001

Chlex minute 17/6/85 refers

now confidential

~~SECRET~~

Prime Minister

The Chancellor sees no difficulty in seeing off the Commission's proposals on tax harmonization.

But he advises against a row at the European Council, because this would simply ~~cause~~ rouse unnecessary parliamentary concern & attention

CDP 13/6

This line will present difficulties in the House! shall have to be more direct in answering question

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

FOREIGN SECRETARY

MILAN EUROPEAN COUNCIL: TAX HARMONISATION

The Commission's proposals on the internal market for the Milan European Council will include a paper on indirect tax harmonisation. As agreed at OD(E)(85)3rd meeting, I am writing to let you know how the Commission's expected proposals would affect our indirect tax arrangements and those of other Member States; and to set out my views on how we might aim to handle this issue at the European Council.

Likely content of Commission's proposals

2. Although we cannot be certain at this stage, it seems probable that the Commission will propose the gradual harmonisation of excise duty rates around a weighted average of the existing rates in the Ten. This would involve substantial changes in the level of most excise duties in nearly all Member States. The details are set out in the tables in Annex A below. For the UK there would be large reductions in most duties and this applies also in Ireland and Denmark; other Member States would have to impose large increases. Once harmonisation had been achieved, excise duties could not then be changed unilaterally except perhaps in a narrow range round the harmonised rates.

3. So far as VAT is concerned, the likelihood is that the Commission will propose a two-tier structure with a lower rate of around 5 per cent and a standard rate of either 16 per cent or 17 per cent. Arthur Cockfield has, however, hinted at some flexibility in his approach and he may propose a range of rates rather than single figures, eg. 2 per cent - 6 per cent for the reduced rate and 16 per cent - 18 per cent for the standard rate.

The reduced rate would generally cover the items presently zero-rated in the UK. Annex B shows that, as with excise duties, such a proposal would involve considerable changes in the VAT tax structure and rates in most Member States. Again, once harmonisation had been achieved, Member States would not be permitted to vary VAT rates outside the agreed bands.

Implications of Commission proposals for UK

4. The Commission's proposals are of course unacceptable to us. They would reduce our freedom to set our own tax rates. We could not accpet, and public opinion here would not accept, such a fundamental infringement of our sovereignty. Nor could we accept the loss of fiscal room for manoeuvre. Moreover, the implications for our tax structure are extremely unattractive. We believe in gradually shifting the burden of tax from direct to indirect taxation. But the Commission's proposals, while they would increase VAT revenue by some £4 billion, would also reduce revenue from excise duties by about the same amount. Our ability to increase indirect taxation in the long term would inevitably be constrained by such a huge loss in excise duty revenue. And the large reductions in alcohol and tobacco duties would be fiercely opposed by the health lobbies.

Attitude of other member states

5. The Commission's proposals will cause equal if not greater difficulty for a majority of other Member States. Annex C below summarises the main consequences of the Commission proposals for other Member States. The most striking features are:

- the major upheavals in the direct/indirect tax structures in Luxembourg, Denmark and Ireland, with the last two of these having to make good huge revenue losses;

- large increases in beer duty in Belgium, Germany and the Netherlands;

- the introduction of duty on all wines in Greece and Italy, on home-produced wines in Luxembourg and on table wines in Germany and (a dramatic increase) in France;

- increases in tobacco duty in the three major tobacco producers - France, Italy and Greece.

Taking these consequences for other member states, the Commission's proposals are unlikely to have any more chance of making headway than on previous occasions in the past once they get into the formal Council machinery and a detailed discussion starts at expert level.

6. What is less certain, however, is whether, apart from Denmark and Greece, other Heads of Government will be prepared to voice their objections at Milan. It is worth noting that the recent agreement between France, Germany and the benelux countries on the reduction of frontier controls of persons apparently contains an Article 26, which commits the parties to explore the possibilities for harmonisation of indirect taxes and to that end supporting any proposals the Commission may make. This is despite the fact that the Benelux countries are known to have strong objections to the substance of the Commission's proposal. It is therefore possible that at Milan a number of countries may be willing to subscribe to tax harmonisation in fairly general terms as a long-run goal for the Community (cf. the EMU), while privately intending to ensure that little or no practical progress is made in that direction.

Tactics

7. Although the Commission's tax approximation proposals will

be unacceptable to us they form part of the wider package on the completion of the internal market, which we know the Commission will be asking the European Council to endorse at Milan. We are agreed that it is in the UK's interest to make progress on the latter, in particular in such areas as non-life insurance and harmonisation of industrial standards; and I know from our discussion at OD(E) that you are concerned that we should not allow other member states to make our opposition to tax harmonisation an excuse for blocking work on these other aspects of the internal market.

8. My own view is that in any case it could be both unnecessary and counter-productive for us to get out in the lead in refusing even any discussion of the Commission's proposals. Unnecessary, because neither the Commission nor other member states can be in any doubt from the last European Council and from subsequent contacts of our opposition on the substance of the issues. Counter-productive, because to have a major argument over the proposals at Milan would give them more publicity than they deserve and unnecessarily focus Parliamentary attention on the future handling of them. Moreover we should aim to force other Member States into the open and not allow them to shelter behind our opposition.

9. I accordingly suggest the following line of approach. First, in the run-up to Milan we should continue our efforts to persuade the Commission to separate their tax harmonisation proposals from the rest of the internal market package and to put them into "Green Paper" form, preferably without any targetry or calendar.

10. Second, at Milan itself we should work for the Commission's proposals simply to be remitted to the ECOFIN Council for a detailed study of the possibilities for tax harmonisation and of its costs and benefits. Such a study would need to cover not only the details of how tax harmonisation might work, but also wider issues, such

as:

- whether alignment of tax rates is necessary for the abolition of fiscal frontiers;

- whether present differences in tax rates seriously hamper intra-Community trade;

- whether the implications for fiscal and economic management in Member States are acceptable;

- the social and industrial consequences.

It would, of course, have to be clear that this study was undertaken on a no-commitment basis. We could not, for example, go along with 1992 or any other target date for removing fiscal frontiers and harmonising tax rates. We would, if necessary, have to make it clear that these were unrealistic.

11. I believe that this tactic will lead eventually to the defeat of the Commission's initiative, since the study would bring home the major difficulties it would create for all Member States. But it would achieve this without our incurring the odium of taking the lead in opposition, and without imperilling our other objectives in the Community.

12. If you and other copy recipients of this minute agree, my officials will work up briefing along these lines for the European Council.

13. I am sending copies of this minute to the Prime Minister and other members of OD(E) and to Sir Robert Armstrong.

NL.

N.L.

12 June 1985

ANNEX A

EFFECT OF HARMONISATION ON EXCISE DUTIES IN MEMBER STATES BY COUNTRY

1. Belgium

2. Denmark

3. France

4. Germany

5. Greece

6. Ireland

7. Italy

8. Luxembourg

9. Netherlands

10. United Kingdom

Notes

1. This analysis is based on figures contained in the Commission working paper "Suppression des Frontieres Fiscales", Feb 1985. These figures were based on 1982 data.

2. The figures for changes in revenue as a percentage of GNP assume zero price elasticities. In practice, the effects would be smaller, the higher the price elasticities.

1 **BELGIUM**

	% change in duty	Change in revenue as % GNP
Beer	+117	+0.16
Wine	- 48	-0.03
Spirits	+ 51	+0.10
Tobacco	+ 29	+0.18
Petrol	+ 9	) +0.19
Derv	+ 51	)
Total		+0.60

Belgium would have to increase all its main duties except for wine. However, the reduction in wine duties would have only a small effect on revenue. Duty increases of over 50% will be required for beer and spirits and derv. Beer is as popular in Belgium as in the UK.

2 DENMARK

	% change in duty	Change in revenue as % GNP
Beer	- 48	-0.20
Wine	- 86	-0.13
Spirits	- 47	-0.16
Tobacco	- 52	-0.59
Petrol	+ 2	) +0.16
Derv	+176	)
Total		-0.92

Denmark would be affected similarly to us as far as duties are concerned, except in the case of <u>derv</u>, which Denmark would have to increase substantially. Duties on alcoholic drinks, especially <u>spirits</u>, and <u>tobacco</u>, would have to be reduced. The reduction in <u>tobacco</u> duty appears to have serious revenue consequences.

3 FRANCE

	% change in duty	Change in revenue as % GNP
Beer	+445	+0.07
Wine	+229	+0.09
Spirits	- 7	-0.02
Tobacco	+ 87	+0.27
Petrol	+ 1	) -0.01
Derv	- 10	)
Total		+0.40

France would have to make major increases in beer, wine and tobacco duties. The increase in wine duty would not be popular with the producers and the increase in tobacco duty could also prove difficult in view of the amount of revenue it will raise [and of the close links between the state and the industry].

4 GERMANY

	% change in duty	Change in revenue as % GNP
Beer	+223	+0.18
Wine	- 24	-0.01
Spirits	+ 5	+0.01
Tobacco	- 20	-0.15
Petrol	+ 18	) +0.07
Derv	- 34	)
Total		+0.10

The only major change required by Germany would be a massive increase in beer duty, which could cause difficulties, given the German taste for beer. (Germany is reported to have the highest per caput beer consumption in the world). Germany does not charge duty on table wine but has a relatively high charge on fortified wine - hence the apparently modest change required for harmonisation shown in the table in fact disguises much more dramatic changes in the duty structure.

5 GREECE

	% change in duty	Change in revenue as % GNP
Beer	- 12	-0.02
Wine		+0.15
Spirits	+2578	+0.60
Tobacco	+ 135	+1.35
Petrol	- 35	) -0.39
Derv	+ 299	)
Total		+1.69

The required increases in duty on wine and spirits would be enormous: Greece currently has no duty on wine. The increase in tobacco duty could also prove difficult given the revenue implications.

6 IRELAND

	% change in duty	Change in revenue as % GNP
Beer	-76	-1.34
Wine	-94	-0.18
Spirits	-63	-0.65
Tobacco	-20	-0.35
Petrol	- 2	) -0.18
Derv	-36	)
Total		-2.70

The effect on Ireland will be similar to that on us, larger reductions being required in the duties on alcoholic drinks, and lesser, but still significant reductions in duties on tobacco and derv.

7 **ITALY**

	% change in duty	Change in revenue as % GNP
Beer	+ 68	+0.03
Wine		+0.19
Spirits	+384	+0.29
Tobacco	+ 52	+0.36
Petrol	- 25	) -0.02
Derv	+886	)
Total		+0.85

Italy would have to increase duties on all except petrol. The massive increase in derv duty seems to be balanced out in revenue terms against the reduction in petrol. Therefore, the main problem for Italy would probably be on the alcoholic drinks. Italy has no duty on wine and the increases in duty on spirits is particularly high. The increase in tobacco duty could also prove difficult given the apparently high amount of revenue it will yield.

8 LUXEMBOURG

	% change in duty	Change in revenue as % GNP
Beer	+125	+0.15
Wine	- 33	-0.03
Spirits	+825	+0.96
Tobacco	+ 82	+1.86
Petrol	+ 21	) +0.81
Derv	+131	)
Total		+3.75

Luxembourg would have to increase all the duties except wine. The increases in spirits, beer and tobacco duties look likely to prove the most difficult, but as Luxembourg-produced wine is not currently taxed, the wine changes could also lead to serious political difficulties.

9 **NETHERLANDS**

	% change in duty	Change in revenue as % GNP
Beer	+22	+0.03
Wine	-66	-0.04
Spirits	+14	+0.04
Tobacco	+21	+0.12
Petrol	+24	) +0.26
Derv	+76	)
Total		+0.41

The increases in petrol and derv seem to be the only likely source of difficulty for the Netherlands.

0 UNITED KINGDOM

	% change in duty	Change in revenue as % GNP
Beer	-56	-0.30
Wine	-94	-0.20
Spirits	-53	-0.25
Tobacco	-36	-0.46
Petrol	0	0
Derv	-50	-0.16
Total		-1.37

The United Kingdom would be faced with large reductions in all the excise duties except the duty on petrol. The total revenue loss would be nearly £4 billion.

ANNEX B

RATES OF VALUE ADDED TAX IN FORCE IN MEMBER STATES ON 1 MARCH 1985

	Standard rate	Increased luxury or higher rate	Reduced rate	Coverage of zero rating
United Kingdom	15%	-	-	Wide variety of goods and services
Belgium	19%	25%, 33%	6%, 17%	Minimal
Denmark	22%	-	-	Minimal
Germany	14%	-	7%	-
France	18.6%	$33^1/_3$%	5.5%, 7%	-
Ireland	23%	-	10%	Wide variety of goods and services
Italy	18%	38%	2%, 9%	Minimal
Luxembourg	12%	-	3%, 6%	-
Netherlands	19%	-	5%	-

Notes

1. Exports from all the above countries are generally zero-rated.

2. Greece at present has no VAT.

ANNEX C

EFFECT OF HARMONISATION ON OTHER MEMBER STATES

1. To examine the effect of harmonisation on other Member States, we have had to rely on analysis provided by the Commission based on 1982 figures. Changes may have occurred since then so this must only be taken as a broad guide to the likely effects.

2. So far as the overall revenue effects of harmonisation are concerned, the analysis shows that harmonisation of excise duties and VAT is likely to be roughly revenue neutral for the Netherlands (as well as the UK). Four countries - Belgium, Denmark, France and Ireland - will have to reduce their indirect taxation while three countries - Germany, Italy and in Luxembourg - will have to increase it. (Figures for Greece not provided.) The effects are greatest in Luxembourg, Denmark and Ireland where the changes would amount to major upheavals in their direct/indirect tax structures. Countries which rely heavily on such taxes will have the particular problem that they will lose control over a major revenue-raising instrument (quite apart from the effect on revenue receipts).

3. On the excise duties side, five countries will have to make increases - probably six if full details were available for Greece. The main points to emerge are:

- <u>Beer</u> duty would rise in six countries, the traditional beer drinking countries (Belgium, Germany and the Netherlands) being particularly affected. Like us, Denmark and Ireland would have to reduce beer duty significantly.

- Duty on all <u>wines</u> would have to be introduced in Greece and Italy, and for table wine in Germany. A dramatic increase would be necessary in France. Germany would have to reduce its fortified wine duty, and the other six countries would have to reduce their duties. Again, Denmark and Ireland face a similar situation to us.

- Spirits duty would have to rise in six countries, Greece, Italy and Luxembourg being particularly affected. Once again, like us, Denmark and Ireland would have to make large reductions.

- Tobacco duty would rise in six countries; France, Greece, Italy and Luxembourg being particularly affected. Only Denmark would have to make a larger reduction than us.

- Petrol duty could be harmonised most easily, no country having to adjust the duty by more than one third. Germany, Luxembourg and the Netherlands would have to make the largest increases; Greece and Italy making the largest reductions.

- Derv duty would be more difficult to harmonise. Denmark, Italy and Luxembourg would have to make the largest increases. We would have to make the largest reduction but Germany and Ireland would also have to make large reductions.

4. On the VAT side, three countries besides us would have to increase their revenue from VAT - Germany, Luxembourg and Italy, Luxembourg being the most affected. France and Denmark would suffer the largest reductions. However, these results are based on the assumption that there would be a single rate of 13 per cent. In practice, we expected there to be two rates; a standard rate of around 17 per cent and a reduced rate of around 5 per cent. On this basis, harmonising the standard rates would most affect Denmark and Ireland, with standard rates exceeding 20 per cent, and Luxembourg, with a standard rate of only 12 per cent. All other countries except Denmark already operate non-zero reduced rates but only Ireland has an extensive coverage of zero-rates.

5. These upheavals would have serious industrial consequences

in many cases, with corresponding political, social and economic problems. Although we have neither the time nor the information to attempt a full survey, some examples serve to give a flavour of the difficulties involved.

- Those wine-producing countries which would have either to introduce or to increase substantially duties on wine would face major economic, social and political problems. The effect would be to depress wine consumption, particularly of low quality wine. Other things being equal, this will increase the Community's wine lake and the cost to the Community Budget of disposing of it. It will also call into question the viability of many wine growing areas, most of them situated in the poorest and politically more volatile regions, so that there will undoubtedly also be pressure on the Community's Guidance Section funds to relieve the worst effects of harmonisation. Also, there would be serious control difficulties in applying a new or increased duty to (probably) hundreds of thousands of producers, and costly administrative structures would be required.

- Similar considerations apply in the case of Community tobacco, where tax changes could reinforce a shift in consumer tastes away from dark tobaccos. Since the pace of change would largely be outside the agricultural lobbies' control, there would be serious difficulties in the tobacco-growing regions of France, Italy and Greece. Larger quantities of low-quality tobacco would have to be disposed of under subsidy from the Community Budget and there would be calls for increased Guidance Section expenditure to support the incomes of the producers in question.

These large-scale problems could be repeated in microcosm, in particular industrial and commercial sectors all over the community, wherever major tax changes threatened significant and uncontrolled shifts in the market. Whether large or small, difficulties of this nature are likely to mobilise local political forces and to lead to a variety of conflicting pressures on EC governments.

6. To summarise, the major difficulties for each State are likely to be as follows:

<u>Belgium</u>:	Increases in beer duty
<u>Denmark</u>:	Big loss of revenue
<u>France</u>:	Large increases in wine duty
<u>Germany</u>:	Introduction of wine duty; increases in beer duty
<u>Greece</u>:	Introduction of wine duty; large increases in spirits and tobacco duties
<u>Ireland</u>:	Big loss of revenue; ending of VAT zero-rates
<u>Italy</u>:	Introduction of wine duty
<u>Luxembourg</u>:	Large increases in excise duties and VAT
<u>Netherlands</u>:	Increases in petrol and derv duties

Euro Council Milan

SECRET

cc FCO
DTI
MAFF
LOD
M/S, FCO
PC.

VC

1

10 DOWNING STREET bc

From the Private Secretary

14 June 1985

Dear Rachel,

MILAN EUROPEAN COUNCIL: TAX HARMONISATION

The Prime Minister has noted the Chancellor's minute of 12 June in which he recommends that we should avoid a major argument at the Milan European Council over the Commission's proposals for indirect tax harmonisation.

The Prime Minister has commented that the line proposed by the Chancellor risks putting the Government in difficulty in the House; and that she would have no option there but to be sharply critical of the expected Commission proposals.

I am copying this letter to the Private Secreraries to the members of OD(E) and to Richard Hatfield (Cabinet Office).

Yours sincerely,

Charles Powell

C.D. POWELL

Mrs Rachel Lomax,
HM Treasury.

SECRET