of competition within the Community.

Thirdly, then, we are left with much less direct possible effects of zero-rating. For example, it could certainly be argued that the zero-rating of food produces a lower general level of food prices (see table 5); and that this permits a



lower general level of wage-rates. "Industrial costs" are thereby lower, and products can be sold at an unfairly low price.

A number of possible answers exist to this argument. The Commission itself provides one in the very next sentence to the one already quoted from the "Global Communication": "It should also be remembered that, for any given yield of revenue, zero rating in one area must inevitably lead to a higher overall rate of tax elsewhere". The zero rate on food has to be paid for: for example by a higher standard VAT rate or higher direct taxes on personal incomes (in which case the lower wage-rate argument falls); or higher corporate taxes (in which case the competitive advantage argument falls).

However, the most important rejoinder is that the argument goes much wider than zero-rating - indeed, it goes so wide that the zero-rating issue is of relative unimportance. Industrial costs vary from Member State to Member State for a wide variety of reasons, including the entire system of taxation. Labour costs are directly affected by different levels and different systems of financing social security.

Indeed, it can be argued that very high rates of VAT currently represent a greater distortion of competition than the zero rate.

Denmark, for example, finances much of its ambitious social security system through general taxation, notably the almost blanket 22% VAT rate. But this tax is of course rebated on exports - an option not available to competitors whose social security systems are funded by employer and employee contributions.

Many differences like these affect relative competitiveness; and they raise fundamental questions about long-term Community policy. For example:

- Should it be the objective of Community policy to equalise entirely all conditions of competition ?

- If so, should countries with below-average tax or social costs be forced to raise them (which would make it much more difficult for the lesser-developed to catch up economically with the more developed); or should those with above-average costs cut them (thus lowering standards) ?

- Is the Community really ready for a uniform tax and social security system (there are doubts whether it is yet ready even for an "approximated" VAT system).

Two conclusions can perhaps be drawn:

**First**, in the light of such major questions, the Commission's opposition to zero-rating seems out of proportion to its importance in determining comparative costs.

**Secondly**, if ending zero-rating would marginally equalise competitive conditions, so would the introduction at Community level of a zero rate on certain key commodities. Indeed, this could well be regarded as "harmonization of social conditions in an upward direction".

### THE SOCIAL ISSUES

What are the social benefits (if any) of a zero rate ?

One of the advantages of taxing spending (indirect taxation) over taxing incomes (direct taxation) is that there are no disincentive effects. Another is the encouragement given to savings, and hence to investment. It is for these reasons that Conservative governments in the UK have broadly implemented a policy of shifting the emphasis from direct to indirect taxation over the years.

From several points of view, the best form of indirect taxation is a single flat rate on all transactions. The administrative problems of multiple rates (for example, the classification of goods and services) are avoided. There are no distorting effects on the economy as a whole.

Such a system, however, has one drawback - it is regressive. People clearly pay more tax the more they spend; but the proportion of spending going in tax is the same for rich and poor. Moreover, the rich tend to save more than the poor. The result is that tax takes a higher proportion of income from the poor than from the rich.

In the case of income taxes, this defect is corrected by the devices of higher rates on higher incomes (progressivity) and various allowance systems. These devices, however, also have drawbacks: notably the disincentive effects of high marginal rates and "poverty traps".

The regressivity of indirect taxes can be removed through the mechanism of "reduced" rates on certain basic commodities. The proportion of income spent on food by the less well-off is about double the UK national average. The zero-rating of most foods therefore reduces the regressivity of the VAT system, as does the zero-rating of gas and electricity. As a result, according to the Consumers in the European Community Group, the UK VAT system is "probably mildly progressive".

Strong though this case is, however, it should not be accepted without reservations. As we have seen, the benefits of zero rating are unlikely to be handed over in their entirety to the consumer. Indeed, one argument for the zero rating of food within the Community as a whole - and one which should be popular, given the pressures on the Community Budget - is that some of the benefits may be passed back up the chain to the farmer.

When we pass from commodities like basic foods and fuel, moreover, the "social" case for zero rating becomes much less persuasive. The relief from taxation of children's clothes, for example, was a principle carried over into the UK VAT system from the Purchase Tax which preceded it. In turn, this derived from a time when memories were strong of children going barefoot and in rags.

Today, however, it would be difficult to show that zero rating is an efficient and equitable method of helping poorer

families with their clothing bills. Children's clothes are not only bought by the poor - indeed, most children's clothes are bought by people well able to afford a 15% tax. The Institute of Fiscal Studies estimates that, in 1984, 63% of the benefit of zero rating and exemption in the UK went to households with above average incomes. In addition, as in the case of food, a proportion of the benefit is probably absorbed by suppliers.

Were children's clothes subject to VAT at 15%, nearly an extra £300 m. a year would have been raised in revenue during fiscal 1986/7. Had this been added to the £4,450 million spent on child benefits over the same period - a 6.75% increase - it is probable that poorer families would have been substantially better off.

Two arguments are usually deployed against this reasoning: first, that the payment of the extra VAT would be certain, while the raising - and constant updating - of child benefits would not; and second, that parents might spend the extra benefits on riotous living rather than on children's clothes.

This second, traditional argument in favour of benefits in "kind" rather than "cash" is surely outdated, besides being insultingly patronising. Even were it true in individual cases, local authority services exist to deal with them.

The first, however, is more serious. It must be concluded that if certain zero ratings are to be ended as a result of Community action, the Community must also consider how the social consequences are to be met.

#### SOME SPECIAL CASES

Zero rating UK covers about 25 - 30% of consumer spending in the UK. Apart from basic foods, gas and electricity, and children's shoes and clothes, it applies to: sewage, and water charged through the rating system; books, periodicals and newspapers; drugs, medicines and medical appliances;

passenger transport; charities; new construction (but not repairs); caravans and houseboats; international services; and, of course, gold and bank-notes.

It is interesting to compare this list with the goods and services which the Commission advocates should fall within its proposed lower VAT band of 4-9%. Food and energy are included, as are water supplies, pharmaceuticals, books, newspapers and periodicals and passenger transport.

In these cases, then, the question is not whether a "reduced rate" should be charged, but whether that rate can be zero.

In the case of charities the alternative proposed to zero rating is exemption, which would remove the ability of those organisations to recover their input taxes. Similar arguments exist in the case of certain services and of gold (see the proposed 18th and 19th VAT Directives).

This leaves children's shoes and clothes, construction and caravans and houseboats, which the Commission believes should be fully rated.

#### Children's shoes

Although these are usually linked with children's clothes in discussions of zero rating, there is a health argument as well as a social argument in the case of shoes. Badly-fitting footwear in childhood can cause lasting foot abnormalities; and zero rating might be considered a cost-effective way of avoiding later medical expenditure.

Putting a 15% VAT on children's shoes would raise some £40 million a year in the UK, which could of course be redistributed in child benefit. Whether countries with positive rates of VAT on children's shoes have worse records of foot abnormalities than the UK is a matter for investigation.

## Housing and construction

The pattern of VAT and other taxation on land, construction and buildings in the European Community is complex. Different rates can apply, for example, to the sale of land, the sale of buildings, construction, and construction products.

In the UK, construction is currently zero rated, as is building material used for structural work. Dealings in property are exempt. Repairs are taxed at 15%.

This is one of the areas in which the UK has faced legal action for breach of the 6 VAT Directive. It is the opinion of the Advocate General that the zero rating of housing is compatible with the Directive, but not building for commercial use.

Whatever the final decision of the Court, however, the issue will remain of how the industry is to be taxed after 1992.

Several points can usefully be made.

1. Buildings do not cross frontiers. There would therefore seem to be no reason why VAT rates should not vary widely between, say, zero in the UK and 22% in Denmark if the sole objective is the elimination of fiscal frontiers.
2. But building materials do. A wide discrepancy in tax rates could result in trade distortion across an "open" frontier.
3. Taxing building materials while at the same time zero rating buildings should present few problems, since builders can reclaim input taxes.
4. It would be extremely difficult to show that the zero rating of housing gave the UK any competitive advantage. Even the zero rating of commercial buildings - where the final user is likely to be registered for VAT - will scarcely affect competition, for the reasons given earlier in connection with commercial fuel bills.

### Books, periodicals and newspapers

This is one of the most controversial issues. Zero rates of VAT - not merely reduced rates - exist in this field in six Member States: half the Community. Books are zero rated in Ireland, Portugal and the UK; newspapers are zero rated in Belgium, Denmark, Italy, Portugal and the UK (but not Ireland, where the rate is 10%); and periodicals are zero rated in Portugal and the UK (but not in Ireland, where the rate is 25%). Belgium classifies a newspaper as a daily or weekly publication, Denmark as one appearing not less than once a month, Italy as a daily.

In the case of newspapers, there is a practical rather than philosophical justification for zero rating. Papers with a cover-price are in competition with "give-aways", which are financed entirely by advertising. Rather than attributing a complicated notional price to the "give-aways", zero rating of cover-prices is a simple solution.

In the case of books, enough has been written against the possibility of a "tax on knowledge" for the case in favour of zero rating to be well known. Arguments in favour of limiting zero rating to "serious" works - Jane Austen but not Mills and Boon, for example - come up against virtually insuperable problems of classification.

Finally, there are the periodicals, again giving rise to some problems of definition. They tend to be financed partly out of advertising (taxed) and partly through the cover price (zero rated). Broadly, the more "up market" the periodical, the greater is the importance of the cover price.

For the sake of simplicity, there is a good case for the UK solution of zero-rating all publications.

It might also be asked whether approximation of VAT is necessary at all in the case of the printed word. The Community is divided into language areas, and cross-border tax problems (between Belgium and France, for example, or the UK and Ireland) might be solved on a bilateral basis. The

dawning era of electronic publishing, however, may be changing all that.

But such considerations as this lead to the essential question: why should our VAT rates be changed at all ?

### THE CASE FOR APPROXIMATION

The Single European Act which came into force in 1987 committed all twelve Member States to making the Community "an area without internal frontiers". As the Commission emphasises in the Global Communication, this does not mean "a Europe with fewer or simpler frontier controls, but one with no such divisive frontier controls at all".

The Internal Market White Paper of 1985 had noted that one of the most important reasons for frontier controls between Member States was indirect taxation: VAT and Excise Duties. As long as goods were exported VAT-free, and as long as rates varied widely, it would be necessary to check goods crossing frontiers - even to levy taxes there.

This logic is incontrovertible. Even measures like the Postponed Accounting System proposed in the 14th VAT Directive, which would avoid the payment of VAT at frontiers by VAT-registered traders, would not avoid the need for checks on goods at frontier crossings. The scope for tax evasion, fraud and trade distortion would be too great.

To achieve the elimination of fiscal frontiers, the Commission is therefore proposing two major changes:

1. Exports from one Member State to another would no longer be zero rated. Tax would be paid in the country of purchase, and revenues credited to the appropriate Exchequer through a "clearing system" (see earlier).
2. To avoid "artificial" trade across frontiers, caused merely by tax differences, rates of VAT would be



"approximated" and Excise Duties fully harmonized. In the case of VAT this would mean all countries keeping the rate on any particular product within a 5-6% band - a spread which US experience with Sales Tax indicates is compatible with open frontiers. Two bands are proposed: "normal" (14-20%) and "reduced" (4-9%). Excise duties, however, would have to be identical to preserve the 5-6% spread, since VAT is charged on top of Excise.

The consequences of these proposals would be far-reaching - indeed would go to the very heart of national sovereignty. The finance ministries of Denmark and Ireland would be obliged to make massive cuts in indirect taxation; others, like Luxembourg, Spain and Portugal, would have to levy large increases.

In the UK, the overall revenue effect would be roughly neutral. But, once adopted, the Directives would put national indirect tax systems into a straight-jacket, which could only be adjusted thereafter by a unanimous decision of Council.

And yet...and yet....almost every body which has examined the issue - including the Council's own "high level group of fiscal experts", and the UK House of Lords - has concluded that the Commission is broadly right. If the tax frontiers really are to come down, the bullet of fiscal approximation has to be bitten on.

Of the alternatives, two have been popular:

1. The so-called "Irish solution" would avoid the agony of legislation. Instead, the national governments would simply abolish frontier controls at the end of 1992, and face - or plan for - the consequences.

The trouble with this solution is that it is politically incredible. The willingness of governments to open their frontiers "just like that" would be more convincing had they demonstrated a greater willingness in the past merely to increase travellers' allowances. The Commission is even now taking legal action against the two high-tax countries.

Denmark and Ireland, for trying to restrict further the rights of their citizens to buy in next-door countries!

The problem lies in the fact that the "Irish solution" puts no pressure at all on low-tax countries to increase rates. They would do well at the expense of high-tax neighbours. It would appeal to shoppers, but not to Finance Ministers. The solution would be meetings half way - which is exactly what the Commission is proposing in the first place.

2. The greater use of computers to simplify border controls and manage tax liabilities would certainly cut the cost of intra-Community trade considerably. Differences in tax rates could exist as at present. The main problems would be technical rather than legal: installing fully compatible systems throughout the Member States.

Indeed this is perhaps the best "second best" solution. Yet it has one major defect: only companies registered for VAT would fully benefit. Small companies and ordinary citizens would still face "customs" controls at frontiers - little would change after 1992. So much for a Citizen's Europe!

### THE CHOICE OF RATES

The Commission's proposals for the approximation of VAT involve finding solutions to three problems:

- a) the number of different VAT rates;
- b) the allocation of products to different rates; and
- c) the level of the rates themselves.

In theory, the Commission notes in its draft Directive (COM(87)321 final/2), "a single VAT rate system is the most simple". However, "since all the Member States (with the exception of Denmark and the United Kingdom) apply at least two VAT rates, a reduced rate and a standard rate, it would seem desirable not to upset the tax structure of the majority of Member States".

The calculations behind the choice of 4-9% for the reduced rate can be found in the Global Communication. The reduced rates in the Member States "currently vary from 1% to 10%", but "those with significant coverage vary from 4% to 10%".

Member States would be free to fix their reduced rate anywhere in this band. Nevertheless, the Commission also recommends, because of the inclusion in this rate band of "certain sensitive sectors", that "Member States fix their rate in the lower half of that band".

However, in its calculations, the Commission has ignored the existence of zero rates (hence the revealing remark about Denmark and the UK, both of which have a zero rate).

On the Commission's basis - ignoring Denmark and the UK, and taking Ireland's reduced rate to be 10% - the Community average reduced rate is 7%. However, if the UK's zero rate is included, the Community average is under 6.5%. If Ireland's reduced rate is taken to be 0, the average is only 5.5%. The average of the lowest rates (including zero) in each country is under 2% !

Table 9: Reduced VAT rates

	normal rate	reduced rate	lowest rate
Belgium	6		0
Denmark	-		0
Germany	7		7
Spain	6		0
France	7		4
Greece	6		3
Ireland	10		0
Italy	9		0
Luxembourg	6		3
Netherlands	6		6
Portugal	8		0
UK	(0)		0

## CONCLUSIONS AND SOLUTIONS

1. If a "barrier-free" Europe is really what we want, the Commission is right. Something along the lines of the Cockfield proposals is required.

2. It does not follow, however, that the Commission is right about zero rating, which is entirely compatible with the abolition of fiscal frontiers.

3. The principle of zero rating is open to criticism:

- not all the benefits necessarily accrue to consumers;

- a more efficient way of helping poorer families might be to levy tax and redistribute the income through benefits.

- replacing the zero rate with a positive rate would increase revenue, allowing a reduction in direct taxation or the standard VAT rate, or an increase in spending on health, etc.

4. Nevertheless, the complete relief from VAT of a product or a service is a legitimate objective of tax policy, particularly to reduce the system's regressivity.

5. It cannot be shown that zero rating, (or a rate lower than that needed to balance input tax rebates) distorts competition any more than other tax or social security differences, which it is not suggested should be changed.

6. In terms of potential distortions of trade, once frontier controls are removed in 1992, the difference between 0% and 5% is no better or worse than that between 5% and 10%.

7. Between 25 and 30 per cent of spending is zero-rated in

the UK, a much higher proportion than in any other Member State. On the other hand, a zero rate does exist on publications and other items (e.g. some cultural events) in six other countries; and the most important zero-rated items would be taxed at a "reduced" rate under Commission proposals.

8. The UK zero rate might be tackled in one of four ways:

a) By confining "fiscal approximation" to those goods and services which can cross frontiers.

This would mean that Member States would retain the freedom to fix any VAT rate they wished where the removal of frontier controls would be unlikely to create "artificial" trade. This would be a solution in the case, for example, of buildings and possibly in the cases of gas, water and transport.

b) By derogation.

The Global Communication specifically offers this way out, while noting that "the proliferation of derogations would present serious problems that could threaten the operation of the internal market". Derogations, the Commission adds, "always carry a cost - which ultimately is borne primarily by the Member State concerned....Derogations may well lead neighbouring Member States to insist on the maintenance of frontier controls directed specifically against the Member State concerned."

The Commission also points out, however, that derogations are least acceptable "where cross-border shopping is easy..."; and this is hardly the case for Britain (though it is for Ireland).

Derogation might therefore be the best solution, should we wish to preserve zero-rating on some items not featuring on the Commission's "reduced rate" list (e.g. children's shoes).

c) By amending the Commission proposal, so that the lower limit of the "reduced rate" band is zero.

The "centre of gravity" of the reduced rate band should, in any case, be lower than the Commission allows. Its calculations have not taken account either of the UK and Irish zero rates, or rates in other Member States below the normal reduced rate. This solution is perfectly compatible with the objective of abolishing fiscal frontiers.

It would mean that the UK could keep zero rating for food; gas and electricity; water; pharmaceuticals; books newspapers and periodicals; and passenger transport.

There is, however, one problem: the upper limit of the "reduced rate" band would have to be 5-6%, putting even greater revenue pressure on the high-tax countries. But these countries will possibly seek derogations, in any case, for the affected items. Starting the "reduced rate" at zero is also likely to commend itself to the European Parliament.

d) By creating a separate zero rate at Community level.

The "reduced rate" band would be left as it is, but the special zero rate would apply to items rated at zero or very low rates in a number of Member States. One obvious candidate for such a rate would be publications.

9. In the UK we must now consider carefully on which goods or services our zero rate can be objectively justified. We might then apply for derogations, or exclusion from approximation.

10. Better, however, would be to have the courage of our convictions. We should accept the case for approximation. And then we should launch a campaign to spread the benefits of our own system to the other 270 million Community citizens.



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Telephone: 01-620 1313

*Ch/Draft minute  
OK?*

FROM: P JEFFERSON SMITH  
DATE: 19 February 1988

- 1. Economic Secretary
- 2. Chancellor of the Exchequer

*mgw*

cc

**PS/Chancellor**  
 PS/Chief Secretary  
 PS/Paymaster General  
 PS/Financial Secretary  
 Mr Culpin  
 Miss Sinclair  
 Mr Michie  
 Mr Cropper  
 Parliamentary Clerk

*19/2*

*OK →*

**ECJ INFRACTION PROCEEDINGS: SPECTACLES AND OTHER GOODS SUPPLIED WITH MEDICAL CARE**

You asked for a draft minute for the Chancellor to send the Prime Minister about the impending publication of the European Court's decision in the infraction proceedings on spectacles and other goods supplied with medical care. This is attached.

You also decided that the holding statement to be made on publication of the judgment should be given by means of an arranged Parliamentary Question; this would then be publicised by press notice. A draft Question and Answer for your approval are attached. The Question would need to be put down on Monday (22 February) if it is to be answered on Tuesday, the day of the judgment. (The Answer and the press notice would not of course be released until we had received the text of the judgment and it was clear that it was adverse.)

*PJS*

P JEFFERSON SMITH

Internal distribution: CPS                      Ms Barrett  
    Mr Knox                                      Mr Monk  
    Mr Allen                                      Mr Geddes

BUDGET SECRET - TASK FORCE LIST

Q To ask Mr Chancellor of the Exchequer, if he will make a statement following the decision of the European Court of Justice in the proceedings taken against the United Kingdom over exemption from value added tax for spectacles and certain other goods supplied with medical care.

A The United Kingdom has a Treaty obligation to implement rulings from the European Court. The Government will abide by the Court's decision but we need to study the judgment in detail before we can make any firm decisions about how to proceed. Any amendment to United Kingdom law imposing taxation will have to be proposed to and approved by the House of Commons.



Prime Minister

EUROPEAN COURT OF JUSTICE: VALUE ADDED TAX ON SPECTACLES AND OTHER GOODS SUPPLIED WITH MEDICAL CARE

*I understand that, tiresomely,*  
~~You will wish to have forewarning that~~ on Tuesday (23 February) the European Court is to publish its judgment in the infraction proceedings taken against us by the EC Commission over our VAT exemption for spectacles and certain other goods supplied with medical care.

The Commission's case is that the relevant provision of the EC Sixth Directive on VAT (which was adopted in 1977 and lays down a harmonised system of exemptions from the tax) permits exemption only for the services of doctors and other medical professions; it does not extend to goods supplied in connection with their services. Our VAT reliefs for many goods supplied in connection with medical care, for example, drugs and medicines on prescription and artificial limbs, are in fact protected under other provisions of the Directive; the Commission's proceedings will in practice ~~bite~~ <sup>affect</sup> only ~~(on)~~ spectacles, contact lenses and privately purchased hearing aids.

*WE* On the basis of the Advocate General's opinion, which the Court normally follows, ~~we expect the Court's judgment to be adverse.~~ <sup>the</sup> ~~We~~ shall therefore be obliged to apply VAT at a positive rate to spectacles and the other goods concerned. <sup>is likely to go against us</sup> This should not mean that the price of spectacles would increase by ~~the full 15%~~ <sup>anything like</sup> of the standard rate of VAT, <sup>not 360-2400 but</sup> because ~~Opticians are at present exempt from VAT,~~ <sup>thus already</sup> and ~~suffer sticking tax on their purchases.~~ <sup>This means that</sup> prices should rise only by the amount of VAT on the retail margin. ~~The annual revenue~~

~~The yield would be about 725 million~~

would be about £25M. Arrears of 'own resources', to compensate for the fact that these goods have not in the past been included in the VAT 'own resources' base, will also have to be paid; this would cost around £20M altogether.

*As you may recall,*

An adverse judgment will be not unexpected. We fought the infraction proceedings through to the European Court not because we expected to win but to allow breathing space for the breaking of the optician's monopoly to bring down prices. *This has duly occurred;* We have been successful in this, ~~though in the event the judgment came unfortunately~~ *comes* at a time when the NHS is a subject of public concern. However, we have no option but to comply with the judgment, and my view is that if we are to have controversy over it, we had better get it over quickly.

*I propose that,*

*the Economic Secretary should answer*

As an immediate response, we intend to put out a holding statement, and Peter Lilley will answer an arranged PQ, *along the lines* This will say that "the UK has a Treaty obligation to implement rulings from the European Court. The Government will abide by the Court's decision but we need to study the judgment in detail before we can make any firm decisions about how to proceed. Any amendment to United Kingdom law imposing taxation will have to be proposed to and approved by the House of Commons". ~~I would then bring forward the necessary legislation, not in the Budget, but at the Committee Stage of the Finance Bill.~~

*However, in practice, I see no value in a*

~~holding statement~~ *on this*

*given the controversy this is likely to cause, it seems to me that it is better we get it over the course, would not take any decision in time for the Budget, but would bring forward the necessary clause in time for the Committee Stage of the Finance Bill.*

*But the proposed impositions of the tax now, with an annual yield of some £25 million, would come at a particularly awkward time, given the sensitivity over the NHS in general - eye-testing in particular. [I am copying this minute to John Moore]*

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INDIRECT TAX APPROXIMATION: MEETING OF THE ECONOMIC POLICY  
COMMITTEE ON 18/19 FEBRUARY 1988

SUMMARY

1. MOST DELEGATIONS PRESS FOR THE DRAFT REPORT TO ADDRESS THE BASIC QUESTION OF HOW FAR TAX APPROXIMATION WOULD CONTRIBUTE TO THE CREATION OF THE INTERNAL MARKET, AND TO INCLUDE QUANTIFICATION OF COSTS/BENEFITS OF THE COMMISSION'S PROPOSALS AND POSSIBLE ALTERNATIVES. CHAIRMAN'S SUMMARY FAILS TO REFLECT THE TENOR OF DISCUSSIONS, BUT AT LEAST RECOGNISES THE NEED FOR MORE COST/BENEFIT ANALYSIS. NEXT MEETING ON 16/17 MARCH TO AGREE FINAL REPORT FOR SUBMISSION TO APRIL ECOFIN COUNCIL.

DETAIL

2. THE EPC HAD BEFORE IT AN OUTLINE, PREPARED BY THE CHAIRMAN FOLLOWING CONTRIBUTIONS FROM SEVERAL MEMBER STATES, OF THE REPORT WHICH WOULD BE MADE TO THE ECOFIN COUNCIL IN APRIL, FOR SUBSEQUENT DISCUSSION AT THE INFORMAL ECOFIN COUNCIL IN MAY. THE CHAIRMAN (MOLITOR) REMINDED DELEGATIONS THAT THE PURPOSE OF THE REPORT WAS NOT TO RESOLVE TECHNICAL PROBLEMS, BUT TO GIVE THE COMMITTEE'S VIEWS MAINLY ON THE ECONOMIC AND SOCIAL ASPECTS OF THE COMMISSION'S TAX APPROXIMATION PROPOSALS.

3. DENMARK HELPFULLY GOT THE DEBATE STARTED ON THE RIGHT NOTE BY SUGGESTING THE REPORT SHOULD ANALYSE MORE FULLY WHAT ROLE TAX APPROXIMATION COULD PLAY IN REDUCING BARRIERS WHICH DISTORTED COMPETITION AND IN REDUCING COSTS OF TRADE IN THE COMMUNITY. IN THEIR VIEW THE CURRENT VAT SYSTEM DID NOT DISTORT COMPETITION. MORE STUDY WAS NEEDED OF THE COSTS OF CROSSING FRONTIERS TO IDENTIFY THOSE WHICH MIGHT BE DUE TO DIFFERENCES IN TAX RATES AND HOW THEY COULD BE REDUCED. THE COSTS OF THE COMMISSION'S PROPOSALS NEEDED QUANTIFYING. CLEAR DISADVANTAGES WERE THAT FISCAL FLEXIBILITY WOULD BE REDUCED, AND PLACING MORE RELIANCE ON DIRECT TAXES WOULD RUN COUNTER TO THE GENERAL THRUST OF TAX POLICIES IN THE COMMUNITY. IN ESSENCE THREE QUESTIONS NEEDED TO BE ANSWERED:

- (I) WHAT IS THE OBJECTIVE TO BE ATTAINED:  
(II) WHAT ARE THE MECHANISMS TO ACHIEVE THIS OBJECTIVE:  
(III) WHAT ARE THE COSTS/BENEFITS OF THE AVAILABLE APPROACHES.

4. THESE COMMENTS FOUND ECHOES IN THE CONTRIBUTIONS OF ALMOST ALL OTHER DELEGATIONS. ALL AGREED THAT THE OBJECTIVE WAS TO COMPLETE THE INTERNAL MARKET. THE REPORT SHOULD ANALYSE THE LINKS BETWEEN THIS AND TAX APPROXIMATION. HARMONISATION WAS NOT AN END IN ITSELF, AND MORE QUANTIFICATION WAS REQUIRED BEFORE A BALANCED JUDGEMENT COULD BE MADE IN ECONOMIC TERMS OF ANY PROPOSED CHANGES. THE AMERICAN EXPERIENCE HAD SHOWN THAT COMPLETE HARMONISATION OF TAXES WAS NOT NECESSARY FOR THE CREATION OF A BARRIER-FREE MARKET. MANY PRACTICAL STEPS COULD BE TAKEN TO REDUCE BORDER COSTS.

5. FRANCE FELT THE COMMISSION'S PROPOSALS REPRESENTED A GOOD FINAL ARRIVAL POINT, BUT THE ROAD TO IT WOULD BE VERY DIFFICULT AND IT WOULD TAKE LONGER THAN THE END OF 1992 TO ACHIEVE. IF THE DESTINATION SYSTEM OF VAT WERE NOT RETAINED, THEN WITH A 6 PERCENTAGE POINT STANDARD RATE BAND THERE WOULD BE DISTORTION OF THE CHOICE OF LOCATION OF FACTORS OF PRODUCTION. TAX APPROXIMATION COULD NOT BE REGARDED AS A PRE-CONDITION OF COMPLETING THE INTERNAL MARKET.

6. GREECE AND IRELAND PREDICTABLY STRESSED THE NEED FOR MORE REGIONAL SUPPORT AND 'COHESION' IN COMPENSATION FOR BUDGETARY LOSSES ETC. BELGIUM FELT THAT TAX APPROXIMATION WAS A NECESSARY CONDITION FOR THE ESTABLISHMENT OF THE INTERNAL MARKET, EVEN IF IT WAS NOT A SUFFICIENT CONDITION. IN THEIR VIEW THE BENELUX EXAMPLE SHOWED THAT HARMONISATION 'FROM BELOW' COULD NOT ACHIEVE THE ELIMINATION OF FISCAL BARRIERS, AND THAT IT HAD TO BE COMBINED WITH A CERTAIN AMOUNT OF HARMONISATION 'FROM ABOVE'.

7. SEVERAL DELEGATIONS MENTIONED THE NEED FOR HARMONISATION OF SOME DIRECT TAX PROVISIONS. THERE WAS NO CLEAR VIEW ABOUT EXCISE DUTIES, OR ABOUT THE OUTLINE REPORT'S RANKING IN ORDER OF IMPORTANCE OF (I) MINERAL OIL: (II) TOBACCO AND ALCOHOL: AND (III) OTHER EXCISES. GERMANY CONSIDERED THAT TAX APPROXIMATION WAS A LONG-TERM OBJECTIVE, AND THAT SETTING TAX RATES IN ECU AND PROVIDING FOR INDEXATION WAS UNACCEPTABLE: REALIGNMENT OF CURRENCIES WOULD HAVE AN EFFECT ON TAX RATES.

8. THE COMMISSION (DG II) CONFIRMED THAT THE STUDY ON THE COSTS OF NON-EUROPE HAD BEEN COMPLETED, BUT WOULD NOT BE AVAILABLE UNTIL

RESTRICTED

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MDHIAN 8406

IT HAD BEEN EXAMINED AT THE HIGHEST LEVELS IN THE COMMISSION. A DOCUMENT WAS CIRCULATED (BY HAND OF BYATT, HM TREASURY) LISTING 5 CATEGORIES OF ECONOMIC DISTORTIONS OR COSTS WHICH WERE RELEVANT TO THE QUESTION OF INDIRECT TAX HARMONISATION. THE COMMISSION (DG XXI) REMINDED THE COMMITTEE THAT THE PROPOSALS WHICH HAD BEEN MADE STEMMED DIRECTLY FROM THE SEA. BUT THE COMMISSION WAS OPEN TO ANY OTHER SUGGESTIONS PROVIDED THEY ACHIEVED THE ABOLITION OF INTERNAL BARRIERS.

9. THE CHAIRMAN'S SUMMING UP DID NOT TAKE PROPER ACCOUNT OF THE TENOR OF DELEGATIONS' CONTRIBUTION. IT BASICALLY EXPANDED ON THE EXISTING STRUCTURE OF THE OUTLINE REPORT WITHOUT ADDRESSING THE QUESTION OF WHETHER TAX APPROXIMATION WAS A NECESSARY AND COST-EFFECTIVE STEP TOWARDS ESTABLISHING THE INTERNAL MARKET OR WHETHER OTHER BETTER MECHANISMS EXISTED OR SHOULD BE LOOKED FOR. IT DID AT LEAST RECOGNISE THAT THE COSTS OF TAX APPROXIMATION HAD TO BE SET OUT ALONGSIDE THE BENEFITS OF COMPLETING THE INTERNAL MARKET. THE ESSENCE OF THE COMMISSION'S PAPER ON DISTORTIONS WILL BE INCORPORATED.

10. THE NEXT EPC MEETING ON 16/17 MARCH WILL AIM TO ADOPT A FINAL REPORT FOR THE APRIL ECOFIN COUNCIL. DELEGATIONS WERE INVITED TO FEED IN ANY COMMENTS/SUGGESTIONS IN ADVANCE.

HANNAY

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CONFIDENTIAL

FROM: MISS C EVANS

DATE: 29 February 1988

MR R ALLEN - C & E - by fax

*Wb The Honourable  
A. G. G. @ X. v.*

- cc **Chancellor**
- Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir Peter Middleton
- Sir Geoffrey Littler
- Sir Terence Burns
- Mr Scholar
- Mr Byatt
- Mr Lankester
- Mr Odling Smee
- Mr A Edwards
- Mr Culpin
- Miss Sinclair
- Mr Riley
- Mr Pickford
- Mr R I G Allen
- Mr Michie
- Mr Ford

*Mr Hudson*

- PS/IR
- PS/C&E
- Mr Knox
- Mr Oxenford

} FAX

**TCSC DRAFT REPORT ON TAX APPROXIMATION**

The Committee's advisers have prepared the attached draft report for consideration by the Committee on Wednesday <sup>2 March</sup>. As usual they have sent us the draft in confidence for factual checking. It should not be revealed that we have it.

2. Could you let me have any suggested corrections/amendments by noon tomorrow, 1 March, please so that I can give them to the Clerk ahead of the meeting on Wednesday. If you have any suggestions for amendments which are not simply factual, please copy them to Ministers for clearance.

*CE*

MISS C EVANS

In confidence

TREASURY AND CIVIL SERVICE COMMITTEE

Draft 26.2.88

Chairman's Draft Report

THE EUROPEAN COMMISSION'S PROPOSALS ON THE APPROXIMATION OF  
INDIRECT TAXATION

Introduction

1. Our predecessor Committee reported twice during the last Parliament on the issue of indirect taxation within the European Community.<sup>1</sup> The second of these Reports, entitled 5 "The Defence of VAT zero-rating", was published in February 1987. Since then, in August 1987 the Commission submitted substantive proposals<sup>2</sup> to the European Council as sign- posted in its 1985 White Paper on the Internal Market.<sup>3</sup> In 10 January 1988 the Select Committee on European Legislation published a report on these proposals,<sup>4</sup> concluding:

"The Committee considers that this wide-ranging package of tax proposals undoubtedly raises matters of major political importance... [and] therefore recommends that they be further considered by the House at an early date."<sup>5</sup>

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- 15 1. Fourth Report (1984-85) HC57-I, Harmonisation of VAT, and Fourth Report (1986-87) HC45, The Defence of VAT Zero-Rating
2. COM(87) 320, 321, 322, 323, 324, 325, 326, 327, 328
3. COM(85)310
- 20 4. Eighth Report (1987-88) HC43-viii, pp v-xiii. This Report provides a clear summary of the proposals and of their estimated effect on the UK Government's revenue
5. ibid p.x

2. As part of our continuing interest in this subject, and in response to that Committee's Report, we decided to look at some of the issues involved. Accordingly we took evidence from the Economic Secretary to the Treasury, Mr 5 Peter Lilley MP, and officials, and from Lord Cockfield, Vice-President of the European Commission. We should like to thank those who gave evidence to us. Their evidence will be of value when the House debates these proposals. We felt, however, that it was important for us to make a 10 short Report to the House before the debate. We do not address the proposals in great detail, nor do we deal with the separate issue of the current infraction proceedings taken by the European Commission against the United Kingdom's zero-rating of construction services, fuel and 15 power and certain other goods.<sup>6</sup> We concentrate instead on some of the major political arguments and questions of principle raised by the Commission's proposals for future fiscal approximation.

#### The Commission's Proposals

20 3. For VAT, the Commission has suggested a two-rate system, in which there would be two permissible bands of taxation: a standard rate band of 14 to 20 per cent, and a reduced rate band of 4 to 9 per cent, which would apply to foodstuffs, energy products, water supplies, pharmaceutical 25 products, books, magazines, periodicals, and passenger transport. For excise duties the Commission proposes

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6. see Mr Lilley's evidence Q63-75. This was the burden of the Report on Defence of Zero Rating, Fourth Report (1986-87) HC45



standardised rates of duty on tobacco and alcohol-based products (including alcoholic drinks) and mineral oils. We do not deal in this Report with the proposed changes in the administration and collection of VAT and excise duties.

5 This omission must not, however, be taken as indicating our approval.<sup>7</sup>

4. Lord Cockfield told us<sup>8</sup> that it was,

"in the light of the programme for the completion of the internal market and in the light of the obligations imposed upon the Commission by the Treaty that we have put forward these specific proposals..."

Later<sup>9</sup>, he said:

"The point that is important is that the Commission's function, ... is to produce proposals which reflect the general practice of the Member States."

He explained that "one of the basic principles that [the Commission have] always followed is that in this process of harmonisation or approximation, we should cause the least disturbance to the maximum number of States".

20 5. Lord Cockfield was asked why one should go for "the general practice" rather than the best practice, to which he responded that there was no means of judging what was the best practice.<sup>10</sup> While acknowledging that there was a

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7. see, for example, QQ35-43

25 8. Q1

9. Q3

10. Q4

great deal to be said for a single rate he argued that there would have been much opposition from ten Member States.<sup>11</sup>

6. We do not doubt that the Commission has performed its appointed task conscientiously, within its remit. But it is clear to us that the project was flawed. The resultant set of proposals would appear unlikely to be wholly acceptable to anyone. The fundamental difficulty seems to have been that the exercise was based on an almost legalistic search for approximation rather than a search for the most sensible and desirable solution.<sup>12</sup> Nor are we sure that, even within the terms of the exercise it has carried out, the Commission has convincingly shown that the proposed approximation is necessary for the completion of the internal market. Once the approximation is agreed, there would be no easy way of improving the structure of indirect taxation.

7. The level of indirect taxation is only one element in the price differentials between member states which may produce "deflections of trade".<sup>13</sup> Variations in direct taxation, particularly payroll and corporation taxes, may have a much larger impact on companies' profitability, and competitiveness, than the variations in rates of VAT. And the fact that the same product bears a different price in one EC state than in another (encouraging cross-border shopping) is due to a myriad of factors such as currency

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11. Q5

12. It should be noted that the Commission's Global Communication emphasised "that the present package is not an attempt to design an ideal fiscal system for the Community, but a blueprint for abolition of fiscal frontiers" (COM(87)320, p3)

13. Q23; It should be noted that in the present system, where VAT is levied at the rate prevailing in the country of consumption, low VAT countries do not have a competitive advantage, for all goods bear the same rate of VAT regardless of where they are produced. It is the Commission's proposed switch to the "origin principle"

fluctuations, direct and indirect subsidies, the level of interest rates, preferential government loans, legal, social, and market differences. Approximating VAT will not remove price differentials or place all EC companies on an equal footing. We suspect that a single European market which will forge twelve nations together may well be able to sustain larger differences in the levels of indirect taxation than the United States upon which model the Commission has based its proposals.<sup>14</sup>

10 VALUE ADDED TAX

8. As the Commission's proposals would bring to an end the UK's zero-rating of certain categories of goods and services, on which the Government has pledged not to levy VAT,<sup>15</sup> we questioned Lord Cockfield about the UK's response to his proposals. He told us:<sup>16</sup>

"in the Global Communication we said that the Member States should study the proposals and they should respond to them, and we are waiting for them to respond..."

20 However, as Mr Lilley has said in response to a recent parliamentary question<sup>17</sup>:

"The Global Communication contained no specific invitations to respond; Member States were invited only to evaluate the Commission's ... proposals. The Economic and Financial

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25 14. Q49  
15. See Appendix T  
16. Q72  
17. Official Report, c772(WA), 19 February 1988

Affairs Council (ECOFIN) has referred the proposals to the Economic Policy Committee (EPC) for economic analysis and will discuss them in the light of EPC's report, which is expected in the spring. The Commission should be in little **5** doubt about the Government's view on UK zero rating."

The Prime Minister has made the Government's position clear. She said on 16 February:

"We shall insist on our right to determine zero rating."<sup>18</sup>

But evidently Lord Cockfield and the Commission are only **10** prepared to take cognisance of a formal reply. We therefore recommend that the Government should send such a reply without delay making plain that abolition of the zero-rating principle is not something on which there can be unanimity and that the Government is not prepared to **15** consider any draft which includes it. We think it is important that this fundamental issue should not form part of subsequent negotiations on other aspects of approximation. We believe there are overwhelming arguments in favour of the retention of zero-rating. Ministers **20** should seek to persuade other Member States of its positive merits.

9. The Commission evidently consider the possible retention of a zero-rate only by derogation. Lord Cockfield argued that "every derogation carries a price with it and it is

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**25** 18. Official Report, c821, 16 February 1988

for the Member State asking for the derogation to assess for itself what the price is and whether it is prepared to pay for it."<sup>19</sup>

Pressed to clarify what "the price" would be, he enlarged:  
5 "What I am saying to you is that you might well find that other Member States were not prepared to accept the kind of deflection of trade which would occur and that they might - I am not saying they would occur because we are in the field of speculation now - find it necessary to maintain  
10 border controls against the United Kingdom."<sup>20</sup>

We do not find this argument against derogations convincing. It is difficult to imagine that if the United Kingdom were to choose to maintain the zero-rate of VAT on the present limited range of goods and services, the other  
15 Member States would find it necessary, for that reason alone, to maintain border controls.

10. One other possibility, consistent with the retention of a zero-rate, would be to argue for a reduced Community-wide rate of, say, 0-6% rather than the 4-9% at present proposed  
20 by the Commission. Whether or not such an alternative is adopted, we are sure, however, that the Government should argue positively for the use of a zero-rate as one part of a package of proposals.<sup>21</sup> We believe that it should do so for the situation post-1992 not as a "temporary derogation"  
25 or "special measure" but as part of a Community wide proposal which has real advantages..

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19. Q20

20. Q23

30 21. The evidence of the Economic Secretary to the Treasury made it clear to us that no such attempt has yet been made, see Q86

EXCISE DUTIES

11. In evidence to us Lord Cockfield said<sup>22</sup>:

"The excises .. are much more difficult to deal with than VAT, not least because of the high unit value and because  
5 of the enormous variation in practice as between one Member State and another, but these problems simply have to be solved."

The Commission's task was undoubtedly difficult. We do not, however, think it is acceptable for duty rates which  
10 reflect, in part, social and health policies, simply to be averaged. It is not self-evident, for instance, how one should calculate the average of a policy, on the one hand, which seeks to discourage smoking by levying high rates of tax on cigarettes and a policy, on the other hand, which  
15 seeks to encourage domestic tobacco production, by levying correspondingly low rates of tax. To attempt to produce such an average amounts to the Commission suggesting changes in Member States' health policies under the guise of tax harmonisation. Further difficulties would arise,  
20 for example, for transport in rural areas, and for transport costs generally, because of the Commission's proposals for common rates of excise duty on petrol and other mineral oils.<sup>23</sup>

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22. Q44

25 23. The Institute for Fiscal Studies published a report suggesting a number of alternative approaches: Report Series no 28: Fiscal Harmonisation (February 1988)

THE SINGLE EUROPEAN MARKET

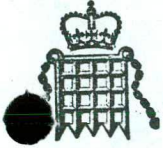
12. We support the concept of a single market in Europe, and welcome the opportunities it offers the UK. We do not believe, however, that the goal of a Europe without  
5 frontiers should be sought at any price. Nor are we convinced that the Commission's proposals for indirect taxation are the best, or only way forward. They are beset with problems, some of which we have touched upon in this Report. As Lord Cockfield said, the fiscal proposals are  
10 only a small part<sup>24</sup> of the package of proposals designed to abolish intra-Community frontier controls by 1992. The abolition of these controls raises many important questions which are outside our remit about, for instance, the fight against drugs, terrorism, and rabies, not just cross-border  
15 shopping.

X | 13. We intend to continue to monitor the Community's progress on fiscal approximation. In the meantime, and before the Economic and Financial Affairs Council (ECOFIN) considers the Economic Policy Committee's report<sup>25</sup> we share  
20 the view of the European Legislation Committee that the House should debate the Commission's proposals and be kept fully informed of the Government's intentions.

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24. Q1

25. See para 8 above



H.M. CUSTOMS AND EXCISE  
KING'S BEAM HOUSE, MARK LANE  
LONDON EC3R 7HE  
01-626 1515

*prh*

CONFIDENTIAL

FROM: P R H ALLEN

DATE: 1 March 1988

MISS C EVANS

cc Chancellor  
Chief Secretary  
Financial Secretary  
Paymaster General  
Economic Secretary  
Sir Peter Middleton  
Sir Terrence Burns  
Mr Scholar  
Mr Byatt  
Mr Lankester  
Mr Odling-Smee  
Mr A Edwards  
Mr Culpin  
Miss Sinclair  
Mr Riley  
Mr Pickford  
Mr R I G Allen  
Mr Michie  
Mr Hudson  
Mr Ford  
  
Chairman  
Mr Knox  
Mr Jefferson Smith  
Mr Oxenford

**TCSC DRAFT REPORT ON TAX APPROXIMATION**

1. We have only one amendment to suggest to the draft report attached to your note of 29 February. This is to propose the substitution of "claims to have" for "has" in page 5 line 9. It is, of course, our contention that the US experience suggests a different approach to this issue.



We also think it might be worth pointing out to the Clerk that page 7, footnote 21 is not entirely fair. The Government has not "argued positively for the use of a zero rate as one part of a package of proposals" because no substantive discussion of the proposals has yet taken place. (In the time available we have not checked all the detailed cross-references and footnotes).

2. The report is generally helpful to the Government's approach and presumably therefore will provoke a predictable response from Lord Cockfield. The two recommendations - (a) that the Government should send the Commission a written reply in effect vetoing the proposals as they affect UK zero rating and (b) that there should be a debate before ECOFIN discuss the EPC report - will require further consideration.
3. It is perhaps worth noting a couple of potentially awkward points that the Committee have not raised - (a) from the lists of zero-rated goods in various categories which we sent them, the number of sensitive items not covered by Government pledges and (b) the argument currently being run by Teddy Taylor MP that the European Court will have the power after 1992 to declare to UK zero rates illegal under the Treaty of Rome and/or the Single European Act. It seems unlikely that any debate will take place without these being raised.

RA.

P R H ALLEN



FROM: J M G TAYLOR  
DATE: 1 March 1988

MISS C EVANS

cc PS/Paymaster General  
PS/Economic Secretary  
Sir P Middleton  
Sir G Littler  
Mr Scholar  
Mr Byatt  
Mr Lankester  
Mr A J C Edwards  
Mr Michie  
PS/IR  
PS/C&E  
Mr Knox - C&E  
Mr Oxenford - C&E  
Mr R Allen - C&E

**TCSC DRAFT REPORT ON TAX APPROXIMATION**

The Chancellor has seen your minute and enclosure of 29 February to Mr R Allen (Customs).

2. He has noted, in particular, the threat (paragraph 13 of the draft report) of a debate before ECOFIN considers the Economic Policy Committee's report.

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

J M G TAYLOR

*Php*

*✓*

FROM: P R H ALLEN

DATE: 10 March 1988

PS/ECONOMIC SECRETARY

I attach briefing for Treasury first order questions and for PM's question time on (a) Herr Kohl's speech re VAT approximation to the European Parliament yesterday and (b) the publication of the TCSC report on tax approximation earlier today. Could you copy to **PS/Chancellor** and to No. 10 please?

*RA*

Richard Allen

**MINISTER IMMEDIATE**



**HERR KOHL'S COMMENTS ON INDIRECT TAX HARMONISATION IN SPEECH TO EUROPEAN PARLIAMENT (Times, FT, Guardian today)**

Line to take

1. Herr Kohl has said "consultations" on Commission's proposals will be held during German presidency. Presidency free to discuss what it wishes; and UK ready to enter into consultations. But important to note that tax approximation did not feature among items identified by Herr Kohl as priority areas for progress during German presidency.
2. Government not convinced of relevance of proposals for tax approximation to completion of single market; and have made our position on zero rates perfectly clear. Our position ultimately protected because decisions on proposals require unanimity.
3. ECOFIN has referred proposals to its Economic Policy Committee for analysis before discussing further later this year.

## BACKGROUND NOTE

1. Today's press coverage concerns Herr Kohl's speech to the European Parliament yesterday (9 March).
2. His comment that the Commission's proposals will be discussed during the German Presidency does not, of course, commit the Presidency to achieving any particular degree of progress on the issue.
3. Herr Kohl also identified a number of priority areas for progress during the German presidency. Tax approximation was not among among them. Hence the Times's comment that Herr Kohl "put the VAT issue firmly at the top of the agenda" does not appear to be borne out by what the Chancellor actually said, a transcript of which is attached.

EXTRACT FROM KOHL'S SPEECH TO  
THE EP ON TAX APPROXIMATION

9/3/88

①

Mr President, Ladies and Gentlemen,

The Community now has the way clear for the realisation of the internal market by 1992. We will make every endeavour to achieve decisive progress by the next European Council in Hanover in June. Our most important objectives over the coming months are, in particular, the complete liberalisation of capital movements; freedom to provide services in insurance and for financial services; a further reduction in technical barriers to trade, ie the standardisation of differing national norms, standardisations and technical specifications; the opening of the public procurement markets, notably in the telecommunications sector and the provision of services; the mutual recognition of diplomas for technical occupations so as to go on making the right of establishment more easily practicable; the further harmonisation of transport policy with a view to a common transport market which affords all participants identical and fair condition of competition; the harmonisation of a national company law; and the conclusion of the Community patent agreement, together with the creation of a Community trade mark law. These two measures are indispensable for the creation of a European technological Community.

Tax harmonisation must also be pushed forward within the next few years as an important measure for the completion of the internal market. The Commission has rightly indicated that a uniform internal market requires eliminating existing tax differences. Consultations will be held on the Commission proposals on the harmonisation of VAT and excise duty during this half of the year.

**TCSC REPORT ON THE COMMISSION'S TAX APPROXIMATION PROPOSALS  
(REPORT PUBLISHED NOON TODAY)**

Line to take

Grateful to Committee for work it has put in. Raised a number of important issues. Clearly, will wish to examine recommendations carefully before replying fully in due course.

**BACKGROUND NOTE**

1. The Committee published its report at noon today. A press conference coincided with publication.
2. The Committee heard evidence from the Economic Secretary on 13 January; and Lord Cockfield on 15 February.
3. The Report contains two main recommendations : that the House should debate the Commission's proposals in advance of ECOFIN's discussion of EPC's report (expected later this spring); and that the Government should write to the Commission, formally setting out its views on the proposals.

TREASURY FIRST ORDER QUESTIONS: 10 MARCH 1988

SUBJECT BRIEF ON VALUE ADDED TAX

I. FACTUAL

A. EUROPEAN COMMISSION'S PROPOSALS FOR TAX APPROXIMATION

1. Commitments - domestic: In exceptional circumstances of election campaign, Prime Minister gave specific undertakings not to extend VAT to food, gas, electricity or young childrens' clothing and footwear. (Commitments confirmed at Prime Minister's Question Time: OR 16 July vol. 119 no. 20 col. 1270).

2. Commitments - EC: Prime Minister has made clear that UK could not accept proposals which restricted right to apply VAT zero rates (Press conference, 29 May 1987, reported in Times, 30 May and Accountancy Age, 4 June).

3. Commission's approximation proposals: Commission propose standard VAT rate band of 14-20 percent; and reduced rate band of 4-9 percent. Reduced rate to cover foodstuffs; heating and lighting; water; pharmaceutical products; books, newspapers and periodicals; and passenger transport. Construction and young children's clothing and footwear (now zero rated in UK) would be standard rated. Rates of major excise duties (alcoholic drinks, tobacco products, hydrocarbon oils) would be harmonised.

4. Derogations: Commission recognised sensitivity of certain issues, eg VAT zero rates for some Member States, but no derogations included in proposals.

Unanimity requirement: Under Article 17 of Single European Act all tax measures require unanimous agreement.

5. Timetable for discussions: Initial procedural discussion held at ECOFIN on 16 November. Proposals remitted to Economic Policy Committee (EPC) for macro-economic evaluation. Oral interim report given by EPC Chairman to December ECOFIN. Full report promised by Spring 1988. No date fixed for next ECOFIN discussion but likely to be late Spring/early Summer. No question of early decisions.



6. Revenue: If Commission package adopted as drafted (with 4% VAT on items on reduced rate, 15% on rest) revenue from VAT would increase by about £3 billion in full year. (Excise proposals would produce offsetting loss to revenue of about £2 billion), so net revenue effect is a £1 billion increase.

B. INFRACTION PROCEEDINGS ZERO RATE

7. Zero rate infraction proceedings: Separate matter from approximation. Commission contend that certain UK zero rates not in accord with 6th VAT Directive. Areas under challenge.

- animal feedstuffs, seeds, live animals yielding food for consumption - (all supplies);
- Sewerage services and water (supplied to industry);
- News services (all supplies);
- fuel and power (**except** supplies to final consumers);
- construction of buildings (**except** houses "within social policy");
- Protective footwear and clothing (supplied to employers).

It should be stressed that the Commission is not challenging the zero-rating of food in the shops.

8. Advocate General's Opinion and timing of final judgement: Advocate General's role is to assist Court in identifying the relevant issues in the case. His conclusions, set out in his Opinion, may be followed by the Court in its judgment (more usually, but not invariably, they are), **but** they are not binding, have no legal effect and no action need be taken as a result of them. Advocate General in this case gave his Opinion on 2 December 1987. Date of final judgement not yet known.

C. INFRACTION PROCEEDINGS - MEDICAL GOODS

9. Infraction proceedings - medical goods: Separate matter from approximation and zero rate cases. European Court judgement requires UK to tax certain medical goods at present exempt. Principal items affected are spectacles, contact lenses and privately purchased hearing aids.

10. UK exempts from VAT:

- services supplied by statutorily registered health professionals (eg doctors, dentists, opticians) and associated supply of goods;
- since December 1984, also supply of spectacles by non-opticians under prescription.

11. EC Sixth VAT Directive allows exemption for:

- medical care supplied by medical and paramedical professionals.

12. European Court judgement rules that goods are not covered by Sixth Directive exemption unless minor and inseparable from medical care.

13. Statement by Economic Secretary in answer to written Question from Mr Tony Baldry on 23 February (Col 142) and Private Notice Question from Mr Nigel Spearing on 24 February (Cols. 291-302): Government will abide by decision but time needed to study it in detail and consult interested trade bodies before final decisions taken. Legislation to impose tax would require approval of House of Commons. Stressed no connection with zero rates case or harmonisation proposals.

14. Cost. VAT at 15% on items affected estimated to raise £25M. 'Own resources' cost about £2M per year; UK also liable to pay arrears (back to 1979) and interest of about £20M.

15. Timing of implementation. No deadline set for compliance with Court's decision. Time needed to study judgement and consult trade associations before final decision taken.

16. Treaty obligation to comply. Treaty of Rome binds all member states to conform with Directives agreed by member states. Article 171 requires member states to comply with judgements of European Court of Justice.

17. Adoption of Sixth Directive. Sixth Directive agreed by all member states in May 1977 under Labour Government. Exemptions for health then in force were not changed (thought to accord with Directive). (Other changes to accord with Directive made by Finance Act 1977).

18. Ending of universal free eye test proposed in Health and Medicines Bill at present before Parliament. Free test will remain for children, full time students under 19, those on low incomes (including recipients of FIS and supplementary benefit), registered blind and partially sighted. All others to buy privately at whatever price (if any) opticians charge. No date yet decided for implementation.

19. Hearing aids are available on free loan under NHS to all in medical need. Judgement affects only privately purchased aids.

D. VAT ON CONFECTIONERY

20. Representations: A few urging relief for confectionery. In particular, the Biscuit, Cake, Chocolate and Confectionery Alliance submitted a report to the Chancellor in December last arguing that confectionery was food which should not be taxed and pressing for zero rating. It was claimed that the resultant reduction in revenue would not be as great as expected because relief would boost industry, increase employment and reduce inflation.

21. Law: Briefly, chocolates, sweets and similar confectionery; and chocolate biscuits and similar products, taxed at standard rate as exception to zero rating of food (Group 1 of Schedule 5 to the VAT Act 1983).

22. Imports and Exports: Imports liable to tax at standard rate in same way as home produced products. Exports zero rated.

23. Revenue: Estimated revenue yield from sales of chocolates, sweets and similar confectionery is some £400m in 1987-88. Including chocolate biscuits and similar products estimated amount is some £450m.

24. EC position: Contrary to EC law to extend zero-rating.

E. VAT ZERO RATING OF FUNERAL CHARGES

25. Present exemption covers essential supplies associated with burials and cremations, eg services of undertaker making arrangements for cremation or burial, disposal of ashes, transport and the supply of a coffin and associated goods. Does not extend to discretionary items eg flowers, gravestones. (Extension of zero rating to funeral charges - see 78)

F. VAT LIABILITY OF HOSPITAL RADIO BROADCASTING EQUIPMENT

26. Talking books and newspapers for blind and specialised equipment for their production zero-rated since inception of tax. Relief extended in 1986 Budget to cover non-specialised sound recording equipment, parts and accessories and cassette recorders on free loan to the blind.

27. Budget representations from Charities VAT and Tax Reform Group ask for relief for similar supplies to those hospitalised/bedridden (eg TV or wireless sets).

G. VAT ON NEWSPAPERS

28. Representations: 210 MP letters on newspapers dealt with since June 1987. 3 previous Parliamentary Questions (mostly in association with books). No commitments given (see 31).

29. Revenue: VAT at 15% on newspapers alone would raise about £385 million in full year.

30. RPI effect: VAT at 15% on newspapers alone would add 0.2 percent to RPI.

## II. POSITIVE

### A. EUROPEAN COMMISSION'S PROPOSALS FOR TAX APPROXIMATION

31. Tax Approximation: Government firm believer in benefits of Single Market. But has ensured (eg by keeping unanimity for changes in EC tax law) that national interest safeguarded.

32. Zero rate: Cannot be abolished in face of UK opposition. Clear commitments already given.

33. Use of 'veto': Proposals unacceptable as drafted. But discussion between Member States at very early stage - wrong to anticipate outcome. UK committed to completion of Single Market, but how this best achieved is matter for discussion between Member States.

34. Advantage of Internal Market: Government attaches great importance to completion of single market by 1992. Will improve competition and open up exciting opportunities for British industry. Will bring major benefits to the European economy as a whole by reducing business costs and stimulating greater competitiveness and increased efficiency. Will help us to build the sort of industrial capability which will allow Britain and Europe to compete successfully in world markets in the next century. We want to ensure that British business makes the most of these opportunities.

35. Awareness by UK business of internal market: Single Market will mean significant new opportunities and challenges for British businesses. They must plan ahead now. That is reason for awareness campaign. Major conference at Lancaster House on 18 April, will be followed by series of events throughout country.

### B. INFRACTION PROCEEDINGS ZERO RATE

36. Government's response to Commission' challenge: Government completely and utterly rejects Commission's arguments; strong case put in writing to Court, issue similarly vigorously defended at oral hearing (15 September 1987) before the Court. Commission wrong to bring case - zero rates provided for when we joined Community, nothing has changed - Government has said so publicly many times.

37. No connection with Commission's "Tax Approximation" Proposals. Lord Cockfield recently made public Commission's proposals for VAT rate approximation with lower rate band (4-9 %) and standard rate band (14-20%) but no provision for zero-rate. Infraction case is completely separate issue and has no bearing on tax approximation proposals.

38. Interference by EC in UK's social policy objectives Commission challenge is on legal issue and not attack on UK's social policy as such. If Commission thinks that member state is in breach of Community law, it has a right to apply to European Court of Justice for a declaration. Commission thinks we are wrong in this case, we do not.

C. INFRACTION PROCEEDINGS - MEDICAL GOODS

39. Medical care remains exempt. EC judgement affects only goods supplied apart from care. Sight test is medical care and can continue to be exempted.

40. Many goods unaffected, eg:

- goods supplied free (eg on loan from NHS);
- drugs and medicines on prescription and specialist aids for handicapped (zero-rated under separate provision of Sixth Directive and not under challenge);
- false teeth and other dental prostheses (exempted under separate provision of Sixth Directive).

D. VAT ON CONFECTIONERY

41. Why not relieve all confectionery: Matter for Budget judgment, but has to be borne in mind that inessential expenditure, yielding substantial revenue (£450m a year) which would have to be replaced.

42. Why not extend VAT to all confectionery: A tempting prospect which would be well received in Brussels!

E. VAT ZERO RATING OF FUNERAL CHARGES

43. Exemption covers essential supplies connected with burial and cremation and gives a wide measure of relief.

F. VAT LIABILITY OF HOSPITAL RADIO BROADCASTING EQUIPMENT

44. Wide range of reliefs from VAT for specialist goods and services for disabled and charities caring for them.

Includes medical, scientific, computer, video and refrigeration equipment purchased with charitable or donated funds and to be used solely in medical research, diagnosis or treatment.

III. DEFENSIVE

A. EUROPEAN COMMISSION'S PROPOSALS FOR TAX APPROXIMATION

45. VAT merely one element in price: The Government accept that a range of costs, in addition to VAT, enter into the price of items purchased by consumers. These prices differ between different Member States and there frequently appears to be no direct relationship between VAT rates and prices in different Member States. That is one reason why the Government has yet to be convinced that tax harmonisation on the lines proposed by the Commission is necessary to achieve the Internal Market. By comparison, in the USA single market, individual states are free to charge differing rates of indirect taxation.

46. Tax measures needed to complete Single Market: Milan and Brussels European Councils did not identify tax measures as priority area. Other measures (eg on technical standards) more important to completion of single market.

47. Derogations: Too early to say how discussion will go; but commitments quite clear.

48. Loss of Sovereignty: Position perfectly clear: will reject proposals restricting UK's ability to use zero rating. UK's position protected because EC tax changes require unanimity.

49. Government to extend VAT to books etc: Matter for Budget judgment.

50. Indirect tax harmonisation not necessary to achieve Internal Market: Government notes with interest views expressed recently by Institute for Fiscal Studies. We see considerable merit in view that tax rates should be harmonised only in cases of clear distortion of trade; otherwise we believe that replying on market forces [as in the USA] is preferable to imposed harmonisation which is likely to be very disruptive to many Member States.

51. UK derogations or failure to harmonise could exclude us from the benefits of the Internal Market: We note the comments made recently by Lord Cockfield. However, since agreement on EC tax proposals has to be unanimous, it is not clear how he envisages his proposals will come into force if one or more Member States cannot accept them. UK's commitment to Internal Market not in doubt; but will be achieved through reason and discussion, not through imposed solutions or threats of exclusion.

52. Government response to Commission's proposals: No Member State appears to have regarded it as necessary to respond by writing to the Commission. Discussion in appropriate Ministerial Council is normal approach. Proposals to be considered by Economic and Finance Ministers' Council (ECOFIN). ECOFIN asked its Economic Policy Committee (EPC) to provide an analysis of economic implications of proposals. When EPC report has been considered and UK completed its own internal examination of proposals, Government will respond in ECOFIN, which is the appropriate forum.

53. Approximation could be imposed by the European Court: No. There is no way in which the Court could impose any particular scheme of tax approximation (eg abolition of UK VAT zero rates) in the absence of specific Community legislation. Since tax approximation requires unanimity, UK can prevent unacceptable Community legislation.



B. INFRACTION PROCEEDINGS

54. What would be the effect if the UK were to lose the case at the European Court?

Government would have to study exact terms of Court's judgment; but, if zero-rating of any of supplies challenged were ruled to be illegal, Government would feel bound to impose taxation on them at a positive rate.

[NOTE: (not for disclosure) The Chancellor has insisted that the options open to him in the event of an adverse ruling should not be publicised. He has consented only to it being stated that the UK has a Treaty obligation to respect rulings from the European Court, that we shall study the detailed judgment closely and consider our options, and that the judgment could not include a direction to apply a particular positive rate as Community law does not prescribe one].

SPECIFIC ITEMS

55. Food: Food in shops is not under challenge by Commission; Animal feeding stuffs, certain seeds and live animals for human consumption are. (These are essentially products which will become food and which are normally purchased by farmers and not private individuals. Farmers registered for VAT recover any tax charged).

56. Sewerage services and water: Supplies to domestic housing not under challenge: only non-domestic supplies are. (Most business users could recover any VAT charged).

57. News services: Newspapers not being challenged: the challenge is directed at news service supplies to businesses such as those made by Reuters. (Much of the tax would therefore be recoverable).

58. Fuel and power/protective clothing and footwear: Only supplies to businesses are being challenged. (Most businesses would be able to recover the tax).

#### CONSTRUCTION OF BUILDINGS

59. What construction is being challenged? Challenge thought to apply essentially to construction of new buildings in non-domestic sector (offices, etc). The Commission was asked to clarify its position on housing but, apart from making it clear that it did not challenge local authority housing, all it would say was that the indiscriminate granting of a zero-rate to the rest of the housing sector was "disproportionate".

60. Housing: Housing - most blatant example of where Commission challenge is wrong. Clearly housing is for final consumer - houses lived in by private individuals. Clearly also for social reasons/benefit - Governments of all parties have recognised this. Zero rating of new houses just one strand in this policy - housing benefit rent and rates rebate schemes, fixed rent levels, security of tenure and tax relief for owner occupiers are all other aspects to encourage public and private sector housing.

61. Would jobs be at risk? If, because of an additional burden of irrecoverable tax, the private sector reduced its requirement for new construction, there could be consequential effects on employment in the industry.

62. EC likely to impose Cockfield proposals on tax harmonisation in same way  
No. Infraction concerns interpretation of Directives already agreed by all member states. Cockfield proposals cannot be implemented without unanimous agreement of all member states including UK.

#### C. INFRACTION PROCEEDINGS - MEDICAL GOODS

63. Price of spectacles should not rise by full amount of VAT Current price already has hidden tax element since retailers cannot reclaim tax on goods and services bought to make exempt supplies. National Association of Optometrists estimate that prices should rise by no more than 3-4%. Government's policy of deregulating opticians resulted in substantial fall in prices in last 3 years.

64. Imposing tax on disability. Treaty obligation to comply with Court judgement. Current voucher system (for children, full time students under 19, people on low incomes and those needing complex lenses) will continue; covers about 25% of all prescriptions for glasses.

65. Coincidence with introduction of charges for eye tests likely to cause hardship Two measures unrelated. Many needy groups will continue to get free eye test.

66. Government allowing EC to dictate domestic tax matters. As EC member, UK must respect European Court rulings on interpretation of Directives - including Sixth Directive - already agreed by all member states.

67. Court likely to find against UK in zero-rates infraction proceedings. Case unconnected with zero-rates infraction (on construction, fuel and power, etc) - concerns different Articles of Sixth Directive and different legal arguments. Judgement in zero-rates case not expected for several months.

68. EC likely to impose Cockfield proposals on tax harmonisation in same way. No. Infraction concerns interpretation of Directives already agreed by all member states. Cockfield proposals cannot be implemented without agreement of all member states including UK.

69. Not first time UK have been forced to change taxation to comply with ECJ judgement. Court ruled in 1983 that rates of excise duty on wine and beer discriminated against wine. Duties altered in 1984 Budget to comply.

70. Other countries obliged to comply with ECJ judgements on tax matters eg Italy obliged to alter VAT regime which discriminated against Scotch Whisky.

D. VAT YIELD ON CONFECTIONERY

71. Borderline between standard-rated and zero-rated confectionery unclear: Accept there are definitional problems, created partly by wide range of new confectionery products now on market, such as cereal bars. Paymaster General therefore asked Customs to review borderline in consultation with the trade. Aim is to clarify borderline to reduce complexity of administration, both for Customs and traders. Consultation paper issued last July.

72. Quaker Oats High Court decision on liability of a chewy cereal bar: Customs are considering implications of judgment. Will be taken into account in review of borderline which was subject of consultation paper.

73. Additional revenue if all cereal bars taxed: At existing 15 percent rate, would be about £5m a year.

74. Confectionery is no longer a luxury but part of everyday diet: Many foods which are part of everyday living are taxed eg ice cream, crisps, salted peanuts. Unfair to single out confectionery for relief while these products remained taxed.

75. VAT inhibits growth/hastens decline of UK confectionery industry: Confectionery industry not alone in food area in being subject to VAT. But no reason to suppose that VAT is significant factor. Changes in consumer taste and other factors are at work, eg competition from imports. Very difficult to justify singling out of confectionery industry for special treatment.

76. EC infraction proceedings (zero rates): Confectionery not at issue in this case.

#### E. VAT ZERO RATING OF FUNERAL CHARGES

77. Relief should apply to all costs connected with funeral eg flowers, wreaths, commemorative items such as gravestones. VAT is a broad based tax. Such a relief would go very wide indeed and there would be pressure to extend further (eg funeral catering services). Revenue loss would have to be made good from elsewhere.

78. Zero-rating would give greater measure of relief. Extensions of zero-rating would conflict with our EC treaty obligations. Successive governments since inception of tax have seen exemption as appropriate treatment for funerals.

F. VAT LIABILITY OF HOSPITAL RADIO BROADCASTING EQUIPMENT

79. Why relieve talking books for blind and not hospital radio?

Two are different in kind. Relief for talking books and newspapers parallels relief for books and newspapers for sighted. Hospital patients not usually permanently deprived of this source of information/entertainment.

80. Many other worthy candidates for special VAT treatment

(See CVTRG representations above). Difficult to draw defensible borderlines between competing good causes; any extension of VAT relief would invite repercussive claims for similar treatment for other disadvantaged sections of community. General relief from VAT for charities/disadvantaged would be prohibitively expensive in revenue terms.

G. VAT ON NEWSPAPERS

81. Government to extend VAT to newspapers? Matter for Budget judgement.

82. European Court of Justice (ECJ) could force UK to impose VAT on newspapers: Zero rating for newspapers unassailable under existing EC Law.

PP5.p1  
*[Handwritten signature]*

The Hon. Francis Maude MP  
Parliamentary Under Secretary of State for  
Corporate Affairs

The Rt Hon John Major MP  
Chief Secretary to the Treasury  
HM Treasury  
Parliament Street  
LONDON  
SW1P 3AQ

CHIEF SECRETARY	
REC.	15 MAR 1988
ACTION	Mr Waller
COPIES TO	Ex. PM's Mr Anderson
	Mr Lancaster
	Mr Monek Mr Burgner
	Mr Edwards Mr Hill

Department of  
Trade and Industry

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Direct line  
Our ref  
Your ref  
Date

215 4417

15 March 1988

*See John*

*2*  
*(Re X, has much to do with the 877's (the advert) & promotion of products below?)*  
*Are we (CS)?*  
*Aug 12/88*  
*under*  
*ambn?*

In David Young's absence abroad, I am writing to give you details of the rationale behind the Single Market Campaign which David intends to launch on 18 March, and how we shall monitor its progress. I understand that our officials are discussing the proposals in more detail but I thought I should write to you in view of your responsibility for overseeing presentation.

Completing the Community's single market is one of our longstanding priorities and was the principle focus of our Presidency in 1986. It involves the responsibilities of many Government departments but DTI takes the lead.

British business needs to be preparing itself for the challenge of the single market. The way British business responds over the next 4-5 years will have a crucial bearing on whether we gain or lose from completing the single market, and will determine the competitive strength of British industry in the EC and world markets well into the next century. Awareness in this country is lower than among our main competitors, particularly the French.

This is the background to the proposals which David Young submitted to OD(E) in September for a concerted effort to get the single market message across to British business. As he reported to OD(E) at the end of January we have developed the first stages of a major national campaign which will need to be sustained over the next 5 years. It will be launched at the national conference at Lancaster House on 18 April, which the Prime Minister will open. Lancaster House will be followed by 20 regional breakfasts in every part of the country.

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As foreshadowed at OD(E), all of this will be backed up by a comprehensive information service to business, including an introductory booklet to be mailed out to nearly 125,000 companies with 10 or more employees, a detailed information pack and a 1992 hotline open from 18 March, and media coverage (paid and unpaid) associated with the national and regional conferences.

When David announced our campaign last October the level of awareness of the 1992 target among British companies was around 16%. We need this figure to be very much higher if British business is to respond to the challenge successfully. Our published target is to reach 90% awareness by the end of the year. This would be around the level which the French have already achieved.

This demanding target will require an intense effort backed up by the necessary resources. In this country the level of awareness rose only to 24% in January. This is despite an increasingly intense level of media interest.

We expect our booklet and hotline, and the media interest prompted by the Lancaster House conference and subsequent regional breakfasts to achieve an increase but not enough to bring us within reach of the high levels of awareness in other Member States. All the advice we have had makes it clear that we will not achieve this without an effective paid media campaign including television advertising. This has also been the French experience. The French Government's successful campaign in getting the message over to French business has used several rounds of television advertising and we are being criticised for not matching their efforts. Moreover, I believe that the campaign needs to reach the country as a whole and not just businessmen. I know that David shares this view. A major change in business attitudes and actions will only take place once the single market and the target date of 1992 are well known throughout the country.

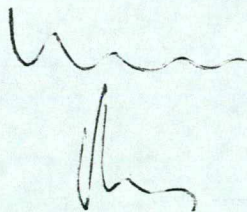
We are therefore planning an initial burst of television and other advertising around the time of the Lancaster House conference.

For how long and with what intensity the advertising and other parts of the campaign will continue will depend on how fast we move towards our 90% target. I believe that a budget of around £8 million should be the minimum figure for advertising for the next financial year. We will of course monitor the effects of

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our campaign very carefully. Since November we have been conducting a "rolling" telephone survey to monitor awareness among companies. The survey questionnaire also included questions aimed specifically at testing the impact of our campaign.

Monitoring in this way will enable us to track progress very specifically and to slow up the advertising if necessary. In any event I do not expect to commit more than £12 million on the campaign as a whole in the next financial year. I am copying this letter to the Prime Minister, the members of OD(E) and to Douglas Hurd, Peter Walker, Tom King, Nicholas Ridley, Kenneth Baker, Malcolm Rifkind, Paul Channon, John Moore and Sir Robin Butler. X



FRANCIS MAUDE





## Inland Revenue

Policy Division  
Somerset HouseFROM: J B SHEPHERD  
DATE: 17 MARCH 1988

PS/Chancellor

Article in Financial Times 15 March 1988: proposals for harmonisation of corporate tax systems within the European Community

A copy of the briefing note called for by No. 10 on 15 March went up through you (further copy attached top copy only).

As a sequel to the Article you have now had a copy of a telegram from Hannay UKREP reporting a telephone conversation with Lord Cockfield 15 March.

Two of the points in the second paragraph of the telegram are new and were not available when Tuesday morning's brief was prepared. First, the long awaited Commission communication on corporate taxation would appear to have been down-graded (if the Cockfield view prevails) from a "White Paper" to an apparently lower key "consultative document". Second, the timetable for publication has slipped yet again, this time to mid-1988.

On a point of detail, from the context ("a mass of old proposals dating from the 1970's already on the table") the reference to withholding tax (paragraph 2, line 5) concerns dividends only ie this is the 1975 proposal for a harmonised partial imputation system. Neither this proposal nor the draft directive on parents and subsidiaries cause us too much difficulty but there are a number of technical problems still to be resolved and "coming to fruition during the German precedency" if by that Lord Cockfield means securing adoption as directives, by 30 June 1988 looks to be a long shot.

*M*  
J B SHEPHERD

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cc	PS/Chief Secretary	Mr Isaac
	PS/Paymaster General	Mr Painter
	PS/Financial Secretary	Mr Houghton
	PS/Economics Secretary	Mr Corlett
	Sir G Littler	Mr Beighton
	Mr Scholar	Mr McGivern
	Mrs Lomax	Mr Johns
	Mr Peretz	Mr Shepherd
	Mr A J C Edwards	Mr Sullivan
	Miss Sinclair	Mr Reed
	Mr Cropper	Mr Willis
	PS/Customs & Excise	Mr Marshall
		Mr Alpe
		PS/IR

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OF 151722Z MARCH 88  
INFO ROUTINE EUROPEAN COMMUNITY POSTS

FRAME ECONOMIC  
COMMISSION PROPOSALS ON DIRECT TAXATION

1. LORD COCKFIELD TELEPHONED ME ON 15 MARCH MUCH DISTRESSED BY THE STORY ON THE FRONT PAGE OF TODAY'S FINANCIAL TIMES THAT THE COMMISSION WAS ON THE POINT OF TABLING PROPOSALS ON DIRECT TAXATION. HE SAID THERE WAS NO TRUTH ON THIS STORY AT ALL WHICH HAD BEEN CONCOCTED BY AN IRRESPONSIBLE OFFICIAL IN ONE OF HIS DEPARTMENTS. THE DIRECT QUOTATION ATTRIBUTED TO HIMSELF WAS A LIE.

2. LORD COCKFIELD WENT ON TO SAY THAT, WHEN HE ARRIVED AT THE COMMISSION, THERE HAD BEEN A MASS OF OLD PROPOSALS ON COMPANY TAXATION DATING FROM THE 1970S ALREADY ON THE TABLE. IT WAS POSSIBLE THAT ONE OR TWO OF THESE (ON THE TAXATION OF SUBSIDIARIES AND WITHHOLDING TAX) MIGHT COME TO FRUITION DURING THE GERMAN PRESIDENCY. BUT THERE WAS NO QUESTION OF THE WIDER ISSUES REFERRED TO IN THE FINANCIAL TIMES ARTICLE BEING DEALT WITH IN THAT TIMESCALE NOR IN THAT WAY. WHAT HE WAS CONTEMPLATING WAS A CONSULTATIVE DOCUMENT BASED SUBSTANTIALLY ON US AND UK COMPANY TAXATION REFORMS WHICH WOULD PROBABLY NOT ISSUE MUCH BEFORE THE SUMMER HOLIDAYS. HE HAD THE SUPPORT OF DELORS FOR THIS APPROACH.

3. LORD COCKFIELD CONCLUDED BY ASKING THAT THIS ACCOUNT OF THE POSITION BE BROUGHT TO THE ATTENTION OF MINISTERS. THE LAST THING HE WANTED AT THIS MOMENT WAS ANOTHER CONTENTIOUS ISSUE RELATED TO TAXATION BEING AIRED IN THE UK AND AT WESTMINSTER.

HANNAY

YYYY

POLICY DIVISION

FROM: J B SHEPHERD  
DATE: 15 MARCH 1988

Miss Zealey  
Central Division

Article in FT 15 March 1988

Proposals for harmonisation of corporate tax systems  
within European Community

BACKGROUND NOTE

Details of proposal

1. The proposals set out in the FT article are those which the writer expects to see in a White Paper to be published by Commission dealing with Company Taxation. It is all speculative and U~~X~~REP Confirmed today 15 March that the document has not yet been published. It has been on the stocks for some years and there are no surprises in the list of topics to be covered, which had been around and discussed in working parties in some cases, since the late 1960's.

2. Proposals for harmonisation of the corporation tax base include proposals to align rules for

- depreciation (capital allowances for plant and machinery)
- deductability of expenditure as tax allowable expenses of a business
- tax exempt provisions
- Stock Valuation
- incentives for research and development
- carry forward of trading losses.

3. Other related proposals

The article also refers in its final two paragraphs to related proposals as follows:

cc Min Sinclair } HU Tsy.  
Min O'Hara }

cc Mr Painter  
✓ Houghton  
✓ McGivern  
✓ Johns  
✓ Corlett  
✓ Reed  
✓ Alpe

- a. a suggestion that withholding tax rates on interest and dividends be aligned (as yet no draft has been tabled for discussion at Working Group level); and
- b. an old proposal that there should be a formal Arbitration Procedure at Community level, to sort out disputes over taxing rights between member states involving international double taxation.

LINE TO TAKE

We are, of course, already aware of the proposals referred to in the newspaper article. We look forward to the opportunity to study in detail the Commission proposals when the White Paper on Company Taxation is published.

DEFENSIVE

The UK line has consistently been that the case for tax harmonisation/approximation has not been demonstrated.

BACKGROUND

- a. The Commission's proposals may limit the Chancellors and Parliaments freedom to decide national tax policy.
- b. The Commission's objectives are the harmonisation of the tax rates and the tax base throughout the Community. Its approach so far has been to repeat this objective at regular intervals without producing evidence to justify the objectives.
- c. Discussions in ECOFIN have showed that most Member States share the view that the Commission's proposals must be studied without commitment to tax harmonisation/approximation.



J B SHEPHERD

CENTRAL DIVISION

*Mr Stepled.*

ARTICLE IN FINANCIAL TIMES 15 MARCH 1988 ON PROPOSALS FOR  
HARMONISATION OF CORPORATE TAX SYSTEMS WITHIN EUROPEAN COMMUNITY

The Treasury have asked us to provide briefing for the Prime Minister on the above-mentioned article by 12 noon today. They require a background note giving details of the proposals, what stage the proposals have reached, and what the next stages of consultation with member states are. They also require a line to take.

I should be grateful if you could let me have something on this by 11.45 if possible.

Many thanks

*Wendy Zealey*

MISS W ZEALEY  
Room 44 New Wing  
Ext 7621

15 March 1988

# FINANCIAL TIMES

LONDON - FRANKFURT - NEW YORK



1984

No. 30,489

Tuesday March 15 1988

## NEWS SUMMARY

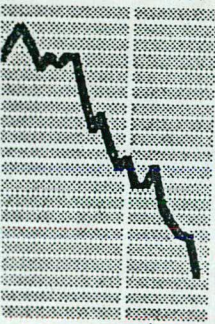
### Venezuela announces big reserves

LAN oilfields in the state of Monagas have at least 8.6bn barrels of quality light crude oil, Minister Arturo Hernandez said.

Fields were found by any Petroleos de Venezuela. The estimates are core one of the largest wide. Back Page

The markets had largely discounted the International Cocoa talks in London but sharply again. The

## Commodity Futures



February 1988 Mar

second position contract closed down £24 one, the lowest level since 1982. Cocoa pact in a dead-end street,

FAX, debt-burdened media group, immediate closure of newspaper in Sydney on Sun-

TOR, Japan's sector manufacturer, a European design UK. Back Page

strengthening the hostile take-overs will have to intentions if they

# Row likely over plan to harmonise company tax allowances in EC

BY RICHARD WATERS

PROPOSALS for harmonising elements of national corporate tax systems within the European Community have been agreed in principle by officials in Brussels.

The plan, agreed last week by the European Commission's direct tax division, is likely to meet fierce resistance in several countries, not least the UK, which is already fighting Commission plans to harmonise value added tax and other indirect taxes.

The proposals envisage a common approach to what is included in companies' taxable income and to what deductions they may take to reduce their tax bills. This would weaken the power of individual countries to use fiscal incentives to influence corporate activity.

The plan is believed to remain the subject of heated debate between different directorates within the Commission. However, Lord Cockfield, the British commissioner responsible for the EC internal market, is expected to ask the full 17-member Commission to approve it as early as Easter.

If approved, the plan would be put to the EC Council of Ministers, where it would require the support of all 12 member states before it could take effect.

The directive would harmonise

the corporate tax bases of each country. This would mean, for instance, that allowances for capital investment, or depreciation, would have to be standardised.

There would also have to be consistency on tax incentives for activities such as research and development.

Current tax law in these areas differs considerably between states. Depreciation allowances are applied in states such as France and West Germany but at different rates. France allows 50 per cent of the cost of buildings to be deducted from tax in the year of purchase; West Germany has a depreciation allowance of 2 per cent a year on buildings constructed between 1924 and 1985.

The UK does not give tax relief on depreciation. Capital allowances, which had the same effect, were largely abolished for buildings and plant on April 1, 1986. Member states would, however, remain free to apply incentives to influence companies' behaviour, said an official closely involved with drawing up the plan. Lord Cockfield said: "They would still be able to give direct subsidies, or to reduce tax rates."

Lord Cockfield is also expected to produce a statement of principle on further harmonisation of corporate direct taxes. This would not contain proposals for a

legislative change but would say that it was intended to bring direct tax systems and rates into line eventually.

Harmonising tax rates is likely to be the last stage of the process, an official said yesterday. A proposal for member states to bring their corporation tax rates into a band of 45-55 per cent has been stuck at the Commission for 13 years because of lack of support.

Plans to harmonise the direct tax systems of EC member states have been floated at various times since 1969, though none has resulted in a directive. Those still pending include:

- A plan to bring withholding tax rates on interest and dividend payments into line. France and Italy are vociferous supporters of this plan, say EC officials. They believe that proposals to free the flow of capital within the EC, allowing nationals to open bank accounts abroad, would result in money flowing to low withholding tax areas unless rates were harmonised.

- Proposals to ease the tax burden on companies with subsidiaries in other member states. At the moment, companies and their advisers claim that double taxation can result when a national tax authority claims that profits reported abroad were in fact made in its jurisdiction.

# Hachette bids for US book publishing

By George Graham and Janet Bush in New York

HACHETTE, the leading publisher, has set its sights on becoming the world's best publisher with a £224m bid for Grölier encyclopaedia company.

If successful, the French would be immediately Simon and Schuster of and Bertelsmann of West Germany many in world publishing would have a leading position in the encyclopaedia market.

Hachette has seemed to have a lead in the direction for a year since it reportedly failed to win the licence for TF1, the French television channel.

Although the group has been aggressive in the book sector, launching its ELLE far afield as China, it has been slower to seize overseas opportunities in the book division.

Hachette, which has a 10 per cent of the French book market, may have been spurred into action by the formation of Groupe de la Librairie, a challenger to its domestic publishing supremacy created by an agreement between C. G. L. Occidentale, the community offshoot of CGE, and CE. The acquisition of CE would give Hachette access to the company's tant mailing list.

Hachette is involved in the market through Curtis, the American edition of its magazine Elle, a joint venture with Rupert Murdoch's News Corporation. The acquisition of CE, which earned \$22m last year, would give Hachette access to the company's tant mailing list.

Hachette's encyclopaedia subsidiary, Le Livre de Poche, is a European leader in the door-to-door market. But

# European microchip plan aims to surpass Japanese

BY GUY DE JONQUIERES, INTERNATIONAL BUSINESS EDITOR

DECISIONS are due to be taken under discussion for almost two

RESTRICTED

*BS (Chancellor)*

FROM: P D P BARNES  
 DATE: 23 March 1988

NOTE OF A MEETING HELD IN ROOM 51/2, TREASURY CHAMBERS, PARLIAMENT STREET, AT 6.15pm ON TUESDAY 22 MARCH 1988

Those Present

Economic Secretary  
 Mr Oxenford - C&E  
 Mr Richard Balfe, MEP  
 Mr Alman Metten, MEP

*Gratify committee  
 for C&E (via BS)  
 on Mr Metten's proposal.*

VAT APPROXIMATION : VISIT BY MR ALMAN METTEN

Mr Alman Metten MEP, the rapporteur appointed by the European Parliament to draw up the report on the approximation of VAT rates and the harmonisation of excise duties, called on the Economic Secretary. He reported his plan to replace Lord Cockfield's proposed VAT bands, of 4-9% and 14-20%, by bands of 0-6% and 16-22%.

Detail

2. The Economic Secretary explained the UK Government's position. We favoured a move towards the Single European Market, but we did not think that it was necessary to approximate VAT rates in order to achieve this, and we had difficulty with Lord Cockfield's proposals. We did not see the difference in rates of VAT applied by member states as either the only or the largest factor which accounted for price differences between states. Nor did we think that differences in VAT rates would create significant distortions to trade, since this had not been the experience of the United States, where indirect taxes varied from state to state. In any case, checks (for example, for rabies) and other frontier obstacles (for example, the English Channel) would need to remain whether or not VAT was harmonised. It would in any case be politically impossible to impose VAT on food, children's clothing, or fuel.

RESTRICTED

RESTRICTED

But as EC citizens were unlikely to come to the UK specifically to buy such day to day items, he did not think that the retention of zero-rates for these goods would cause problems for the internal market.

3. Mr Metten thanked the Economic Secretary for his exposition of the UK Government's views. He said that a majority in the European Parliament favoured the creation of a Single European Market, and saw approximation of VAT rates as a necessary means to that end. He did not accept the analogy with the United States, since the differences between rates of VAT in EC countries were much larger, and exempted Danish traders, for example, were already making many of their large purchases in the Federal Republic of Germany.

4. Mr Metten said that he saw his job as rapporteur of Parliament was to find as big a majority as possible for some kind of approximation. He thought that the principle of two separate VAT bands, as proposed by the Commission, was the correct one, but that the particular bands proposed by the Commission would be unacceptable to a number of member states. Mr Metten was therefore canvassing the idea of two bands at different rates from those proposed by the Commission.

- (i) A band of 0-6% would replace the Commission's proposed 4-9% band, in order to gain the support of those countries such as the UK which would face political difficulties if they abandoned their zero-rates.
- (ii) A band of 16-22% would replace the Commission's proposed upper band of 14-20%. This was because Ireland, with an upper rate of 25%, and Denmark, with a 22% standard rate, would have difficulties with an upper band of 14-20%. Denmark would be unable to raise direct taxes to recoup any revenue lost through lower VAT rates since their direct tax rates were already some of the highest in the world, and VAT accounted for 15.5% of GNP. Mr Metten



RESTRICTED

realised that this proposal would entail the UK's raising its rate of VAT by at least 1%, but he hoped that this would be a politically acceptable price for the preservation of existing zero-rates.

5. The Economic Secretary thanked Mr Metten for coming.

PB

P D P BARNES  
Private Secretary

cc PS/Chancellor  
PS/Chief Secretary  
PS/Financial Secretary  
PS/Paymaster General  
PS/Sir P Middleton  
Sir G Littler  
Mr Scholar  
Mr Culpin  
Mr A J C Edwards  
Mr Turnbull  
Mr R I G Allen  
Mr Pickford  
Miss Sinclair  
Mr Michie  
  
Mr Knox - C&E  
Mr Jefferson Smith - C&E  
Mr P R H Allen - C&E  
Mr Oxenford - C&E  
PS/C&E

RESTRICTED



~~BF 12/4 2/19~~

FROM: MOIRA WALLACE  
DATE: 28 March 1988

*mpw*

PS/ECONOMIC SECRETARY

cc Mr Culpin  
Mr A J C Edwards  
PS/C&E

**VAT APPROXIMATION: VISIT BY MR ALMAN METTEN**

The Chancellor has seen your note of the Economic Secretary's meeting with Messrs Balfe and Metten. He would be grateful for Customs' comments, routed via the Economic Secretary, on Mr Metten's proposal.

*mpw.*

MOIRA WALLACE



*passed on  
X to Cans -  
we will return  
to Ch...  
repeats para 2.*

H.M. CUSTOMS AND EXCISE  
NEW KING'S BEAM HOUSE  
22 UPPER GROUND  
LONDON SE1 9PJ  
TEL 01-620 1313 Ext 5023

*pp3 p1.*

FROM: P R H ALLEN  
DATE: 29 MARCH 1988

Economic Secretary

cc: Chancellor ✓  
Chief Secretary  
Paymaster General  
Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Scholar  
Mr Culpin  
Mr Edwards  
Miss Sinclair  
Mr R I G Allen  
Mr Michie  
Miss C Evans

*Handwritten notes in red ink:*  
1. w/ paper to Sir  
2. is subject  
3. House indicates  
4. 75%  
5. VAT  
6. 1/1000

**GOVERNMENT RESPONSE TO THE TCSC REPORT ON THE EUROPEAN COMMISSION'S PROPOSALS ON THE APPROXIMATION OF INDIRECT TAXATION**

1. The Report generally supports the Government's stance, particularly on VAT zero rating and the policy implications of the Commission's proposals for alcohol and tobacco taxation. It involves three main recommendations ((a) positively, (b) and (c) implicitly).

- (a) that the Government should write to the Commission formally setting out its position on zero rating (paragraph 8);
- (b) that the Government should argue for the use of zero rates on a Community-wide basis (paragraph 10); and
- (c) that the House should debate the Commission proposals in advance of ECOFIN's consideration of EPC's report (paragraph 13).

Internal circulation: CPS, Mr Knox, Mr Jefferson Smith, Mr Nash, Mr Cockerell, Mr M Knox, Mr Oxenford

2. (a) Written statement to the Commission.

We consider that this would be playing into Lord Cockfield's hands. It would allow him to portray the UK as the focus of opposition to the proposals, and set us up as the scapegoat for lack of progress in discussions. It would also create what could be a thoroughly unwelcome precedent under which the Commission would expect written responses to all draft proposals. In some cases we might have powerful reasons for wishing to avoid revealing UK views in advance of the appropriate Council discussions in Brussels. We suggest that the Government could reasonably point out that no Member State has considered it necessary or appropriate to write to the Commission in advance of discussions; and that discussion of the proposal will take place at ECOFIN, which is the appropriate forum.

3. (b) EC-wide zero rating.

There could be tactical reasons for urging a Community zero rate or a reduced rate band of 0 to 6% on our EC partners. However, this could have implications for the Government's stance that tax approximation is not necessary to achieve the internal market and would suggest that the Government was prepared to accept tax approximation if the tax rates and rate structure were right. This would need careful consideration and it would be prudent to avoid opening this potential Pandora's box in the context of the reply to the TCSC. We suggest therefore that we should argue that the application of particular rates of VAT is a matter for the national parliaments of the Member States concerned. The Member States have, after all, had ample opportunity to consider the relative merits of zero rating; and if some have decided to eschew them, that is their business - not ours. In any case, the Government's view is that the Commission has failed to demonstrate the case for tax approximation.

4. (c) Timing of a debate

We see some advantage in the House of Commons debating the proposals in advance of the informal ECOFIN in May. At that stage, the Government can reasonably take note of points raised in debate without having to defend what may well be an inconclusive discussion at ECOFIN - which could disappoint those who would like to see the Commission's proposals rejected out of hand.

5. The report also contains a factual error in paragraph 9 which we suggest is worth clearing up.

6. We therefore suggest a reply to the Report in the terms of the attached draft.

RA.

P R H ALLEN

1. The Government welcomes the Committee's report and greatly appreciates the considerable work which has gone into its preparation.

U  
2. The Government agrees with the Committee that the European Commission has not demonstrated that tax approximation is necessary for the completion of the internal market. On the question of zero rating, the Government notes the Committee's recommendation that it should write to the Commission formally setting out its position. It takes the view, however that this is a novel suggestion by the Commission which could create an unwelcome precedent for the future. No other Member State has considered it necessary or appropriate to set out its views in writing. Discussions will take place in the appropriate forum - the Economic and Finance Ministers Council (ECOFIN) - in due course. That is the way such proposals have been dealt with in the past and there seems no good reason why normal procedures should be overturned in this case in order to assuage the legalistic concerns of the Commission. In any case, the European Commission can be in no doubt as to the Government's position on this issue, which has been publicly stated on numerous occasions.

Y | 3. The Government notes the Committee's suggestion that the United Kingdom should argue the case for the application of zero rates on a Community-wide basis. We shall certainly argue that there are good reasons why the United Kingdom should continue to apply zero rates and why zero rating can be a valuable element in a VAT system. ~~We take the view, however, that the rates of indirect tax applicable in other Member States should remain a matter for the national parliaments of the states concerned.~~

4. In paragraph 9 of the Report it is stated that zero rates are applied to a "limited range of goods and services". The Government should point out that, in fact, approximately one third of consumers' expenditure in the United Kingdom is incurred on zero rated items. | X

We are not convinced, however, that ~~the~~ no imposition of tax approximation is necessary for the achievement of the internal market.



CH/EXCHEQUER ✓ 514	
REC.	05 APR 1988 05 APR 1988
ACTION	Mr A. J. C. EDWARDS
COPIES TO	EST SIR P. MIDDLETON MR LANKESTER MR MORTIMER MR MERCER MR BONNEY

PRIVY COUNCIL OFFICE  
WHITEHALL, LONDON SW1A 2AT

31 March 1988

Dear Paddy,

**SELECT COMMITTEE ON EUROPEAN LEGISLATION : ENQUIRY ON OVERLAP OF EC TREATY POWERS**

The Clerk to the House of Commons Scrutiny Committee has written to the Cabinet Office (copy attached) to request a Memorandum outlining the various areas where the EC Treaty provisions overlap and the Government's interpretation of the relationship between these provisions. A reply is asked for by 25 April.

The request raises two points of concern. The first is that the Committee is not acting on the basis of specific proposals to the Council but is conducting a general enquiry. This is a departure from normal procedure and could in theory be construed as an over-generous interpretation of the Committee's terms of reference. The request is nevertheless a reasonable one, in the light of the broad remit of the Committee to advise on the legal importance of proposals. I believe that we must respond civilly.

The second concern is the terms of the reply. The issue of the overlap of Treaty powers is not new. The judgments in the battery hens and hormones cases, mentioned in the Clerk's letter, relate to the situation before the coming into force of the Single European Act. However the extension of qualified majority voting, the pressures on the Community institutions to meet the 1992 deadline for the single market and new procedures with the European Parliament have certainly highlighted the problems in this area. The jurisprudence of the ECJ in this area is as you know limited and our approach will have to be considered on a case by case basis. Our reply to the Scrutiny Committee should be in the form of a low-key statement of the legal position to the extent that it is known. I propose that if you are content the Treasury Solicitor's Department should prepare a draft reply, for circulation at official level to interested Departments, which will be cleared with you.

The Committee indicated that, following receipt of the Memorandum, it may hold a public evidence session with Government witnesses. I suggest that in that case we should look to the Treasury Solicitor's Department to supply witnesses. I would hope that by keeping discussion on the legal plane we could avoid being drawn into discussion of the implications for current policies.

In view of the wider interest I am copying this letter to Geoffrey Howe, Nigel Lawson, Douglas Hurd, Norman Fowler, Nicholas Ridley, David Young, Kenneth Baker, John MacGregor, Paul Channon, John Moore, Cecil Parkinson, Kenneth Cameron and Sir Robin Butler

**JOHN WAKEHAM**

The Rt Hon Sir Patrick Mayhew QC MP  
Attorney General



OVERSEAS OFFICE  
HOUSE OF COMMONS  
LONDON SW1A 0AA  
01-219 3000 (Switchboard)  
01-2195467 (Direct Line)

EUROPEAN LEGISLATION COMMITTEE

~~18~~ <sup>21</sup>  
~~18~~ <sub>3</sub>  
18 March 1988

Dear Boyd,

With the coming into effect of the Single European Act, the precise choice of Treaty base for Community legislation seems to the Committee to have taken on greater significance, particularly in view of the procedural implications of different bases in areas where Treaty powers overlap. One obvious area is the overlap between Articles 100 and 100A, but there are a number of others, including the relationship between Article 43 and Article 100, explored by the European Court of Justice in the recent hormones and battery hens cases.

The Committee wishes to explore this whole area in greater detail, and I have therefore been asked to request the submission of a Memorandum outlining the various areas where Treaty powers overlap and the Government's interpretation, having regard to any relevant jurisprudence of the Court, as to the relative precedence of the various powers involved.

The Committee envisages that, following receipt of the Memorandum, it will wish to hold a public evidence session with Government witnesses. It wishes to arrange this for as soon after the Easter Recess as is practicable. Accordingly, it would be helpful if I could receive the Memorandum in time for the Committee to consider it at its meeting on Wednesday 13 April.

I shall be happy to discuss this request further with you if that would be helpful.

Yours ever  
Chris Taylor.

C R M WARD  
Clerk of the Committee

B E McAdam Esq  
Cabinet Office  
70 Whitehall  
London SW1A 2AS



## COMMONS SCRUTINY COMMITTEE

### TERMS OF REFERENCE

The Select Committee on European Legislation is appointed under Standing Order No 105, viz:

#### Select Committee on European Legislation

105.- (1) There shall be a Select Committee to consider draft proposals by the Commission of the European Communities for legislation and other documents published for submission to the Council of Ministers or to the European Council whether or not such documents originate from the Commission, and to report its opinion as to whether such proposals or other documents raise questions of legal or political importance, to give its reasons for its opinion, to report what matters of principle or policy may be affected thereby, and to what extent they may affect the law of the United Kingdom, and to make recommendations for the further consideration of such proposals and other documents by the House.

(2) The Committee shall consist of sixteen members.

(3) The Committee and any Sub-Committee appointed by it shall have the assistance of the Counsel to Mr Speaker.

(4) The Committee shall have the power to appoint specialist advisers for the purpose of particular inquiries, either to supply information which is not readily available or to elucidate matters of complexity within the committee's order of reference.

(5) the Committee shall have power to send for persons, papers and records; to sit notwithstanding any adjournment of the House; to adjourn from place to place; and to report from time to time.

(6) The quorum of the Committee shall be five.

(7) The Committee shall have power to appoint Sub-Committees and to refer to such Sub-Committees any of the matters referred to the Committee.

(8) Every such Sub-Committee shall have power to send for persons, papers and records; to sit notwithstanding any adjournment of the House; to adjourn from place to place; and to report to the Committee from time to time.

(9) The Committee shall have power to report from time to time the minutes of evidence taken before such Sub-Committees.

(10) The quorum of every such Sub-Committee shall be two.

(11) The Committee or any Sub-Committee appointed by it shall have leave to confer and to meet concurrently with any Committee of the Lords on the European Communities or any Sub-Committee of that Committee for the purpose of deliberating and of examining witnesses.

(12) Unless the House otherwise orders, each Member nominated to the Committee shall continue to be a member of it for the remainder of the Parliament.



the department for Enterprise

The Rt. Hon. Lord Young of Graffham  
Secretary of State for Trade and Industry

The Rt Hon John Major MP  
Chief Secretary to the Treasury  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

Department of  
Trade and Industry

1-19 Victoria Street  
London SW1H 0ET

Switchboard  
01-215 7877

Telex 8811074/5 DTHQ G  
Fax 01-222 2629

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subsidy, the EST SW  
take no more to E(A), but this  
is how packed group. The level of  
gov. advert. attracts many M...*

Direct line 215 5422  
Our ref DW2CSN  
Your ref  
Date 31 March 1988

**SINGLE MARKET CAMPAIGN ADVERTISING**

My disappointment with the style and tone of your letter of 29 March was matched only by my acute concern, which I am sure you share, at reading about it in so many of this morning's newspapers. I regret that we could not have dealt with this on a bilateral basis.

Much of your letter seems to me a thinly veiled attack on the whole principle of using advertising, particularly on television, as part of the effective presentation of Government services, activities and policies. If we differ on that basic point - which is fundamental to much of the work of my Department - I would wish to propose an early meeting chaired by the Prime Minister, and involving Nigel Lawson, Geoffrey Howe and Kenneth Clarke.

X

On the other hand if your difficulty is just with the scale of the single market campaign then we should now reinstate the meeting you cancelled at short notice last week. Your main concern here seems to be with our initial target of 90 per cent business awareness by the end of this year rather than 1992. The very fact that you put it in this way indicates the scale of our problem. The Single Market will be a reality in 1992. Industry and commerce need to plan for it now not then. Indeed for many industries 1992 has already effectively arrived.



I do not consider this 90 per cent target in any way unrealistically high or unsustainable. The 90 per cent awareness we are seeking by the end of this year is simply of the objective of completing the single market by 1992. Indeed our campaign must achieve a lot more than that. We need to ensure that firms are actually planning action to meet the challenge of 1992. In France, following a sustained paid media campaign, that figure is already 87 per cent.

For us to set a figure lower than 90 per cent for initial basic awareness would be indefensible and damaging.

I am copying this letter only to the Prime Minister, Nigel Lawson, Geoffrey Howe, Kenneth Clarke and to Sir Robin Butler.

*Law*  
*David*



HM CUSTOMS AND EXCISE  
 NEW KING'S BEAM HOUSE  
 22 UPPER GROUND  
 LONDON SE1 9PJ  
 TEL 620 1313 Ext 5059

1. Mr Jefferson Smith
2. PS/Chancellor

From: ALISON FRENCH  
 Date: 6 April 1988

- cc: PS/Chief Secretary  
 PS/Paymaster General  
 PS/Economic Secretary  
 Sir P Middleton  
 Sir G Littler  
 Mr Byatt  
 Mr Scholar  
 Mr Culpin  
 Mr Edwards  
 Miss Sinclair  
 Mr R I G Allen  
 Mr Michie  
 Miss C Evans

*ch/On the factual point,  
 this amounts to "you were right!"*

*On your drafting amendment  
 behind, the new proposed sentence  
 duplicates 1st sentence of para 2.*

*Shall we drop Y entirely? mpw 6/4*

*noted!*

*OK*

**GOVERNMENT RESPONSE TO THE TCSC REPORT ON THE EUROPEAN COMMISSION'S PROPOSALS ON THE APPROXIMATION OF INDIRECT TAXATION**

1. I understand that the Chancellor has queried a factual point in Richard Allen's note of 29 March on the above subject. The draft Government response attached to Mr Allen's note states that "approximately one third of consumers' expenditure in the United Kingdom is incurred on zero rated items", whereas the Budget brief says that about 25 percent of consumers' expenditure is zero rated.

2. All of consumers' expenditure is either taxable at the standard rate, zero rated or exempt for VAT purposes. In fact, about half is standard rated, 25 percent is zero rated and 25 percent is exempt. Thus it is true to say that about one third of consumers' expenditure on goods and services liable to VAT (ie excluding exempt items) is zero rated. But, for the purposes of the response to the TCSC, it is probably clearer to refer to zero rated goods and services as a proportion of total consumers' expenditure (rather than taxable expenditure). I suggest the final sentence of the draft response should read "The Government should point out that, in fact, zero rated goods and services account for about one quarter of total consumers' expenditure in the United Kingdom."

*(but they didn't)*

*indeed!*

Alison French  
 ALISON FRENCH  
 DPU 1

UNCLASSIFIED



FROM: MISS M P WALLACE

DATE: 7 April 1988

*MP*  
*15*  
*BF*  
*12/4*  
*(to)*  
*(A)*

MISS C EVANS

cc PS/Chief Secretary  
PS/Paymaster General  
PS/Economic Secretary  
Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Scholar  
Mr Culpin  
Mr Edwards  
Miss Sinclair  
Mr R I G Allen  
Mr Michie

Ms French C&E  
PS/C&E  
Mr Jefferson Smith C&E

**GOVERNMENT RESPONSE TO THE TCSC REPORT ON THE EUROPEAN COMMISSION'S PROPOSALS ON THE APPROXIMATION OF INDIRECT TAXATION**

The Chancellor has seen Mr Allen's minute of 29 March to the Economic Secretary, and Ms French's further minute of 6 April. He is now content for the Government response to issue, subject to two amendments:

- (i) recast final sentence as suggested by Ms French in her minute;
- (ii) delete final sentence of paragraph 3.

*MPW.*

MOIRA WALLACE

pl 1. cc Miss Evans  
2. of 15/4 to m



FROM: G R WESTHEAD  
DATE: 13 April 1988

APS/CHANCELLOR

cc PS/Chief Secretary  
PS/Paymaster General  
PS/Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Scholar  
Mr Culpin  
Mr Edwards  
Mr Dyer  
Miss Sinclair  
Mr R I G Allen  
Mr Michie  
Miss French - C&E  
PS/C&E  
Mr Jefferson Smith - C&E

Ch/procedurally X is clearly all wrong. If you are content with Y in principle, we shall commission draft for EST(?) to send to Lord Pres.

mpw 15/4

GOVERNMENT RESPONSE TO THE TCSC REPORT ON THE EUROPEAN COMMISSION'S PROPOSALS ON THE APPROXIMATION OF INDIRECT TAXATION

Mr Allen's minute of 29 March set out the three main recommendations of the TCSC report and the suggested Government response.

2. This is to confirm that the Economic Secretary is content with TCSC's proposal that the House should debate the Commission proposals in advance of ECOFIN's consideration of the EPC's report and that, as Mr Allen says, we should try and arrange for this to take place before the informal ECOFIN in Lubeck in May.

3. If the Chancellor is similarly content on this point, our Parliamentary Branch will need to contact the House authorities.

Guy Westhead

GUY WESTHEAD  
Assistant Private Secretary

*Handwritten notes in red ink:*  
As you say, 3 is (stems)  
Ausside.  
draft for Est to send to Lord Pres.  
copies for Fin's min. It should  
inform him of the date of the debate  
with, & argue that if there is  
to be a pre-estimate of the TCSC  
recommendations, we should have  
a debate on the subject @ all;  
I'd like to see this done.

Bf 22/4



FROM: MISS M P WALLACE

DATE: 18 April 1988

APS/ECONOMIC SECRETARY

cc PS/Chief Secretary  
PS/Paymaster General  
PS/Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Scholar  
Mr Culpin  
Mr Edwards  
Mr Dyer  
Miss Sinclair  
Mr R I G Allen  
Miss Evans  
Mr Michie  
  
Miss French - C&E  
PS/C&E  
Mr Jefferson Smith - C&E

**GOVERNMENT RESPONSE TO THE TCSC REPORT ON THE EUROPEAN COMMISSION'S PROPOSALS ON THE APPROXIMATION OF INDIRECT TAXATION**

The Chancellor has seen your minute of 13 April. He would be content in principle for the House to debate the Commission's proposals before ECOFIN considers the EPC's Report. He would be grateful if Customs could provide a draft letter for him to send to the Lord President, copied to the Foreign Secretary. The letter should inform him of the date of the Lübeck Meeting and argue that if there is to be a debate on this subject it should be pre-Lübeck as the TCSC have recommended. However, the Chancellor has added that if the Lord President would sooner have no debate at all, we could live with that.

A handwritten signature in dark ink, appearing to read 'M P Wallace'.

MOIRA WALLACE



*Sorry: pl redo*

FROM: MISS M P WALLACE

DATE: 18 April 1988

APS/ECONOMIC SECRETARY

cc PS/Chief Secretary  
 PS/Paymaster General  
 PS/Sir P Middleton  
 Sir G Littler  
 Mr Byatt  
 Mr Scholar  
 Mr Culpin  
 Mr Edwards  
 Mr Dyer  
 Miss Sinclair  
 Mr R I G Allen  
 Miss Evans  
 Mr Michie  
 Miss French - C&E  
 PS/C&E  
 Mr Jefferson Smith - C&E

**GOVERNMENT RESPONSE TO THE TCSC REPORT ON THE EUROPEAN COMMISSION'S PROPOSALS ON THE APPROXIMATION OF INDIRECT TAXATION**

The Chancellor has seen your minute of 13 April. He ~~is~~ <sup>would be</sup> content in principle for the House to debate the Commission's proposals before ECOFIN considers the EPC's Report. He would be grateful if Customs could provide a draft letter for <sup>him</sup> ~~the Chancellor~~ to send to the Lord President, copied to the Foreign Secretary. The letter should inform him of the date of the Lubeck Meeting and argue that if there is to be a debate on this subject it should be pre-Lubeck as the TCSC have recommended. However, the Chancellor has added that if the Lord President would sooner have no debate at all, we could live with that.

MOIRA WALLACE

FROM: A J C EDWARDS

DATE: 20 April 1988

CHANCELLOR

cc Chief Secretary  
Paymaster General  
Sir P Middleton  
Sir G Littler  
Mr Lankester  
Mr Scholar  
Mr Peretz  
Mr Culpin  
Mr Mercer  
Mr Mortimer  
Mr Tyrie

**CABINET, 21 APRIL:**

**EC Matters**

You may wish to report briefly on the outcome of Monday's ECOFIN:

- Indirect tax approximation. Discussion of EPC report which was relatively well disposed to Commission's dirigiste ideas. No member states are opposing outright the principle of abolishing fiscal barriers. But several other member states share UK's interest in slow tempo for these discussions. Further discussion at mid-May informal ECOFIN.
- Budget discipline. *Should capital* Good progress on legally binding Decision about limits on agricultural expenditure. But less progress on non-obligatory expenditure. Signs are that big spenders in Council and the Parliament will both try to exploit inconsistencies in Brussels European Council conclusions. Northern member states will need to stand firm.
- Capital movements. Some progress. German presidency still hope to achieve agreement on liberalisation of capital movements before end-June.

AJCE

A J C EDWARDS

EUROPEAN COMMUNITIES  
 ECONOMIC AND SOCIAL COMMITTEE  
 MEMBER OF THE ESC

7 Vauxhall Walk  
 LONDON  
 SE11

12/1  
 EQUIS  
 21 APR 1988  
 EST

*PWP*

The Rt Hon Nigel Lawson MP  
 Chancellor of the Exchequer  
 H M Treasury  
 Parliament Street  
 LONDON  
 SW1P 3AG

20. April 1988

*→ Jonathan 14/2*

ECONOMIC SECRETARY	
REC'D	22 APR 1988
ACTION	MR PH ALLEN
COPIES TO	PS CHANCELLOR
	MR SCHULTZ
	MR CULPIN
	MISS SINCLAIR
	MR MICHIE
	MR JEFFERSON-SMITH
	MR WILMOTT
	MR LOCKER
	PS/CTE

*N. Lawson.*

I have received this morning the briefing on the approximation of indirect tax rates and harmonisation of indirect tax structure. This appeared to be submitted by H M Customs and Excise rather than the Treasury and I would like to clarify that this in fact the Government position.

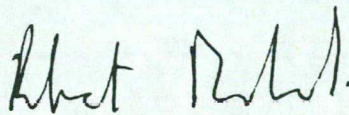
My own view, which appears to be the view expressed by yourself recently at Cambridge, is that the experience of the United States and Canada with different sales taxes in each state and province indicates that harmonisation here is not essential to the opening of the internal market. Nevertheless, I am aware of the fact that the Commission holds very strongly to the opposite view and that there are some important arguments on their side.

In this respect I am slightly concerned about the briefing that we have received from Customs and Excise. First of all it states "that it would limit the Chancellor's room to introduce changes to the tax structure and as such would weaken one of the most important tools of fiscal management". I would have thought that our policy had in fact been, since 1979, to keep VAT levels stable, consistent at 15%, and in fact use other areas to manage fiscal policy, in particular trying to reduce the level of income tax. Secondly, and indeed more importantly, there is no contradiction to the argument by the Commission that this is necessary for opening of the internal market. This surely the core to the whole issue, because if the Commission is right, then obviously our policy would have to change. The Commission argues that the Council, itself, own advisory bodies have stated this, including representatives appointed by yourself, Certainly this is a point that we will have to counter, and I would be very grateful for your view. Thirdly, of course we have to take into account just not the UK interests but the Community's interests as a whole and the question obviously is put that we are in a rather distinct position as an island because we do not have a situation in which many people can regularly pop over the borders to another country and buy goods at a cheaper rate, as occurs for example

Contd./...

from Denmark and from Ireland.

I would be very grateful to you for the definitive Government views on this. I am obviously aware of the fact that certain commitments were made during the election under political pressure from the opposition which would be difficult to move and I am obviously aware of the political effects of some changes. Frankly, my own opinion has always been, that one of the great mistakes of the introduction of VAT was that it was not a flat across the board tax on everything and the concept that some goods are highly desired for the population and should be VAT free is a very weak argument. After all it hardly seems to me to be logical that the books of Barbara Cartland and caviar are VAT free because they are "necessities", whereas my underwear has VAT placed on it, presumably because it is deemed not a necessity! I am still convinced that we in the UK have got a long way to go on this issue ourselves!



R J MORELAND



HM CUSTOMS AND EXCISE  
 NEW KINGS BEAM HOUSE  
 22 UPPER GROUND  
 LONDON SE1 9PJ  
 KING'S BEAM HOUSE, MARK LANE  
 TEL: 01-620 1313 x 5023  
 01-626 1515

FROM: P R H ALLEN  
 DATE: 20 APRIL 1988

APS/CHANCELLOR

- cc PS/Chief Secretary
- PS/Paymaster General
- PS/Economic Secretary
- PS/Sir P Middleton
- Sir G Littler
- Mr Byatt
- Mr Scholar
- Mr Culpin
- Mr Edwards
- Mr Dyer
- Miss Sinclair
- Mr R I G Allen
- Miss Evans
- Mr Michie

*my content to  
 write as drafted?*

*OK in  
 5/2/88; hupw  
 20/4*

GOVERNMENT RESPONSE TO THE TCSC REPORT ON THE EUROPEAN  
 COMMISSION'S PROPOSALS ON THE APPROXIMATION OF INDIRECT TAXATION

I attach a draft letter for the Chancellor to send to the Lord  
 President (your note of 18 April to APS/Economic Secretary).

*RA.*

P R H ALLEN

---

Internal Circulation:	CPS	Mr Wilmott
	Mr Jefferson Smith	Mr Cockerell
	Mr Nash	Mr Kent
	Mr Finlinson	Mr Knox
		Mr Oxenford



~~RAF 375~~

*pm*

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

The Rt Hon John Wakeham MP  
The Lord President of the Council  
Privy Council Office  
Whitehall  
London SW1A 2AT

25 April 1988  
cc: PS/Chief Secretary  
PS/Paymaster General  
PS/Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Scholar  
Mr Culpin  
Mr Edwards  
Mr Dyer  
Miss Sinclair  
Mr R I G Allen  
Miss Evans  
Mr Michie  
Miss French - C&E  
PS/C&E  
Mr Jefferson Smith - C&E

**DEBATE ON THE EUROPEAN COMMISSION'S PROPOSAL ON THE APPROXIMATION OF INDIRECT TAXATION**

The Treasury and Civil Service Committee has recommended a debate on the Commission's proposals on the approximation of indirect taxation "before the Economic and Financial Affairs Council (ECOFIN) considers the Economic Policy Committee's report". This follows an earlier recommendation by the House of Commons Select Committee on European Legislation that the proposals should be further considered by the House "at an early date".

Substantive discussion of the Economic Policy Committee's report by ECOFIN is scheduled for its informal meeting at Lübeck on 13-15 May. If there is to be a debate, it would certainly be desirable that it should take place in advance of the Lübeck meeting at the TCSC recommends - ie not later than the week beginning 9 May.

I suggest a debate on the floor of the House for 1½ hours after 10.00pm. A take note Motion would seem appropriate.

I am copying this letter to Sir Geoffrey Howe, to members of L and OD(E) Committees and to Sir Robin Butler.

**NIGEL LAWSON**



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

The Rt Hon John Wakeham MP  
The Lord President of the Council  
Privy Council Office  
Whitehall  
London SW1A 2AT

25 April 1988  
cc: PS/Chief Secretary  
PS/Paymaster General  
PS/Sir P Middleton  
Sir G Littler  
Mr Byatt  
Mr Scholar  
Mr Culpin  
Mr Edwards  
Mr Dyer  
Miss Sinclair  
Mr R I G Allen  
Miss Evans  
Mr Michie  
Miss French - C&E  
PS/C&E  
Mr Jefferson Smith - C&E

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I am copying this letter to Sir Geoffrey Howe, to members of L and OD(E) Committees and to Sir Robin Butler.

**NIGEL LAWSON**



FROM: ECONOMIC SECRETARY  
DATE: 26 April 1988

CHANCELLOR

MISC 133 : 27 APRIL 1988 - PAPER ON IMPACT OF VAT ON BUSINESS

You asked for my views on the two possible schemes, outlined in paragraph 17 of the MISC paper to reduce the burden of VAT accounting on small businesses (an outline of the 2 schemes is attached at Annex A).

2. I should first of all say that I am yet to consider these schemes in detail, as discussions between Customs and EDU officials are still not complete and there is a measure of disagreement on both sides. But, it is possible that this will form a specific paper for a later MISC 133 meeting in advance of the deregulation White Paper later in the year.

3. Neither idea has yet been worked up into a generally attractive scheme. Both would make the VAT regime faced by small businesses more complex than the present one and than that impinging on larger firms. Also, both schemes would need an EC derogation. The chances of securing this are very slim (particularly for the EDU scheme) so soon after our introduction of cash accounting and annual accounting and coming as it does at the same time as our lobbying for a higher VAT threshold generally.

The EDU scheme would appeal to those traders with very small inputs trading from home. It would in addition, if it proves to be popular, result in a sizeable revenue loss (up to £200 million per annum). If it proved not to be popular, it would be hard to justify the extra costs incurred by Customs of setting it up.



4. The Customs and Excise scheme in its current form would ease entry into the VAT system which is also the basic objective of the EDU scheme. It would also placate those who object to unfair competition from firms below the threshold as to removing the disincentive affect of the threshold. But neither Customs nor Treasury are strong advocates of this alternative which could have considerable resource implications. It was put forward at the request of the EDU who asked Customs for an alternative if their own scheme was unacceptable.

5. In my view the top political priority is not to appease pressures from construction firms above the threshold about unfair competition from unregistered traders. So it would be desirable to modify the Customs and Excise scheme to reflect this. Also, the scheme Customs and Excise are presently working on would require firms to register for VAT below the threshold which would be a burden for both small firms, and Customs (as well as conflicting with our pressure on the EC for a higher threshold).



PETER LILLEY

EDU SCHEME

- (i) All traders qualify once their turnover reaches the quarterly registration threshold (£7250)
- (ii) Traders in the scheme will be obliged to issue invoices on all their taxable supplies, although they will only account for VAT on turnover above the threshold.
- (iii) Input tax will not be recoverable.

CUSTOMS ALTERNATIVE

- (i) 2 registration thresholds would apply. One for service traders and one for goods traders. The service threshold would be £12,000, whilst goods threshold would remain unchanged (£22,100).
- (ii) Where a trader supplied both goods and services, he would be defined as a service trader if at least 80% of the annual turnover was derived from supplies of services.
- (iii) Service trader would be obliged to notify Customs once the turnover of the business exceeded £12,000 per annum (or £4,000 for any quarter). He would then be registered for VAT.
- (iv) Input tax would be fully deductible.
- (v) At end of trader's VAT accounting period he would calculate net tax due in the normal way, but where his annual turnover was:
  - (a) under £15,300, he would pay to Customs only

25% of the net tax due.

(b) over £15,300 but under £18,600 he would pay to Customs only 50% of net tax due

(c) over £18,600 but under £22,100 he would pay to Customs only 75% of the net tax due

(d) over £22,100 all tax due in the normal way.

HM CUSTOMS AND EXCISE  
VAT CONTROL DIVISION D  
ALEXANDER HOUSE 21 VICTORIA AVENUE  
SOUTHEND-ON-SEA X SS99 1AJ  
TELEPHONE SOUTHEND-ON-SEA (0702) 348944 ext



ECONOMIC SECRETARY

cc **Chancellor**  
Chief Secretary  
Financial Secretary  
Paymaster General  
Sir Peter Middleton  
Mr Monck  
Mr Culpin  
Miss Sinclair  
Mr Cropper  
Mr Macauslan  
Mr Flanagan

*1 taken to Rev  
GST has shown  
the ~~same~~ scheme to @ X.  
What are his views  
on New?*

**MISC 133: 27 APRIL 1988**

**A. THE IMPACT OF VAT ON BUSINESS**

1. You will recall that despite initial misgivings it was agreed that we would provide a paper on VAT for MISC. Our concern was that too much would still be expected although we had undertaken the "VAT: Small Business Review" as recently as 1986-87 (resulting in the package of measures announced by the Chancellor in last year's Budget statement). A draft of the paper, with which the EDU is broadly content, is attached for your approval (Annex A).

2. You can expect considerable interest in the paper, particularly in view of the recorded views at earlier stages. In MISC 133(87)9 the Department of Employment highlighted the vast difference in compliance costs between large and small businesses, while the minutes of the meeting on 26 January record the VAT threshold as being 'a stark example of a Government imposed restriction on the development of small business'. An introductory speaking note and defensive briefing will be provided nearer the date.

---

Internal Distribution

- |                    |           |                                |
|--------------------|-----------|--------------------------------|
| CPS                | Mr Fryett | Mr Tweddle (with Annex B only) |
| Mr Jefferson Smith | Mr Hogg   | Mr Gaw (with Annex B only)     |
| Mr Finlinson       | Mr Allen  | Mr Holloway                    |

3. A substantial portion of the paper is given over to the threshold so that the Group will see the background to the present position and the unlikelihood of our being able to get EC agreement to any significant increase. It is inevitable that the EDU will press their idea on the threshold (paragraph 17). As discussions are continuing despite our inability to support their scheme and, we must assume, their lack of support for ours, it is probable that you will be asked for a supplementary paper on this topic for a later meeting.

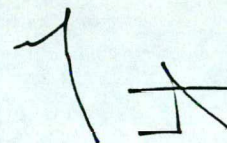
4. Joint visits with the Inland Revenue were discussed at MISC yesterday and it may be necessary to add to paragraph 24 in the light of that discussion.

5. Deregulatory action is being proposed on civil penalties, compliance costs, records and accounts, and bad debt relief. A detailed list is at paragraph 26.

#### **B. DEREGULATION IN CUSTOMS & EXCISE**

6. This paper deals with the general philosophy of deregulation in the department, looks at the opportunities for further deregulation in the functionalism of Customs and of Excise and in an annex details the action currently being taken or under active consideration. Again, a draft is attached for your approval (Annex B), and a speaking note and defensive briefing will be provided. We would expect that there would be less discussion on this paper than the one on VAT.

We are, of course, available for discussion on either or both papers should you wish.

A handwritten signature in black ink, consisting of a stylized 'P' followed by 'TREVETT'.

P TREVETT

RESTRICTED



01-270 4520

 BF 15 M 2874  
 FROM: B O DYER  
 DATE: 27 April 1988  
 29/4  
 [Signature]

PS/ECONOMIC SECRETARY

cc APS/Chancellor  
Mr R SavagePS/Customs and Excise  
Mr P R H Allen - C&E

**DEBATE ON THE EUROPEAN COMMISSION'S PROPOSAL ON THE APPROXIMATION  
OF INDIRECT TAXATION**

I am advised that Murdo Maclean - following this afternoon's meeting between the Government Business Managers and the Opposition - was unable to arrange the debate next week, but that it would take place in the following week - ie before the informal ECOFIN meeting on 13 - 15 May.

2. This allows more time to agree the text of the 'take note' Motion which must, of course, be cleared with No.10; and, I suggest, as a courtesy, with the Foreign Secretary before it is tabled.

3. We are consulting Christopher Ward (Clerk to the Select Committee on European Legislation) on the question of which documents should specifically figure in the Motion (usually those the Scrutiny Committee recommend for debate). I shall let you have his, and our, advice tomorrow.

A handwritten signature in dark ink, appearing to read 'B O Dyer'.

B O DYER  
Parliamentary Clerk

22/01

1. *Morra*  
2. *pmp*



cc. **APS/Chancellor**  
**PS/EST**

We agreed that the EST would deliberate on the terms of the Motion and clear the text with the Chancellor. It will also need to be cleared with No. 10 and, as a courtesy, with the Foreign Secy.

Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 4520

*D. Syme*  
*27/4*

Miss Sarah Straight  
Office of the Government  
Chief Whip  
12 Downing Street  
LONDON  
SW1

**PS/C&E**  
**Mr. P.R.H. Allen - C&E**

27 April 1988

*Dear Sarah,*

**DEBATE ON THE EUROPEAN COMMISSION'S PROPOSAL ON THE APPROXIMATION OF INDIRECT TAXATION**

In the light of the Chancellor's letter of 25 April to the Lord President, you confirmed yesterday that a slot would be found for the above debate one evening next week after 10pm for 1½ hours.

The relevant documents, which we expect to figure in the 'take note' Motion, are:

- COM(87)320 final - Global Communications from the Commission
- COM(87)321 final/2 - Proposal supplementing the Common System of VAT and amending Directive 77/388/EEC. Approximation of VAT rates.
- COM(87)322 final/2 - Proposals amending Directive 77/388/EEC - removal of fiscal frontiers.
- COM(87)323 final/2 - The introduction of a VAT clearing mechanism for Intra community sales
- COM(87)324 final/3 - Proposal instituting a process of convergence of rates of VAT and excise duties
- COM(87)325 final/2 - Proposal on the approximation of taxes on cigarettes
- COM(87)326 final/2 - Proposal on the approximation of taxes on manufactured tobacco other than cigarettes
- COM(87)327 final/2 - Proposal on the rates of excise duty on mineral oils

COM(87)328 final/3 - Proposal on approximation of the rates of excise duty on alcoholic beverages and on the alcohol contained in other products

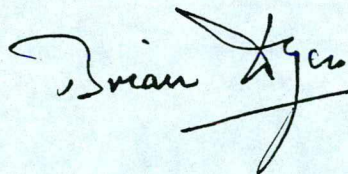
Third Report of the Treasury and Civil Service Committee, Session 1987-88. European Commission's proposals on the approximation of indirect taxation. (H/C No. 248)

Eighth Report of the Select Committee on European Legislation, Session 1987-88. (H/C No. 43VIII)

A note listing and describing the relevant documents is appended below.

The precise wording of the motion is under consideration. I shall forward this to you when agreed.

*Yours Sincerely,*

A handwritten signature in black ink, appearing to read "Brian Dyer". The signature is stylized with a large, sweeping flourish at the end.

B O DYER  
Parliamentary Clerk



## DEBATE ON TAX APPROXIMATION

List Of Documents :- (A to D)

A

### Commission proposals

1. COM(87) 320 final - Global Communication from the Commission.

This introduces and explains the package of tax measures. It reiterates commitments made by Milan European Council and subsequent meetings and enumerates the benefits of completion of the internal market.

2. COM 87 321 final/2. Proposal supplementing the Common System of VAT and amending Directive 77/388/EEC... Approximation of VAT rates.

The proposal would fix two rate bands for VAT. A reduced rate of 4 to 9 per cent, to be applied to foodstuffs (except alcoholic drinks); to energy products for heating and lighting; to water supplies; to pharmaceutical products; to books, newspapers and periodicals; and to passenger transport. A "Standard rate" of between 14 and 20 per cent, to be applied to all other taxable supplies of goods and services as laid down by the sixth VAT Directive.

3. COM(87)322 Final/2 - proposals amending Directive 77/388/EEC - removal of fiscal frontiers.

The proposed Directive would make the necessary technical amendments to the 6th VAT Directive arising both from the change to the VAT treatment of goods and services supplied from one member state to another and from the introduction of a VAT clearing mechanism.

4. COM(87)323 final/2 - The introduction of a VAT clearing mechanism for intra community sales.

As part of the package of measures to abolish frontier controls for VAT purposes, the Commission proposes that goods and services traded across EC frontiers should be treated for VAT purposes in the same way as supplies made wholly within a member state. VAT would be charged by the taxable seller in the member state of exportation and would be deductible by the taxable purchaser in the member state of importation. To ensure that the VAT continued to accrue, as now, to the country of consumption (ie importation), the Commission has outlined a central clearing mechanism to redistribute displaced revenues. No formal proposal has yet been made.

5. COM(87) 324 final/3 - proposal instituting a process of convergence of rates of VAT and excise duties

As a first step in the process of approximation, the

measure would prevent the widening of existing  
disparities between <sup>^</sup>member states indirect tax systems and  
rates, and encourage movement towards the number and  
levels of tax rates which the Commission envisage should  
apply by December 1992.

6. COM(87) 325 Final/2 - proposal on the approximation of  
taxes on cigarettes.

The proposal would fix both the duty structure and the  
rates of taxes on cigarettes.

7. COM(87) 326 final/2 - proposal on the approximation of  
taxes on manufactured tobacco other than cigarettes.

The proposal would fix both the duty structure and the  
duty rates for cigars and cigarillos, for smoking  
tobacco, for chewing tobacco and for snuff.

Arrangements for collecting the duty, including  
arrangements for deferred payment, would be laid down in  
subsequent directives to be agreed not later than 1.1.89.

8. COM(87) 327 final/2 - proposal on the rates of excise duties on mineral oils.

The proposal would fix the same duty rates for each main category of product - leaded petrol, unleaded petrol, diesel oil, heating gas oil, heavy fuel oil, LPG/methane (used as road fuel), kerosene as aviation fuel (private use) and kerosene used for other purposes.

9. COM(87) 328 final/3 - proposal on approximation of the rates of excise duty on alcoholic beverages and on the alcohol contained in other products.

The proposal would fix common rates of excise duties applicable to alcoholic beverages and the alcohol contained in other products.

(B) TREASURY AND CIVIL SERVICE COMMITTEE REPORT.

HC 248

Having taken evidence from EST, Lord Cockfield and officials, the Committee recommended that the Government should send reply to the Commission, without delay, making it plain that abolition of the zero rating principle is not something on which there can be unanimity and that the Government is not prepared to consider any draft which includes it. They further considered that the issue is so important that it should not form part of subsequent negotiations of other aspects of approximation.

They concluded that given the overwhelming arguments for zero rating, Ministers should seek to persuade other Member States of its positive merits. They did not believe that the proposals by the Commission in regard to VAT are essential for completion of the internal market. TCSC would continue to monitor the Commission's progress and recommended the House debate the proposals before ECOFIN considers the EPC report.

(c)

## SELECT COMMITTEE ON EUROPEAN LEGISLATION

HC 43 VIII

EIGHTH REPORT

The Committee examined each of the Commission's proposals for the harmonisation of indirect taxes from both the Commission's and the Department's viewpoint. The Committee found that the wide ranging package of tax proposals raised matters of major political importance. Although the principal proposals are not intended to come into effect until 1992, they noted that some of the subordinate proposals should be agreed not later than 1.1.89 and, more importantly, that the convergence proposals would need to be implemented well in advance of the tax harmonisation proposals.

They recommended that the proposals be further considered by the House at an early date.

D. Explanatory Memoranda (giving policy/revenue implications of each proposal).

8199/87 - Global Communication

8200/87 - Approximation of rates

8201/87 - Amending Directive 77/388/EEC

8202/87 - Clearing House System

8203/87 - Convergence proposal

8204/87 - Cigarettes

8205/87 - Other manufactured tobacco

8206/87 - Mineral oils

8207/87 - Alcohol



FROM: G R WESTHEAD  
DATE: 27 April 1988

cc Miss Sinclair

Ms Barratt - C&E  
Mr Monk - C&E  
PS/C&E

1. *MCU Swellie 28/4*  
2. APS/CHANCELLOR

*Content to write as drafted?  
ch (I wonder on what  
evidence C+E base x?) mmp*

*NOTE EST's  
response for clock shop.  
In the cases,  
Content  
Frankie  
as dupes!*

VAT ON CHIROPODY : CHANCELLOR'S CASE : MR FOWLER MP (ON BEHALF OF MISS TOVEY)

The Chancellor commented recently in the context of his case that he thought the borderline regarding VAT on chiropody was a strange one and asked whether the Economic Secretary was content with the stock reply.

2. In the light of the Chancellor's comments the Economic Secretary has reconsidered the reply though his view remains that the letter is acceptable and that we have a reasonably defensible line here.

3. The Economic Secretary agrees with Customs that the lobbyists (eg Miss Tovey in this case - see Annex A) seem to have confused the actual position about VAT liability here. Whether or not a particular class of medical practitioner is exempt from VAT hinges on whether he or she is enrolled on a statutory medical register NOT on whether he or she operates in private practice or in the NHS. When VAT was first introduced it was recognised that there was a need for relief in the area of health. Accordingly the exemption schedule exempted the services of doctors, dentists, opticians and other health professionals who are enrolled on statutory registers. This decision followed extensive consultations with the professional bodies and was based on the view that relief could only be effectively administered by linking it to the statutory medical registers thus providing a clear-cut borderline. This has stood the passage of time and is generally accepted as reasonable.

4. So, the exemption for the services of chiropodists is confined



X to those having statutory registration. It does not for example extend to members of the British Chiropody Association whose qualifications (so Customs understand), are not regarded as rigorous enough to justify their inclusion on the statutory register.

5. The possibility of extending relief has been examined on a number of occasions - osteopaths have mounted a vigorous campaign in recent years - but Customs have concluded that it is not possible to look at any one group in isolation. There are many other professions with various skills such as chiropractors, psycho-analysts, herbalists, acupuncturists and masseurs as well as religious groups interested in healing, none of which are statutorily registered and hence none of which are registered for VAT. Any erosion of Customs' present position would result in Customs themselves having to make value judgements about professional qualifications and particular medical treatments.

6. The Economic Secretary has also taken the chance to review the stock reply on osteopaths - a copy of which is enclosed at Annex B. He has concluded that he is content with this reply too.

*Guy Westhead.*

**GUY WESTHEAD**

**Assistant Private Secretary**



*W. G. Boyd*  
*Prayers*

MISS WALLIS <sup>ACE</sup>

**INDIRECT TAX HARMONISATION  
DEBATE : WEDNESDAY 11 MAY**

I understand that Mr Lennox-Boyd has suggested to the EST that Government backbenchers might be inspired to table an amendment to the Government's motion (copy attached); referring and approving the Government's manifesto commitment in this area.

2. It is for Ministers to judge the relative merits of such a ploy; but I would have thought that it tends to infer that the Government should have tabled a more robust motion in the first place and needs backbench Members to point them in the right direction. Clearly, if tabled and called, the Government would find it difficult to resist such an amendment.

3. The EST is considering this suggestion and might raise it with the Chancellor at Prayers tomorrow.

**B O DYER**  
**5 May 1988**

RESTRICTED



FROM: B O DYER  
DATE: 28 April 1988

01-270 4520

PS/ECONOMIC SECRETARY

cc APS/Chancellor  
Mr Culpin - FP  
Mr R Savage

PS/Customs and Excise  
Mr P R H Allen - C&E

West. 11 May: 10 pm.

DEBATE ON THE EUROPEAN COMMISSION'S PROPOSAL ON THE APPROXIMATION OF INDIRECT TAXATION : FOUNDING MOTION

As foreshadowed in my minute of 27 April, we have now received advice from Christopher Ward, Clerk to the Select Committee on European Legislation. This is reflected in the draft below:

INDIRECT TAX HARMONISATION

"That this House takes note of European Community Documents Nos. 8199/87 on indirect tax rates and structures, 8200/87 on value added tax rates, 8201/87 on the removal of fiscal frontiers, 8202/87 on a value added tax clearing mechanism for intra-Community sales, 8203/87 + COR 1 on convergence of rates of value added tax and excise duties, 8204/87 and 8205/87 on taxes on cigarettes and other manufactured tobacco, 8206/87 on excise duty on mineral oils and 8207/87 + COR 1 on excise duty on alcohol."

2. The draft Motion details the documents recommended by the Scrutiny Committee for debate, listing them under their Council numbers. Reference to the Eighth Report by the Select Committee on European Legislation and (possibly) the Third Report of the TSCS can be indicated as relevant to the debate in an italic rubric which would appear beneath the Motion on the 'Orders of the Day'. This seems entirely consistent with custom and practice. Of course, if it is deemed appropriate, a clause could be added endorsing the Government's stance in this area; essentially, a political judgement.

  
B O DYER

3rd rep

RESTRICTED



FROM: B O DYER  
DATE: 28 April 1988

*[Handwritten initials]*

01-270 4520

*passed to B.O.D. [initials]*

PS/ECONOMIC SECRETARY

cc APS/Chancellor  
Mr Culpin - FP  
Mr R Savage

*Ch/EST is content with this take note motion (likely date now Wed 11 May, at 10). But we thought we should check that you are content. OK?*

PS/Customs and Excise  
Mr P R H Allen - C&E

**DEBATE ON THE EUROPEAN COMMISSION'S PROPOSAL ON THE APPROXIMATION OF INDIRECT TAXATION : FOUNDING MOTION**

*mpw 4/5*

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2. The draft Motion details the documents recommended by the Scrutiny Committee for debate, listing them under their Council numbers. Reference to the Eighth Report by the Select Committee on European Legislation and (possibly) the Third Report of the TSCS can be indicated as relevant to the debate in an italic rubric which would appear beneath the Motion on the 'Orders of the Day'. This seems entirely consistent with custom and practice. Of course, if it is deemed appropriate, a clause could be added endorsing the Government's stance in this area; essentially, a political judgement.

*end last begin response ex mems*

*issues no recs, other than debate*

*[Signature]*  
B O DYER  
Parliamentary Clerk



PRIVY COUNCIL OFFICE  
WHITEHALL, LONDON SW1A 2AT

29 April 1988

H/EXCHEQUER	
DATE	03 MAY 1988
ACTION	EST
COPIES TO	

J/S

2 questions.  
1st why is the...  
2nd why is the...  
1st why is the...  
2nd why is the...

Dear Nigel

**DEBATE ON THE EUROPEAN COMMISSION'S PROPOSAL ON THE APPROXIMATION OF INDIRECT TAXATION**

Thank you for your letter of 25 April seeking L Committee's agreement to a debate on the Commission's proposals on the approximation of indirect taxation.

You indicated that it was desirable that a debate should take place before the Economic and Financial Affairs Council meeting on 13-15 May. This is a somewhat tight timetable, but I understand that the Whips expect to be able to arrange a debate during the week beginning 9 May.

I am copying this letter to the members of L and OD(E) Committees, Geoffrey Howe and Sir Robin Butler.

*John Wakeham*

JOHN WAKEHAM

The Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer

RESTRICTED



FROM: P D P BARNES  
DATE: 3 May 1988

MR DYER

cc PS/Chancellor 2  
Mr Scholar  
Mr Culpin  
Mr A J C Edwards  
Miss Sinclair  
Mr R I G Allen

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

DEBATE ON THE EUROPEAN COMMISSION'S PROPOSALS ON THE APPROXIMATION  
OF INDIRECT TAXATION : FOUNDING MOTION

Thank you for your minute of 28 April, which the Economic Secretary  
has seen.

2. The Economic Secretary is content with the draft motion you  
suggested.

PD

P D BARNES  
Private Secretary

CONFIDENTIAL

FROM: P J CROPPER  
DATE: 3 May 1988

ECONOMIC SECRETARY

cc Chancellor  
Chief Secretary  
Financial Secretary  
Paymaster General  
Mr Tyrie  
Mr Call

CROPPER  
BT  
3/5

*Ch/- would you like to discuss  
X at our ECT meeting?*

VAT ON CHARITIES

*hgnw 215*

*Yes; Wh. mean that  
will need to be  
copied to relevant  
officers.*

May I suggest that we ought to think again about VAT and Charities, before publication of the ECJ ruling. This might be relevant to the agenda Miss Sinclair is preparing for a meeting with the Chancellor.

2. The VAT Charities Group has written to you expressing keen disappointment that the Budget did not relieve charities from existing VAT imposts. They will become frantic when they realise they are going to have to pay VAT on new construction work, and possibly on heating and lighting in residential homes, water, sewerage etc. etc.

3. Maybe the first step is to make ourselves absolutely clear about the EC position. Do we have any latitude to zero-rate charities, or otherwise arrange to refund them the VAT they pay on their purchases, even if we wanted to? If we do not have any latitude, that is that, and the sooner we say so the better. If we do have any latitude, what is it, and what might we do?

4. My level playing field principles make me want to oppose the charities' plea for relief. On the other hand they are in a peculiarly difficult situation because they do not generally collect VAT on sales, against which to set the VAT they pay on inputs (i.e. they are exempt in respect of the goods and services they provide). So the perceived burden is heavier than in the case of commercial enterprises where VAT on purchases is largely recovered from VAT on sales.

X

5. Essentially, can we clear the ground ahead of the ECJ ruling, so that we are ready to respond clearly and firmly to the concerns the charities will immediately express?



P J CROPPER



ANNOTATED AGENDA

CONFIDENTIAL

FROM: C E C SINCLAIR

DATE: 5 May 1988

CHANCELLOR

cc PS/Chief Secretary  
PS/Financial Secretary  
PS/Paymaster General  
Sir P Middleton  
Sir T Burns  
Sir G Littler  
Mr Anson  
Mr Scholar  
Mr Phillips  
Mr Culpin  
Mr A J C Edwards  
Mr Turnbull  
Mr Burr  
Mr Richardson  
Mr Potter  
Mr Michie  
Mr Cropper  
Mr Jefferson-Smith C & E  
Mr Wilmott C & E  
Mr Tracey C & E  
PS/C & E

**VAT ON NON-DOMESTIC CONSTRUCTION: ECJ JUDGEMENT: MEETING ON 11 MAY: ANNOTATED AGENDA**

As requested by Miss Wallace I attach an annotated agenda prepared by Mr Michie for the above meeting. The agenda falls into 5 parts:

- (a) the exact scope of an adverse ECJ Judgement on VAT on non-domestic construction;
- (b) tidying up existing VAT legislation on property;
- (c) the immediate implications for public expenditure;
- (d) the implications for the continuation of Section 20 of the VAT Act 1983;
- (e) the implications for charities.

2. The agenda is drafted on the assumption that the European Court closely follows the line taken in the Advocate General's Opinion. Annex A sets out the zero rates which are under challenge.

3. The papers for this meeting are:

Mr Jefferson-Smith of 22 March 1988: VAT on non-domestic construction; ✓

Mr Barnes of 6 April 1988: VAT on non-domestic construction; ✓

Mr Jefferson-Smith of 12 April 1988: VAT: Property; ✓

Mr Barnes of 26 April 1988: VAT: Property; ✓

Mr Richardson of 27 April 1988: VAT Infraction Case: Public Expenditure Treatment; ✓

Miss Sinclair of 5 May: VAT: Future of Section 20. ✓

*L. Joseph Mennie*  
A. C. E. C. SINCLAIR

**CONFIDENTIAL**

**ANNEX**

Of the zero-rates challenged by the Commission, the following are regarded by the Advocate General as being in breach of Community legal requirements:

- non-domestic construction;
- civil engineering;
- supplies to industry of water and sewage services;
- supplies to industry of fuel and power;
- protective boots and helmets supplied to employers;
- news services, other than those intended directly for the public or for the production of zero-rated products such as newspapers.

But the following are regarded by the Advocate General as within Community law:

- private housing;
- animal feedstuffs, seeds and live animals yielding food for consumption;
- news services supplied directly to the public or in the production of zero-rated products (eg newspapers).

ANNOTATED AGENDA

A - APPLYING ECJ RULING

U/Customs have not suggested that the meeting should cover aspects of the ECT ruling other than construction, but bizarrely, Mr J-S's submission to EST (9/5, behind) raises other issues, not yet decided, some of them potentially tricky. EST is holding a meeting post Lake Como, but you may wish to glance at J/S note.

1. Timing and Content of response to European Court Judgement

(i) Is it agreed that a short statement promising consultation should be made to the House immediately after the Judgement, followed by a fuller statement some two to three weeks later? Should these statements be made by the Chancellor or the Economic Secretary?

What does this mean?

(ii) Is it agreed that we should take all reasonable steps to mitigate any adverse effects of the change, and that we should give taxpayers the benefit of any doubt, subject to the need for administrative simplicity?

? What does this mean?

(iii) Any conflict between such an approach and long term policy aims on extension of the VAT base?

2. Definitional questions

(a) Communal residential establishments:

(i) should we try to ensure that all such establishments remain zero-rated? or legal/social/or what?

(ii) is there a need to distinguish between long-term (eg old peoples homes) and short-term (eg hotels) establishments with only the former being zero-rated;

(iii) is it agreed that final decisions on the above points can await the outcome of consultations with the interested bodies? [How quickly do we think consultation could be carried out?]

(b) Non-residential buildings for community use (including churches, community centres, sheltered workshops etc):

(i) should we attempt to continue zero-rating these buildings in the knowledge that, whilst they are unlikely to be specifically mentioned in the Judgement, it is almost certainly the case that in EC law they do not qualify for zero-rating?

What does this mean?

(ii) final decision to await outcome of consultations?

(c) **Protected buildings – listed buildings and monuments:**

(i) should the treatment of alterations to listed buildings be consistent with that which is to be applied to communal residential buildings and non-residential community buildings? eg if it is decided that only the former will continue to be zero-rated, then the alteration to a listed residential building would continue to be zero-rated, whereas the alteration of a listed church would not.

(ii) final decision to await outcome of consultations?

(d) **Definition of new buildings**

(i) so as to minimise the opportunity for VAT avoidance, should the definition of new building be extended to cover any building less than five years old?

(ii) final decision to await outcome of consultation?

(e) **Building land**

(i) building land for non-residential purpose to be taxed?

(ii) final decision to await outcome of consultation?

(f) **Scope of option to tax non-residential rents and sales of used non-residential buildings**

should:

(i) the option to tax be allowed for rental of both new and used buildings, and for the sales of used buildings?

(ii) the right to opt to tax rents be given to landlords only?

(iii) there be no right of veto for existing tenants?

(iv) there be some form of transitional relief for existing tenants? eg a three or five year phasing-in of the full charge to tax.

- (v) the option of the right of tax rents be introduced some months after the imposition of VAT on commercial construction? (1 August 1989?)
- (vi) the following conditions be applied to option to tax rents?:
  - (a) the option must be exercised on a building by building basis (as opposed to individual tenants);
  - (b) it must be irrevocable for that building (for both lettings and disposal?);
  - (c) landlords must notify Customs of the properties for which the option to tax has been taken up.
- (v) decisions in respect of (f) (i) to (vi) to be announced as soon as possible (perhaps within 2 or 3 weeks) after the Judgement?

3. **Transitional relief for existing contracts**

- (i) is it agreed that there should be a wide measure of relief for existing contracts as an addition to normal rules?
- (ii) final decisions to await outcome of consultation?

4. **Anti-avoidance provision**

- (i) should there be a self-supply order for construction services, similar to that which already exists for stationery?
- (ii) should main contractors be required to retain and account for output tax charged by sub-contractors?
- (iii) decision in principle now, details after consultation?

5. **Next steps**

Is it agreed that Customs should draft both the short and longer statements to be made after the ECJ ruling in the light of decision on taxbase?

↙ All sorted out, bar hairdressers' chairs (not known when this was prepared)

**B. TIDYING UP EXISTING VAT LEGISLATION IN RELATION TO PROPERTY**

1. The ECJ ruling would be an opportunity to tidy up certain aspects of the legislation on VAT on property. Is it agreed that the following changes should be made in the 1989 Budget?:

- (i) exhibition stands: remove current provision for standard-rating of sites or space at certain exhibitions?;
- (ii) surrenders of interest in property: remove "surrender" from the list of exempt land transactions?;
- (iii) tax all lettings of caravan pitches at seasonal sites?;
- (iv) tax long term lettings of boxes and seats at sports grounds and places of entertainment?;
- (v) tax freehold sales of shooting and fishing rights?;
- (vi) tax sales and long leases of purpose built holiday accommodation?;
- (vii) restrict zero-rating of builders' materials and fittings to supplies by the person who actually incorporates them into the building?;

2. Is it confirmed that no change should be made to:

- (i) the current exemption of the letting of facilities for sports?;
- (ii) the current exemption of hairdressing chair rentals?;  
X (remitted to F&T)
- (iii) the current zero-rating of service charges for leasehold dwellings?;  
X (retain, pro tem)

**C. PUBLIC EXPENDITURE IMPLICATIONS OF ECJ RULING FOR CENTRAL GOVERNMENT DEPARTMENTS AND HEALTH AUTHORITIES**

On the assumption that the Judgement is received in the next two or three months, is it agreed that:

- (i) extra VAT costs be dealt with through public expenditure provision in the forthcoming Survey (departments be advised of this immediately following the first Government statement);
- (ii) a PESC paper be circulated (immediately after the second Government statement), treating new construction VAT costs in neutral terms, but asserting a presumption of absorption for any increased rent costs resulting from the option to tax;
- (iii) for health authorities, any increased rent costs be dealt with similarly through public expenditure; but that, unless it is intended to require health authorities to absorb some or all of the VAT on new construction, refunds for these costs be offered under section 11 of the Finance Act 1984.

**D. SECTION 20**

*(clearly steering towards (c)(i))*

- (a) **abolition:** is it agreed that despite there being no economic justification for allowing section 20 bodies to escape VAT, the practical difficulties of abolishing the section outweigh the benefits?
- (b) **widening:** is it agreed that the problems involved in a wide application of Section 20 (eg inclusion/exclusion of charities) outweigh the presentational benefits on the public expenditure side?
- (c) **continuation:**
  - (i) is it agreed that eligibility for inclusion in Section 20 should continue to be granted only to those bodies which perform local authority type functions and which are funded directly from the rates or rates support grant?;
  - (ii) if the answer to (i) above is 'yes', should a rates-funded benchmark be established eg at least 25% of the funding must be rates-related? Would this help in dealing with (growing) pressure for further extension?

**E. POSSIBLE AMELIORATING PROVISIONS FOR CHARITIES**

Should we:

*Shd also be known*

- (i) attempt to calculate (by employing outside consultants?) the burden which is likely to fall on charities as a result of the Judgement?;

*NW*



- 12
- (ii) ask Customs to find out how charities are treated for VAT in other Member States?;
  - (iii) ask Customs to investigate what action would be open to us to help charities which would not infringe on our EC obligations?;
  - (iv) ask Customs and Inland Revenue to investigate other possible tax 'lollipops' for charities?

[Mr. Fowler]

own minds about whether to cross a picket line and to work. The right hon. Gentleman should respect those individual rights.

**Sir Ian Lloyd (Havant):** The very grave allegations made a few moments ago by the hon. Member for Oldham, West (Mr. Meacher) that standards of safety have been seriously compromised by the management of P and O are so serious that they should either be substantiated immediately or withdrawn.

**Mr. Fowler:** As I have said, the suggestions by the hon. Member for Oldham, West (Mr. Meacher) about safety standards are simply untrue. [Interruption.] I shall tell the hon. Gentleman how I know. The two P and O ferries that have returned to service have been very thoroughly inspected by Department of Transport surveyors. Probably no two ferries have ever been more thoroughly inspected. As my hon. Friend rightly suggests, it would be much better if the hon. Gentleman withdrew those suggestions.

**Mr. Ieuan Wyn Jones (Ynys Môn):** Does the Minister agree that the adversarial nature of legal proceedings means that the parties are now being driven into positions from which it will be difficult for them to negotiate, and because the ferry operators now believe that they have the upper hand in those legal proceedings they are merely waiting for the union's resolve to be crushed? Does not the Minister think that he should now reflect and use his good offices to urge the parties to go to arbitration because that is the only sensible way to resolve the dispute?

**Mr. Fowler:** I do not accept that at all. No objective observer would accept the hon. Gentleman's description of what has taken place. The NUS has been given every opportunity to avoid what has taken place in the courts. The courts have made that clear and the judge has made that clear, and the NUS has only itself to blame.

**Mr. Nicholas Bennett (Pembroke):** Does my right hon. Friend agree that we are seeing the dying gasps of boneheaded trade unionism, which contrasts very much with the new realism of the electricians and the engineers? Does my right hon. Friend also agree that it is not surprising that the Labour party should support the NUS when Mr. McCluskie is a member of its national executive and there is more interest in the leadership contest between the leader of the Labour party and the right hon. Member for Chesterfield (Mr. Benn)?

**Mr. Fowler:** What we do not want to see are the dying gasps of the British ferry industry and the competitive position of British ferries. That is the point. The course on which the hon. Member for Oldham, West (Mr. Meacher) seems determined to take his party means that British jobs will again be lost as a result of union action and the hon. Gentleman's support.

Several Hon. Members rose—

**Mr. Speaker:** Order. I remind the House that this is a private notice question, which is an extension of Question Time, and we must now move on.

PS/Chaneetha, For info

## Business of the House

3.51 pm

**Mr. Frank Dobson (Holborn and St. Pancras):** May I ask the Leader of the House to state the business for next week?

**The Lord President of the Council and Leader of the House of Commons (Mr. John Wakeham):** The business for next week will be as follows:

MONDAY 9 MAY—Consideration in Committee of the Finance (No. 2) Bill.

TUESDAY 10 MAY—At the end on Tuesday motion on the Control of Misleading Advertisements Regulations.

WEDNESDAY 11 MAY—Opposition Day (11th Allotted Day). There will be a debate on an Opposition motion entitled "The Crisis in Housing".

Motion to take note of the European Commission's proposal on the approximation of indirect taxation. Details of the EC documents concerned will be given in the *Official Report*.

The Chairman of Ways and Means has named opposed private business for consideration at seven o'clock.

THURSDAY 12 MAY—There will be a debate on prisons on a motion for the Adjournment of the House.

Motion on the European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (Immunities and Privileges) Order.

The Chairman of Ways and Means has named opposed private business for consideration at seven o'clock.

FRIDAY 13 MAY—Private Members' Bills.

MONDAY 16 MAY—Until seven o'clock, private Members' motions. Second Reading of the Civil Evidence (Scotland) Bill [Lords].

[Debate on Wednesday 11 May 1988

Relevant European Community Documents

8199/87	Indirect tax rates and structures
8200/87	Value added tax rates
8201/87	Removal of fiscal frontiers
8202/87	Value added tax clearing mechanism for intra-Community sales
8203/87 + COR 1	Convergence of rates of value added tax and excise duties
8204/87}	Taxes on cigarettes and other
8205/87}	manufactured tobacco
8206/87	Excise duty on mineral oils
8207/87 + COR 1	Excise duty on alcohol
Relevant Report of European Legislation Committee HC 43-viii (1987-88). para 1	

Relevant Reports of the Treasury and Civil Service Committee

Third Report (1987-88), (HC 248)

First Special Report (1987-88) (HC 438)]

**Mr. Dobson:** First, does the Leader of the House recall telling the House last Thursday that he would try to get the Secretary of State for Social Services to clarify when the special Department of Health and Social Security unit dealing with excessive cuts in housing benefit would be set up, where it would be located, and how people affected should make claims? Since then, there has been no such clarification about that U-turn unit, so will the Secretary of State for Social Services now come to the House to spell out exactly what is going on and to give answers to the questions that hon. Members on both sides of the House are being asked by their constituents?

[Mrs. Ann Winterton]

prevent any possible filibuster and enable right hon. and hon. Members to exercise their own judgment on this important matter?

**Mr. Wakeham:** I have a great deal of sympathy with my hon. Friend. Filibusters and rules of order are matters not for me, but for you, Mr. Speaker. I am sure that the whole House would deprecate the use of filibustering tactics to avoid discussion of this important issue.

**Mr. Robert Maclennan** (Caithness and Sutherland): In view of the reports, which have appeared this morning and been confirmed by a Government spokesman this afternoon, that the Government's chief scientific adviser has recommended the cancellation of the fast breeder reactor programme, and of the alarm and despondency that that report has caused, will the Leader of the House ensure that the Secretary of State for Energy makes a statement next week at the earliest opportunity?

**Mr. Wakeham:** I do not know where the hon. Gentleman gets all his information. The information that I have is that the Government review all their R and D programmes from time to time, which is good management, as the hon. Gentleman will agree. We are considering a range of options for the fast reactor programme, but no decisions have yet been taken. I shall certainly refer his question to my right hon. Friend, as I know of his constituency interest in the matter.

**Mr. Ivan Lawrence** (Burton): As there is obviously deep feeling in the country and among my colleagues in the House about the future of the British passport, would it not be appropriate for the mood of the House to be tested by having a debate on the subject at the earliest possible opportunity?

**Mr. Wakeham:** I shall certainly bear that suggestion in mind. The British passport is not being replaced by a European Community one, as is alleged in some quarters. Rather, a new version of the British passport, machine-readable and in a common format agreed in 1981 with other EEC countries, will start to appear from July when the Glasgow passport office is computerised.

**Mr. Nigel Spearing** (Newham, South): Will the right hon. Gentleman confirm that the import of his announcement about next Wednesday's business is that there will be private business from 7 pm to 10 pm and then a debate on the important proposals of Lord Cockfield and his associates on VAT extensions to food, fuel, domestic building and water and sewerage? According to a written answer that I received on Tuesday, it will also be extended to charity sales from gift shops. Is not one and a half hours too short a time in which to debate this important extension of taxation for the British people? If the right hon. Gentleman persists in having the debate at that time of night, will he consider suspending the rule and making the debate a bit longer?

**Mr. Wakeham:** I appreciate that this is an important matter. I think that the arrangements I have made for the debate are adequate. I am certainly prepared to have discussions if there is a general wish to extend the time.

**Mr. Tony Marlow** (Northampton, North): My right hon. Friend will have seen early-day motion 1053, which has been tabled by various influential Opposition Members.

[That this House condemns the continued Government attempts to interfere with the Independent Broadcasting Authority and British Broadcasting Corporation in their efforts to report and comment on the Gibraltar assassinations; and considers that both the shoot to kill policy and suppression of comment are serious aspects of this extreme right-wing Conservative Government.]

He will notice that it seeks to brand British service men as assassins. I think he will agree with me that it is the most disgraceful and shameful EDM that we have seen. May we have an early opportunity to debate it so that we can point out the way in which certain members of the Labour party seek to twist the knife in the spine of the British services, and so that the public at large, although we are not allowed to say that that is intentional in this place, will make up their minds that it is? It is the Opposition's intention to do all that they can to undermine the success of our service men in the fight against the vile terrorists who, in cold blood, killed three innocent young men in Holland last weekend.

**Mr. Wakeham:** The Government's concern is about the interference with witnesses and the effect that that could have on the inquest that will take place in Gibraltar. Of course, there is no question of the Government seeking to challenge the constitutional independence of the broadcasting authorities; it is the damage that is done that we find reprehensible, and it should not have taken place. That is why I had better restrain myself from making further comments now.

**Mr. James Kilfedder** (North Down): On a point of order, Mr. Speaker. Is it in order for the early-day motion referred to by my hon. Friend the Member for Northampton, North (Mr. Marlow) to remain on the Order Paper, given the terms in which it is couched? It brands three soldiers as assassins, when no decision on that has yet been made in any court of law.

**Mr. Speaker:** Order. The early-day motion is in order.

**Mr. Peter Shore** (Bethnal Green and Stepney): May I press the Leader of the House further on the business announced for Wednesday? It really is not good enough to have a debate lasting one and a half hours after 10 pm on a matter as important as the harmonisation of value added taxes throughout the Community — and the harmonisation of excise duties, too. This is one of the most serious proposals to come out of the EEC. It will affect the sovereignty of the House in ways deeper than many of its other enactments. Surely the matter should have been given a proper debate in prime time.

**Mr. Wakeham:** I have heard what the right hon. Gentleman said. I repeat that I believe that what we have done is right and adequate, but I am certainly prepared to examine the matter again in view of what he has said.

**Sir Ian Lloyd** (Havant): From a somewhat less localised standpoint than the hon. Member for Caithness and Sutherland (Mr. Maclennan), may I express my anxiety about the future of the fast breeder reactor programme? As Great Britain has spent an enormous sum developing this most important technology, and as her reputation stands high and it is at least arguable — I put it no stronger than that — that the future of energy in the next century could depend on the continuation of that

[Mr. Greville Janner]

death of British commandos, may we have a statement from the Home Secretary about how the inquiry is progressing, or can the Leader of the House give some indication? Meanwhile, may we have an assurance that there will be no contacts between the British ambassador in Austria and President Waldheim unless and until he is cleared of these allegations?

**Mr. Wakeham:** The review is being conducted by the Ministry of Defence and it is intended to be as thorough and comprehensive as possible. It is being pursued as quickly as is consistent with proper consideration of the evidence and the need for accuracy. Although good progress is being made, this is a complex and important matter and it would be premature to speculate on when the review might be completed. It would not be appropriate for me to comment on the findings before the review is completed.

**Mr. Bowen Wells:** On Wednesday the harmonisation of VAT and excise duties is to be debated for only one and a half hours. Is it not absurd that we will be considering for such a short time matters that are normally the subject of a Bill—for instance the Finance Bill which occupies much time on the Floor of the House and in Committee? Does my right hon. Friend agree that the question of dealing with European legislation—a question that I have raised with him before—should be immediately considered by the Procedure Committee, which I am delighted to say he has been able to set up? Will he refer this matter to the Committee urgently because clearly he cannot find proper time for it in normal business hours?

**Mr. Wakeham:** My hon. Friend used the word "absurd". I suggest that he reads the Government motion before reaching such a conclusion. I think that what I have done is the sensible way forward, but, as I have said, I am prepared to have discussions to see whether we can find better arrangements.

**Mr. Keith Vaz (Leicester, East):** Will the Leader of the House make time available for an urgent debate about the state of Britain's footwear industry? Is he aware that there are 11,000 footwear workers in Leicestershire and in other parts of the midlands? Is he also aware of the new figures published by the British Footwear Manufacturers Federation which show that the imports have increased dramatically over the past month? When may we have a chance to debate this important matter?

**Mr. Wakeham:** As I am sure the hon. Gentleman will accept, there are many important matters calling for the time of the House and it is impossible to fit them all in. Perhaps an Adjournment debate would enable him to put some of the points that he wishes the House to appreciate.

**Mr. John Marshall (Hendon):** Will my right hon. Friend consider initiating a debate on the future of the confectionery industry which faces the threat of 80 per cent. of the industry being owned by companies in non-EC countries? Is my right hon. Friend aware that Rowntree is subject to a bid by two Swiss companies, both of which are immune to a counter bid from Rowntree?

**Mr. Wakeham:** Under the Fair Trading Act 1973 the Director General of Fair Trading has a duty to advise my right hon. and noble Friend the Secretary of State for Trade and Industry about whether a merger or a

prospective merger should be referred to the Monopolies and Mergers Commission for further investigation. The Director General takes into account all matters which may raise questions of public interest, including the points that my hon. Friend raised, and the likely and significant effect on employment and other matters. I think we had best leave it at that.

**Mr. Dennis Skinner (Bolsover):** Why does not the Leader of the House arrange a debate next week about the seamen's dispute so that we can fully engage in an argument about the real facts? Will he tell his right hon. Friend the Secretary of State for Employment to have a more comprehensive list of the facts when he next appears at the Dispatch Box? Will he tell him, for example, that there is nothing wrong in Labour Members such as myself going to a picket line in Dover or anywhere else when the Prime Minister spends her time sipping gin and tonic and whisky with Jeffrey Sterling in Downing street? He is employed as a special adviser to the Government and the Prime Minister and gives £100,000 for Tory party funds.

There is much talk about a ballot. The Leader of the House should tell his right hon. Friends that all the seamen in Britain wanted a ballot, but were stopped from having one by the Tories' friends in the courts. There is also an argument about safety. If the Leader of the House had watched the BBC programme the other night, he would know that many ships are in jeopardy and that Sterling wants to reduce even further the number of men and women who are employed. The Government are interested in seafarers only when they want them to fight their wars.

**Mr. Wakeham:** The one thing that is quite clear from that diatribe is that the hon. Gentleman does not want to resolve the dispute. I should have thought that he would be the first to understand that in all industrial disputes the resolution of the issues must be a matter for the parties operating within the law and taking cognisance of economic circumstances. I do not think that a debate would improve the situation one iota.

**Mr. Ian Bruce (Dorset, South):** Is my right hon. Friend able to organise a debate on office accommodation in the Palace of Westminster? In view of the comments made in the press by the hon. Member for Brent, East (Mr. Livingstone)—he said that the Labour Whips were not able to give him accommodation—is my right hon. Friend able to confirm that the Opposition Whips were given more than their fair share of accommodation? As all Conservative Members have offices, is it not strange that the Opposition Whips were unable to find the hon. Gentleman an office?

**Mr. Wakeham:** I cannot comment on the remarks of the hon. Member for Brent, East (Mr. Livingstone) about those matters. Office accommodation is not as satisfactory as some people would like, although both sides of the House do their best. The Opposition have their way of doing things and we have our way, and we had best leave it at that.

**Mr. Harry Cohen (Leyton):** May we have a full-scale debate on the P and O attempt to break the National Union of Seamen? Some hon. Members wish to make the point that the P and O management appears to be above the law as it has not been brought before the law for its part in the Zeebrugge tragedy. It is attempting to smash the trade union and to worsen—



HOUSE OF COMMONS  
LONDON SW1A 0AA

A handwritten signature in blue ink, appearing to be 'Nigel', located in the top right corner of the page.

A handwritten signature in blue ink, appearing to be 'Jane', located below the 'Nigel' signature.

May 1988

Thank you for your telephone call to my constituency office on 21 April about the VAT problems of Sightsale Publishing Limited.

Customs tell me that much of the Company's debt has arisen because it chose to pay lesser amounts, centrally assessed by Customs in the absence of the due returns, which were not rendered until many months after the due date.

VAT registered traders who do not submit returns and pay the tax due on time in effect obtain an unfair trading advantage over other traders, including direct competitors, who fulfil their legal obligations.

Customs tell me that the present debt is £16,036.23 and that they would be exceptionally prepared to accept settlement either by:-

(a) an immediate payment of £6,658.28, with the balance payable by 18 equal monthly instalments, or

(b) a deposit of £6,658.28, within the whole debt payable by 18 equal monthly instalments, the initial deposit to be refunded when 9 payments had been made in accordance with the agreed schedule.

I must stress that either alternative would be conditional upon future returns being rendered, and the tax paid by the due date.

If you wish to take up either of these options you should submit proposals as soon as possible to your local VAT office. I have to say that, in the particular circumstances, I consider the proposed terms to be a reasonable compromise, and hope you and your prospective backers will be able to so agree.

I am sorry I cannot be more helpful.

Yours sincerely

NIGEL LAWSON



H.M. CUSTOMS AND EXCISE  
KING'S BEAM HOUSE, MARK LANE  
LONDON EC3R 7HE  
01-626 1515

PWP

PS/ECONOMIC SECRETARY

cc PS/Chancellor  
PS/Chief Secretary  
PS/Financial Secretary  
Mr Byatt  
Miss Sinclair  
Mr Cropper  
Mr Tyrie  
Mr Call

**TAX APPROXIMATION : "VAT - THE ZERO RATE ISSUE" - PAPER PREPARED BY BEN PATTERSON, MEP**

1. The above paper was attached to Mr Cropper's note of 15 February. This note provides a brief outline of the contents of Mr Patterson's paper, highlighting those parts which are helpful to the UK position on zero rating and those which are less so.
2. Mr Patterson examines in detail the obstacles the UK's zero rating is said to present to the European Commission's proposals for the approximation of tax rates throughout the Community.

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Internal Circulation: CPS, Mr Knox, Mr Jefferson Smith,  
Mr Nash, Mr Finlinson, Mr Cockerell, Mr  
Kent, Mr Oxenford

3. Mr Patterson looks at a number of the economic and social issues involved in zero rating and the possible alternatives to this strategy. In particular he examines whether, in the case of food, the benefits of zero rating are fully passed to the consumer and whether a positive rate of VAT would also be passed on in full. He examines the effect of zero rating against the Commission's assertion that zero rating provides a price advantage, distorts competition and is not a tax at all but a form of subsidy. He also looks at the arguments for and against the zero rating of specific categories of goods, ie children's shoes, food, housing and construction and books, periodicals and newspapers.
4. Mr Patterson concludes that whilst the Commission are right insofar as something along the lines of Lord Cockfield's proposals is required for a "barrier free" Europe, they are incorrect about zero rating, which is entirely compatible with the abolition of fiscal frontiers. He suggests that the problem of UK zero rating may be tackled in one of four ways: (i) by confining fiscal approximation to those goods and services which can cross frontiers; (ii) by derogation; (iii) by amending the Commission proposal, so that the lower limit of the "reduced rate" band is zero; or (iv) by creating a separate zero rate at Community level. The "ideal solution advocated by Mr Patterson is UK acceptance of the case for approximation, followed by "a campaign to spread the benefits of our own system (i.e. zero rating) to the other 270 million Community citizens". This seems optimistic, to say the least.
5. Brief comments on the four solutions to the UK zero rate problem follow:-
  - (i) Confining fiscal approximation to "those goods and services which can cross frontiers" would assist the argument that zero-rating does not lead to distortions of trade. However, this suggestion leaves open the question of goods such as food and children's clothes which can be traded across frontiers. It therefore runs the risk of requiring three VAT rates.

(ii) On the question of derogations, the Commission have acknowledged that some countries will face considerable difficulties with fiscal approximation, particularly in the field of zero-rating. Where these difficulties cannot be overcome they have not ruled out the possibility of derogations. However, they see the proliferation of derogations as presenting a serious problem that could threaten the operation of the internal market and the Commission would probably seek to insist that any derogation was strictly temporary.

(iii) The proposal to amend the lower limit of the reduced rate band to zero has much to commend it. However, whilst it would allow the UK to preserve its current zero-rating, the upper limit of the band would probably need to be reduced to 5-6% so as to prevent the distortions to trade that the tax approximation proposals set out to avoid. This course would also bring increased revenue pressures on those Member States with the highest tax rates. Indeed, as Mr Balladur has recently made clear, the French consider that the band widths should be no more than 2%. A 0-2% reduced rate band is unlikely to be acceptable to many Member States.

(iv) To create a separate zero rate at Community level, applying to items rated at zero or very low rates in a number of Member States (the obvious candidate being publications) is completely at odds with the Commission's strategy; and as presented by Mr Patterson the proposal is also unacceptable to the UK, as it appears to provide for zero rating only on those items which are already zero-rated in several Member States; food and young children's clothing would be excluded.

6. One interesting contribution to the general discussion of tax approximation is Mr Patterson's analysis of the effect of zero rating on the competitive position of Member States. He argues that as the revenue lost by zero rating has to be recouped from other taxes, which are unlikely to be rebateable at export (unlike VAT), a country that uses extensive zero



rating may be at a disadvantage compared to one that obtains a high proportion of revenue from VAT and thus needs to get less revenue from other taxes that enter into the cost of exports.

7. Although Mr Patterson's paper does not cover any new ground, it is generally well researched\* and presented and provides a useful insight into zero rating from a social and economic viewpoint. His conclusions as to the overall benefits of zero rating are particularly helpful. However, the paper is less helpful in the importance it attaches to the overall concept of fiscal approximation, the case for which is not proven and which this paper does nothing to prove. Moreover, the recent developments in France (Boiteux report and M. Balladur's reaction) suggest that the prospects for indirect tax approximation are less rosy than Mr Patterson envisages. (A further report on these developments will be submitted before Easter).

RA.

P R H ALLEN

\*However, the suggestion at page 18 of the paper that imposing VAT at 15% on children's shoes would raise about £40 million is incorrect. The figure involved is about £95 million.

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The Lord President of the Council

DEBATE ON THE EUROPEAN COMMISSION'S PROPOSAL ON THE APPROXIMATION  
OF INDIRECT TAXATION

The Treasury and Civil Service Committee has recommended a debate on the Commission's proposals "before the Economic and Financial Affairs Council (ECOFIN) considers the Economic Policy Committee's report". This follows an earlier recommendation by the House of Commons Select Committee on European Legislation that the proposals should be further considered by the House "at an early date".

low the approximation  
of indirect taxation

Substantive discussion of the Economic Policy Committee's report by ECOFIN is scheduled for its informal meeting at Lübeck on 13-15 May. If there is to be a debate, I suggest that it should take place in advance of the Lübeck meeting as the TCSC recommends - ie not later than the week beginning 9 May.

I suggest a debate on the floor of the House for 1 1/2 hours after 10.00 pm. A take note Motion would seem appropriate.

I am copying this letter to Sir Geoffrey Howe, to members of L and OD(E) Committees and to Sir Robin Butler.

it ~~would~~ would  
certainly be done