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FROM: MISS M P WALLACE

DATE: 28 April 1988

PS/ECONOMIC SECRETARY

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

1. Jonathan - you haven't been
any answers on
this, have you?

No, I haven't.

2. Paul, pl check your
colleagues

Delayed by Tax Approx debate,
with have submission by end of
the week.

VAT APPROXIMATION: LOWER BAND OF VAT

... I attach a ^{copy of a} paper which the Chancellor has received from Ben Patterson MEP. The Chancellor has noted Mr Patterson's advocacy of a 0-6 per cent lower band of VAT, also put forward by Mr Alman Metten (my minute of 28 March refers). He would be grateful for Customs' comments, routed via the Economic Secretary, on whether this would be practicable.

Thanks. BF 25/5

mpw.

27/5

MOIRA WALLACE



EP
PE

DISCUSSION PAPER

VAT

THE ZERO RATE ISSUE

BY

BEN PATTERSON

Member of the European Parliament
for Kent West

EUROPEAN DEMOCRATIC GROUP
THE CONSERVATIVES IN THE EUROPEAN PARLIAMENT

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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

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 ?

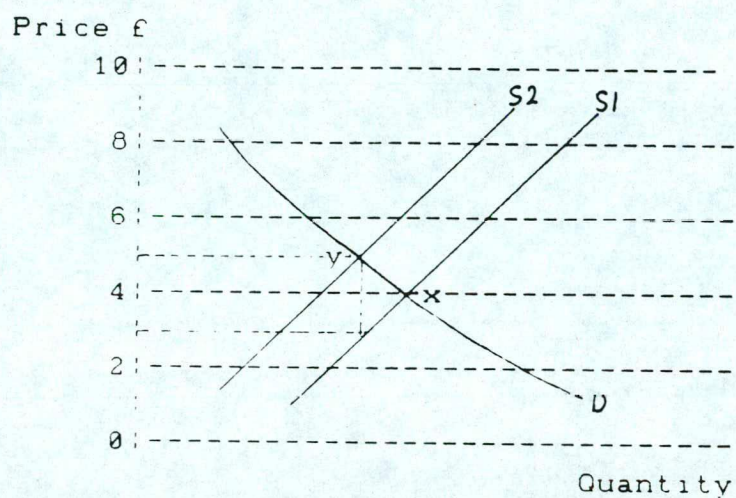
Micro-economic theory predicts that a tax increase is passed on, or must be absorbed by the supplier, according to the elasticity of demand for the product at that price level.

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 (Stationery Office £14)*

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).

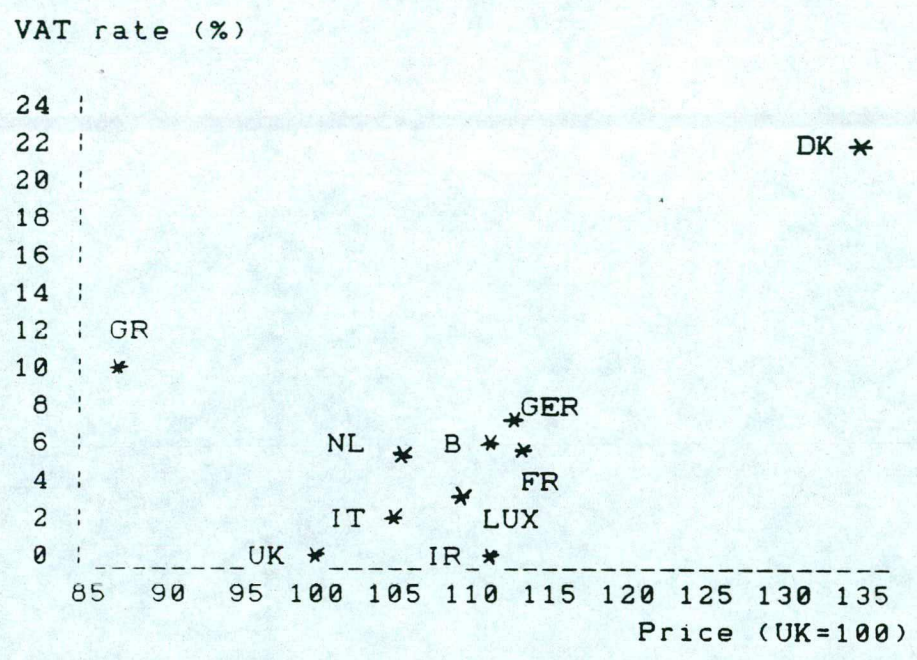
The matter is not, however, as simple as it seems. To begin with, micro-economic analysis of this kind depends on the assumption of perfectly competitive markets - reasonable in the case of most, but perhaps not all, food products. Where there is an element of monopoly, suppliers will be able to pass 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	4	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

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.

"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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FROM: P R H ALLEN
DATE: 6 May 1988

PS/ECONOMIC SECRETARY

cc PS/Chancellor
PS/Paymaster General
Sir P Middleton
Mr Littler
Mr Byatt
Mr Scholar
Mr Culpin
Mr Edward
Miss Sinclair
Mr Riley
Mr Parkinson

DEBATE ON TAX APPROXIMATION

I attach a revised speaking note and supplementary briefing which takes into account the comments of the Economic Secretary. Two items will follow: information on the VAT rates applied by other Member States to cars, and a short background note on the IFS report.

P R H ALLEN

Internal Circulation

CPS

Mr Kent

Mr Jefferson Smith

Mr Cockerell

Mr Nash

Mr Knox

Mr Wilmott

Mr Oxenford

*Sketch p 27
J. G. J.*

DRAFT

DEBATE ON TAX APPROXIMATION: NOTES FOR OPENING SPEECH

- Very grateful to both Select Committee on European legislation and Treasury and Civil Service Committee for work put into both reports. Government has found them most valuable. In most significant areas, confirm that Government's overall approach is one which most Members would support. Both committees underlined desirability of debate on this important topic; am very glad that parliamentary time has been found.
- Commission has put forward wide-ranging proposals covering both VAT and excise. Intended as step (Commission believes an essential step) towards completion of single market.
- For VAT, Commission has proposed "approximation" of VAT rates. All Member States would apply two positive rates: standard rate of between 14 and 20 percent; and reduced rate of between 4 and 9 percent. Reduced rate would apply to foodstuffs (excluding alcohol); energy for heating and lighting; water; passenger transport; pharmaceutical products; and books, newspapers and periodicals. All other taxable items would be standard rated.
- Another major feature of proposals is that exports would no longer be zero rated. Tax would be charged across frontiers, at rate applicable in exporting country. "Clearing House" would reallocate displaced revenues to Member States in which goods or services consumed.
- For excise duties Commission has proposed complete harmonisation of rates. Proposed rates based on mixture of weighted and arithmetic Community averages, intended to ensure minimum distortion to Member States' revenues.

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- Government have already made it clear that have fundamental difficulties with Commission's approach. Major difficulty concerns future of UK's zero rates. As drafted, proposal makes no provision for zero rates, although Commission has hinted at possibility of temporary derogations for Member States with particular difficulties.
- Chancellor has therefore made it quite clear at meetings of Economic and Financial Affairs Council (ECOFIN) - forum at which proposals are discussed - that UK cannot accept proposals which would restrict our ability to apply VAT zero rates.
- Other major areas of difficulty include excise duty proposals for alcohol and tobacco. Commission's use of average rates means that in UK, duty on alcoholic beverages would fall by between 40 and 85 percent, while duty on cigarettes would fall by about 10 percent. Clearly, changes of this magnitude would have marked effect on UK health and social policy; we have therefore made it clear that UK has fundamental difficulties with Commission approach.
- At technical level, also, proposals show every sign of being bureaucratic nightmare. Almost every Member State has problems with concept of clearing house for VAT revenues - as currently proposed would be largely un-accountable, un-auditable and open to fraud.
- UK not alone in facing difficulties with Commission's proposals. At one end of scale are countries, like Denmark and Ireland, which stand to lose substantial amounts of Government revenue. At other end are those who will have to increase indirect taxes substantially or even impose them for first time. Many Member States will have to abolish certain excise duties; many will have to make changes which have serious implications for social, health, transport, budgetary or counter-inflation policies. Some of changes which would be required are both large (in percentage terms) and likely to be highly politically sensitive - for example in Greece, increases of more than 2000% in duty on spirits and around 150% in that on cigarettes; in France an increase of around 650% in duty on beer; Italy,

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Spain, Portugal would have to impose duty on wine for first time; in Denmark, decrease of some 95% in duty on table wine. Although in UK public concern has tended to concentrate on abolition of VAT zero-rating on many frequently-purchased items such as food, domestic fuel and children's clothing, ~~changes in excise duty~~ ^{sharp increase} ~~would be highly unwelcome~~ ^{of alcohol} for health and social policy reasons. All these changes likely to have substantial and largely unpredictable effects on consumption patterns. Effects will, of course, feed through into industry, which will also be affected directly by changes in excise duties on petrol and oils. This is hidden price of benefits which Commission claim for their proposals.

- Underlying UK stance is fact that we have major reservations about desirability, feasibility and necessity of indirect tax harmonisation by bureaucratic plan. We believe Lord Cockfield has put the cart before the horse. Closer alignment of economies of Member States needs to precede approximation of indirect taxes rather than wrenching indirect tax structure of many Member States to drag economies more closely into line.

UK considers that short term adjustment costs need to be taken fully into account in any proposal for achieving final result. This suggests that "busting a gut" to remove all frontier controls by 1992 should be compared to more realistic and more sensible policy of progressively reducing them - so cutting still further relatively small costs they impose on intra-Community trade. Real progress could be achieved by concentrating on progressive reduction of frontier controls which would have immediate practical benefits for inter-community trade and travel. As controls progressively removed, market forces would have increasing influence on indirect tax rate and structures in member states, as occurs at present in United States. That, I would suggest, is the way forward: through liberalisation and response to market pressure; not some mindless search for uniformity for the sake of it.

- Still very early days. Last November, ECOFIN referred proposals to Economic Policy Committee (EPC) - committee of eminent economists - for economic evaluation. Committee's interim report to ECOFIN in April

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(see in Kominsky)

*Also: Peter
has announced
that he will
(see 199 5-1)*

highlighted many of problem areas inherent in Commission proposals. EPC recommended that irrespective of what Ministers eventually decide about harmonisation, Member States should take steps as soon as possible to reduce obstacles to trade. Is approach with which Government would heartily agree.

- Ultimately, changes to EC tax law require unanimous agreement of Member States - so UK's position is safeguarded. Is no question of our being obliged to accept proposals with which we disagree. Pledges given to electorate on zero rates ~~use~~ ^{are} firm commitments which Government stands by.
- Could go on much longer, Mr Speaker; but have kept remarks as brief as possible to enable as many hon Members as possible to contribute to debate. We welcome opportunity to debate these proposals tonight; invaluable opportunity to hear hon. Members views before substantive discussion of proposals gets under way.

BACKGROUND
BRIEFING

I. FACTUAL

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. 199 no. 20 col. 1270 and at regular intervals subsequently).

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 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. Changes in excise duty rates would mean

- Spirits down by £2.50 per bottle
- Beer down by 16p per pint
- Table wine down by 79p per bottle
- Cigarettes down by 15p per packet of 20
- Petrol up by 13p per gall.
- Derv down by 28p per gall.

(Full details in table at Annex A).

4. Timetable for discussions:

Initial procedural discussion held at ECOFIN on 16 November. Proposals remitted to Economic Policy Committee (EPC) for macro-economic evaluation. Preliminary report given by EPC Chairman to 18 April ECOFIN. Ministers agreed substantive discussion to be held at informal MAY ECOFIN.

5. 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 [£3.8 billion] in full year. (Excise proposals would produce offsetting loss to revenue of about [£2.8 billion]).

6. Zero rate infraction proceedings:

Separate matter from approximation. Commission contend that certain UK zero rates not in accord with 6th VAT Directive as not being for clearly defined social reasons and for the benefit of the final consumer. Areas under challenge.

- animal feedstuffs, seeds, live animals;
- sewerage services and water (supplied to industry);
- news services;
- fuel and power (**except** supplies to final consumers);
- construction of buildings (supplies other than to final consumers "within social policy");
- protective footwear and clothing (supplied to employers).

Oral hearings took place on 15 September. Advocate General's opinion delivered 2 December. Sided with UK on some aspects. Judgment not expected until mid year.

II. POSITIVE

7. Tax approximation:

Government committed to completion of internal market; but in line with conclusions of Milan and Brussels European Councils (June 1985 and June 1987) do not consider fiscal harmonisation as priority area. Still considering detail, but already clear we have major difficulties. Secure future for VAT zero rating crucial. Misgivings about social effects of excise changes on alcohol and tobacco. Other Member States have problems too. Willing to enter discussion about appropriate tax measures.

8. Zero rate:

Cannot be abolished in face of UK opposition. Clear commitments already given.

9. 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.

10. 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.

11. 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 present awareness campaign.

III DEFENSIVE

12. VIEWS OF OTHER MEMBER STATES

UK not alone in seeing potential difficulties with Commission's proposals. All Member States will wish to consider and discuss proposals carefully.

13. Does Government think tax approximation essential to completion of internal market?

Government does not consider harmonisation a pre-requisite to completion of the internal market. (Milan and Brussels European councils - June 1985 and June 1987 - did not identify tax measures as a priority area). Alternative approaches need to be considered, relying on operation of market forces. Such an approach could offer similar benefits without associated costs and difficulties. Clearly an area for discussion with other member states.

14. DIFFERENCES IN VAT RATES PRODUCE DISTORTIONS IN TRADE

VAT merely one element in price. 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.

15. Variations in EC industrial costs outweigh variations arising from different VAT rates:

The Government accept that a whole range of factors that enter into industrial costs (and consumer prices) differ between Member States. However, this does not necessarily result in distortion of competition. We are vigorously pursuing those Internal market proposals which reduce or eliminate such distortions of competition. VAT proposals are a separate issue, associated with the Commission's proposals to remove frontier controls.

16. 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.

17. Derogations:

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

18. Loss of Sovereignty:

Proposals require unanimity under Treaty of Rome as amended by Single European Act. No question of UK being obliged to adopt proposals with which it disagrees. Prime Minister has already made clear will not accept proposals which limit the UK's ability to use VAT zero rates.

[If pressed:] are advised that the timetable built into Single European Act creates a political, not a legal commitment. Understand that Commission would not have grounds for instituting legal proceedings if Council failed to agree harmonisation measures by 31.12.1992

19. Infraction proceedings:

Government has mounted vigorous defence of UK position.

20. Threat to zero rating from infraction proceedings:

Case relates to interpretation of existing law. Government fully able to determine own policies within existing law. Judgment not yet available.

[If pressed] UK has Treaty obligation to respect rulings by European court.

Cannot decide now how would react to adverse ruling - would need to study judgment and consider options. Court would not be able to impose particular rate.

21. Government should extend pledges to include books etc:

Chancellor decided not to extend the VAT base in this year's Budget. But gave no further commitments about future years. Government's pledges not to impose VAT on food, gas, electricity and fuel on young children's clothing and shoes hold good. On other items continue to observe the convention that statements on tax matters are made at Budget time - and only then.

22. Indirect tax harmonisation not necessary to achieve Internal Market:

The Government notes with interest the views expressed recently by the Institute for Fiscal Studies. We see considerable merit in the view that tax rates should be harmonised only in cases of clear distortion of trade; otherwise we believe that relying on market forces [as in the USA] is preferable to imposed harmonisation which is likely to be very disruptive to many Member States.

23. Anything other than Commission proposals would be inconsistent with Single European Act?

Do not believe that that is the case. Treaty requires harmonisation only "to extent necessary".

24. How would UK view "two speed" Europe; ie, some Member States embracing Commission system, others remaining outside?

Difficult to see Member States agreeing. Anyway clearly incompatible with creation of single market. If all Member States cannot accept Commission package, sensible to look for alternative ways of achieving Internal Market.

25. How would UK view limited approximation (ie only for commonly-traded items with high tax differentials eg cars)

Not attractive; complicates VAT systems and increases number of rates. Still may be considered at later stage. [If pressed on cars/car tax] VAT and car tax in UK now comes to about 25% - close to level charged in other EC countries.

26. UK Government's view on proposal for VAT clearing house?

UK has considerable doubts about operation and effect of system. PSBR cost considerable - initial once-for-all of £ several billions, continuing monthly cost of £ several hundreds of millions possible. Also need to employ extra control staff. Must be sure payments accurate and timely, system auditable, administration practical and adequate control against fraud. Technical discussion at official level held in Brussels (Financial Question Group) on 21/22 January. It was clear that other Member States share UK concern.

27. UK Government's attitude to derogations?

Commission indicated possibility of using derogations in cases of particular difficulty; however, would be of limited duration. UK would not rule out derogations: we will pursue as discussions get under way.

28. UK Government's attitude to proposal for convergence of VAT and excise duty rates?

Opposed on basis that no point until final destination settled. Once approximated system agreed, convergence would be necessary.

29. What zero rates would UK insist retaining?

Have simply said we want to keep right to retain zero rate. Do not have "shopping list" at this stage. For UK Parliament to decide which it wants to keep. Government will stick by election pledges on food, domestic electricity, gas and fuel and children's clothing and footwear.

30. Will UK argue for, say, 0-7% reduced rate band to safeguard zero rate?

Is obviously a possible option, but no final conclusions reached on what we will be seeking from discussions. Likely to cause problems for other Member States. (French known to be against continuation of zero rating).

31. Would zero rates conflict with internal market?

Commission recognises importance of zero rates for UK. UK does not consider that abolition of our zero rate is necessary for successful internal market.

32. Will European Court abolish zero rating altogether?

Although European Court has power to decide in cases where right to zero rate under sixth VAT directive is not clear, it does not have power to end zero-rating in general.

33. Difficulties in harmonising excise duties?

Central problem is that structure of duties not harmonised; deep differences between Member States. Even if this overcome still effect on social, law and order, transport and economic policies of duty change on alcohol, tobacco and petroleum.

34. UK problems worse than for other Member States?

Different problems: many other Member States have substantial increase in tax; for UK, main problem is that drop in alcohol and tobacco disrupts social and health policy and cuts revenue. Other states still larger changes eg: Greek spirit duty up by over 2000%, Spanish cigarette duty up by about 150%. Germans and Italians would have to introduce duty on wines for the first time. French beer duty up by about 650%. Serious budgetary consequences for several Member States - eg Irish revenue loss of around £1470 million in first year of implementation. Denmark loss of 11% of total taxes and 5.5% of GDP.

35. UK derogations or failure to harmonise could exclude us from the benefits of the Internal Market:

We note comments made recently by Lord Cockfield [offensive, non-Communautaire and unrealistic]. However, since agreement on EC tax proposals must be unanimous, 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,

36. Why has Government not responded to Commission's proposals:

No Member State appears to have regarded it as necessary to respond by writing to the Commission. Discussion in the 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 the economic implication of the

proposals. When the EPC report has been considered and UK completed its own internal examination of the proposals, Government will respond in ECOFIN, the appropriate forum.

37. UK view of Commission's recent report "Europe 1992 - Overall Challenge":

Full report not yet published but interesting to note that Commission's own figures show total cost of frontiers amount to no more than .3% of GDP. Cost of fiscal controls are only small proportion of this and no reason to change our view that removal of fiscal frontiers not a priority at this stage.

REMOVAL OF FISCAL BARRIERS TO INTRA-COMMUNITY TRADE:

BACKGROUND

The White Paper proposals:

The Commission's White Paper, 'Completing the Internal Market', included a set of tax measures designed to remove fiscal barriers to intra-community trade.

Discussion to date:

The White Paper's fiscal measures were not included in the list of areas for priority action drawn up by the Milan European Council in June 1985. Instead they were remitted to the Economic and Financial Affairs Council (ECOFIN) for further study. ECOFIN reviewed the subject in June 1986, concluded that more detailed proposals were needed before political decisions could be taken, and agreed to pursue structural harmonisation while awaiting fuller proposals on tax rates and the VAT clearing system. These were promised for 1 April 1987 but were not approved by the Commission until 15 July. Procedural discussion took place at ECOFIN's meeting on 16 November, when Council remitted proposals to Economic Policy Committee (EPC) for economic analysis. A preliminary report was made by EPC to ECOFIN Council on 18 April. Substantive discussion on the finalised report will take place at the informal May ECOFIN Council.

Commission's tax approximation package:

The Commission proposes 2 rates of VAT.

- A standard rate of 14-20 percent.
- A reduced rate of 4-9 percent.

Member States would be free to fix their national VAT rates at any point within these bands. The reduced rate band would cover: foodstuffs, energy, water, pharmaceuticals, books, newspapers and periodicals and passenger transport.

The Commission recognises the difficulty which the proposals will cause for the UK and Ireland where zero-rates are applied extensively and does not rule out the possibility of a derogation allowing relevant Member States to continue zero rating in 'cases of particular difficulty'.

The package also contains an outline description of the VAT clearing mechanism; a 'convergence' proposal designed to ensure that Member States' VAT and excise rates do not diverge further; and a series of proposals harmonising the rates of excise duty on alcohol, tobacco products and hydrocarbon oils.

UK policy issues:

Under the Treaty of Rome fiscal measures can only be adopted by unanimous agreement in the Council. The UK is therefore in a position to block unacceptable measures in this field. The loss of Parliamentary sovereignty over levels of indirect tax rates is clearly an important issue and one which is likely to weigh heavily with many - if not all - Member States. Perhaps equally important is the question of fiscal management and the nature of the constraints approximation would impose. In addition, the large changes in VAT and excise duty rates that the proposals would require would have a major impact on UK industries (notably distilling, brewing, tobacco) and serious social repercussions (eg UK spirits duty would fall by over 40 percent and cigarette duty by about 10 percent). The overall budgetary impact of the proposed approximation package on the UK would probably not be great, reductions in excise duties being offset by the increase in VAT revenue (this assessment is based on the assumption that zero rating would be abolished; if it were not, the

revenue effect could well be negative). A particular issue for the UK - and the one on which most attention has been concentrated so far - is the future of our zero rate of VAT for food and other items.

Zero rates:

The UK currently applies a zero rate of VAT to a number of goods and services, including food, domestic fuel and power, new construction, pharmaceuticals, passenger transport, young children's clothing and books, newspapers and periodicals. During the election campaign the Prime Minister gave clear commitments not to impose VAT on food, domestic fuel, and young children's clothing. She declined to go beyond these commitments in order not to constrain the Chancellor in future Budgets. Zero rating is permitted under the EC's basic VAT law, the 6th VAT Directive, until an unspecified date to be fixed by council acting unanimously on a proposal from the Commission. The Commission believes that date will not be later than the date of abolition of fiscal frontiers - hence Lord Cockfield's refusal formally to provide for zero rating in his approximation package. The Prime Minister has already made it clear that the UK will not accept proposals which restrict our right to apply zero rating.

VAT ZERO RATE INFRACTION PROCEEDINGS (IF RAISED)

Commission Challenge:

The European Commission began infraction proceedings in 1981 against those member states (Ireland and UK) which made extensive use of zero-rating. This is a separate issue from the harmonisation proposals as it refers to interpretation of existing law rather than drafting new law, and covers only certain, limited UK zero rates. The Commission is not challenging all the UK's zero-rates but only those which it contends do not meet the criteria laid down by the 6th VAT Directive, ie that zero rate should be "for clearly defined social reasons or for the benefit of the final consumer".

The items under challenge are:

- * animal feedstuffs, seeds, live animals yielding food for consumption - (all supplies)
- * sewerage services and water - (supplies to **industry** only)
- * news services - (all supplies)
- * fuel and power - (supplies **other than** to final consumers)
- * construction, buildings etc - (supplies **other than** to final consumers "within a social policy")
- * protective clothing and footwear - (supplies to **employers** only)

The most significant area under threat is construction where the Commission's challenge may extend to domestic housing (other than "within a social policy") as well as commercial building.

UK Response:

The UK has pointed to the invalidity of the Commission attempting to use a judicial procedure to solve a problem which should be addressed by political means in the Council of Ministers.

We contend that the zero-rates under challenge do satisfy the necessary criteria and therefore the UK has the legal right under the 6th VAT Directive to retain those zero-ratings until an unspecified date, to be fixed by the Council on the basis of a commission proposal.

Our case is stronger in respect of some items under challenge than on others. On housing, our case is at its strongest.

Judgment:

The Court's consideration and its final judgment will be based on the full pleadings (both written and oral) of the two parties and the Advocate General's Opinion (delivered on 2 December). The judgment is expected by mid year. We shall need to study in detail the precise terms of the Court's judgment before the Government is able to take decisions.

Chancellor's Concern:

Should the Commission's case be upheld in the European Court, either in whole or in respect of individual items, the United Kingdom would be obliged by the terms of the Treaty of Rome to tax the supplies in question at a positive rate. Current Community legislation would preclude the introduction of a reduced rate of VAT below about 5%. However, 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.

CLEARING HOUSE SYSTEM

1. Under the Commission's proposals, VAT would be charged across frontiers - ie it 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 revenue continued to accrue, as now, in the member state where the goods or services are finally consumed, the Commission has suggested a "clearing house" system. Every month, each member states' tax authorities would provide the Commission with a statement of total VAT charged on exports to other member states, and VAT paid on imports from other member states. This information would be obtained from details provided by registered traders on their VAT returns (traders involved in intra-Community trade would need to complete two additional boxes on their return). The monthly statement would be accompanied either by a claim or by a payment - ie if VAT on imports by a member state exceeded VAT on exports, a refund would be due from the clearing system; if VAT on exports exceeded VAT on imports, a member state would pay into the clearing house. A centrally supervised system would be laid down to check both member states' accounting systems and VAT registered businesses, to verify claims and payments.

2. Our view is that the clearing system should satisfy four central criteria:-

- i) it should ensure that the right money accrues 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 (ie it should not impose unacceptable burdens on tax administrations or traders); and
- iv) it should give a reasonable guarantee that taxes are not evaded.

3. We have identified a number of difficulties inherent in the proposed system:-

- a) the accuracy of member states claims or payments would depend crucially on the accuracy of trader's returns;
- b) businesses would have no incentive to accurately segregate VAT incurred on intra-Community trade from VAT on domestic transactions;
- c) member states' tax administrations would not necessarily have an incentive to check claims for VAT incurred on imports, since, for inflated claims, the loss would not be born by the importing state;
- d) verification of tax returns would be likely to favour aspects which either reduce payments to, or enhance repayments from, the clearing system;
- e) differing VAT accounting periods in different member states would lead to uncertainties about revenue flows;
- f) the system would increase the opportunities for fraud, which, with the removal of border controls, would be more difficult to detect; whilst harmonisation of the legal systems of member states would be necessary to deal with certain types of offences.

4. There are also many gaps in the proposal in important areas of technical detail, eg:-

- i) exactly what accounting requirements do the Commission envisage businesses would have to meet;
- ii) how could differing exchange rates and commercial documents in different languages (which would form the basis of member states claims/payments) be dealt with;
- iii) difficulties in treatment of complex commercial arrangements (eg loan or part exchange sale or return) and so on.

It may be possible to resolve many of these technical difficulties, but the administrative burdens on tax administrations and on businesses would be high.

5. At a meeting of officials in the Financial Questions Group on 21/22 January, all member states and the Commission accepted the UK's suggestion that the feasibility of the clearing system had to be judged on the above criteria; and all delegates expressed considerable doubts about the ability of the proposed system to satisfy these requirements.

RELEVANT EXTRACTS FROM SINGLE EUROPEAN ACT
(SIDELINED)

and determine at first instance, subject to a right of appeal to the Court of Justice on points of law only and in accordance with the conditions laid down by the Statute, certain classes of action or proceeding brought by natural or legal persons. That court shall not be competent to hear and determine actions brought by Member States or by Community institutions or questions referred for a preliminary ruling under Article 177.

2. The Council, following the procedure laid down in paragraph 1, shall determine the composition of that court and adopt the necessary adjustments and additional provisions to the Statute of the Court of Justice. Unless the Council decides otherwise, the provisions of this Treaty relating to the Court of Justice, in particular the provisions of the Protocol on the Statute of the Court of Justice, shall apply to that court.

3. The members of that court shall be chosen from persons whose independence is beyond doubt and who possess the ability required for appointment to judicial office; they shall be appointed by common accord of the Governments of the Member States for a term of six years. The membership shall be partially renewed every three years. Retiring members shall be eligible for reappointment.

4. That court shall establish its rules of procedure in agreement with the Court of Justice. Those rules shall require the unanimous approval of the Council."

ARTICLE 12

A second paragraph worded as follows shall be inserted in Article 189 of the EEC Treaty:

"The Council may, acting unanimously at the request of the Court of Justice and after consulting the Commission and the European Parliament, amend the provisions of Title III of the Statute."

SECTION II

**Provisions Relating to the Foundations and the Policy
of the Community**

Sub-section I—Internal Market

ARTICLE 13

The EEC Treaty shall be supplemented by the following provisions:

"ARTICLE 8A

The Community shall adopt measures with the aim of progressively establishing the internal market over a period expiring on 31 December 1992, in accordance with the provisions of this Article and of Articles 8B, 8C, 28, 57(2), 59, 70(1), 84, 99, 100A and 100B and without prejudice to the other provisions of this Treaty.

The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty."

ARTICLE 14

The EEC Treaty shall be supplemented by the following provisions:

" ARTICLE 8B

The Commission shall report to the Council before 31 December 1988 and again before 31 December 1990 on the progress made towards achieving the internal market within the time limit fixed in Article 8A

The Council, acting by a qualified majority on a proposal from the Commission, shall determine the guidelines and conditions necessary to ensure balanced progress in all the sectors concerned."

ARTICLE 15

The EEC Treaty shall be supplemented by the following provisions:

" ARTICLE 8C

When drawing up its proposals with a view to achieving the objectives set out in Article 8A, the Commission shall take into account the extent of the effort that certain economies showing differences in development will have to sustain during the period of establishment of the internal market and it may propose appropriate provisions.

If these provisions take the form of derogations, they must be of a temporary nature and must cause the least possible disturbance to the functioning of the common market."

ARTICLE 16

1. Article 28 of EEC Treaty shall be replaced by the following provisions:

" ARTICLE 28

Any autonomous alteration or suspension of duties in the common customs tariff shall be decided by the Council acting by a qualified majority on a proposal from the Commission."

2. In Article 57(2) of the EEC Treaty, the second sentence shall be replaced by the following:

"Unanimity shall be required for directives the implementation of which involves in at least one Member State amendment of the existing principles laid down by law governing the professions with respect to training and conditions of access for natural persons."

3. In the second paragraph of Article 59 of the EEC Treaty, the term "unanimously" shall be replaced by "by a qualified majority".

4. In Article 70(1) of the EEC Treaty, the last two sentences shall be replaced by the following:

" For this purpose the Council shall issue directives, acting by a qualified majority. It shall endeavour to attain the highest possible degree of liberalization. Unanimity shall be required for measures which constitute a step back as regards the liberalization of capital movements."

5. In Article 84(2) of the EEC Treaty, the term "unanimously" shall be replaced by "by a qualified majority".

6. Article 84 of the EEC Treaty shall be supplemented by the following paragraph:

" The procedural provisions of Article 75(1) and (3) shall apply."

ARTICLE 17

Article 99 of the EEC Treaty shall be replaced by the following provisions:

" ARTICLE 99

The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, adopt provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market within the time-limit laid down in Article 8A."

ARTICLE 18

The EEC Treaty shall be supplemented by the following provisions:

" ARTICLE 100A

1. By way of derogation from Article 100 and save where otherwise provided in this Treaty, the following provisions shall apply for the achievement of the objectives set out in Article 8A. The Council shall, acting by a qualified majority on a proposal from the Commission in co-operation with the European Parliament and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market.

2. Paragraph 1 shall not apply to fiscal provisions, to those relating to the free movement of persons nor to those relating to the rights and interests of employed persons.

3. The Commission, in its proposals envisaged in paragraph 1 concerning health, safety, environmental protection and consumer protection, will take as a base a high level of protection.

4. If, after the adoption of a harmonization measure by the Council acting by a qualified majority, a Member State deems it necessary to apply national provisions on grounds of major needs referred to in Article 36, or

DECLARATION ON THE POWERS OF IMPLEMENTATION OF THE COMMISSION

The Conference asks the Community authorities to adopt, before the Act enters into force, the principles and rules on the basis of which the Commission's powers of implementation will be defined in each case.

In this connection the Conference requests the Council to give the Advisory Committee procedure in particular a predominant place in the interests of speed and efficiency in the decision-making process, for the exercise of the powers of implementation conferred on the Commission within the field of Article 100A of the EEC Treaty.

DECLARATION ON THE COURT OF JUSTICE

The Conference agrees that the provisions of Article 32d(1) of the ECSC Treaty, Article 168A(1) of the EEC Treaty and Article 140A(1) of the EAEC Treaty do not prejudice any conferral of judicial competence likely to be provided for in the context of agreements concluded between the Member States.

DECLARATION ON ARTICLE 8A OF THE EEC TREATY

The Conference wishes by means of the provisions in Article 8A to express its firm political will to take before 1 January 1993 the decisions necessary to complete the internal market defined in those provisions, and more particularly the decisions necessary to implement the Commission's programme described in the White Paper on the Internal Market.

Setting the date of 31 December 1992 does not create an automatic legal effect.

DECLARATION ON ARTICLE 100A OF THE EEC TREATY

In its proposals pursuant to Article 100A(1) the Commission shall give precedence to the use of the instrument of a directive if harmonization involves the amendment of legislative provisions in one or more Member States.

DECLARATION ON ARTICLE 100B OF THE EEC TREATY

The Conference considers that, since Article 8C of the EEC Treaty is of general application, it also applies to the proposals which the Commission is required to make under Article 100B of that Treaty.

GENERAL DECLARATION ON ARTICLES 13 TO 19 OF THE SINGLE EUROPEAN ACT

Nothing in these provisions shall affect the right of Member States to take such measures as they consider necessary for the purpose of controlling immigration from third countries, and to combat terrorism, crime, the traffic in drugs and illicit trading in works of art and antiques.

Mr Publicover
-FCO
Mr Gray - No 10

Ps/chancellor
Ps/CST PS/EST
Ps/PMG
Ps/Sir P Middleton
Mr Scholar
Mr Turnbull
Mr A J Edwards
Mr RIG Allen
Mr Culpin
Miss Sinclair
Mr Michie
Mr Jefferson -
Smith cte
Mr Knox - cte
Mr PRH Allen -
cte
Mr Hammond -
cte
Ps/cte

Teddy Taylor Esq MP
House of Commons
LONDON
SW1A 0AA

7 March 1988

Teddy Taylor

Thank you for your letter of 22 February 1988 about the power of veto after 1992.

As you know, any proposed tax approximation measure requires unanimity before it can be adopted by the Council. This requirement will continue after 1992, because it is contained in the EEC Treaty, as amended by the Single European Act.

The Conference Declaration on Article 8A of the EEC Treaty explicitly states that the target of 31 December 1992 is a political, not a legal, commitment. The reference to the same time limit in the new Article 99 must be similarly construed, given that the two Articles cross-refer to each other. Therefore, any failure by the Council to adopt tax harmonisation measures before 1 January 1993 would not constitute an infringement of the Treaty entitling the Commission to start legal proceedings.

Moreover, the new Article 99 does not imply any particular form or degree of harmonisation, and expressly states that the tax harmonisation provisions shall be adopted only "to the extent to which such harmonisation is necessary to ensure the establishment and functioning of the internal market." Neither the establishment nor the functioning of the internal market requires the abolition of VAT zero rates. Article 99 also makes it clear that it is for "the Council acting unanimously" to determine which measures of harmonisation to adopt and to what extent harmonisation is necessary. The EEC Treaty does not prescribe the measures and there is no procedure in the Treaty for the Court to usurp the role of the Council in the event of its failing to achieve the necessary unanimity.

*Yours ever
Peter Lilley*

PETER LILLEY

ANNEX A: IMPLICATIONS OF EXCISE PROPOSALS IN UK

1. SPIRITS

i)	<u>DUTY RATE</u>	NOW	£15.77 PER LITRE OF ALCOHOL
		UNDER PROPOSAL	12.71 ECU (£8.54) PER LITRE OF ALCOHOL
		% DIFFERENCE	-46
ii)	<u>TYPICAL PRICE (1)</u>	DIFFERENCE	-£2.50 (70 cl BOTTLE AT 40% VOLUME)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL. VAT) £ million		-£450M
iv)	<u>CONSUMPTION/VOLUME EFFECT</u>		+30%
v)	<u>RPI EFFECT</u>		-0.34%

(1) Off Licence Premises

2. BEER

i)	<u>DUTY RATE</u>	NOW	£27.00 PER HECTOLITRE PLUS 90p FOR EVERY DEGREE OF ORIGINAL GRAVITY OVER 1030 (£33.30 FOR AVERAGE STRENGTH BEER).
		UNDER PROPOSAL	1.35 ECU (£0.91) PER HECTO- LITRE/DEGREE PLATO OF FINISHED PRODUCT @ 15°C (£3.77 FOR AVERAGE STRENGTH BEER).
		% DIFFERENCE	-74
ii)	<u>TYPICAL PRICE (1)</u>		
		DIFFERENCE	-16 PENCE (PINT)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL. VAT)		-£1500 M
iv)	<u>CONSUMPTION/VOLUME</u> EFFECT		+10%
v)	<u>RPI EFFECT</u>		-0.73%

(1) Off Licence Premises

3. STILL TABLE WINE OR MADE-WINE (NOT EXCEEDING 15% VOL)

i)	<u>DUTY RATE</u>	NOW	£102.40 PER HECTOLITRE
		UNDER PROPOSAL	17 ECU (£11.43) PER HECTOLITRE
		% DIFFERENCE	-89
ii)	<u>TYPICAL PRICE (1)</u>	DIFFERENCE	-£0.79 (75 cl BOTTLE)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL VAT) £MILLION		-£515M
iv)	<u>CONSUMPTION/VOLUME</u> <u>EFFECT</u>		+29%
v)	<u>RPI EFFECT</u>		-0.41%

(1) Off Licence Premises

4. WINE OR MADE-WINE (EXCEEDING 15% VOL AND NOT EXCEEDING 18% VOL)

i)	<u>DUTY RATE</u>	NOW	£175.60 PER HECTOLITRE
		UNDER PROPOSAL	85 ECU (£57.13) PER HECTOLITRE
		% DIFFERENCE	-68
ii)	<u>TYPICAL PRICE (1)</u>	DIFFERENCE	-97p (70cl BOTTLE)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL. VAT) £ MILLION		-£70M
iv)	<u>CONSUMPTION/REVENUE</u> <u>EFFECT</u>		+35%
v)	<u>RPI EFFECT</u>		-0.03%

(1) Off Licence Premises

5. WINE OR MADE-WINE (EXCEEDING 18% VOL AND NOT EXCEEDING 22% VOL)

i)	<u>DUTY RATE</u>	LOW	£203.70 PER HECTOLITRE
			UNDER PROPOSAL 35 ECU (£57.13) PER HECTOLITRE
		% DIFFERENCE	-72
ii)	<u>TYPICAL PRICE (1)</u>	DIFFERENCE	-£1.18 (70CL BOTTLE)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL. VAT) £ MILLION		-£15M
iv)	<u>CONSUMPTION/VOLUME</u> <u>EFFECT</u>		+ 35%
v)	<u>RPI EFFECT</u>		NEG

(1) Off Licence Premises

6. CIGARETTES

i)	<u>DUTY RATE</u>	NOW	£31.74 PER THOUSAND PLUS 21% OF RETAIL SELLING PRICE
		UNDER PROPOSAL	19.5 ECU (ABOUT £13.11) PER THOUSAND PLUS 52-54% OF RETAIL SELLING PRICE
		% DIFFERENCE	ABOUT - 14
ii)	<u>TYPICAL PRICE</u>	DIFFERENCE	- £0.15 (20 KING SIZE)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL VAT) £ million		- £415M
iv)	<u>CONSUMPTION/VOLUME</u> <u>EFFECT</u>		+ 4.3%
v)	<u>RPI EFFECT</u>		- 0.29%

7. PIPE TOBACCO

i)	<u>DUTY RATE</u>	HOW	£24.95 PER KILOGRAM
		UNDER PROPOSAL	EXCISE DUTY & VAT TO COMPRISE 54-56% OF RETAIL SELLING PRICE
		% DIFFERENCE	- 17% APPROX
ii)	<u>TYPICAL PRICE</u>	DIFFERENCE	- 12p (PER 25 GRAMS)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL.VAT) £ Million		- £10M
iv)	<u>CONSUMPTION/VOLUME EFFECT</u>		+ 5%
v)	<u>RPI EFFECT</u>		- 0.01%

1. CIGARS

i)	<u>DUTY RATE</u>	NDW	£40.79 PER KILOGRAM
		UNDER PROPOSAL	EXCISE DUTY & VAT TO COMPRISE 34-36% OF RETAIL SELLING PRICE
		% DIFFERENCE	- 53 APPROX
ii)	<u>TYPICAL PRICE</u>	DIFFERENCE	- £0.28 (5 WHIFFS)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL.VAT) £ Million		- £60M
iv)	<u>CONSUMPTION/VOLUME EFFECT</u>		+ 20%
v)	<u>RPI EFFECT</u>		- 0.06%

9. HAND ROLLING TOBACCO

i)	<u>DUTY RATE</u>	NOW	£51.43 PER KILOGRAM
		UNDER PROPOSAL	EXCISE DUTY & VAT TO COMPRISE 54-56% OF RETAIL SELLING PRICE
		% DIFFERENCE	- 55% APPROX
ii)	<u>TYPICAL PRICE</u>	DIFFERENCE	- 82p (PER 25 GRAMS)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL.VAT)		- £90M
iv)	<u>CONSUMPTION/VOLUME EFFECT</u>		+ 21%
v)	<u>RPI EFFECT</u>		- 0.06

10. PETROL

i)	<u>DUTY RATE</u>	NOW	£20.44 PER HECTOLITRE
		UNDER PROPOSAL	34 ECU (£22.85) PER HECTROLITRE
		% DIFFERENCE	+ 12
ii)	<u>TYPICAL PRICE</u>	DIFFERENCE	+ 13p (GALLON)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL. VAT) £ Million		+ £660M
iv)	<u>CONSUMPTION/VOLUME</u> <u>EFFECT</u>		- 1.6%
v)	<u>RPI EFFECT</u>		+ 0.23%

11. DERV

i)	<u>DUTY RATE</u>	NOW	£17.29 PER HECTOLITRE
		UNDER PROPOSAL	17.7 ECU (£11.90) PER HECTOLITRE
		% DIFFERENCE	- 31
ii)	<u>TYPICAL PRICE</u>	DIFFERENCE	- 28p (GALLON)
iii)	<u>REVENUE EFFECT</u> (FULL YEAR INCL. VAT) £ Million		- 2460M
iv)	<u>CONSUMPTION/VOLUME</u> <u>EFFECT</u>		+ 4.5%
v)	<u>RPI EFFECT</u>		- 0.03%

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YOUR TELNO 245 TO BONN: INDIRECT TAX APPROXIMATION

SUMMARY

1. SPANISH TECHNICAL ASSESSMENT OF THE COMMISSION PROPOSALS HIGHLIGHTS THE THREAT TO THE GOVERNMENT'S SHORT-TERM INFLATION OBJECTIVES OF EARLY IMPLEMENTATION. ALTHOUGH THEIR COMMITMENT TO EUROPEAN INTEGRATION WILL INFLUENCE THEIR POSITION THEY MAY RESIST THE COMMISSION'S PRESENT PROPOSALS.

DETAIL

2. THE MINISTRY OF ECONOMY AND FINANCE HAS PREPARED A DETAILED ANALYSIS FOR INTERNAL USE OF THE COMMISSION PROPOSALS. THERE ARE NO PLANS FOR THIS DOCUMENT TO BE PUBLISHED AND WE HAVE ONLY LEARNED OF ITS EXISTENCE THROUGH TALKS WITH OFFICIALS.

3. THE MAIN CONCLUSION WARNS OF THE INFLATIONARY EFFECTS OF THE EARLY ADOPTION OF THE COMMISSION PROPOSALS IN THEIR PRESENT FORM. WE HAVE NOT BEEN GIVEN THE ESTIMATED FIGURES, BUT HAVE BEEN TOLD THAT THE GOVERNMENT'S EFFORTS TO KEEP THE INFLATION RATE IN SPAIN CLOSE TO THE EC AVERAGE IN THE SHORT-TERM WOULD BE DAMAGED. INFLATION IN SPAIN IN 1987 WAS 4.6%. THE OFFICIAL TARGET FOR 1988 IS 3%, ALTHOUGH THE CURRENT FIGURE IS 4.4% WITH UNDERLINING TRENDS ALREADY SET TO PUSH THIS HIGHER.

4. THE MINISTRY SURVEY SHOWS THAT THE REVENUE YIELD FROM INDIRECT TAXATION WOULD INCREASE SIGNIFICANTLY. BUT THE GAINS WILL NOT BE EVENLY SPREAD. THE BULK OF THE EXTRA TAX RECEIPTS WILL COME FROM THE INCREASE IN THE VAT STANDARD RATE TO ACCORD WITH THE 14-20% BAND, WHICH WOULD BE AT LEAST 2% HIGHER THAN THE PRESENT STANDARD RATE USED IN SPAIN (12%) AND WOULD CATCH MANY EVERYDAY ITEMS OF CONSUMPTION. THIS WOULD BE POLITICALLY UNATTRACTIVE. ASSIMILATION

OF THE REDUCED RATE (6%) TO THE PROPOSED LOWER BAND PRESENTS FEW DIFFICULTIES, NEITHER DOES THE ELIMINATION OF THE LUXURY RATE (33%), WHICH COVERS ITEMS SUCH AS CARS AND JEWELLERY. SINCE VAT COVERAGE IN SPAIN IS ALREADY COMPREHENSIVE, THE ONLY ISSUES AT STAKE ARE THE PACE OF INTRODUCTION OF APPROXIMATION AND TERMS OF APPLICATION.

5. A FURTHER PROBLEM IS THE LIKELY IMPACT ON SPANISH INDUSTRY AND THE ECONOMY OF SHARPLY INCREASED EXCISE DUTIES. SPECIAL TAXES ON WINE, SPIRITS AND TOBACCO IN SPAIN HAVE TRADITIONALLY BEEN MUCH BELOW THE EC AVERAGE. THE GOVERNMENT MADE SOME INITIAL MOVES IN THE LAST BUDGET TO INCREASE THE RATE OF DUTY LEVIED BY MORE THAN INFLATION TO HELP NARROW THE DIFFERENTIAL. RAPID INTRODUCTION OF EXCISE RATES AT THE LEVEL OF THE COMMISSION PROPOSALS WOULD HAVE A SERIOUS EFFECT ON PUBLIC OPINION. IT WILL ALSO HARM THE SPANISH TOBACCO INDUSTRY, WHICH CONCENTRATES HEAVILY ON THE USE OF LOCALLY-GROWN BLACK TOBACCO IN CIGARETTE PRODUCTION. THIS HAS ALWAYS BEEN A CHEAPER PRODUCT AND MORE POPULAR WITH THE CONSUMER THAN LIGHTER TOBACCO CIGARETTES WHICH ARE MOSTLY IMPORTED. ANY MOVES WHICH COULD CAUSE A SHIFT IN THE MARKET IN FAVOUR OF THE LIGHTER BLENDS, SUCH AS CLOSING THE GAP IN PRICES, WOULD CAUSE PROBLEMS FOR SPANISH PRODUCERS AT A TIME WHEN THE TOTAL EUROPEAN CIGARETTE MARKET IS CONTRACTING.

COMMENT

6. THE MINISTRY SURVEY IS UNLIKELY TO BE DECISIVE IN ESTABLISHING SPANISH GOVERNMENT POLICY. THE PRIME MINISTER, IN PARTICULAR, IS KNOWN TO BE A STRONG ADVOCATE OF CLOSER EC ECONOMIC INTEGRATION AND THE CHANGES INVOLVED WOULD BE COMPARATIVELY MINOR COMPARED WITH THOSE WHICH THE SPANISH ECONOMY HAS HAD TO WEATHER SINCE ACCESSION. HOWEVER CONVERSATIONS WITH THE BANK OF SPAIN REVEAL A PREFERENCE FOR MARKET LIBERALIZATION PRECEDING TAX APPROXIMATION. OUR GENERAL CONCLUSION IS THAT THE SPANIARDS COULD WELL BE ALLIES IN RESISTING THE CURRENT COMMISSION PROPOSALS.

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YOUR TELNO 245 TO BONN: INDIRECT TAX APPROXIMATION

SUMMARY

1. EXCEPT PERHAPS FOR SPECIAL INTEREST GROUPS SUCH AS SCHIPHOL AIRPORT, THE DUTCH GENERALLY SUPPORT THE GOAL OF GREATER INDIRECT TAX APPROXIMATION. THEY ARE LIKELY TO SUPPORT CAUTIOUS PROGRESS TOWARDS IT.

DETAIL

2. THERE HAVE BEEN NO INDEPENDENT ANALYSES IN THE NETHERLANDS LIKE THAT OF THE IFS, BUT REGULAR CONTACTS WITH THE FOREIGN, ECONOMIC AFFAIRS AND FINANCE MINISTRIES RECENTLY HAVE INDICATED THAT THE DUTCH ARE INDEED GIVING A GOOD DEAL OF THOUGHT TO THIS ISSUE INTERNALLY.

3. IN PRINCIPLE THE DUTCH ARE IN FAVOUR OF GREATER HARMONISATION. THEY SEE IT AS PART OF THE LONGER- TERM GOAL OF GREATER ECONOMIC AND MONETARY COOPERATION. THE GOVERNMENT RECENTLY DECIDED TO INCREASE THE LOWER RATE OF VAT FROM 6% TO 7% AND TO TRANSFER A NUMBER OF ITEMS FROM THE HIGH RATE (20%) TO THE NEW LOW RATE. THEY TOOK INTO ACCOUNT COMMUNITY DEVELOPMENTS IN PUTTING FORWARD THESE CHANGES.

4. BECAUSE OF THEIR LONG LAND BORDER WITH THE FRG, THE MINISTRY OF FINANCE CONSIDER THAT THE COMMISSION'S PROPOSAL FOR A 6% BAND FOR THE STANDARD RATE WOULD IMPACT ADVERSELY ON HIGHER VALUE ITEMS SUCH AS FURNITURE AND MOTOR CARS. THEY WOULD PROBABLY PREFER A NARROWER BAND OF 1.5-2%. THEY WOULD ALSO LIKE TO SEE SUCH HARMONISATION ACHIEVED BY AN INCREASE IN FRG RATES BECAUSE OF THE LOSS OF REVENUE WHICH WOULD OCCUR IF THE DUTCH 20% RATE HAD TO BE LOWERED.

5. THAT SAID, THE DUTCH ARE WELL AWARE OF THE CONSIDERABLE DIFFERENCES OF VIEW AMONG MEMBER STATES ON HARMONSATION. THE

FOREIGN MINISTRY SEEM MOST LUKEWARM TOWARDS THE IDEA OF BRINGING MATTERS TO A HEAD TOO SOON. MR VAN SWINDEREN, THE DIRECTOR-GENERAL FOR EUROPEAN COOPERATION, ARGUED AT A RECENT EC AMBASSADORS' LUNCHEON (IN THE CONTEXT OF A POSSIBLE AGENDA FOR HANOVER) THAT IT WOULD BE PREMATURE TO PRESS FOR HARMONISATION. THE MINISTRY HAD RECENTLY CONDUCTED A SURVEY IN THE USA AND HAD FOUND TAX DIFFERENCES OF UP TO EIGHT PERCENTAGE POINTS BETWEEN CONTIGUOUS STATES. HARMONISATION DID NOT THEREFORE SEEM A PREREQUISITE FOR PROGRESS ON THE SINGLE MARKET. THE MORE IMMEDIATE PRIORITY WAS FREEDOM OF CAPITAL MOVEMENTS.

6. OTHER MINISTRIES MIGHT WANT TO MOVE MORE QUICKLY. RUDING HAS MADE CLEAR TO ME THAT HE REGARDS THIS QUESTION AS IMPORTANT IN THE MARCH TOWARDS 1992. MY GUESS IS THAT THE GOVERNMENT WILL OPT TO PUSH MATTERS ALONG IN THEIR PREFERRED DIRECTION, BUT AT A CAUTIOUS PACE.

7. AS REGARDS THE CONCERNS OF SCHIPHOL, THE AIRPORT AUTHORITIES CONSIDER THAT THEY WILL BE HIT BY ABOLITION OF DUTY FREE SALES. THEY MADE A PROFIT OF DFL 60 MILLION FROM THESE LAST YEAR MAINLY TO TRAVELLERS WITHIN EUROPE. THE AIRPORT HAS RECENTLY OPENED AN EXPENSIVE EXTENSION TO THE DUTY-FREE SALES AREA. IF SUCH SALES ARE ENDED, THE AIRPORT ARGUES THAT IT WILL NEED SOME FORM OF COMPENSATORY INCOME. THE AIRPORT AUTHORITIES ARE TRYING TO FORM A LOBBY OF OTHER EUROPEAN AIRPORT AND FERRY OPERATORS TO PUT THEIR CASE TO THE COMMISSION. THE MINISTRY OF FINANCE SEEM LESS EXERCISED BY THIS KIND OF PROBLEM.

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Tax approximation etc.

You may like to see these tels.
before this afternoon's meeting.

2. Although the meeting will touch on
direct tax, FST is of course unworkable
to some \therefore of CWH. It proved
impossible to organize a meeting to
which all could come before the informal
ECOFIN this w/e. We will try to
make sure that he can come to any
future meetings.

JH 7/5

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YOUR TELNO 245 TO BONN : INDIRECT TAX APPROXIMATION

SUMMARY

1. INCREASING DANISH CONCERN ABOUT THE COMMISSION'S TAX APPROXIMATION PROPOSALS BUT NO REPORTS OR ANALYSES OF HOW THEY MIGHT AFFECT DENMARK.

DETAIL

2. THE MINISTRY OF ECONOMIC COORDINATION RECENTLY STATED PUBLICLY THAT THE COMMISSION'S PROPOSALS WOULD MEAN A LOSS TO THE DANISH REVENUE OF DKR 18 BILLION PER YEAR (APPROX. #1.56 BILLION). THIS WAS DONE TO EXPLAIN HOW THIS REVENUE LOSS WOULD AFFECT GOVERNMENT EXPENDITURE ON HEALTH AND SOCIAL WELFARE.

3. WE UNDERSTAND THAT THE INDUSTRIAL COUNCIL ARE PREPARING AN ANALYSIS OF THE AFFECT OF THE COMMISSION PROPOSALS. WE HAVE BEEN PROMISED SIGHT OF THIS TOWARDS THE END OF MAY. WE HAVE ALSO BEEN TOLD BY THE LOCAL EC OFFICE (PLEASE PROTECT) THAT THEY BELIEVE THE COMMISSION SERVICES IN BRUSSELS HAVE ALREADY COMMISSIONED A REPORT ON TAX APPROXIMATION AS IT WILL AFFECT DENMARK. THIS IS SAID TO REACH A MORE FAVOURABLE CONCLUSION (DUE TO THE DYNAMIC EFFECT ON COMMERCIAL ACTIVITY OF LOWER VAT LEVELS) THAN THE DANISH GOVERNMENT'S PROJECTIONS. THE MAIN FINANCIAL INSTITUTIONS WILL HAVE UNDERTAKEN STUDIES OF THE SUBJECT BUT, TO BEST OF OUR KNOWLEDGE NONE HAVE BEEN COMPLETED. BANKS AND ACCOUNTANCY FIRMS HAVE RECENTLY DEVOTED STAFF RESOURCES TO EXPLAINING TO THEIR CLIENTS THE OVERALL EFFECT OF THE SEM.

4. AS A RESULT OF OUR VARIOUS ENQUIRIES WE EXPECT TO OBTAIN COPIES OF SOME PRELIMINARY STUDIES IN DUE COURSE BUT TOO LATE FOR YOUR DEADLINE.

5. WE UNDERSTAND FROM THE FINANCE MINISTRY THAT THE DANES WILL HAVE

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CONSIDERABLE DIFFICULTY IN FIELDING A MINISTER FOR THE ECOFIN COUNCIL
BECAUSE OF THE ELECTION HERE ON 10 MAY.

UNWIN

FCO PLEASE PASS SAVING ADDRESSEES
YYYY

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YOUR TELNO 245 TO BONN: INDIRECT TAX APPROXIMATION

SUMMARY

1. SPANISH TECHNICAL ASSESSMENT OF THE COMMISSION PROPOSALS HIGHLIGHTS THE THREAT TO THE GOVERNMENT'S SHORT-TERM INFLATION OBJECTIVES OF EARLY IMPLEMENTATION. ALTHOUGH THEIR COMMITMENT TO EUROPEAN INTEGRATION WILL INFLUENCE THEIR POSITION THEY MAY RESIST THE COMMISSION'S PRESENT PROPOSALS.

DETAIL

2. THE MINISTRY OF ECONOMY AND FINANCE HAS PREPARED A DETAILED ANALYSIS FOR INTERNAL USE OF THE COMMISSION PROPOSALS. THERE ARE NO PLANS FOR THIS DOCUMENT TO BE PUBLISHED AND WE HAVE ONLY LEARNED OF ITS EXISTENCE THROUGH TALKS WITH OFFICIALS.

3. THE MAIN CONCLUSION WARNS OF THE INFLATIONARY EFFECTS OF THE EARLY ADOPTION OF THE COMMISSION PROPOSALS IN THEIR PRESENT FORM. WE HAVE NOT BEEN GIVEN THE ESTIMATED FIGURES, BUT HAVE BEEN TOLD THAT THE GOVERNMENT'S EFFORTS TO KEEP THE INFLATION RATE IN SPAIN CLOSE TO THE EC AVERAGE IN THE SHORT-TERM WOULD BE DAMAGED. INFLATION IN SPAIN IN 1987 WAS 4.6%. THE OFFICIAL TARGET FOR 1988 IS 3%, ALTHOUGH THE CURRENT FIGURE IS 4.4% WITH UNDERLINING TRENDS ALREADY SET TO PUSH THIS HIGHER.

4. THE MINISTRY SURVEY SHOWS THAT THE REVENUE YIELD FROM INDIRECT TAXATION WOULD INCREASE SIGNIFICANTLY. BUT THE GAINS WILL NOT BE EVENLY SPREAD. THE BULK OF THE EXTRA TAX RECEIPTS WILL COME FROM THE INCREASE IN THE VAT STANDARD RATE TO ACCORD WITH THE 14-20% BAND, WHICH WOULD BE AT LEAST 2% HIGHER THAN THE PRESENT STANDARD RATE USED IN SPAIN (12%) AND WOULD CATCH MANY EVERYDAY ITEMS OF CONSUMPTION. THIS WOULD BE POLITICALLY UNATTRACTIVE. ASSIMILATION OF THE REDUCED RATE (6%) TO THE PROPOSED LOWER BAND PRESENTS FEW

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DIFFICULTIES, NEITHER DOES THE ELIMINATION OF THE LUXURY RATE (33%), WHICH COVERS ITEMS SUCH AS CARS AND JEWELLERY. SINCE VAT COVERAGE IN SPAIN IS ALREADY COMPREHENSIVE, THE ONLY ISSUES AT STAKE ARE THE PACE OF INTRODUCTION OF APPROXIMATION AND TERMS OF APPLICATION.

5. A FURTHER PROBLEM IS THE LIKELY IMPACT ON SPANISH INDUSTRY AND THE ECONOMY OF SHARPLY INCREASED EXCISE DUTIES. SPECIAL TAXES ON WINE, SPIRITS AND TOBACCO IN SPAIN HAVE TRADITIONALLY BEEN MUCH BELOW THE EC AVERAGE. THE GOVERNMENT MADE SOME INITIAL MOVES IN THE LAST BUDGET TO INCREASE THE RATE OF DUTY LEVIED BY MORE THAN INFLATION TO HELP NARROW THE DIFFERENTIAL. RAPID INTRODUCTION OF EXCISE RATES AT THE LEVEL OF THE COMMISSION PROPOSALS WOULD HAVE A SERIOUS EFFECT ON PUBLIC OPINION. IT WILL ALSO HARM THE SPANISH TOBACCO INDUSTRY, WHICH CONCENTRATES HEAVILY ON THE USE OF LOCALLY-GROWN BLACK TOBACCO IN CIGARETTE PRODUCTION. THIS HAS ALWAYS BEEN A CHEAPER PRODUCT AND MORE POPULAR WITH THE CONSUMER THAN LIGHTER TOBACCO CIGARETTES WHICH ARE MOSTLY IMPORTED. ANY MOVES WHICH COULD CAUSE A SHIFT IN THE MARKET IN FAVOUR OF THE LIGHTER BLENDS, SUCH AS CLOSING THE GAP IN PRICES, WOULD CAUSE PROBLEMS FOR SPANISH PRODUCERS AT A TIME WHEN THE TOTAL EUROPEAN CIGARETTE MARKET IS CONTRACTING.

COMMENT

6. THE MINISTRY SURVEY IS UNLIKELY TO BE DECISIVE IN ESTABLISHING SPANISH GOVERNMENT POLICY. THE PRIME MINISTER, IN PARTICULAR, IS KNOWN TO BE A STRONG ADVOCATE OF CLOSER EC ECONOMIC INTEGRATION AND THE CHANGES INVOLVED WOULD BE COMPARATIVELY MINOR COMPARED WITH THOSE WHICH THE SPANISH ECONOMY HAS HAD TO WEATHER SINCE ACCESSION. HOWEVER CONVERSATIONS WITH THE BANK OF SPAIN REVEAL A PREFERENCE FOR MARKET LIBERALIZATION PRECEDING TAX APPROXIMATION. OUR GENERAL CONCLUSION IS THAT THE SPANIARDS COULD WELL BE ALLIES IN RESISTING THE CURRENT COMMISSION PROPOSALS.

FCO PLEASE PASS SAVING

GORDON LENNOX

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YOUR TELNO 245 TO BONN:

INDIRECT TAX APPROXIMATION

1. WE ARE NOT AWARE OF ANY SUBSTANTIVE PUBLISHED ANALYSIS OF THE COMMISSION'S PROPOSALS ON TAX APPROXIMATION BY ITALIAN GOVERNMENT OR PRIVATE ORGANISATIONS. THERE IS HOWEVER A COMMISSION WORKING ON THE IMPLICATIONS WITHIN THE AMBIT OF THE MINISTRY OF FINANCE. YOU WILL WISH TO BE AWARE THAT IN THE PROGRAMME DOCUMENT OF THE DE MITA GOVERNMENT FISCAL HARMONISATION IS TWICE SPECIFICALLY SINGLED OUT AS ONE OF THE ELEMENTS OF COMPLETION OF THE INTERNAL MARKET BY 1992 TO WHICH ITALY MUST BE READY TO CONFORM.

THOMAS

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FM LUXEMBOURG
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INFO ROUTINE OTHER EUROPEAN COMMUNITY POSTS

YOUR TELNO 245 TO BONN : INDIRECT TAX APPROXIMATION

SUMMARY

1. REPORT BY PATRONAT SEES COMMISSION'S PROPOSALS FOR TAX HARMONIZATION AS UNNECESSARY, TECHNICALLY FLAWED AND SERIOUSLY DAMAGING TO LUXEMBOURG'S ECONOMY.

DETAIL

2. THE STUDY OF THE IMPLICATIONS FOR LUXEMBOURG OF THE SINGLE MARKET COMMISSIONED FROM THE ECONOMIC AND SOCIAL COMMITTEE IS EXPECTED TO BE READY IN JUNE. IN THE MEANTIME WE HAVE BEEN GIVEN A COPY OF A 60 PAGE REPORT PREPARED BY THE PATRONAT LIAISON COMMITTEE AS THEIR CONTRIBUTION TO THIS EXERCISE. PREDICTABLY IT DEVOTES MUCH ATTENTION TO INDIRECT TAXATION.

3. THE MAJOR GENERAL POINTS ARE:

A) HARMONIZATION OF INDIRECT TAXES IS NOT A PREREQUISITE FOR THE SINGLE MARKET.

B) COMPETITION WOULD IN ANY CASE TEND TO BRING NATIONAL SYSTEMS CLOSER TOGETHER.

C) THE PRESENT SYSTEM OF COLLECTING VAT AT DESTINATION HAS A NEUTRAL EFFECT ON TRADE FLOWS. THE COMMISSION'S PROPOSAL TO TAX AT ORIGIN WOULD CREATE DISTORTIONS BECAUSE BUSINESSES WOULD SEEK THEIR SUPPLIES IN COUNTRIES WITH THE LOWEST TAX. (AN 11 PAGE ANNEX DEVELOPS THE TECHNICAL ARGUMENT.)

D) THIS IN TURN WOULD RESULT IN PRESSURE FROM COUNTRIES LOSING TRADE TO REDUCE THE WIDTH OF THE BAND ON VAT RATES ALLOWABLE.

E) AT ONE POINT THERE IS A PASSING REFERENCE TO THE EROSION OF 'OUR FISCAL SOVEREIGNTY, WHICH IS ONE OF THE MOST SIGNIFICANT ATTRIBUTES OF SOVEREIGNTY IN THE ECONOMIC FIELD'.

4. FOR LUXEMBOURG IT IS ARGUED THAT THERE WOULD BE THE FOLLOWING

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ADVERSE EFFECTS:

A) PRICES WOULD GO UP 5-8% AS A RESULT OF INCREASES IN VAT AND EXCISE DUTIES.

B) THIS WOULD BE REFLECTED IN COSTS BECAUSE OF THE INDEXATION OF SALARIES.

C) THE HOTEL AND RESTAURANT TRADE WOULD BE PARTICULARLY HIT AS WOULD SALES OF CERTAIN CONSUMER GOODS (ESPECIALLY TOBACCO, FOOD, DRINK, PETROL). HIGHER PRICES WOULD LEAD TO LOWER DOMESTIC DEMAND AS WELL AS DAMAGING THE TOURIST TRADE. CROSS FRONTIER TRADE WOULD SUFFER SERIOUSLY FROM THE LOSS OF LUXEMBOURG'S EXISTING COMPETITIVE ADVANTAGE. IT IS ESTIMATED THAT SOME FLUX 35-40 BILLION WORTH OF BUSINESS WOULD BE LOST IN THIS WAY, AND THAT SOME 320 BUSINESSES WOULD SHUT DOWN LEADING TO A LOSS OF SOME 1,120 JOBS. THE EFFECT OF INCREASED STAFF SALARIES ON COSTS WOULD CAUSE FURTHER LOSSES, PERHAPS DOUBLING THE ABOVE FIGURES.

D) THE BANKS WOULD STAND TO LOSE INSTITUTIONAL INVESTORS IF VAT WERE IMPOSED ON BANKING OPERATIONS (IE IF THE PRESENT OPTIONAL REGIME WERE ABOLISHED) SINCE THE COST TO CUSTOMERS WOULD GO UP 14% OVERNIGHT. NO FIGURES FOR LOSSES ARE GIVEN.

5. IN THE MEANTIME, GOVERNMENT MINISTERS CONTINUE REGULARLY TO REFER TO THE PROBLEMS IN THIS FIELD IN THEIR SPEECHES (EG PRIME MINISTER'S SPEECH TO THE LUXDEALERS - SEE FARR'S LETTER OF 31 MARCH TO LINDA DUFFIELD, ECD(I)). THEIR LINE IS BROADLY THAT THE COMMISSIONS'S PROPOSALS ARE UNNECESSARY FOR A SINGLE MARKET, THAT LUXEMBOURG WILL HAVE GOOD COMPANY IN OPPOSING THEM AND THAT DECISIONS IN THIS FIELD MUST BE TAKEN BY UNANIMITY. AT THE SAME TIME HOWEVER THEY ARE WARNING THAT LUXEMBOURG WILL HAVE TO ACCEPT SOME CHANGES, POSSIBLY EVEN IN THIS FIELD, AND MUST RISE TO THE CHALLENGE THAT THESE WILL OFFER.

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MR RATFORD

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FROM: P D P BARNES
DATE: 9 May 1988

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Culpin
Mr A J C Edwards
Mr Riley
Miss Sinclair
Mr Cropper
Mr Tyrie

Ch
Received at 3PM!
(at first glance seems OK)
AA

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

ECONOMIC SECRETARY'S SPEECH IN DEBATE ON VAT HARMONISATION, WEDNESDAY 11 MAY : FIRST DRAFT

I attach a first draft of the speech which the Economic Secretary is to deliver in Wednesday's debate. This closely follows speaking notes provided by Customs and Excise.

2. The Chancellor and copy recipients may like to glance at this before the meeting on the Single European Market this afternoon.

PP

Guy Westhead

P D P BARNES
Private Secretary



FROM: P D P BARNES
DATE: 9 May 1988

NOTE

DEBATE ON TAX APPROXIMATION : DRAFT SPEECH (1)

Timing

2. Mr Speaker, this is a very timely debate. Next weekend, the European Council of Finance Ministers (ECOFIN) are meeting informally to discuss approximation. It is right that the House should have the opportunity to discuss these matters beforehand. And I know that my Rt Hon Friend the Chancellor will study carefully the views which are expressed tonight.

Select Committees' Reports

3. I am very grateful both to the Select Committee on European Legislation and to the Treasury and Civil Service Committee for the work they have put into their reports. The Government has found them both most valuable. Both reports confirm that, in most significant areas, the Government's overall approach is one which most Members support.

Cockfield Proposals

4. The Commission has put forward wide-ranging proposals which cover both VAT and excise duties. The proposals are intended as a step, which the Commission believes is essential, towards the completion of the single market.

5. For VAT, the Commission has proposed the "approximation" of VAT rates. All Member States would apply two positive rates: a standard rate of between 14 and 20%; and a reduced rate of between 4 and 9%. There would therefore be no scope to apply a zero rate. The reduced rate would apply for foodstuffs (excluding alcohol);

to energy for heating and lighting; to water; to passenger transport; to pharmaceutical products; and to books, newspapers and periodicals. All other taxable items would be standard rated.

6. Another major feature of the proposals is that exports would no longer be zero rated. Tax would be charged across frontiers, at a rate applicable in the exporting country. A clearing house would reallocate displaced revenues to Member States in which goods or services are consumed.

7. For excise duties, the Commission has proposed a complete harmonisation of rates. The proposed rates are based on a mixture of weighted and arithmetic Community averages, intended to ensure minimum distortion to Member States' revenues.

UK difficulties

8. The Government shares the Commission's ultimate objective which is to create a single internal market by removing unnecessary obstacles to trade. We are firmly committed to that. But as we have already made clear, we have fundamental difficulties with the Commission's approach. Our major difficulty concerns the future of UK's zero rates. As drafted, the proposal makes no provision for zero rates, although the Commission has hinted at the possibility of temporary derogations for Member States with particular difficulties. We have made specific pledges to the electorate to retain zero rating on food, fuel and power, and childrens clothing^{^ shoes ?}. And I can assure the House that we neither wish nor intend to resile from these pledges. As far as zero rates on other goods and services are concerned it is for this Parliament at Westminster to decide whether to retain or alter them. The Chancellor has made it quite clear last November at meetings of ECOFIN that the UK cannot accept proposals which would in any way restrict our ability to apply zero rates of VAT.

9. We have other areas of difficulty with the Commission's proposals, of which the most major are their proposals for excise duty for alcohol and tobacco. The Commission's use of average rates means that in the UK, the duty on alcoholic beverages would fall

by between 40 and 85%, while the duty on cigarettes would fall by about 10%. Clearly, changes of this magnitude would have a marked effect on UK health and social policy; we have therefore made it clear that the UK has fundamental difficulties with the Commission's approach.

Other Countries' difficulties

10. The UK is not alone in facing difficulties with the Commission's proposals. Almost every Member State has problems with the concept of a clearing house for VAT revenues. As currently proposed, the clearing house would be largely unaccountable, unauditible, and open to fraud.

11. The approximation and harmonisation proposals affect each country differently. At one end of the scale are countries like Denmark and Ireland which rely heavily on indirect taxes and stand to lose substantial amount of Government revenue. At the other end are those who will have to increase indirect taxes substantially or even impose them for the first time. Many Member States would have to abolish certain excise duties; many would have to make changes which have serious implications for social, health, transport, budgetary or counter - inflation policies. Some of the changes which would be required are both large (in percentage terms) and likely to be highly politically sensitive. For example, Greece would need to increase its duty on spirits by more than 2000% and on cigarettes by around 150%; France would need an increase of around 650% in the duty on beer; Italy, Spain, and Portugal would have to impose a duty on wine for the first time; and in Denmark the duty on table wine would have to decrease by some 95%. In the UK, public concern has tended to concentrate on the abolition of VAT zero rating on many frequently-purchased items such as food, domestic fuel, and childrens clothing, and these are concerns which the Government shares. But changes in excise duty would also be highly unwelcome for health and social policy reasons. All these changes would be likely to have substantial and largely unpredictable effects on consumption patterns. The effects would of course feed through into industry, which would also be affected directly by changes in excise duties on petrol and oils. This is the hidden cost of

the proposals which must be balanced against the benefits which the Commission claim.

Fundamental doubts-alternative approach

12. We should not forget that the ultimate objective both of the Commission's proposals and of our own approach to the internal market is to dismantle unnecessary barriers to trade. The Commission has made clear that it sees its proposals simply as a necessary pre-condition to obtaining agreement on the dismantlement of barriers. But now that there is a danger of getting bogged down in disagreements on this intermediate step, attention is turning to the idea that we should move direct to starting to dismantle unnecessary barriers.

13. The Commission originally baulked at this idea for fear that it would lead to trade distortions caused by differences in the rates of indirect tax in different Member States. But in fact, VAT differences at least are usually small in comparison with other factors affecting prices. And some of those other factors often offset VAT differences. For instance, countries which rely heavily on indirect taxes may rely less on direct taxes, and vice versa. In any case, Governments who found that they were losing trade and revenue across their borders could bring specific rates more into line with those of their neighbours. The example of the United States shows that it is possible for individual states to retain fiscal autonomy without damaging the internal market as a whole. Market realities prevent too large a difference in taxes between states, particularly neighbouring states, but still leave some freedom of action.

14. The Commission acknowledge the attractiveness of making steps in this directions. But they say that they judge that Member States would not agree to dismantle barriers for fear that they would be forced into an unpalatable realignment of tax rates. It is therefore ironic that the Commission should think that it will be easier to obtain an agreement on a comprehensive and therefore even more unpalatable realignment of rates before taking a single step towards the desirable goal of dismantling barriers.

Conclusion

15. It is still very early days. Last November, ECOFIN referred proposals to the Economic Policy Committee - a Committee of experts - for economic evaluation. The Committee's interim report to ECOFIN in April highlighted many of the problem areas inherent in the Commission's proposals. The Committee recommended that, irrespective of what Ministers eventually decided about harmonisation, Member States should take steps as soon as possible to reduce obstacles to trade. This is an approach with which the Government can heartily agree.

16. Ultimately, any change to European tax law requires the unanimous agreement of Member States. So the UK's position is safeguarded. There is therefore no question of our being obliged to accept proposals with which we disagree. Let me repeat once more: the pledges we have given to the electorate on zero rates are firm commitments by which the Government stands.

17. I could go on much longer, Mr Speaker. But I have deliberately kept my remarks as brief as possible to enable as many hon Members as possible to contribute to the debate. I am glad that we have the opportunity to debate these proposals tonight. And I look forward to hearing the views of hon Members before Ministerial discussion of these proposals gets under way.



01-270 4520

CHANCELLOR

Mans Park
2-Prayers

DEBATE ON INDIRECT TAX HARMONISATION

The minutes of this morning's Prayers records Mr Lennox-Boyd saying the Treasury practice of tabling motions earlier than they need increased the risk of amendments and that the Government motion need only have been tabled by today!

2. For the record, it is Treasury practice, all else being equal, to table these motions as near the procedural deadline as possible. On the motion in question, however, we were very specifically exhorted by the business managers - through Murdo Maclean last Tuesday - to get the motion down as speedily as possible to assist negotiations with the Opposition in settling the following week's business.

3. We pulled out all the stops to meet this request, believing it to be in the interest of Treasury Ministers. We had been given to understand that delay on our part might lead to the business managers having to concede to Opposition pressure for a debate in prime time. I drafted the motion, cleared it with the House Authorities, Treasury Ministers, the Prime Minister, ~~and~~ the Foreign Secretary and tabled it within 24 hours. Hopefully, our expedition contributed to the agreement reached, through the usual channels, with the Opposition (reluctantly on their part) to the debate taking place after 10pm for 1½ hours this Wednesday.

4. Given this background, I am sure we did the right thing (1½ hours after 10pm is better than a full half-day debate in prime time); albeit that we may have to deal with an amendment from Mr Taylor.

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

B O DYER
 9 May 1988



FROM: P D P BARNES
DATE: 9 May 1988

Handwritten signature

P S / CHANCELLOR

cc PS/Paymaster General
Mr Cropper
Mr Tyrie

VAT APPROXIMATION DEBATE

I understand that the Chancellor asked at Prayers for the Economic Secretary to consider the terms of an inspired Amendment to be used if a hostile amendment to the original motion were to be put down by a backbencher.

... 2. I attach two possible alternatives.

Handwritten notes in red ink:
Over taken
(Trust)
Given acceptance of
the Taylor
PP
June

Handwritten signature: Guy Westhead.

P D P BARNES
Private Secretary

At end of motion add, "and approves the stance taken by Her Majesty's Government in respect of the proposals contained in these documents."

or

At end of motion add, "and supports the Government's firm commitment to achieving a single European market, believes that this is compatible with the retention by the UK of VAT zero rates, and does not believe that the pursuit of unnecessary harmonisation should delay steps to reduce border obstacles to free trade with the European Community."



mp

FROM: MISS M P WALLACE

DATE: 10 May 1988

PS/ECONOMIC SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Culpin
Miss Sinclair
Mr Cropper *Mr Dyer*
Mr Tyrie

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

DEBATE ON VAT HARMONISATION

The Chancellor was grateful for your minute of 10 May. He agrees with the Economic Secretary's view that we can accept Mr Taylor's amendment.

M.P.W.

MOIRA WALLACE



FROM: P D P BARNES
DATE: 10 May 1988

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Tyrie

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

DEBATE ON VAT HARMONISATION

The Economic Secretary has learnt that Mr Teddy Taylor MP has put down an amendment to the Motion on VAT harmonisation which reads:

"Line 7, at end add, 'and welcomes the assurances of HM Government that it will oppose any proposals to levy indirect taxation on foods, fuel and children's clothing.'"

2. The Economic Secretary sees nothing to be gained from inspiring a counter-amendment.

thy
same advice
from Mr Dyer
behind.

OK?

Wpaw
10/5

*I agree. LSP can
accept Mr Taylor
amendment.
PB*

P D P BARNES
Private Secretary

ORDERS OF THE DAY AND NOTICES OF MOTIONS—*continued*

- * 14 MATRIMONIAL PROCEEDINGS (TRANSFERS) BILL [LORDS]: Not amended (*in the Standing Committee*), to be considered.
- * 15 BRITISH STEEL BILL: As amended (*in the Standing Committee*), to be considered.

For an Amendment, see page 1905 of Supplement to Votes.

- * 16 COURT OF SESSION BILL [LORDS]: Second Reading.

17 INDIRECT TAX HARMONISATION

The Prime Minister
 Secretary Sir Geoffrey Howe
 Mr Chancellor of the Exchequer
 Mr Secretary Hurd
 Mr Secretary Walker
 Mr Secretary Younger

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.

As an Amendment to the Prime Minister's proposed Motion (Indirect Tax Harmonisation):

Mr Jonathan Aitken
 Mr Bill Walker
 Sir Richard Body
 Mr Roger Moate
 Mr Teddy Taylor
 Mr Richard Shepherd

Line 7, at end add 'and welcomes the assurances of Her Majesty's Government that it will oppose any proposals to levy indirect taxation on food, fuel and children's clothing.'

18 PUBLIC PETITIONS

Mr John Wakeham

That Standing Order No. 133 (No debate on presentation of petition) be left out and the following be inserted:

Time and
 manner of
 presenting
 petitions

133 (1)—Every petition presented under Standing Order No. 132 (Presentation of petitions) not containing matter in breach of the privileges of this House, and which according to the rules or usual practice of this House can be received, shall be brought to the Table—

(a) on Mondays, Tuesdays, Wednesdays and Thursdays, after a Minister of the Crown shall have signified his intention either to move 'That this House do now adjourn', for the purpose of bringing the sitting to a conclusion, or to move, pursuant to Standing Order No. 10 (Sittings of the House (suspended sittings)) 'That the proceedings of this day's sitting be suspended', and

(b) on Fridays, at the commencement of public business;

Provided that petitions remaining to be presented at ten o'clock on a Friday on which private Members' bills have precedence under paragraph (4) of Standing Order No. 13 (Arrangement of public business) shall stand over and may be brought to the Table after a Minister of the Crown shall have signified his intention to move 'That this House do now



PS / Chancellor

Indirect Tax Harmonisation

I am sure we can live with
Teddy Taylor's Amdt. below. It
does little more than reiterate the
Govt's pledges in this area. To be
precise the Govt. has always referred
to 'Young' Children's Clothing, and
in respect of 'Fuel' has tended to
specify 'Gas and Electricity'. The
EST can make this clear in the
debate on Wednesday.

R. Ager
10/5.

ORDERS OF THE DAY AND NOTICES OF MOTIONS—*continued*

- * 14 MATRIMONIAL PROCEEDINGS (TRANSFERS) BILL [*LORDS*]: Not amended (*in the Standing Committee*), to be considered.
- * 15 BRITISH STEEL BILL: As amended (*in the Standing Committee*), to be considered.

For an Amendment, see page 1905 of Supplement to Votes.

- * 16 COURT OF SESSION BILL [*LORDS*]: Second Reading.

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Secretary Sir Geoffrey Howe
Mr Chancellor of the Exchequer
Mr Secretary Hurd
Mr Secretary Walker
Mr Secretary Younger

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Mr Bill Walker
Sir Richard Body
Mr Roger Moate
Mr Teddy Taylor
Mr Richard Shepherd

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Time and
manner of
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petitions

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(b) on Fridays, at the commencement of public business;

Provided that petitions remaining to be presented at ten o'clock on a Friday on which private Members' bills have precedence under paragraph (4) of Standing Order No. 13 (Arrangement of public business) shall stand over and may be brought to the Table after a Minister of the Crown shall have signified his intention to move 'That this House do now

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YOUR TELNO 245 TO BONN: INDIRECT TAX APPROXIMATION

1. FURTHER TO ROME TELNO 270, WE HAVE BEEN GIVEN A COPY OF THE DRAFT TEXT OF AN UNPUBLISHED STUDY BY THE BANK OF ITALY ON INDIRECT TAX HARMONISATION.

2. THE PAPER CONCLUDES INTER ALIA THAT THE PROPOSALS SO FAR ADVANCED PRESENT MANY DIFFICULTIES, IN PARTICULAR IT IS NOT YET POSSIBLE TO GUARANTEE EQUAL TREATMENT OF GOODS PRODUCED IN DIFFERENT COUNTRIES OR ESTABLISH AN EFFICIENT REGULATORY SYSTEM IN THE ABSENCE OF CONTROLS AT FRONTIERS. IN THE BROADER CONTEXT, TAXATION ACCORDING TO COUNTRY OF ORIGIN COULD HAVE IMPORTANT POLITICAL AND INSTITUTIONAL IMPLICATIONS. THE BANK STUDY ESTIMATES THAT THE EFFECT ON ITALY OF THE COMMISSION'S PROPOSALS AT PRESENT CONSUMPTION LEVELS WOULD BE AN INCREASE IN VAT RECEIPTS OF SOME 2000 BILLION LIRE WITH ACCOMPANYING INFLATIONARY PRESSURES. PROPOSED CHANGES IN EXCISE DUTIES WOULD LEAD TO A ONE PER CENT REDUCTION IN PRICES AND A FALL IN EXCISE RECEIPTS OF 10,000 BILLION LIRE ACCOMPANIED BY PROBLEMS IN ADMINISTRATION AND DISTRIBUTION. THE EFFECT OF VAT APPROXIMATION ON FAMILY BUDGETS WOULD BE UNFAVOURABLE TO SMALL FAMILIES AND TO THOSE ON LOW INCOMES.

3. COPY OF PAPER (IN ITALIAN) FOLLOWS BY CONFIDENTIAL BAG OF 13 MAY FOR WEBB ECD I.

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SIR J FRETWELL
MR RATFORD

ADDITIONAL 1

FRAME

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003222
MDHIAN 9022

RESTRICTED
FM BRUSSELS
TO IMMEDIATE FCO
TELNO 153
OF 111046Z MAY 88
INFO ROUTINE ALL EC POSTS

FRAME ECONOMIC

YOUR TELNO 245 TO BONN: INDIRECT TAX HARMONISATION

SUMMARY

1. UNLESS POLICY IS RADICALLY MODIFIED BY THE NEW FINANCE MINISTER, THE BELGIANS WILL CONTINUE TO SUPPORT THE COMMISSION PROPOSALS AND THE PRINCIPLE OF TAX APPROXIMATION.

DETAIL

2. THERE HAVE BEEN NO RELIABLE ANALYSES OR COMMENTARIES ON THE COMMISSION PROPOSALS PRODUCED IN BELGIUM. A 'BUREAU DE PLAN' STUDY IN TABULAR FORM EXAMINING ECONOMETRIC IMPLICATIONS FOR BELGIUM IS NOT TAKEN SERIOUSLY IN THE FINANCE MINISTRY.

3. WITH THE CHANGE OF FINANCE MINISTERS IN THE NEW GOVERNMENT ONLY HAVING BEEN ANNOUNCED ON 8 MAY, AND THE MINISTER'S CABINET YET TO BE RE-FORMED, THERE IS CURRENTLY A DEGREE OF UNCERTAINTY AS TO THE GOVERNMENT'S OFFICIAL POSITION ON INDIRECT TAX APPROXIMATION. HOWEVER, WE UNDERSTAND THAT, FOR THE TIME BEING, THE GOVERNMENT REMAINS FIRMLY COMMITTED TO THE PRINCIPLE OF HARMONISATION AND HAS LITTLE SYMPATHY FOR THE UK APPROACH.

4. FINANCE MINISTRY CONTACTS HAVE USED THE MARKET FORCES ARGUMENT, AS ADVANCED BY THE INSTITUTE OF FISCAL STUDIES, IN SUPPORT OF THE NEED FOR FIXED MINIMUM VAT RATES TO PROTECT THEIR VAT REVENUES FROM FALLING TOO LOW. FOR THIS REASON THEY WOULD IDEALLY LIKE TO SEE THE LOWER LIMITS OF THE COMMISSION'S PROPOSED BANDS RAISED BY 1 OR 2 PER CENT. (THEY ARE NOT CONCERNED ABOUT THE UPPER LIMITS). BUT THEY COULD LIVE HAPPILY WITH THE COMMISSION PROPOSAL AS IT STOOD.

5. THE FINANCE MINISTRY BELIEVE BELGIUM STANDS TO GAIN FROM THE CURRENT PROPOSALS, SINCE THE LOSS IN VAT REVENUE WOULD BE MORE THAN COMPENSATED BY INCREASED EXCISE REVENUES. THE OVERALL GAIN IN REVENUE, WHICH THE NEW GOVERNMENT PROGRAMME PLANS TO USE IN CUTTING DIRECT TAXATION, IS ESTIMATED AT APPROXIMATELY 30 BILLION

RESTRICTED

003222
MDHIAN 9022

FRANCS.

PETRIE

YYYY

DISTRIBUTION 205

MAIN 203

.FRAME ECONOMIC ECD (I)

ADDITIONAL 2

FRAME MR P J WESTON CAB OFFICE

NNNN

FROM: I C R BYATT
DATE: 17 May 1988

- 1. SIR P MIDDLETON
- 2. CHANCELLOR

Em
Ch.
Agree with this general approach?

- cc
- Sir T Burns
 - Sir G Littler
 - Mr Lankester
 - Mr Scholar
 - Mr Culpin
 - Mr Edwards
 - Miss Sinclair
 - Mr Riley
 - Mr Ford
 - Mr Parkinson

Copies attached for:

- Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary

Stamps
Jan. 21 X
Miss Stoltenberg 17/5
Sir Andrew
of Jan - June
in his
low

- Mr Jefferson Smith
- Mr Allen

discuss
this if discuss
to stop
so much
steps
no

INDIRECT TAX APPROXIMATION

I understand that at the informal Ecofin, Mr Stoltenborg suggested that the UK might consider putting a paper to the EPC which might look at whether a more limited definition of harmonisation might be adequate. Sir G Littler asked me to consider what the main elements might be and to send them to you.

2. I think it would be useful to put in such a paper and suggest that it should cover the following ground:

(i) it would rehearse for a market approach rather than centralised bureaucratic imposition - ie for "bottom up" rather than "top down" approximation. (The top down/bottom up argument has already come out in EPC discussions.) An important aspect of the market approach is the argument that competition in tax rates can be positively beneficial, provided lower tax rates result from lower public expenditure and a sound fiscal position.

An important proviso!

(ii) the present system of destination based indirect tax does not distort production - with the exception of some complications on cross border shopping by final consumers and tax exempt bodies. So the main reason for any harmonisation would be to reduce the costs of trading across frontiers.

20-17-5

(iii) the costs imposed on traders could be reduced significantly by administrative improvements, the Benelux system, the use of the 14th Directive (ie the Postponed Accounting System) etc.

(iv) liberalisation for final consumers could be achieved by a progressive increase in travellers allowances. VAT and the excise duties can be treated either separately or jointly.

(v) there is a strong case for a minimum rate of excise duty for alcohol and tobacco (for health reasons).

(vi) it is necessary to investigate what is really necessary in the transport areas. (EPC has talked generally about consistency with wider EC transport policies but this has not been looked at. It is not obvious that doing so would point to identical levels of excise duty for petrol and derv.)

3. On this basis the kind of harmonisation which is needed is:-

(i) co-ordination on measures to reduce the costs of crossing borders,

(ii) agreed progress in raising travellers' allowances,

(iii) agreement on minimum rates of tax for commodities where health issues (and other matters vital to member states) are at stake.

4. We should be able to produce something which could even be helpful in getting some progress on the reduction of frontier barriers without going down the Cockfield route. How helpful, is very difficult to judge. But it should do no harm - except in so far as we would be seen as ready to discuss minimum rates of tax in a limited context.

5. On timing, the EPC will meet on 27 May and 8 July. If you were content with the above I could tell the EPC on 27 May that there would be such a paper. It could be discussed on 8 July, unless the German Chairman wants to rush things.

I C R BYATT

BF to m 28/5



FROM: G R WESTHEAD
DATE: 19 May 1988

MP

APS/CHANCELLOR

cc Mr Michie
Miss Wallace - MCU

Mr P R H Allen - C&E
Mr Oxenford - C&E
Mr Geddes - C&E
Mr Dane - C&E

STOCK REPLY TO CORRESPONDENCE ABOUT VAT ON BOOKS AND NEWSPAPERS

Thank you for your minute of 17 May which we discussed on the telephone.

2. I can confirm that the Economic Secretary is content with the two alternative drafts for letters about VAT on books, etc (outlined in Annex C to your minute). We are all agreed that no reference to pledges should be made where the letter refers only to VAT on books and there is nothing about the EC dimension.

3. As you know, the reply submitted by Customs for the Chancellor's signature in response to the one from Mr Howell MP was the incorrect draft. It needs to be replaced by the non-EC stock draft.

Guy Westhead

GUY WESTHEAD
Assistant Private Secretary



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

FROM: J M G TAYLOR

DATE: 20 May 1988

MR BYATT

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester
Mr Scholar
Mr Culpin
Mr Edwards
Miss Sinclair
Mr Riley
Mr Ford
Mr Parkinson

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

INDIRECT TAX APPROXIMATION

The Chancellor has seen your note of 17 May. He has commented that what you propose seems fine.

2. On timing, he has commented that Stoltenberg has set a deadline of end-June, which fits well with a proposed discussion on 8 July - though if the discussion slips to September, so much the better!

A handwritten signature at the bottom of the page.

J M G TAYLOR

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FROM: CHIEF SECRETARY

DATE: 23 May 1988

CHANCELLOR

X and Y pl
plus Baker letter
of 2/19/82

cc:
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Anson
Mr Scholar
Mr H Phillips
Mr Culpin
Mr A J C Edwards
Mr Turnbull
Mr Gilhooly o.a.
Mr Burr
Mr Richardson
Mr Potter
Mr Michie
Mr Cropper

Ch/
If you agree, way would
be clear for CST to
write to Mr Baker on
the one specific case. *OK*

Canth. upon.

Mr Jefferson Smith C & E
Mr Wilmott C & E
PS/C & E

VAT ON NON-DOMESTIC CONSTRUCTION: PUBLIC EXPENDITURE IMPLICATIONS

As agreed at your meeting on 11 May, I have considered with the Economic Secretary and officials the public expenditure issues in Mr Richardson's minute of 27 April, and Miss Sinclair's of 5 May. As at your meeting, our assumption was that the Judgement will follow the Advocate General's Opinion.

Implications of ECJ ruling

2 I agree with officials' recommendation that for government departments any extra VAT costs should be dealt with through public expenditure. Although the alternative - some form of refund - would neutralise the effect on the planning total, this presentational benefit would be outweighed by the anomalies

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created, and the consequent pressure for more extensive VAT refunds.

3 Provided that the European Court reach their judgement in time, I would intend to deal with the implications for departments in the forthcoming Survey. In practice I would expect to concede virtually all the costs of VAT on non-domestic construction. Failure to compensate programmes would be criticised by colleagues and by industry as being unfair and unreasonable.

4 Since we are prepared to compensate programmes in this way, I think it would be clearly preferable to indicate this at the time of the announcements, thus avoiding criticism from Departments and Parliament and allowing us to take credit for what we would in any case ultimately be forced to concede.

5 I therefore recommend that the Parliamentary announcement on the tax changes should make clear that we take a sympathetic view of the implications of new construction VAT for public expenditure programmes, and shall consider in the Public Expenditure Survey what compensation adjustments should be made in these programmes. I envisage however, that this would take the form of a once-for-all adjustment in the programme; thereafter the department would have to find the full costs, including VAT, from within its allocation. The PESC paper circulated to departments should take a similar line, and not the neutral one originally proposed by officials. I now envisage this paper issuing immediately after the first Parliamentary announcement, in view of your decision to make it fuller and more substantial; this will simplify and accelerate the PES handling.

6 On the other hand, I think it is reasonable to expect departments to absorb any increased rent costs resulting from the option to tax. These costs would be small in relation to departments' running costs, particularly in the early transitional years. In contrast to the sympathetic consideration to be given to new construction VAT, the PESC paper should assert a presumption of absorption for any costs of the option to tax rents. I believe that the more positive line I am suggesting on new construction

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should make it easier to hold the line on this.

7 I should also expect health authorities to accommodate any increased rent costs, which should be less than £1 million in 1988-89. We should however give health authorities full compensation for the costs of VAT on new construction. I endorse officials' recommendation that this be effected through refunds under Section 11 of the Finance Act 1984, simply extending the current arrangement in respect of VAT on building alterations and extensions.

Future of Section 20

8 Miss Sinclair's minute of 5 May, with Mr Anson's of 6 May, sets out clearly the arguments over extension or abolition of Section 20 of the VAT Act 1983.

9 I endorse officials' view that there is no case for extending Section 20; as Mr Anson says, it would be perverse in economic terms and be criticised as shielding government from the effects of its own taxation. I accept that as more and more local government-type functions are undertaken by bodies funded from the centre, we will come under increasing pressure to extend Section 20. I believe that we can legitimately resist such pressures, and impose upon these bodies the same expenditure disciplines which we apply to the central departments.

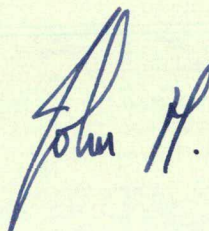
10 I accept that there is a strong case in economic logic for abolishing Section 20, and ceasing to allow local authorities to escape VAT; and the obvious time for such a change would be the introduction of the new financial regime for local authorities. However, abolition would involve considerable practical difficulties for Customs and for local authorities; would be unlikely to realise any public expenditure savings, in view of the pledge that VAT should not become a burden on the rates; and would discourage contracting-out unless alternative refund arrangements were made. We should also need to consult local authorities about the move - an awkward complication in current circumstances. On balance, therefore, I conclude that abolition

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of Section 20 would involve disproportionate difficulties, and I recommend that the status quo be retained. Peter Lilley agrees with this view. I also recommend that entry to Section 20 should continue to be allowed only to bodies which perform local government-type functions and which are funded directly from rates or rate support grant. But I see no reason to introduce a rates-funded benchmark, as each case can properly be considered on its merits.

Summary

11 Subject to your agreement, I recommend that officials should plan to handle the public expenditure implications of the ECJ VAT Judgement on the line described in paragraph 2 - 7 above. I recommend no further action on the abolition or extension of Section 20, nor any changes in the criteria for determining eligibility for Section 20 status.

A handwritten signature in blue ink, appearing to read "John H.", is written over a faint, mirrored watermark of the word "CONFIDENTIAL".

JOHN MAJOR

~~BF 3/6~~



(pnp)

rr

Ch/Your reference to conflicting earlier advice from C+E makes me wonder if they have really answered your question. In earlier advice they have, I understand, made the point that a positive rate below say 3 or 4 per cent would not be consistent with the provision of the 6th Directive that rate should not be so low that reclaimable VAT on inputs exceeded output tax charged, so that traders actually got a net refund. If that point is what you had in mind, then Customs say it would merely be one more reason to amend 6th Directive (which would need amendment anyway if were to "institutionalise" zero-rating in a Patterson-type scheme) ~~how? mprw 116~~

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~~BE 27/5~~



FROM: P D P BARNES
DATE: 25 May 1988

(pwp)

PS/CHANCELLOR

- cc PS/Sir P Middleton
- Sir G Littler
- Sir T Burns
- Mr Byatt
- Mr Scholar
- Mr A J C Edwards
- Mr Culpin
- Mr Gilhooly
- Mr Riley
- Miss Sinclair
- Mr Michie
- Mr Parkinson

WPA.
2. I take it that X
means that C&E was
delivered with a positive
rate within the 10-6%
(This implies an increase in
will be a severe hit).

- Mr Jefferson Smith - C&E
- Mr Allen - C&E
- Mr Oxenford - C&E
- PS/C&E

VAT APPROXIMATION : LOWER BAND OF VAT

... Mr P R H Allen's minute of 20 May (attached) responds to the Chancellor's request for comments on Mr Patterson and Mr Metten's proposals. I also attach a table showing the items presently zero rated which would be included in the standard rate band under these proposals, and the revenue consequences of this.

2. The Economic Secretary thinks that the line we should take in response to these proposals is: we welcome the recognition that the zero-rating is acceptable in principle; we see no reason why our freedom to retain existing zero-rates should be curtailed; we welcomed the acceptance of market pressures in restraining excessive VAT rates; but we believe that setting minimum rates would be more appropriate for excise duties, because of health and social policy reasons, than for VAT.

doesn't allow for refund

VAT on inputs ~~charging~~ to customers

3/4% 15%

value of s/r inter-med supplies not done recently done since

PB

P D P BARNES
Private Secretary

4% - - - new dir have 2 amend for perma 0 rating.

ITEMS PRESENTLY ZERO RATED WHICH WOULD BE INCLUDED
IN STANDARD RATE BAND. RATE OF VAT ASSUMED TO BE 15%

	NET REVENUE	RPI IMPACT
	£M	%
Young children's clothing	280	0.13
Young children's footwear	95	0.05
CONSTRUCTION		
Non-residential	300	0.00
residential	900	0.00
Aids for the handicapped)	
Certain caravans and houseboats)	
Certain supplies by Charities) NEG	0.00
Supply and repair of lifeboats for RNLI)	
Alterations to protected buildings)	



HM CUSTOMS AND EXCISE
NEW KINGS BEAM HOUSE
22 UPPER GROUND
LONDON SE1 9PJ

TEL: 01-620 1313 Ext 5023

FROM: P R H ALLEN
DATE: 20 May 1988

PS/ECONOMIC SECRETARY

cc Mr Byatt
Mr Edwards
Mr Culpin
Mr Gilhooly
Mr Riley
Mr Michie
Mr Parkinson

VAT APPROXIMATION : LOWER BAND OF VAT

1. Moira Wallace's note of 28 April mentioned that the Chancellor had requested comments, routed via the Economic Secretary, on whether the proposals put forward separately by Messrs Metten and Patterson for a 0-6 per cent lower rate band would be practicable.
2. The short answer is "yes", since it would enable the UK to continue to use zero rates; but this leaves open the more fundamental question of the relevance of tax approximation to the completion of the internal market. To indicate assent to the concept of a 0-6 per cent rate band would imply agreement to the wider principle.

Internal circulation: CPS Mr Cockerell
 Mr Jefferson Smith Mr Knox
 Mr Nash Mr Oxenford
 Mr Wilmott Miss Stuart

3. In any case, there would still be difficulties with the scope and coverage of the lower rate band - for instance, the Commission's proposals envisage taxing children's clothes at the standard rate. Moreover, it would be unlikely to find favour with those Member States which would have to make larger changes to their existing rates than those required by the current proposals. Also, it would not meet the wishes expressed by the French and Dutch that the rate bands should be considerably narrower than 6%.
4. On balance, given the UK's stated difficulty with the basic principle of tax approximation, we would recommend against giving a public welcome to a proposal of this sort.
5. For the record, the Metten proposals would also require a minimum increase in the UK VAT rate to 16%. You may also recall that I submitted short analysis of the Patterson paper in March:- for convenience a further copy is attached.

RA.

P R H ALLEN



8/11

CHANCELLOR OF THE EXCHEQUER'S OFFICE: MEETING

SUBJECT	INDIRECT TAXATION
DATE	TUESDAY 8 th NOVEMBER
TIME	3:45 pm
VENUE	Chancellor's Room, Treasury/ No. 11/Conference Room/House of Commons
PAPERS	TO BE CIRCULATED BY FP.
THOSE ATTENDING	<p>EST</p> <p>Mr SCHOLAR</p> <p>Mr CULPIN</p> <p>Mr MICHIE</p> <p>Mr RICHARDSON</p> <p>Mr GILHOOLY</p> <p>Mr WILMOTT</p> <p>Mr JEFFERSON SMITH</p> <p>Mr TRACEY</p> <p>MISS FRENCH</p> <p>CC</p> <p>Sir P. MIDDLETON</p> <p>} C&E</p>

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CHANCELLOR

FROM: ROBERT CULPIN
DATE: 11 November 1988

*Ch. Agenda - which is
in two parts - at the front of
each section. 27/11/11*

MONDAY'S INDIRECT TAX MEETING

Customs have insisted on doing the Agenda, taking stuff from us. The important points are these.

2. Do you postpone the starting date for taxing non-domestic construction? Customs say yes, FP no.

3. Charities' non-business premises can be zero-rated. That lets out churches, lifeboat stations, etc. For the rest, Customs say non-business means anything except shops, offices and storage premises. Are you content to tax charities' offices and storage space?

4. Remember charities gain £50 million in 1990 from mandatory rate relief.

5. Old people's homes and so on can also continue to be zero-rated. Some practical difficulties. Customs want to tax barrack blocks and university residence halls; the Economic Secretary doesn't.

6. Get Customs to confirm that these zero ratings for charities, old people's homes, etc are Commission-proof.


7. For water, fuel and power, the problem is to identify industrial users. Customs want customer declarations. Heavy compliance costs. FP prepared to look at something more rough and ready - eg zero-rating the domestic electricity tariff and taxing other electricity.

*John P
John P
(over)*

8. Do you extend the transition period for the option to rent? Customs yes, FP no. (EST may have settled.)

9. Can Customs publish draft clauses at the turn of the year?

10. Do we extend VAT on transport - options in Agenda?

A handwritten signature in black ink, appearing to be 'Rc', is written above the name Robert Culpin.

ROBERT CULPIN

REVISED MEETING NOTICE



CHANCELLOR OF THE EXCHEQUER'S OFFICE: MEETING

SUBJECT	INDIRECT TAXATION
DATE	MONDAY 14 / 11 / 88
TIME	11:30 am
VENUE	Chancellor's Room, Treasury/ No. 11/Conference Room/House of Commons
PAPERS	TO BE CIRCULATED BY FP
THOSE ATTENDING	EST Mr LANKESTER * Mr SCHOLAR Mr CULPIN Mr R.I.G. ALLEN * Mr MICHIE Mr RICHARDSON Mr GILHOOLY Mrs CHAPLIN Mr TYRIE Mr CALL Mr JEFFERSON-SMITH Mr WILMOTT Mr TRACEY Miss FRENCH } C&E cc Sir P. MIDDLETON * ONLY IF EC IS TO BE DISCUSSED.

AMENDMENT TO MOTION ON INDIRECT TAX HARMONISATION IN THE NAME OF
THE PRIME MINISTER

Mr John Smith

Mr Gordon Brown

Mr John Marek

Mr Stuart Holland

Mr Nick Brown

Mr Chris Smith

At end add "and supports the Chancellor of the Exchequer in his recent statement that 'VAT harmonisation is a distraction' and resolves that no Minister of the Crown shall give assent to any EEC Instrument that authorises variation in the scope or rate of VAT or Excise Duties payable in the United Kingdom unless authorised to do so by a Resolution of this House".

Separate copies to:

PS/Chancellor

PS/PMG

PS/EST

Mr. Scholar

Mr. Culpin

Miss Sinclair

Mr. Cropper

Mr. Tyrie

Mr. Jefferson Smith - C&E

Mr. Wilmott - C&E

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

SUBJECT: Indirect Taxation

LOCATION: HMT.

CAST LIST.	PHONE NO.	DATE + TIME.			
		Tues 8/11. 3.45pm	Wed 9/11. 11.00am	Wed 9/11. 3.00pm	Thurs 10/11. 3.45pm.
		✓ IF NO GIVE REASON	✓ IF NO GIVE REASON	✓ IF NO GIVE REASON	✓ IF NO GIVE REASON
EST.		✓	X	✓	✓
Scholar	5181	✓	✓	X	
Culpani	5264	✓	✓	✓	
Machie	4922	✓	✓	✓	
Richardson	4779	✓	✓	✓	
Gilhooly	4550	✓	✓	X	
Wilmott. C+E	3913- 5015	✓	✓	✓	
Jefferson Smith C+E	3913- 5013	✓	✓	✓	X
Tracey C+E	3913- 5370	✓	✓	✓	
Miss French C+E	3913- 5059	✓			
Call.	5107				
AGT.	5025				
Chaplin	5027				
TL					
R.I.G. ALLEN					

PAPERS:

Speech ^{ing out}
Education
Seminar

X lunch
engagement

MTg at
4.30

X difficult

VAT ON DOMESTIC
PASSENGER FLIGHTS

BF 11/11

WILMOTT
→
EST
2/11



CH/EXCHEQUER	
REC.	-3 NOV 1988
ACTION	
COPIES TO	

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

(for meeting)
 (John)

FROM: P G WILMOTT
 DATE: 2 NOVEMBER 1988

ECONOMIC SECRETARY

BUDGET STARTER NO. 41:
VAT ON DOMESTIC PASSENGER TRASPOR

John
Done
Ch
you were going to square PER's office!

Exceptionally grudging. I still think this is sensible & defensible. Discuss @ indirect tax meeting on Tuesday?
AA

Yes

- Mr Westhead's note of 13 September asked us to examine, as a Budget starter, the potential for applying VAT at the standard rate to domestic air travel and non-staged bus and coach journeys while retaining the status quo for rail and tube travel.
- The purpose of zero-rating passenger transport. The zero-rating of passenger transport has always been justified as a social measure primarily to relieve expenditure on essential journeys and especially that incurred by the lower income groups without their own private transport. However, public transport is substantially used not only by commuters and businessmen in all income groups but also for non-essential purposes

Distribution:

- Chancellor
- Sir P Middleton
- Mr Scholar
- Mr Culpin
- Mr Revolta
- Mr Gilhooly
- Mr Michie
- Mrs Chaplin
- Parly Counsel

- CPS
- Mr Jefferson Smith
- Mr Nissen
- Mr Michael
- Mr Cockerell
- Mr Gaw
- Mr Allen
- Mr Tracey
- Mr Cowan
- Ms French

such as social or recreational excursions or as holiday travel. It is impracticable to confine the relief to essential journeys by low income groups; as we so often point out in MP correspondence, the VAT system is not well suited to the fine tuning of reliefs.

X The broad application of the zero rate can also be justified on the grounds of keeping public transport as cheap as possible in order to ease congestion on the roads.

3. The EC Dimension. The EC Commission's 1992 proposals are for the taxing of transport in the lower rate band and, as the Annex to this submission illustrates, only three EC member states, Germany, Italy and Spain, tax any transport at their standard rates. Even so, Germany and Italy have a reduced rate for urban transport and Spain applies its reduced rate to all road and rail transport with the standard rate applying to air. In fact Spain is the only country to have a differential between different modes of transport. If the UK were to decide at this juncture to impose VAT at the standard rate on air and long distance road transport only and to keep the zero rate for all the rest, we would certainly be the odd man out and the transport lobby would no doubt make full use of these EC comparisons. While the Commission would no doubt be pleased that we were voluntarily surrendering part of one of our zero rates, this pleasure would be balanced by some irritation that we were not doing so in such a way as to facilitate "approximation".

4. Vehicle Excise Duty. The Economic Secretary said that he had noted that buses and coaches do not fully cover their track costs but since then he will no doubt have seen the letter dated 12 September from the Secretary of State for Transport to the Chancellor proposing to increase VED in the next Budget to compensate for that deficiency.

5. Effect on tourism. The imposition of VAT at 15% on domestic journeys, particularly by coach, would considerably increase the costs of the UK holiday industry which already feels it has to work hard to overcome the disadvantages of the British climate. Those representing the industry are given to complaining that many of their EC competitors benefit unfairly because tourist hotel accommodation in some member states is taxed in a lower rate band; no doubt they will see this proposal as adding insult to injury.

6. Air travel. Air travel is an obvious candidate to be taxed in any exercise such as this, aimed at raising revenue through more precise targeting of VAT relief. Air travel is, in the main, a 'luxury', if only from the point of view of cost, and it neither

forms part of the expenditure of low income families nor is its use normally necessary for essential journeys such as commuting to work. It is in most cases simply a quicker alternative to other modes of transport. A large proportion of passengers on domestic flights travel on business and of course in these circumstances the tax will normally be recoverable. The balance of passengers will, in the main, be travelling for social, holiday or recreational purposes. However even if a journey is for an essential purpose the choice of air travel is usually the 'luxury' alternative.

7. The argument for taxing air travel is however considerably weakened in the context of this starter by the pre-condition that rail travel shall continue to be zero-rated. British Rail's Inter-City services are clearly in direct competition with most of the domestic air services carrying the same categories of business and recreational passengers. The airlines, who would certainly mount vigorous opposition to the proposal, would be quick to exploit this weakness especially as Inter City is now run as a business with, we understand, no public subsidy.

8. The fact that air travel is the principal means of passenger transport to the Highlands and Islands of Scotland and even to Northern Ireland is another potential problem which will arise if air travel is seen as being singled out for standard rating. There would be an outcry from those concerned with the welfare and economy of those regions and there would inevitably be pressure for a relief to and from remote areas which could be difficult to define and administer.

9. Travel by boat. Mr Westhead's note was silent as to your preferences for the liability of travel by boat on rivers, canals and in UK territorial waters. If the criterion for relief is subsidisation from central government, then travel by boat would have to be standard-rated. ?? ferries to the Western Isles

10. Bus and coach travel. The effect of this starter is to impose tax on most long distance bus and coach journeys. Again the case for doing this is weakened if BR Inter City is to remain zero-rated. Furthermore long distance buses and coaches are widely used by the less well off because fares are substantially cheaper for a given journey compared with the alternatives. Coach would rarely be used in preference to air or rail travel but for the price factor since it is unlikely to be as quick or convenient.

but see X!

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11. Although many non-staged coach journeys can be described as discretionary ie for holiday recreational or social purposes, this is by no means always the case. For instance the use of coaches for long distance commuting is now widespread and we understand they are regularly used by students to get to and from college at the beginning and end of term. On the other hand it cannot be assumed that all local staged fare buses are used for essential journeys; many such journeys, probably the majority after working hours, are made for discretionary purposes connected with recreation or pleasure.

12. We have looked at the current Department of Transport rules defining what constitutes a staged service for the purpose of fuel duty rebate (FDR) and although zero-rating could be based on these they are not the kind of rules we would have chosen as a basis for VAT relief since they are complicated and in some respects imprecise and subjective. Nevertheless given that the rules do exist it would be possible simply to frame the VAT relief by reference to those routes which qualify for FDR. Since bus and coach operators must know which of their routes qualify it should, at least in theory, be possible for them to determine the fare income attributable to those routes. Our concern is that we would be superimposing eligibility for VAT relief on a somewhat insubstantial structure where eligibility is based on qualifying mileage and fuel consumption whereas our interest would be in establishing the standard rated fare receipts on the non qualifying mileage. FDR only represents a small percentage subsidy in relation to fares but the imposition of VAT at 15% to the non qualifying fares will provide a considerable incentive for manipulation of the figures to increase the qualifying proportion. In this situation close cooperation between this Department and Department of Transport would be essential since any abuse detected by one would have ramifications for the other. We understand that the Treasury are currently reviewing the FDR rules. If this starter is to run we shall need your permission to consult Department of Transport officials on mechanics and detailed implementation. One point that should be kept in mind, however, is what would happen if FDR were to be abolished for any reason in the future.

13. Revenue estimates. The estimated revenue gain in a full year from applying VAT at the standard rate to domestic air travel and non-staged bus and coach services is :-

Air	£30m
Coach and Bus	£90m
Total	£120m

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The estimates, based on CSO expenditure data, are very tentative and would need authority to consult Department of Transport if more certainty were required. The gain for 1989-90 would be, at best, no more than £50m because we would have to give several months notice of the change so that the carriers could gear themselves up to issuing tax invoices for business travellers.

Conclusions

14. We have fundamental misgivings about this starter because the criteria on which it is based lead both to inconsistency of treatment for journeys of identical motivation and to inequitable treatment of the different modes of transport. While we appreciate the subsidy argument for not taxing rail and tube, in our view it is not a strong one in the VAT context. We tax tickets for Covent Garden even though the prices are heavily subsidised by Arts Council Grant. And we do not differentiate between coal, gas, electricity and oil according to whether they are in the public or private sector.

15. Air transport is the one mode for which it would be least difficult to justify removal of the relief but we could expect stiff opposition from the airlines and the Scottish and Irish interests. There would also be problems over taxing internal flights for passengers booked through to overseas destinations, eg Edinburgh to Hong Kong via Heathrow.



for P G WILMOTT

PM/cvh 25.10.87 [1st part]
SYSTEM OF VAT ON PASSENGER TRANSPORT

National transport

Member State	Air	Sea	Inland waterways	Rail	Road
Belgium	6	6	6	6	6
Denmark	Exempt	Exempt	Exempt	Exempt	Exempt (2)
Germany	14	7	7	14/7(3)	14/7(3)
France	7	7	Exempt/7(4)	7	7
Ireland	Exempt	Exempt	Exempt	Exempt	Exempt
Italy	18	18	18	18/Exempt (7)	18/Exempt (7)
Luxembourg	6	-	Exempt	6	6
Netherlands	6	Exempt/6 (8)	Exempt/6 (8)	6	6
U.K.	0(10)	0(10)	0(10)	0(10)	0(10)
Portugal	8	8	8	8	8
Spain	12	12	12	6	6
Greece	6	6	6	6	6

(1) As a rule, flat-rate amounts are charged when vehicles registered abroad enter the country. A rate of VAT is applied to domestic vehicles. The current exemption in Denmark applies to all regular traffic, domestic or foreign.

- (2) Non-regular traffic: 22%
- (3) Long distance: 14%
Urban transport: 7%
- (4) Rhine: Exempt
- (5) Transport to or from abroad: 7%
Transport in transit and transport on the Rhine: Exempt
- (6) Transit: Exempt
Other: 7%

- (7) Long distance: 18%
Urban transport: Exempt
- (8) Ferries opting for taxation and regular vessels: 6%
- (9) In practice no VAT

- (10) Means of transport with ~~less~~ than 12 persons: 15%
- (11) However, a special tax is collected at the frontier.

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Annotated Agenda: Indirect Taxes

14 November 1988

PART 2

Passenger Transport

VAT: Background

Current Position on Transport Zero-Rates

1. ° international travel - all zero rated, but under Commission proposals intra-Community travel would be taxed in lower rate band;
- ° domestic - rail : all zero-rated;
buses and coaches : all zero-rated;
air : all zero-rated;
ferry : all zero-rated;
taxis : all standard rated.

Legal Restrictions

2. ° domestic - none;
- ° international - until proposed EC Directive is adopted, we cannot tax intra-Community travel, and even after directive is adopted, we cannot tax travel outwith the Community.

Options for 1989 Finance Bill

3. There are no legal restrictions on what you can do with regard to the VAT taxation of domestic transport, but international transport will have to remain zero-rated. Possible options for taxing are:

*W. J. ...
200-1000-2000?
200-1000-2000?*

- o domestic air travel only - revenue yield around £25m/30m. Justification would be that air travel is a luxury. Problems: direct competition with high-speed trains; air travel to Scottish Isles etc not a luxury;
- o domestic air travel plus first-class rail (excluding season tickets) - could increase revenue yield to around £35m/40m. Problems: omits coaches; first class rail fares are to be increased significantly in January 89, and an additional 15% VAT may be seen as excessive;
- o domestic air travel plus all non-scheduled surface services - tax "bespoke" services ie on the same grounds as taxis standard-rates. But probably little additional revenue to be gained;
- o tax all journeys except staged services, season ticket travel, and all urban travel - this was the original proposition examined by Customs, and it could yield around £200m. However, your view was that as rail and tube fares are subsidised, they should be left out of VAT;
- o air plus non-stage coach journeys - this could yield around £120m (£30m air, £90m coach); but it seems difficult to justify taxing a coach journey to say Birmingham whilst retaining the zero-rate for the same journey by train (especially as the long distance coaches tend to be used by the less well off).

Vertical line with 'X' in a circle

*now
congratulations!
Dip into*

Which of the options, if any, do you wish to pursue for the 1989 Finance Bill?

*The bill was down,
but for air and
the stage*

CONFIDENTIAL

4. Related matters: Hackney carriage VED

You have given provisional approval to Mr Channon for his proposed increases to the rates of VED for buses and coaches. These increases are significant, and you may wish to bear them in mind when considering the options for extending VAT base to include coach journeys. Mr Channon's proposals are as follows:

<u>No of seats</u>	<u>Old Rate</u>	<u>New Rate</u>	<u>Maximum Increase</u>
under 9	£52.50	£100	£ 47.50
9 - 16	£52.50	£130	£ 77.50
17 - 35	£52.50 - £68.25	£210	£157.50
36 - 60	£69.30 - £94.50	£320	£250.70
over 60	£95.55	£490	£394.45



DEPARTMENT OF TRANSPORT
CH/EXCHEQUER
2 MARSHAM STREET LONDON SW1P 3EB

21/10

REC.	21 OCT 1988
ACTION	EST
COPIES TO	

My ref:

Your ref:

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

PWP
BF 26/10

21 OCT 1988

Dear Nigel,

1989 BUDGET: GOODS VEHICLE MOTORING TAXATION

Thank you for your letter of 30 September responding to my proposals for the hackney taxation class (taxis, buses and coaches). I was grateful for your encouraging reply.

Peter Bottomley has already written to Peter Lilley with details of our 'minor starter' proposals. There is only one other major matter I wish to deal with this year - rigid goods vehicle excise duty rates. I am making no proposals for VED for cars. We agreed last year that there were sound reasons for continuing to shift the balance of motoring taxation for cars away from VED by increasing fuel duty to produce any additional revenue required from motoring taxation. I am still of that view and I was pleased that you took the additional revenue you required last year from fuel duty.

The heavier rigid goods vehicles were subject to modest increases in their rates of VED last year. That was to begin bringing the excess of taxation over allocated costs for those vehicles more into line with that paid by articulated vehicles of similar weight. Our policy is to allocate any excess disproportionately to heavier vehicles because of their greater social and environmental impact, as recommended in the Armitage Report.

The increase in 1988 was intended to demonstrate commitment to the Armitage principle and set the scene for possible further increases in future years. The issue of equity between rigids and artics has featured in the Opposition comments in the last three Finance Bill Committee Stage debates. The National Audit Office in its report on the Regulation of Heavy Lorries criticised us on the related issue that the progression of the excess with rising vehicle weight was not consistent. And of course there is an economic efficiency argument for ensuring that whatever the overall level of motoring taxation any excess is applied consistently

CHANNON
TO
CX
21 OCT

CONFIDENTIAL

across all goods vehicle types so that the full economic implications of transport choices are brought home to users.

Peter Lilley wrote to John Marek after the Committee Stage and, commenting on the 10% rise, gave a reasonably clear indication that the balance between rigids and artics would be addressed again. I have been considering the options in the context of proposals for the 1989 Budget.

Trends in vehicle numbers and uses tend to widen the gap between the excess paid by rigids and that paid by similar articulated vehicles. Increases in fuel duty generate more revenue from articulated vehicles because they tend to use more fuel. So even if rigids were to be brought to parity with artics, their VED would need periodic adjustment if the difference in the excess were not to widen again.

The present difference in the excess is disturbing, and calls for rises in VED for most rigid goods vehicles. For this coming Budget therefore I propose we increase VED on those vehicles to bring their excess further into line. What I am proposing is a range of selective increases that will generate something under £50 million extra revenue. I have concluded that it would not be right to impose on the industry, particularly the small concerns that own many heavier rigids, a greater increase in direct costs in a single year (VED is paid in advance and has a higher profile than fuel duty which is paid 'as-you-go'). This means, however, that at least one more increase of that order will be required to bring rigids to parity with artics.

Because of the effect of fuel duty rises on any such measures, I hope you will this year consider a novel approach, which has been discussed between our officials. You made it clear in last year's Budget speech that the fuel duty increases were the size they were because they had been set to produce the equivalent to the revalorisation of all motoring tax revenue - fuel duty and VED together. What I propose for this year is that you offset the extra VED revenue that my proposals will produce (about £70 million in total, including the proposals for hackneys) against any increase in the total revenue you require from motoring taxation this year and recover the remainder through an increase in fuel duty.

If you agree to this principle it will provide a durable and simple mechanism for dealing with any inequalities in the present taxation structure arising from changing track cost considerations and would not impinge in any way on your freedom to determine at any stage what level of overall revenue you require from motoring taxes. My officials are still working on the details of the new rates for each tax class and will be in touch again with yours in due course. But I felt it was important to put the strategy to you as soon as possible.

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If you were to decide that you did not need to raise further revenue from motoring taxes I would not wish to proceed with more than the sort of modest rise you agreed to for rigids last year. That amounted to around £18 million and was equivalent to the product of revalorisation of goods vehicle VED.

I would in any case wish still to proceed with the increases for hackneys and to deal also, come what may, with Special Types, the 400 vehicles we separated out last year because of their serious track cost shortfall. We set their VED at £1,600 initially and gave strong hints that it would go up this year to £3,100. I propose to follow through with that, pending the results of a new survey of their track costs which may reveal the need for further increases.

You referred in your letter to the large number of tax classes for goods vehicles and asked if there was any scope for simplification. I agree the list is daunting. And I agree that simplification would have presentational advantages. But the goods sector does not offer the same rich opportunities that the hackneys did. What I have suggested for hackneys is a structure which has about the same number of classes as it would under the gross weight regime that applies to goods vehicles.

There is no track cost reason for changes in tax rate for every extra passenger, which is the current hackney structure. HGVs, however, change only every 2 tonnes, and the difference is significant for track costs. For example, per thousand kilometres travelled on motorways 23-25 tonne 3-axle rigids incur 19% more costs than 21-23 tonners.

The two tonne band structure has now been adopted as the basis for the European Commission's latest draft directive on the allocation of infrastructure costs to goods vehicles. We are supporting this because (a) it involves us in no costly changes; (b) it ought to result in other states raising their VED levels, to the advantage of UK hauliers engaged in international competition; and (c) it will help overcome resistance to greater liberalisation of the European haulage market, where we stand to do better than most.

The other factors leading to a proliferation of tax rates are the number of axles a vehicle has (another feature of the EC directive), and the concessions for farmers and showmen. I strongly support reflecting, by means of tax rates, the differing amounts of wear and tear caused by the same weight distributed over different numbers of axles. A 6-axle 36-tonner incurs 22% less track costs in a year than a 2 + 3 axle vehicle. Higher wear leads to more demands for maintenance expenditure. As for farmers' and showmen's concessions, they reflect much lower use and would be very difficult to remove now.

Simplification would not save any costs or staff. It would affect the calculation of track costs however, by requiring still further averaging of costs between vehicle types that we are already aware may have significantly different patterns of lading, road use and fuel consumption. Changes, which would not be driven, as in the hackney class, by a clear failure to cover costs, might need full consultation with the haulage industry and with manufacturers. The effects on the vehicle market could not be certain and I would wish to avoid bunching below tax thresholds: this is a problem that will have to be watched in the new hackney structure. Nor would it be possible to avoid opening the whole of the track cost and motoring taxation policy to debate.

Nevertheless I have asked officials to look at the matter further: it may be that much would be achieved if the tables could be presented to the public in a simplified and more understandable format.

Paul

Paul

PAUL CHANNON



cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Revolta
Mr Riley
Mr Macpherson

Treasury Chambers, Parliament Street, SW
01 270 3000

PS/Customs & Excise

Mr Jenkins -
Parly Counsel

30 September 1988

*cc. Mr Michie
Mr Gubboly*

Rt Hon Paul Channon Esq MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

BUDGET 1989: HACKNEY TAX CLASS; VEHICLE EXCISE DUTY

Thank you for your recent letter outlining the results of the review of the hackney classes. I am grateful for the work which your officials have done on this.

Your proposal for a reduction in the number of tax bands for hackneys from sixty to five is most welcome and will be a very worthwhile simplification. I note and am grateful for your description of the gross vehicle weight system which applies to goods vehicles; as you say, there is a large number of classes. Is there any scope for simplification here - not perhaps as radical as that which you propose for hackneys, but something which could make the list of tax classes less daunting?

I am, in principle, content with your proposals for substantial increases in the level of VED for hackneys and note that the VED for taxis would be set at the existing rate for cars. The fact that these proposals should allow coaches and buses together to come up to track cost coverage (excluding fuel duty rebates for buses) would be a real plus in presentational terms.

I will make my final decision on the hackney rates after you write with your proposals for the other main VED starters, and this will

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TO
CHANNON
30SEPT

CONFIDENTIAL



allow me to take into account the further work which your officials are currently undertaking.

I look forward to hearing from you in due course.

A handwritten signature in black ink, appearing to read "Nigel Lawson".

NIGEL LAWSON

CONFIDENTIAL



FROM: Ms K ELLIMAN

DATE: 20 September 1988

APS/ECONOMIC SECRETARY

cc PS/Chancellor
PS/Chief Secretary
Mr Anson
Mr Scholar
Mr Culpin
Mr Revolta
Mr Turnbull
Mr Gilhooly
Mrs M E Brown
Mr Michie

VAT ON PASSENGER TRANSPORT

The Paymaster General has seen your minute of 16 September.

2. He has commented:

"Economic straws in the wind:

a. Woolworths' private expectation is that retail sales will continue at full throttle during 1988 and only ease off as a post Christmas hangover/New Year resolution in January 1989;

b. the property market is deep into one day conferences on VAT and property, and there will be a considerable slowing down in development activity until all parts of this complex market have worked out what the implications of this new playig field will be. Decisions are already going on 'hold' and will remain so".

*The reference
Eh. to
some
mistake,
Smelly.*

KIM ELLIMAN
Private Secretary

CONFIDENTIAL



1. Box (!)
2 MP

FROM: G R WESTHEAD
DATE: 16 September 1988

MR WILMOT

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
Mr Scholar
Mr Anson
Mr Culpin
Mr Revolta
Mr Turnbull
Mr Gilhooly
Mrs Brown
Mr Michie

PS/C&E
Mr Jefferson-Smith C&E
Mr Cockerell - C&E
Mr Allan - C&E
Mr Tracey - C&E

VAT ON PASSENGER TRANSPORT

In my minute of 13 September on the above I said (in paragraph 2b) that the Economic Secretary would like Customs to see whether the present rules for staged journeys for fuel rebate needed tidying up.

2. Arrangements are in fact already in hand to pursue this particular point here in the Treasury and there is therefore no need for it to be included in Customs' remit.

Guy Westhead

GUY WESTHEAD
Assistant Private Secretary

CONFIDENTIAL



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2. pup.
Can I see
all pps on
this
PI?

WESTHEAD
→
WILMOTT
1319

FROM: G R WESTHEAD
DATE: 13 September 1988

MR WILMOTT - C&E

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
Mr Scholar
Mr Anson
Mr Culpin
Mr Revolta
Mr Turnbull
Mr Gilhooly
Mrs Brown
Mr Michie

PS/C&E
Mr Jefferson-Smith C&E
Mr Cockerell - C&E
Mr Allan - C&E
Mr Tracey - C&E

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M

VAT ON PASSENGER TRANSPORT

The Chancellor and the Economic Secretary discussed this issue earlier today after Prayers. They decided that they would like officials to explore, as a Budget Starter, the possibility of VAT on domestic air, bus and coach travel, but excluding staged journeys. This should not encompass VAT on rail or tube travel, on the grounds that both areas receive Government subsidy. The Economic Secretary notes that buses and coaches do not fully cover their track-costs, in the way that cars do.

2. In working this up as a Budget Starter, the Economic Secretary would be grateful if Customs could look particularly at (a) revenue yield and (b) to see whether the present rules for staged journeys for fuel rebate need tidying up.

Guy Westhead

GUY WESTHEAD
Assistant Private Secretary

4/10
mp

BF 23/9 to m



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

My ref:

Your ref:

REC.	13 SEP 1988
ACTION	EST
COPIES TO	BF 26/9

✓ 13/9

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

Dear Nigel

✓ ✓

12 SEP 1988

Any advice yet?

M. advice to come this evening or 1st thing Monday morning

BUDGET 1989: HACKNEY TAX CLASS VEHICLE EXCISE DUTY

I indicated during the course of our correspondence on the 1988 motoring taxation issues that I saw a case for a thorough review of the "Hackney" class, which was unique in falling short of track costs. Your letter to me of 22 February asked if that could be pursued.

The hackney taxation class comprises taxis, buses and coaches. The class as a whole came to track cost coverage for the first time this year as a result of the fuel duty rises in the last Budget. Fuel duty has a disproportionate impact on this class because VED accounts for only 3% of revenue. But within the class buses and coaches will still fall short of their estimated track costs by £15 million in 1988/89.

VED rates for the class are currently determined by seating capacity. There are no fewer than sixty rates of duty starting at £52.50 for buses and taxis with up to twenty seats. For goods vehicles we tax by reference to those factors which directly determine the amount of wear and tear they generate - gross vehicle weight (gvw) (in two tonne bands) and the number of axles it is spread over. There are a large number of rates, but two tonnes affects the amount of wear on the road. The weight of hackneys varies much less. The gvw system is logical and equitable, is accepted by the trade and has currency within the European Community, where it has been accepted as the basis for a harmonised taxation structure for goods vehicles. Indeed there are early indications that the same system is being considered by the Commission as a basis for taxing buses and coaches. To apply this gvw system to hackneys would produce eight weight bands for buses and coaches.

CHANNON
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12 SEP

The present position is unsatisfactory in several respects: the structure ignores the essential factors of weight and axle numbers which determine the track costs of these vehicles. the rates are inadequate to deliver a total motoring tax revenue to meet the estimated present level of track costs and there is concern in some quarters that taxation below track cost levels gives express coaches in particular a competitive edge over BR services. Robert Adley has highlighted the fact that a coach needs to have 66 seats before it pays more VED than a private car.

The obvious way of solving the first of these problems is by moving to gvw taxation for hackneys. However, this requires a clear and unambiguous statement of the vehicle's weight. HGVs bear an official plate showing this: there is no comparable plating system for hackneys. That would be expensive and take a long time to introduce. Such a system would also require the collection of further statistics. I am not yet convinced these measures are necessary: officials are working on them further. The other problems of the current hackney system can be solved quickly. The new bottom line for the Hackneys must be track cost coverage. HGVs currently carry a substantial excess of taxes over costs, which we attribute to unquantifiable social and environmental costs, but we have no such policy for hackneys.

I propose therefore to bring all the hackneys to track cost coverage and at the same time to reduce the number of tax bands in the class to something like the number we would have under a gvw taxation regime. This will rectify the primary deficiency by bringing the class as a whole, and buses and coaches in particular, to track cost coverage. It seems to me to be important that we show that each band in the class covers its allocated costs.

In practice some rates will produce a small excess over track costs. That is because they are dictated more by comparison than by track cost calculation. All hackneys under twenty seats pay £52.50 at present. I intend that taxis should pay £100, the same as the smallest commercial vehicles and minibuses (9-16 seats) pay £130, the same as the goods vehicles from which they are derived.

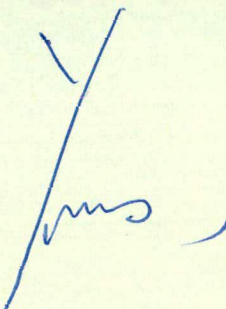
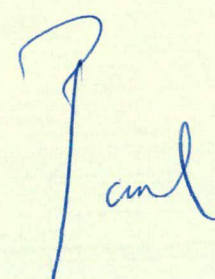
In all I am proposing five tax bands. The highest rate of VED will be £490. Express coaches will fall in a band that includes urban service buses and pay £320. It has not proved possible to find any single physical characteristic by which to identify express coaches. In practice most operators have a fleet of vehicles which is pressed into whatever service their operational pressures require. Given that that band will be covering track costs we shall be able to say quite categorically that express coaches that run more on motorways, which have lower unit maintenance costs, will be more than covering their costs. Unless operators are prepared to dedicate vehicles to use only on such services and we can come up with a way of reflecting that in VED rates I think we shall have to accept an element of rough justice in the rates.

What I propose will produce an additional £20 million in revenue and add no more than 1% to operators' costs. Taxi operators for example will find costs rise by ¼p per mile against fares of 80p per mile. Nevertheless they will be seen as hefty increases because the low proportion of motoring taxation contributed by VED meant the old rates were very low. The new rates compare with the old ones as follows:

No of seats	old rate	new rate	maximum increase
under 9	£52.50	£100	£47.50
9-16	£52.50	£130	£77.50
17-35	£52.50 - £68.25	£210	£157.50
36-60	£69.30 - £94.50	£320	£250.70
Over 60	£95.55.....	£490	£394.45

These rates reflect our current, published, estimates of the track costs of hackneys. Recent information leads us to suspect that those estimates may be too low. But there is insufficient time to set up the very extensive and costly survey that would be necessary to provide better information before the Budget was settled. I have therefore set in hand some rather less sensitive, but speedier work which I hope will be concluded around the turn of the year. If it proves that we are close to the right figures then I hope you will be able to accommodate some adjustments to these rates (up or down).

If however it proves that the track cost deficit is substantially higher then I would propose to go ahead with these rates, which are about the most I think we can ask the industry to absorb in one year, and use the following year to improve our understanding of hackney track costs. We adopted the same principle last year with the special types, where we deferred the second stage increase to allow time for further study and for the industry to adjust. I hope you will agree that a similar approach, should it prove necessary, would be appropriate in this case.

PAUL CHANNON



BF

15/10

Ch

These papers won't show to you in August.

I think the headlines for "urban" (which seems to mean "short distance") and for season tickets look v unattractive.

I prefer a scheme along lines of my 3/6 minute:

(a) tax domestic air-travel

(b) don't tax rail travel

(silly until put on sounder financial footing)

(c) tax all bus & coach travel except staged bus services

(d) up VED on coaches as well.

Word with EST?

John P. S. -
AA



Handwritten signature

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

FROM: P G WILMOTT
DATE: 10 August 1988

WILMOTT
→
EST
10/8

ECONOMIC SECRETARY

cc: Chancellor
Mr Culpin
Mr Revolta
Mr Gilhooly
Mr Michie

VAT ON PASSENGER TRANSPORT

1. At our meeting on 26 July we undertook to provide further information on three points.

AVTUR international exemption

2. We are precluded from taxing fuel used for international flight by Article 8 of the Standard Air Service Agreement entered into bilaterally by the UK and virtually all other countries of the world as parties to the Convention on International Civil Aviation opened for signature at Chicago on 7 December 1944.

The scope for defining a borderline for urban transport

3. The Germans and Italians have reliefs (reduced rate and exemption respectively) for urban transport. You wanted to know how they defined urban transport. The position in both countries is similar. They seem to allow relief for any journeys within a town or parish boundary or journeys of less than 50 kilometres in the case of those proceeding outside a town or parish boundary.

Internal distribution: CPS
Mr Jefferson Smith
Mr Nissen

Mr Cockerell
Mr Allen
Mr Tracey

4. While these criteria might be made to work outside London and the main conurbations, a 50 kilometre limit (roughly 30 miles), certainly in London, would leave tens of thousands of commuters unprotected. Even 50 miles would leave the very long distance commuters exposed. However with a limit as great as 50 miles casual travellers on journeys of say 90 miles could be tempted to break them at the mid point and thus get two zero rated tickets for approximately 45 miles each instead of one ticket plus 15% VAT. (The Germans do not have to worry so much about this form of avoidance as the differential between their standard and reduced rates is only 7%.)

5. It would be possible to combine a relief based on a 30 mile limit with a relief for season ticket contracts for unlimited distances. However even this would not be wholly satisfactory. Employees, especially women, working only two or three days per week would get no benefit from the season ticket relief because season tickets would not be economic for them. And there may be some remote communities (eg in parts of Scotland) for whom weekly or fortnightly journeys to the nearest town are essential but where that town is more than 30 miles distant. Nevertheless if the Chancellor wanted to tax air and other long distance travel in the UK but without offending large numbers of long distance commuters or many remote rural communities, we would suggest retaining zero rating for all journeys of less than 30 miles and for all journeys under season ticket contracts for weekly or longer periods. We would prefer a two-pronged relief of this kind to one confined to staged bus journeys; the latter would discriminate against local rail and underground travel, not to mention travel by boat (eg ferries to the Isle of Wight and river traffic on the Thames).

6. The one major disadvantage of the 30 mile limit is that there would be a big jump in the price of tickets at the 30 mile point. That would obviously attract some criticism. However we think it would be excessively complex to relieve the first 30 miles of longer journeys, especially bearing in mind VAT invoicing requirements for business travel. Also although we cannot put a figure on it, that would also significantly depress the yield.

Revenue Estimates

7. The revenue gain from taxing all domestic passenger transport at 15% at 1988-89 prices would be

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	£m
Air	25
Rail	255
Bus and Coach	<u>300</u>
Total	<u>580</u>

If the zero rate were retained for all journeys of less than 30 miles and for all weekly or longer season tickets for journeys of any length, the revenue gain from taxing all other journeys would be of the order of

	£m
Air	25
Rail	100
Bus and Coach	<u>75</u>
Total	<u>200</u>

However, these figures are very tentative. If any greater degree of certainty were required, we would need to have authority to consult DTp.



P G WILMOTT

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FROM: S M A JAMES
 DATE: 28 July 1988

NOTE OF A MEETING HELD IN ROOM 52/2, TREASURY CHAMBERS, AT 3.30pm
 ON TUESDAY 26 JULY 1988

Those Present: Economic Secretary
 Mr Michie
 Mr Wilmott - C&E
 Mr Tracey - C&E

VAT ON PASSENGER TRANSPORT

The meeting considered Mr Wilmott's submission to the Economic Secretary of 15 July.

EC Provisions and Constraints

2. The Economic Secretary sought clarification of EC law on the application of VAT to international travel. Mr Wilmott explained that the EC Sixth VAT Directive prevented us from applying VAT to journeys wholly outside the UK's territory or to the portion of journeys to or from the UK which take place outside the UK. We can therefore only extend VAT to the domestic leg of international journeys. If this were not the case there might be double taxation with two countries applying VAT to the whole of an international journey.

3. The Sixth Directive allowed Member States to tax the domestic leg of EC travel "having regard to the distances travelled". This meant that if 100 miles of a 1000 mile journey took place in UK territory, the UK would be able to impose VAT on a tenth of the journey. But because of the administrative difficulty of taxing the part of the journey over UK air space, we have never attempted to do so.

4. The draft EC Directive on passenger transport, which would

NOTE OF
 MEETING
 26/7

be published shortly, was expected to propose that travel between members states be taxed at the rate in force in the country of departure, and that approximated rates be applied to urban EC (and domestic) travel within the proposed lower band of 4-9%. But the Commission's zero rating of travel outside the EC would remain.

5. There are no EC barriers to an extension of taxation on domestic transport; indeed, taxation is the ultimate goal of the Sixth Directive.

Domestic Transport

6. Various options were discussed for drawing new borderlines so as to tax some transport which is currently zero-rated. One obvious possibility would be to tax domestic air travel. Mr Michie pointed out that if VAT were imposed on air travel alone there might for example be problems in justifying a tax on the shuttle from London to Glasgow, whilst maintaining the zero-rate for first class inter city trains travelling across the border. It was important that any new borderlines could be presented as being both logical and fair.

7. A more desirable alternative to taxing air travel alone would be perhaps taxing all forms of transport except for essential travel. But identifying essential travel and drawing new borderlines could be difficult. One possibility might be to continue to zero-rate season tickets and tickets purchased via OAP concessionary cards. If this zero-rating were extended to fuel rebated staged bus services, the borderline might be more acceptable to the rural lobby.

8. It was noted that Germany and Italy charged a lower rate of VAT on urban travel as compared to long distance travel. Mr Michie said it would be useful to find out in greater detail how these countries defined such journies.

9. The Economic Secretary thought it worth exploring further the option of restructuring zero-rating to urban travel.

restructuring?

*Why?
(but why
tax rail
travel
anyway)*

International Travel

10. The Economic Secretary agreed with the conclusion in Mr Wilmott's submission that domestic policy considerations should influence our policy on international travel. But given existing EC Sixth Directive constraints, we were clearly limited on what we could do at present.

Departure Tax

11. The Economic Secretary was not attracted to the idea of a departure tax; the Government was not in the business of creating new taxes. Mr Michie was of the view that the introduction of such a tax did not rest easily with the concept of a single internal market.

Other Options

12. The Economic Secretary noted that AVTUR had been abolished in 1986. He wondered if it would be possible to impose such a tax on fuel used for international flights. Customs officials agreed to investigate this.

Conclusions

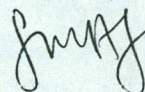
13. The Economic Secretary summarised the conclusions of the meeting:

- (i) The Economic Secretary was not inclined to pursue the option of a departure tax.
- (ii) The options for extending VAT to international travel were constrained by EC law;
- (iii) The Economic Secretary was not in general minded to extend VAT to domestic travel but this might be explored along with possible reliefs eg season ticket travel and fuel rebated journeys;

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(iv) Customs officials would provide advice on the following questions:

- the scope for defining a borderline for urban transport (with details of the German and Italian systems, if possible);
- AVTUR international exemption;
- an estimate of the costs of the various reliefs on domestic transport discussed (FP to assist with this).

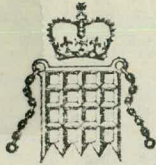


S M A JAMES
Private Secretary

cc Those present

PS/Chancellor
Mr Culpin
Mr Revolta
Mr Gilhooly

PS/C&E



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

BF to More
25/7
27/7
py

FROM: P G WILMOTT
DATE: 15 July 1988

ECONOMIC SECRETARY

- cc Chancellor
- Chief Secretary
- Sir P Middleton
- Mr Anson
- Mr Scholar
- Mr J Gieve
- Mr Culpin
- Mr Turnbull
- Mrs M E Brown
- Mr Gilhooly
- Mr Macauslan
- Mr Revolta
- Mr Cropper

WILMOTT
→
EST
15/7

VAT ON PASSENGER TRANSPORT

1. Mr Allan's note of 3 June asked for advice on the scope for drawing a rather tighter borderline for the zero-rating of non-air travel. He also asks about the constraints imposed by EC law on the taxation of air travel within the Community. This submission sets out the legal framework within which any changes in UK taxation would have to take place, and then considers, first, the factors influencing a possible change in taxation of domestic transport and, second, what options might be available to tax international travel.

EC Provisions and constraints

2. Community law prevents us from applying VAT either to journeys that take place wholly outside the UK or to that portion of journeys starting or finishing in the UK that takes place outside the UK. There are thus clear limits to our freedom to extend

-
- | | |
|----------------------------|--------------|
| Internal distribution: CPS | Mr Cockerell |
| Mr Jefferson Smith | Mr Allen |
| Mr Nissen | Mr Tracey |

VAT to international transport. However, Article 33 of the Sixth Directive does allow member states to introduce other taxes provided they do not have the characteristics of turnover taxes. It is therefore feasible to think in terms of introducing some form of single stage tax on passenger movements, provided that it does not discriminate against other member states contrary to the Treaty of Rome (this point was also raised by Mr Barnes in his note of 6 June to Mr Tracey).

3. Article 28.5 of the Sixth Directive provides that, at the end of the transitional period, international passenger transport shall be taxed in the country of departure for that part of the journey which takes place within the Community. It places on the Commission the responsibility of proposing the detailed rules and procedures for doing this and we expect these to appear soon in the form of a draft Council Directive.

4. Article 28.3 of the Sixth Directive contains a number of different derogations one of which permits member states to exempt (domestic) passenger transport during the transitional period until there is unanimous agreement that it should be taxed. The draft 18th Directive, which first appeared in December 1984, proposes the abolition of derogations under Article 28 but political problems have arisen for over the timetable for their withdrawal and there has been much redrafting. In its present form the Directive envisages the phased abolition of derogations and the transport exemption is among those scheduled to be withdrawn in the last phase on 1 January 1990. However, progress has been very slow and there now seems little prospect of the 18th Directive being agreed in its present form. Discussions on this are about to recommence at working group level and we shall maintain the line taken hitherto that abolition of the passenger transport derogation should only be considered in the light of the Commission's promised draft Transport Directive. The Commission's proposals to tax passenger transport at the point of departure are, we think, unlikely to become a reality before 1992.

Other Member States' practice

5. We have obtained, as background, information on the treatment of passenger transport in other Community countries: this is at Annex 1. International transport is with few exceptions zero-rated but national transport is generally taxed, at between 6 and 18 per cent.

Domestic transport

6. At present the bulk of domestic public transport by road, rail, sea and air is zero-rated. The Chancellor is correct in his understanding that the criteria for zero-rating is based on the carrying capacity of the vehicles involved. Passenger transport in vehicles designed or adapted to carry not less than 12 passengers is zero-rated. Otherwise it is standard-rated (this applies to taxis, hire cars - including, since deregulation, some local minibus services - and certain light aircraft and small boats). There is no EC barrier to an extension of taxation in the domestic field (indeed, taxation is the ultimate goal of the Sixth Directive), so we have a pretty free hand. But we cannot, of course, extend zero-rating.
7. The Chancellor's reference to "drawing a rather tighter borderline" suggests that he has ruled out extending taxation to all passenger transport in the UK. This would of course be the simplest course administratively, and the least likely to cause distortions. It would also offer the best 'fit' with the Community's long-term aims. But if some transport is to remain zero-rated, it would be helpful in establishing a new borderline to be clear about the underlying reasons for continuing relief in certain areas.
8. The classic approach is to attempt to tax forms of transport which are bespoke services to individuals, mainly classed as discretionary expenditure, while relieving essential expenditure, especially that incurred by the less well-off. The problem with public transport is that ready-made distinctions on which to base a tax borderline are hard to come by. Much travel is discretionary - whether for leisure, pleasure, family or other reasons. Yet it is most likely to be the less well-off who have recourse to public transport for these purposes (this is not necessarily a pointer to continuing relief, however, since those who use private cars for journeys of this kind, including the less well-off, are already substantially taxed). Journeys that might be described as essential are those that take people to and from their place of work and those that provide the necessary links with shopping facilities and public amenities for people without their own transport. Yet it is hard to distinguish, for road and rail (including underground) travel at least, between commuters and shoppers on the one hand and leisure and pleasure travellers on the other. It might be possible, for rail travel, to retain relief for season tickets (which could be defined as any ticket purchased to cover a period of seven consecutive days or more) while taxing ordinary single and return tickets. This would relieve commuters but probably not help those without their own car who relied on public transport for shopping etc. A similar distinction could probably be made to

*This is all making a terrible meal of things.
 Surely no point in trying to tax rail travel
 at all when it is still heavily subsidised.*

apply to coach travel, which - in the South East at least - is increasingly used by commuters, and to ~~whom~~ bus and underground travel, where the use of bus passes of one kind or another appears to be spreading. For air travel there seems little justification, on this basis, for relief. An approach on these lines would permit some consistency across different modes of transport, and could be presented as retaining relief for certain forms of essential travel. But it would not zero-rate all essential journeys, some of which, perhaps especially in rural areas, could become taxable.

9. This is a different approach to that suggested in paragraph 4 of Mr Allan's minute, which envisaged the zero-rating of stage bus services. Although at first sight this borderline would be relatively easy to operate, we see other drawbacks. If rail travel remained zero-rated, there would be a tax disincentive to long distance bus and coach travel (where private companies are offering stiff competition to the railways). If it did not, there would be distortions with short-distance and urban rail travel, since there would be no simple way of zero-rating rail journeys on any similar basis, (applying a simple distance criterion - zero-rate rail journeys up to X miles, for example - would be arbitrary and open to an obvious, if inconvenient, abuse by "disaggregation").

10. Continuing relief for domestic ferry travel would have to be looked at carefully in the light of our long term approach to tolls on estuarial and other crossings - there would be little logic in taxing a shortcut by bridge or tunnel while zero-rating a similar ferry crossing. But where there was no direct alternative of this kind relief would probably be problem-free.

Other taxes on transport

11. I attach a table (Annex 2) showing the main indirect taxes on different modes of transport (chiefly excise duties on fuel and VED on buses and coaches). But we see an important distinction between these charges, which affect the overhead and input costs of the different sectors of the transport industry, and VAT on fares, which is more a direct charge on consumers and a major factor influencing their behaviour.

International transport

12. If all domestic transport were to be taxed, complete relief for international travel would look anomalous. Since we could not apply VAT to the whole of an international journey, we would have a choice - either tax only the UK leg or devise a

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non-VAT charge that could cover the whole journey. The problem would not be confined to air travel: coach transport to and from the Continent is already a tourist reality, rail would be brought in with the opening of the Channel Tunnel (we would be pressed immediately to say how it would be affected), and - technically - continental ferries and similar vessels make part of the voyage in UK waters. We could probably apply a rough-and-ready apportionment scheme to tax the domestic part of the journey; it would be reasonably precise for rail travel, a little less so for sea and road transport, and fairly arbitrary for air. We should need to rely heavily on transport operators for the correct application of the tax. The alternative would be a departure tax, or something similar.

13. Departure taxes already exist in some EC Member States, which is an indication that they are in principle acceptable in the eyes of the Commission. However there are cases before the European Court of Justice in which the interpretation of Article 33 of the Sixth Directive is in question and we would need to study these carefully before deciding to introduce any such tax in the UK. Some research was done in 1985 on the effect of introducing a departure tax in the UK and this has been suitably updated and is attached at Annex 3. Clearly it is possible by this means to raise significant amounts of revenue but there are also drawbacks, the most serious of which are the adverse effect it could have on the numbers of visitors coming to this Country and the costs of administration. Another important factor would be the extra accounting requirements it would impose on the travel industry which has only recently been burdened with the complications of the Tour Operators' Margin Scheme. It would also be difficult to present a lump-sum departure tax as a true counterpart of an inland VAT charge, while modulating it for distance etc would be administratively awkward and could fall foul of article 33.

14. If certain forms of domestic transport retain relief, the case for a matching international tax would depend on the form and extent of the relief. Extending VAT to all but commuting, or urban travel in some guise, would still highlight the apparent anomaly of relief for all international journeys. But the retention of relief on a larger scale (eg for all rail travel) would call into question any general move to tax international travel. Although we feel that the international tail should not be allowed to wag the domestic policy dog, there is a sense in which it constrains, or at least interacts with, the domestic options.

Summary

15. (i) We cannot apply VAT to international passenger journeys.
- (ii) But we have complete freedom of action to apply VAT to domestic journeys which are currently zero-rated, including the domestic leg of ~~our~~ an international journey.
- (iii) It is hard to find suitable general criteria for continuing relief; distinctions based on kinds of journeys may be easier to defend than discrimination between modes of passenger transport (apart from taxis, hire cars etc, which must remain taxable).
- (iv) New borderlines could be difficult and costly to administer; we shall need to consider the practical aspects in due course.
- (v) Looking at domestic policy first enables you to consider the treatment of international travel in the light of the approach chosen; in some circumstances the absence of a tax charge on international journeys could be hard to defend - the choice for taxation could then lie between VAT on the inland leg and a suitable non-VAT tax.

Conclusion

16. Domestically we have considerable scope, but internationally the options are limited. The issues are complicated. Whatever criteria are chosen for taxation, it seems preferable to avoid anything too arbitrary in relation to the nature of the journey undertaken or discriminatory between different modes of transport. Ministers will be expected to justify their policies and this will be easier if any changes are backed by clearly defined and easily understood principles. Before we do further work on possible alternatives we would welcome an opportunity to discuss these issues with you.



P G WILMOTT

PM/cvh 25.10.87 [1st part]
SYSTEM OF VAT ON PASSENGER TRANSPORT

Member State	<u>National transport</u>				
	Air	Sea	Inland waterways	Rail	Road
Belgium	6	6	6	6	6
Denmark	Exempt	Exempt	Exempt	Exempt	Exempt (2)
Germany	14	7	7	14/7(3)	14/7(3)
France	7	7	Exempt/7(4)	7	7
Ireland	Exempt	Exempt	Exempt	Exempt	Exempt
Italy	18	18	18	18/Exempt (7)	18/Exempt (7)
Luxembourg	6	-	Exempt	6	6
Netherlands	6	Exempt/6 (8)	Exempt/6 (8)	6	6
U.K.	0(10)	0(10)	0(10)	0(10)	0(10)
Portugal	8	8	8	8	8
Spain	12	12	12	6	6
Greece	6	6	6	6	6

(1) As a rule, flat-rate amounts are charged when vehicles registered abroad enter the country. A rate of VAT is applied to domestic vehicles. The current exemption in Denmark applies to all regular traffic, domestic or foreign.

(2) Non-regular traffic: 22%

(3) Long distance: 14%
Urban transport: 7%

(4) Rhine: Exempt

(5) Transport to or from abroad: 7%
Transport in transit and transport on the Rhine: Exempt

(6) Transit: Exempt
Other: 7%

(7) Long distance: 18%

Urban transport: Exempt

(8) Ferries opting for taxation and regular vessels: 6%

(9) In practice no VAT

(10) Means of transport with ~~less~~ than 12 persons: 15%

(11) However, a special tax is collected at the frontier.

SYSTEM OF VAT ON PASSENGER TRANSPORT

Member State	International transport (taxation of that part of journey effected on national territory)				
	Air	Sea	Inland waterways	Rail	Road
Belgium	0	0	6	6	6 flat-rate amounts (1)
Denmark	0	0	-	Exempt	Exempt/22/ flat-rate amounts (1)
Germany	0	7	7	14	14/flat-rate amounts (1)
France	0	0	7/Exempt (5)	0	7/Exempt (6)
Ireland	0	0	-	0	0
Italy	0	0	0	0	0
Luxembourg	0	-	Exempt	0	0
Netherlands	0	0	6	6	6 (9)
U.K.	0	0	-	0	0
Portugal	0	0	0	0	0 (11)
Spain	0	0	12	6	6
Greece	0	0	-	6	6

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(9) In practice no VAT

(10) Means of transport with ~~less~~
than 12 persons: 15%

(11) However, a special tax is
collected at the frontier.

	Fuel Duty	VED (12 month rate)
Cars	20.44p/litre (petrol)	£100
	17.29p/litre (derv)	
Taxis	20.44p/litre (petrol)	£52.50
	17.29p/litre (derv)	£100 (if also used privately)
Stage buses	Bus fuel grant gives fuel refund of all duty (petrol and derv)) Range from £52.50 for up to 20 seats to £115.50 for 80 seats.
)
Coaches	20.44p/litre (petrol)) £1.05 for each additional seat.
	17.29p/litre (derv))
Rail (Diesel locomotives)	1.1p/litre (gas oil) (rebated rate)	-
Air	Nearly all scheduled services	Nil (aviation turbine Kerosene)
	Light aircraft a few scheduled services.	10.22p/litre (AVGAS)
Coastal Waters eg. Scottish ferries	Nil. (gas oil and fuel oil) (full refund of rebated rate of duty under coastal waters relief)	-

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A POSSIBLE DEPARTURE TAXBACKGROUNDIntroduction

1. There continues to be a steady trickle of letters recommending to Treasury Ministers the introduction of a tax on people leaving the country. Correspondents generally envisage a simple tax charged as a fixed amount on each person leaving the country. Some have suggested that the tax ought to apply only to overseas visitors leaving the country; others that it should also cover British residents making visits abroad. This paper considers the implications of introducing a new tax on these lines.

Practice abroad

2. Many countries collect taxes or fees from departing air passengers designed to help pay for aviation facilities. The United Kingdom operated a "tax" of this kind in the early post-war years before the establishment of the British Airports Authority, the proceeds going to the former Ministry of Civil Aviation. Nowadays the BAA, in common with its counterparts in most other industrialised countries, collects all airport charges direct from the airlines. These "airport taxes" are different from "departure taxes" proper, levied on international passenger travel and designed to raise revenue for the national exchequer. As far as we can establish, only a few countries operate such departure taxes: Belgium, Denmark, Ireland, Australia, New Zealand, Canada, Japan, Sweden, India and Israel.

European Community and OECD considerations

3. The fact that Belgium, Denmark and Iceland operate departure taxes of various sorts suggests that such a tax would not contravene any EC commitments. Certainly, provided it did not discriminate against other EC residents, such a tax would not seem to infringe the specifically fiscal constraints of the Treaty of Rome. However, the introduction of a departure tax would be contrary to two OECD Recommendations on international tourism to which the UK is a signatory. It has to be said, though, that quite a few OECD countries ignore these recommendations. At OECD Tourism Committee meetings the UK has consistently urged other member countries to remove their departure taxes (the imposition of departure taxes by European countries such as Denmark and Sweden, for example, is thought to hamper the efforts of the British Tourist Authority and incoming tour operators to encourage weekend breaks/off peak travel etc because the flat rate tax becomes a significant proportion of the travel cost).

A POSSIBLE UK TAX

Tax base

4. Most overseas countries seem to limit the scope of their departure taxes to departures by air. But in many cases this is more an inevitable consequence of geography (ie of long land frontiers) than a deliberate choice, and there seems no reason in principle why such a United Kingdom tax should not cover departures by sea as well. Indeed there might well be criticism from air operators on the ground of inequality of treatment if it did not. The tax base would need to be as wide as possible, both to maximise revenue and to eliminate difficult borderlines. But there could nevertheless be some awkward decisions on coverage. For example, we should have to decide whether the tax should cover just departures by overseas residents (which could be difficult to police) or whether it should extend to departures by United Kingdom residents. The treatment of business travellers would need to be decided; in practice it would be very difficult to confine the tax to either business or non-business travellers, as there are many "dual-purpose" travellers, EC nationals do not have to give a reason for travelling, and there would be ample opportunity for

not v diff for Japan, Australia, New Zealand etc!

others to misdescribe their reasons for travelling. If the tax were to extend to sea travel, account would have to be taken of the effect of even a small charge on cross-channel day trips, which could be significant (the added cost to travellers arising out of the French restriction on "no passport" excursions in 1965 markedly affected day-trip traffic). Decisions would also be needed on the treatment of children, transit passengers, departures via the Irish land boundary and the Channel Tunnel.

Revenue

5. The potential yield from a tax could be considerable. If the tax were applied at the rate of £10 per head to all departures from UK ports and airports it would yield around £400 million per annum. The following table breaks this down:-

	<u>Air only</u>	<u>Air and Sea</u>
	£m	£m
UK residents		
Business*	25	30
Other	135	230
Total	160	260
<hr/>		
Visitors		
Business*	30	35
Other	60	105
Total	90	140
<hr/>		
All travellers		
Business*	55	65
Other	195	335
Total	250	400

[* Business covers only those trips clearly identified as business (see paragraph 4)]

These figures do not take into account the effect of a departure tax on demand. The overall trend in trips both to and from the UK is still upwards. But because such a high proportion of trips are discretionary, it is possible that the imposition of a £10 per head departure tax would reduce demand by as much as 5%-10%. Over the last 5 years, the number of trips **from** the UK has risen by about 10% per annum on average (though this high level may not be sustained in full this year) and the number of trips **to** the UK by about 5%. So a departure tax could cost a year's growth.

Implementation

6. We do not think that collection of the tax physically at the point of departure is a practical proposition, whether responsibility rested with Customs or with the airport and seaport operators. The staff effort required would be considerable, and the possibilities of congestion and delay boundless. The tax would be highly perceptible to travellers, which in this instance is unlikely to be a virtue. The only practical scheme is likely to be a variant of the Irish practice (ie a surcharge on ticket sales). Control would be exercised on the basis of vendors' records and would necessitate record-keeping and the filing of returns by a large number of travel agents, airlines, tour operators, ferry companies and other transport firms. We have not considered in detail what staff resources would be required for control and enforcement, but think it could involve up to 150 extra staff.

Public and political reaction

7. The introduction of a departure tax would in all probability be vigorously opposed by the airlines, who already face relatively high airport charges in the United Kingdom, and by airport authorities. The travel trade more generally could be expected to object both to the loss of business it would entail and to the increased bureaucratic burden; especially as they are still familiarising themselves with the complications of the tour operators' VAT margin scheme, in operation since 1 April 1988. The reaction of the public is more difficult to gauge. From the letters we have received we think there would be some support for such a tax particularly if it reduced taxes elsewhere. But the more likely

overall reaction from the travelling public would be hostile. Business travellers could be expected to resent any extra cost on necessary travel, much of it directed at export effort. It seems probable, too, that there would be resistance from the UK tourist trade, which has campaigned persistently for relief from VAT for tourist services used by overseas visitors. A departure tax of, say, £10 would well mean £10 less spent by overseas visitors on British goods and services. There would probably be much critical talk of restrictions on personal freedom to travel abroad and of increased burdens on the less well-off (a flat-rate tax would be regressive).

6. There could also be adverse political reactions. Department of Trade and Industry Ministers could be embarrassed by a tax that appeared to conflict with their policy of encouraging international tourism to Great Britain. It would also run counter to the drive for cheaper European air fares, and would sit oddly with the line that the UK has adopted in the OECD (see paragraph 3).

SUMMARY

9. The revenue potential of a departure tax is considerable. However, to maximise the benefit it would be necessary for the tax to cover all air and sea departures. Attempts to discriminate between UK residents and overseas residents and between tourists and businessmen would increase the problems of administration while reducing revenue. The tax would impose a significant new burden on the travel industry in the UK (overseas visitors currently spend about £7 billion a year in the UK). There could be a disincentive to business travel. A departure tax could be criticised as inconsistent with the Government's general policies on tourism and international travel and trade.

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FROM: P D P BARNES
DATE: 6 June 1988

MR TRACEY - C&E

cc Mr Wilmott - C&E

VAT ON PASSENGER TRANSPORT

We spoke.

2. As I said, the Economic Secretary would be grateful for a short note explaining how the Sixth Directive prevents Member States from putting a tax on foreign travel, even if they do not call the tax VAT.

BARNES
→
TRACEY
6/6

PB

P D P BARNES
Private Secretary



FROM: A C S ALLAN

DATE: 3 June 1988

BF 17/6
~~23/6~~
~~30/6~~
15/7
6/9

PS/ECONOMIC SECRETARY

- cc PS/Chief Secretary
- Sir P Middleton
- Mr Anson
- Mr Scholar
- Mr R I G Allen
- Mr Culpin
- Mr Turnbull
- Mrs M E Brown
- Mr Gilhooly
- Mr MacAuslan
- Mr Revolta
- Mr Cropper

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

ALLAN
→
PS/EST
3/6

VAT ON PASSENGER TRANSPORT

The Chancellor has seen your minute of 27 May.

2. He still finds it bizarre that the Commission's proposal would result in flights within the EC being subject to VAT, but flights outside the EC continuing to be exempt. But he wishes to retain as a starter for 1989 the possibility of applying the standard rate to air travel within the UK and to air travel from the UK to other EC destinations. Is the latter possible under existing Community law?

3. The Chancellor has also been considering further the question of VAT on non-air travel. As he understands it, the present rules for road travel are that travel in vehicles with twelve seats or more is zero-rated, while travel in smaller vehicles (e.g. taxis, mini-cabs, hire-cars etc) is taxed at the standard rate.



4. The Chancellor would be grateful for advice from Customs, routed through the Economic Secretary, on whether there is scope for drawing a rather tighter borderline for this zero-rating. The social case for zero-rating bus travel applies primarily to local authority bus companies and private sector companies in direct competition. There seems a much weaker case for zero-rating coach travel generally, particularly coaches chartered for excursions etc. Is there a case for limiting the zero-rating to bus travel which attracts a rebate on road fuel duty? (as I understand it, this applies to scheduled bus services with stops not more than 15 miles apart). Using this definition would mean that inter-city bus services, as well as excursions, were caught: does this matter? It would, presumably, help British rail.

5. It would also be necessary to consider how this might link in with applying the standard rate to flights from the UK to other EC countries. Presumably we would tax coach travel from the UK to other EC countries, and perhaps ferry and hovercraft travel as well. Are there any EC wrinkles here? Would we be able to tax all forms of passenger transport to other EC countries except rail travel?

6. There probably still remains a social case for zero-rating domestic ferry travel - e.g. in the Western Isles.

7. The Chancellor would be grateful for a note analysing these issues, and including comparisons of the VAT rates, fuel/power duty rates and (where appropriate) VED rates applying to each form of passenger transport.

ACSA

A C S ALLAN

CONFIDENTIAL



FROM: P D P BARNES
DATE: 27 May 1988

PS/Chancellor

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Scholar
Mr A J C Edwards
Mr Culpin
Mr Turnbull
Mr Gieve
Mr Revolta
Miss Sinclair
Mr Michie
Mr Cropper

Mr Jefferson Smith C&E
Mr Wilmott - C&E
Mr Tracey - C&E
Mr Allen - C&E
PS/C&E

BARNES
→
PS/CH&E
27/5

VAT ON PASSENGER TRANSPORT

Mr Tracey's minute (attached) responds to the Chancellor's queries about the VAT treatment of air journey's to non-member states.

2. Mr Tracey tells me that article 9 of the Sixth VAT Directive says that, "the place where transport services are supplied shall be the place where transport takes place." I understand that, because of the administrative difficulty of taxing the part of a journey over UK air space, this has always been interpreted as meaning that international flights are exempt from VAT. The Commission's proposal will, I understand, change this in respect of intra-EC journeys, but not in respect of journeys to non-member states.

*Bozans. How is still a
promise Stanton for
1989.*

3000-rated?

fb

P D P BARNES
Private Secretary

CONFIDENTIAL

CONFIDENTIAL

26 MAY 1988



H M CUSTOMS & EXCISE
VAT ADMINISTRATION DIRECTORATE
NEW KING'S BEAM HOUSE
22 UPPER GROUND
LONDON SE1 9JP 9PJ

01-620 1313 382-5369

FROM : MR J W TRACEY

DATE : 25 MAY 1988

26/5

PS/ECONOMIC SECRETARY

ABL
26/5

VAT ON PASSENGER TRANSPORT

1. Miss Wallace's minute of 25 May refers.
2. The Chancellor's presumption about imposing VAT on journeys to overseas destinations outside the EC is not correct. Neither under the Sixth Directive, nor under the Commission's proposed amendments, could member states impose VAT on transport taking place outside the Community. The essence of the Commission's plan is that, subject to the different rates of VAT permitted by the approximation Directive, journeys within the Community are to be taxed as though it was a single country except that each member state will collect tax by reference to departures from its territory. They would point out, for example, that the Germans already tax flights from Hamburg to Munich; what more natural, in the Internal Market, than journeys from Hamburg to Madrid should be taxed as well. Obviously this is a more difficult concept for us because of our zero rating of all domestic transport but there is already an incentive to go on holiday to non-EC countries which do not tax hotel and other tourist services whereas such services are taxed at various VAT rates in all member states.
3. If it were lawful to impose VAT on air travel to all overseas destinations, the yield at 15% would be in the region of £225m (£125m Community, £100m elsewhere).

TRACEY
→
PS/EST
25/5

J W TRACEY

Internal Circulation

CPS Mr Jefferson Smith Mr Wilmott Mr Allen

BR 27/5



FROM: MISS M P WALLACE

DATE: 20 May 1988

4/6

PS/ECONOMIC SECRETARY

cc PS/Chief Secretary

Sir P Middleton

Mr Anson

Mr Scholar

Mr Culpin

Mr AJC Edwards

Mr Turnbull

Mr Gieve

Miss Sinclair

Mr Revolta

Mr Michie

Mr Cropper

Mr Jefferson Smith - C&E

Mr Wilmott - C&E

Mr Tracey - C&E

Mr Allen - C&E

PS/C&E

VAT ON PASSENGER TRANSPORT

The Chancellor was grateful for your minute of 18 May.

2. He has noted that if we were to have VAT (at 15 per cent) on air travel, it would appear that this will yield £150 million (£25 million from internal UK air journeys, and £125 million from journeys to other EC member states). However, he has commented that presumably, if we were to impose VAT in this way we would also impose it ^{on} air journeys to overseas destinations outside the EC as well. Does not the proposed EC directive cover this? Otherwise, there would be absurd distortions, not to mention an incentive to go on holiday outside the EC.

3. The Chancellor would therefore be grateful if Customs could let him have an indication of the yield from applying VAT to air travel to all destinations.

mpw.

MOIRA WALLACE

WALLACE
→
PS/EST
30/5

CONFIDENTIAL



FROM: P D P BARNES
DATE: 18 May 1988

APS/CHANCELLOR

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Scholar
Mr Culpin
Mr Turnbull
Mr Gieve
Miss Sinclair
Mr Revolta
Mr Michie
Mr Cropper

Mr Jefferson Smith - C&E
Mr Wilmott - C&E
Mr Tracey - C&E
Mr Allen - C&E
PS/C&E

Handwritten notes in red ink:
If we were to have VAT @ 15% on air travel, it wd apply the same as you @ 150% (725m from return on air travel for states). But present VAT is 100% on air travel, we wd also have VAT on other journeys to other parts of the world. Also on other journeys to other parts of the world.

VAT ON PASSENGER TRANSPORT

Your minute of 5 May said that the Chancellor would be interested to know what 15% VAT on air transport would yield.

2. The Economic Secretary has asked me to send you the attached minute from Customs which I hope meets the Chancellor's point.

BARNES
→
APS/CH&E
18/5

RB

P D P BARNES
Private Secretary

Handwritten notes in red ink:
Please show to the Board on 20th or 21st. I think we should go to the Board on 20th or 21st. So when you see the Board on 20th or 21st.

CONFIDENTIAL



H M CUSTOMS & EXCISE
VAT ADMINISTRATION DIRECTORATE
NEW KING'S BEAM HOUSE
22 UPPER GROUND
LONDON SE1 9JP

From: J W TRACEY
Date : 13 May 1988

01-620-1313 382-5369

Private Secretary to the Economic Secretary

VAT ON PASSENGER TRANSPORT

Miss Wallace's minute of 5 May refers.

15% VAT on internal UK air journeys would yield at 1988-89 prices about £25 million (compared with £255m for train and £300m for bus and coach).

On the point about whether or not the same VAT regime should apply to surface public transport and air transport, clearly the airlines would have grounds for complaint if there was not equality of VAT treatment for routes on which they were in fact in competition with surface transport, particularly BR's Inter City which is of course heavily used by business travellers.

For completeness, the yield if we agreed to adopt the Commission's proposal to tax journeys to other Member States on the country of departure basis would be in the order of :

	15%	5%
Air	£125m	£45m
Surface	£ 25m	£10m

I stress, however, that these are very uncertain estimates.

J W TRACEY

CPS Mr Jefferson Smith Mr Wilmott Mr Allen

TRACEY
→
REJECT
13/5

CONFIDENTIAL



BF 19/5

FROM: MISS M P WALLACE

DATE: 5 May 1988

PS/ECONOMIC SECRETARY

cc PS/Chief Secretary

Sir P Middleton

Mr Anson

Mr Scholar

Mr Culpin

Mr Turnbull

Mr Gieve

Miss Sinclair

Mr Revolta

Mr Michie

Mr Cropper

Mr Jefferson Smith- C&E

Mr Wilmott - C&E

PS/C&E

VAT ON PASSENGER TRANSPORT

The Chancellor has seen your minute of 28 April. He agrees with the Economic Secretary's advice that we could live with taxation on the basis of country of departure. But he has commented that we may wish to reconsider - in due course - whether it necessarily follows that because surface public transport is predominantly used by lower income groups, and is therefore zero-rated, the same must apply to air transport. He would be interested to know what 15 per cent VAT on air transport would yield.

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

MOIRA WALLACE

 WALLACE
 →
 PS/EST
 SIS

CONFIDENTIAL



FROM: P D P BARNES
DATE: 28 April 1988

PS/CHANCELLOR

- cc PS/Chief Secretary
- Sir P Middleton
- Mr Anson
- Mr Scholar
- Mr Culpin
- Mr Turnbull
- Mr Gieve
- Miss Sinclair
- Mr Michie
- Mr Cropper

- Mr Jefferson Smith - C&E
- Mr Wilmott - C&E
- Mr P R H Allen - C&E
- Mr Cockerell - C&E
- Mr Tracey - C&E
- Mr Oxenford - C&E

*Control to follow
BSG is advised re
taxation on basis of
country of departure.
But we may wish to
consider whether to
subject public transport
to VAT (or some
other rate) as
is predominant use
of air for VAT
on air for VAT
on air for VAT*

VAT ON PASSENGER TRANSPORT

The Economic Secretary has considered with officials the European Commission's proposals to impose VAT on travel within the Community. However, he thinks we should first decide whether we wish to make any change in our present domestic regime irrespective of EC developments. His conclusion is that we should retain zero rates for passenger transport, but he sees no need to resist taxing on the basis of country of departure. He would be interested to know whether the Chancellor shares his view.

Passenger Travel within the UK

2. The Economic Secretary believes the social argument for retaining a zero rate on domestic public transport has strengthened over the years. Wider ownership of cars has meant that public transport is predominantly used by lower income groups.

3. The gradual phasing out of subsidies on public transport cuts both ways. It can be argued that the removal of cash subsidies should be followed by removing the implicit subsidy of a zero VAT rate. But on balance the Economic Secretary believes that the removal of subsidies make it politically more difficult

BARNES
PS/CHC
28/4

to impose a positive rate of VAT.

4. Other factors to bear in mind are, he thinks, first, that growing environmental concern and road congestion reinforce the political case for retaining a zero rate on public transport. And, second, that it would not be possible to put the blame for standard rating public transport on the EC since the Commission are pressing for a low rate.

Passenger travel between EC states

5. At present travel between states (and outside the Community) is 'exempt with refund' - ie effectively zero rated. This sits very well with UK practice of zero rating domestic transport. The Economic Secretary sees no reason to seek a change.

6. The forthcoming EC directive is likely to propose (i) taxing travel between member states at the rate of the country of departure and (ii) approximating rates applied to intra EC (and domestic) travel within the proposed lower band of 4-9%. The Economic Secretary notes that in agreeing to the EC Sixth Directive we accepted the principle of taxation on the country of departure basis, though we retain a veto on timing.

7. The civil aviation industry is opposed to both proposals. However, if travel between member states had to be taxed at all they would much prefer to have a special single rate of tax, rather than a regime which applied the rate of tax in force in the country of departure. This is because they would want to avoid the tariff and ticketing problems of having different rates of VAT applied to the outward and inward legs of return trips. They would also want to avoid a different rate of tax for domestic and intra-EC journeys because otherwise there would be complications in respect of inland legs of journeys to other member states e.g. Edinburgh - Madrid via Heathrow.

8. But even if a uniform 'euro-rate' on travel within and between member states were acceptable to the industry, the Economic

Secretary thinks it would be difficult for the UK to endorse. Like any lower rate it would encourage lobby groups to press for supplies currently standard rated to be taxed at the lower rate. He doubts whether the Government's possible ability to ring-fence a euro-rate on inter-state travel, on grounds of its unique application, would deter such lobbying.

9. In addition, a euro-rate on travel between states would cause distortions if domestic travel were taxed at a different rate. This would be particularly true in the UK given that we intend to retain the zero-rate on domestic travel. For example, travellers from the north of the UK to a destination in another member state would have an incentive to make a zero-rated domestic journey to a southern port or airport and then a separate journey to their final destination, rather than to make a through journey from a northern port or airport and pay VAT at the euro-rate. But as the industry may wish to retain this option, the Economic Secretary thinks that it would be wiser for us to rely on the likely opposition of the Commission and other member states, rather than to rule it out ourselves.

Conclusion

10. If we were to agree to change to the place of departure basis, but insisted on retaining our zero-rate both for domestic journeys and journeys to other member states, the Economic Secretary accepts that there would be a small distortion since a traveller from another member state to an inland destination in the UK would do better not to purchase a single through ticket from his town of origin to his UK destination. Instead it would pay him to buy a ticket only so far as the UK frontier and then buy a second zero-rated ticket for onward travel within the UK. Obviously the distortion would be greater if the relevant rates were zero and 9% rather than, say, 5 and 7%. He is not inclined, however, to accept the argument, likely to be advanced by other member states and the Commission, that retaining the zero-rate here would give us an unfair advantage in relation to tourist and business travel in what was supposed to be a single market.

CONFIDENTIAL

The Economic Secretary also points out that the practical problems of living with a zero rate and eleven positive rates would be no greater than living with 12 different rates in the low rate range.

11. Our zero rate for transport has not featured in the current zero-rates infraction case, on which the ECJ's judgment is still awaited. Officials cannot entirely rule out the possibility that the Commission will eventually mount a challenge to our transport zero rate on the grounds that much public transport is for business and recreational purposes and does not therefore satisfy the final consumer/social policy criteria. Much would depend on what the EC eventually say about these criteria - in the context of fuel and power for example - and whether we are alone in objecting to the Commission's internal market plans for VAT on transport. But, that possibility is thought to be remote and the chance of such an action succeeding is even remoter.

12. All things considered, the Economic Secretary thinks that, barring the unlikely event of a case before the European Court which obliged us to end it, we should not consent to proposals which would result in the loss of our zero rate for passenger transport. But he thinks we could live with the problems that would result from moving to a country of departure basis, and therefore thinks that we should not resist a solution along these lines.

hs

P D P BARNES

Private Secretary

mwp



FROM: MOIRA WALLACE
DATE: 9 February 1988

24/2
25/2

PS/ECONOMIC SECRETARY

VAT PASSENGER TRANSPORT

... The Chancellor has seen Miss Massie's note of 4 February (attached) setting out the background to recent press reports of "European Commission proposals to impose VAT on travel within the community". The Chancellor would be grateful if the Economic Secretary could examine the issues in more detail.

mwp

MOIRA WALLACE

WALLACE
→
PS/EST
9/2



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

FROM : H M MASSIE

DATE : 4 February 1988

APS/CHANCELLOR

VAT PASSENGER TRANSPORT

You asked about the report in the Times on 30 January 1988.

Ian Walton at UKREP has reported that DG XX1 see the position as follows:

- (a) the general rule in the Sixth VAT Directive is that passenger transport (both domestic and international) is taxable;
- (b) the place of supply of transport services is the place where the transport actually takes place (Article 9.2(b));
- (c) but exemption from VAT is allowed on a transitional basis for passenger transport supplied in the Community (Article 28.3(b) and Annex F17) until the end of the transitional period (usually taken to mean the abolition of fiscal frontiers);
- (d) when fiscal frontiers are abolished passenger transport is to be taxed in the country of departure for that part of the journey taking place within the Community (Article 28.5) - the Council must unanimously establish the detailed rules on the basis of a Commission proposal;

(e) the draft 18th VAT Directive, in its latest compromise version, calls on Member States to try to abolish most of the remaining derogations in Article 28.3(b), including passenger transport, by 1 January 1990;

(f) the Commission is therefore simply meeting a commitment which the Council imposed on them in 1977 by drafting a Directive to tax passenger transport in the country of departure, and has set the starting date as 1 January 1990 to tie in with the draft 18th Directive.

2. Any draft Directive which is finally presented to the Council will be based on Article 99 of the Treaty, and must be adopted unanimously. The Commission's proposal for approximation of VAT rates (document 8200/87) places passenger transport in the lower band of VAT (4%-9%), and this too would require unanimous agreement.

3. As recently as 21/22 January, during discussions on the VAT Clearing System, the Commission indicated that they had not solved all the technical problems associated with taxing transport in the Member State of departure. The latest draft, which is currently in the hands of the Cockfield Cabinet, is said to have overcome the remaining difficulties. Ian Walton does not have full details yet, but broadly for international transport:

(a) all trips starting in one Member State and ending in another would be taxable in the Member State of departure;

(b) stop-overs and stops for refuelling, even if they occurred in a third country, would be ignored, ie the journey would still be regarded as a single supply taking place entirely in the Community;

(c) a trip starting in the Community and ending in a third country would be exempt from VAT - not yet clear whether input tax would be recoverable.

4. We will, of course, need to see the full text before deciding what problems might arise.

Heather Massie

H M MASSIE (MISS)
Private Secretary



*pse can you get this for me
from Press cutting?*

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

*I will be grateful
if you will examine
this memo closely.
M.
(It is with
certain details @
present)*

FROM : H M MASSIE
DATE : 4 February 1988

APS/CHANCELLOR

behind
X

VAT PASSENGER TRANSPORT

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MASSIE
→
APS/CHC
4/2

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4. We will, of course, need to see the full text before deciding what problems might arise.

Heather Massie

H M MASSIE (MISS)
Private Secretary

Euro-tax may put 15% on airline fares Holidaymakers will be the worst hit by VAT

By Harvey Elliott, Air Correspondent

Air fares within Europe could rise by up to 15 per cent after proposals by the European Commission to impose value-added tax on travel within the Community.

A detailed plan which would tax passengers flying anywhere within the EEC while exempting those travelling to countries outside the Community almost ready to be put formally to ministers.

Airline chiefs are preparing a campaign against the proposal to harmonize taxation and tariffs within Europe and to boost revenue going into the Community coffers.

Under EEC plans the new tax would be imposed from January 1, 1990.

EEC's taxation department in Brussels said last night: "We have already prepared a draft directive which is now under detailed examination within the Commission's special services department."

"There are still some difficult tactical problems to be overcome, but our intention is to put the draft directive to the full Council of Ministers as soon as possible."

The plan met with immediate hostile reaction from airlines.

Mr Peter Smith, managing director of International Leisure Group, whose airline, Air Europe, is mounting a new

British Airways said last night: "We have never believed that air transport should be subject to taxation because it is vital to intra-Community commerce and trade". The British Government is waiting for the EEC's

European scheduled network, said: "This would be absolutely insane."

"It would immediately place both passengers and airlines within Europe at a disadvantage and force travellers to fly to countries outside Europe. It would not help the EEC's finances at all and indeed would damage the economies of the countries involved."

The EEC is adamant that the tax will go ahead. "Our intention is to charge VAT on transport within the Community while giving aircraft flying beyond its borders an exemption".

Airlines and passenger consumer groups were told of the plan at a meeting last week in Geneva held by the International Air Transport Association (Iata).

An Iata spokesman said last night: "We are very apprehensive about the proposals but cannot take any positive action until the directive has been published in full."

"We have not yet been told exactly what percentage of VAT they will charge, for example, but we are having to assume that the EEC are going to put the squeeze on airlines."

"Certainly so far they are being very dogmatic and doctrinaire. If it goes ahead there is no doubt whatsoever that it would mean a sharp increase in air fares."

One of the worried delegates

at the Iata meeting was Mr Richard Botwood, of the Air Transport Users' Committee.

He said: "We believe that this proposal is wholly wrong. It would mean travel within Europe was penalized at the expense of travel outside the Community. We would certainly want to fight it."

"It has been put forward just at a time when we had begun to hope that the gradual liberalization of air services within Europe would lead to a reduction in fares, not an increase."

Initially VAT would be imposed at a rate between 4 and 9 per cent. However, when this is compounded with the probable increase in airport charges and the phasing out of duty-free sales within Europe, airlines predict that it could add about 15 per cent to the cost of an air ticket.

Those suffering most would be holidaymakers flying to Mediterranean resorts or passengers buying their own tickets. Businessmen would be able to reclaim the VAT.

European officials have long regarded travel as an anomaly within the tax laws. They claim that air transport should have been eligible for tax since the VAT directive of May 1977, but was allowed to remain zero-rated "only on a transitional basis".

The department within the EEC in Brussels responsible for the project also claims that it will result in "a valuable simplification and rationalization of the tax for passenger transport throughout the Community as a whole".

There are bound to be anomalies which will anger airlines. Anyone flying, for example, to Rome, will have to pay the VAT but someone

Calculating the VAT to be imposed on a journey with stops in Europe but ending in a non-EEC country will be even harder, with part of the ticket subject to the tax and part exempt.

Non-EEC airlines will be exempt too, yet some of them may be asked to levy VAT on any fares relating solely to a European sector of the journey.

When the draft directive is completed it will go before the Council of Ministers which will be pressed hard to approve it.

The European Regional Airlines Organization is to study the proposals at its full council meeting in Toulouse next month.

In a newsletter to members the organization says: "The seriousness of the VAT proposals dictate that ERA must do all possible to lessen their damaging effects."

TODAY

EEC set to slap 15% VAT on air fares

THE cost of travel in Europe could rise by up to 15 per cent under Common Market plans to put VAT on air fares.

The move will drive holidaymakers away from Continental destinations, say angry airline bosses.

They are launching a campaign to stop the plan.

Air Europe chief Peter Smith said: "This plan is absolutely insane."

"It would immediately place both passengers and airlines within Europe at a disadvantage and force travellers to fly to countries outside Europe."

Damage

Far from boosting EEC coffers, the tax would damage the economies of member countries, he added.

A delegate to the meeting of the International Air Trans-

was announced, said: "It would mean that travel within Europe was penalised at the expense of travel outside the Community."

Businessmen would be able to reclaim the VAT, but not holidaymakers.

NEWSPAPER
ARTICLES
30/1

ELJ JUDGEMENT
ON ZERO RATES:
OPTIONS FOR
DECISION.