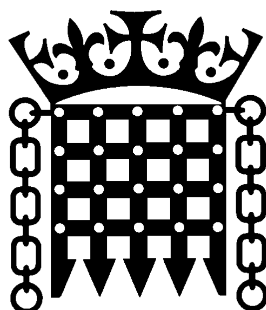
VAT Harmonisation

Research Paper 97/31

27 February 1997



The harmonisation of VAT across the Member States of the European Union has been recognised for some time as an integral part of the creation of the Single European Market. Nonetheless, the process has been controversial, no more so than in this country, as many have argued harmonisation will result in the abolition of the UK's zero rates of VAT on items such as food and children's clothing. This paper gives a short history of VAT harmonisation, before summarising the current state of play in this area, focusing on the UK's ability to retain the use of its zero rates. It concludes with a discussion of whether the UK could be forced to abandon zero-rating, by the Commission taking this country to the European Court of Justice. Particular mention is made of the UK's discretion in charging VAT on domestic supplies of fuel and power. A summary of the current rules governing Member States' VAT rates is attached as an appendix.

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Summary

The harmonisation of indirect taxes - of both Value Added Tax (VAT) and excise duties - has been seen for some time as integral to the creation of the Single European Market. Though the first steps toward harmonising the VAT systems of Member States were taken in the late 1960s, it was the sixth EC VAT directive (77/388/EEC), adopted on 17 May 1977, which marked a turning point in establishing common rules for VAT in each country. In effect, Member States agreed on common criteria for the VAT base, specifying those goods and services which could be exempted from tax.

Agreement on harmonising the rates of VAT was not reached until June 1991, and incorporated in directive 92/77/EEC of 19 October 1992, which amended the sixth VAT directive accordingly. In brief, all Member States:

- must apply a standard VAT rate of 15% or more from 1 January 1993.

- have the option of applying one or two reduced rates, no lower than 5% to certain specified goods, as listed in Annex H of the directive.

- are able to continue charging any lower rates, including zero rates, that had been in place on 1 January 1991 for the duration of the "transitional period".

Initially it was intended that the "transitional period" would come to an end on 31 December 1996, with the inception of a definitive VAT system. The process has been subject to considerable delay. Indeed, no specific legislative proposals for a definitive system have yet been made by the Commission. In the absence of any new agreement, the arrangements described above may continued indefinitely.

The most recent development has been the publication of a 'communication' by the Commission in July 1996 (COM(96)328 final), proposing that legislative proposals be brought to the Council over the next four years. It should be emphasised that this document does ***not*** make any specific recommendations and, at present, there is ***no*** requirement under EU law to oblige the UK to get rid of any of its zero rates of VAT by a given date.

That said, the Commission foresees one of the elements in a definitive VAT system to be a substantial degree of harmonisation both in tax rates and in the tax base. This may have encouraged some commentators to suggest the UK will have to abolish some, or all, of its zero rates - such as those on food or on children's clothing. As Philip Oppenheim, Exchequer Secretary, noted in a recent written answer: "the European Commission aspires more generally to further harmonisation of VAT rates as part of its suggested programme for a common system of VAT. But there are no legislative proposals on rates on the table and the UK's zero rates - including that for food - are fully safeguarded under existing EC agreements."[1]

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[1] HC Deb 13.2.97 c.314W

I. VAT - an introduction

The decision to introduce VAT in the UK was publicly announced by the then Chancellor, Anthony Barber, in his Budget speech on 30 March 1971. Following consultation, a White Paper on the new tax was published in March the following year,[2] and the principal provisions relating to the tax were contained in the *Finance Act 1972*. The tax came into operation on 1 April 1973, replacing purchase tax and selective employment tax.

VAT is charged on the supply of all goods and services made in the course of a business by a taxable person, unless they are specifically exempt from tax. VAT is charged at the standard rate, which is currently 17½%, or at the zero rate.[3] The tax is levied on the additional value of each transaction, and is collected at each stage of production and distribution. A business pays VAT on its purchases - known as input tax, and charges VAT on its sales - known as output tax. It will settle up with HM Customs and Excise for the difference between the two. In the end the cost of the tax is borne by the final consumer. All businesses must register for VAT if their turnover of taxable goods and/or services is above a given threshold. The registration threshold is £48,000 at present.[4]

It is worth emphasising the difference between supplies which are exempt from VAT, and those that are charged a zero rate. Supplies which are zero-rated are technically taxable, though no actual tax is paid on them. They count as part of the taxable turnover of a business for registration purposes, and VAT charged on inputs related to zero-rated activities can be reclaimed. This is not the case with exempt supplies, which are outside the tax system. Businesses which make exempt supplies do not charge output tax, and cannot reclaim input tax. In effect, a business making exempt supplies has to absorb the VAT charged it by its suppliers. At present VAT applies to about 60 per cent of consumer expenditure on goods and services in this country.[5] Receipts from the tax were £43.1 billion in 1995-96, accounting for about 16% of general government receipts in that year. By way of comparison, receipts from income tax accounted for about 25% of government receipts for the same period.[6]

VAT was first introduced in the UK at a single standard rate of 10%. The Labour Government reduced it to 8% on 29 July 1974. For reasons of energy conservation, petrol was taxed at a higher rate of 25% from 18 November 1974, and a 'luxury' rate of 25% was introduced on 1 May 1975. In addition to petrol, this applied to most domestic electrical appliances; radios, television sets and hifi equipment; boats, aircraft and caravans; cameras and binoculars; as well as to furs and jewellery. This higher rate was reduced to 12½% as from 1 April 1976. A single standard rate of 15% was introduced on 18 June 1979, which was increased to 17½% on 1 April 1991. A reduced rate of 8% was introduced on domestic

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[2] *Value Added Tax* Cmnd 4929 March 1972

[3] The one exception is the supply of domestic fuel & power charged a reduced rate of 8% since 1 April 1994.

[4] With effect from 27 November 1996.

[5] HC Deb 13.2.97 c.313W

[6] *Financial Statement & Budget Report 1997-98* HC 90 November 1996 p.68

supplies of fuel and power on 1 April 1994; this remains the only reduced rate charged in this country. These changes are summarised in the table below.

Date of Change	Reduced Rate %	Standard Rate %	Higher Rate %
1 April 1973	-	10	-
29 August 1974	-	8	-
18 November 1974	-	8	25 (petrol only)
1 May 1975	-	8	25
12 April 1976	-	8	12½
18 June 1979	-	15	-
1 April 1991	-	17½	-
1 April 1994	8	17½	-

The major changes made to VATable items since 1973 are listed below. Most changes have been small, detailed ones, often applying just to charities.

March 1973 Budget
1. Zero rate on childrens clothing and footwear
2. Zero rate on ice cream, sweets, soft drinks and crisps etc[7]

March 1974 Budget
1. Standard rate on ice cream, sweets, soft drinks and crisps etc

November 1974 Budget
1. Higher rate of 25% on petrol

March 1975 Budget
1. Higher rate of 25% on domestic appliances; radios, TV and hifi equipment; boats and aircraft; caravans; cameras and binoculars; furs and jewellery.

April 1976 Budget
1. Higher rate cut from 25% to 12½%

[7] Both supplies were to have been standard-rated under the original legislation.

March 1979 Budget

1. Higher rate of 12½% abolished & all goods subject to the standard rate
   - standard rate increased from 8% to 15%

March 1982 Budget

1. Zero rate on supplies of building alterations - eg, double glazing, loft insulation, damp-proofing

March 1984 Budget

1. Standard rate on hot takeaway food and drink
2. Standard rate on alterations to buildings and civil engineering works

March 1985 Budget

1. Standard rate on newspaper advertisements

March 1988 Budget

1. Standard rate on cereal bars

March 1989 Budget

1. Standard rate on non-residential construction & property development
2. Standard rate on news services
3. Standard rate on certain protective boots and helmets
4. Standard rate on fuel and power supplied to businesses
5. Standard rate on water and sewerage services supplied to industry[8]
6. Certain reliefs for charities

March 1990 Budget

1. Certain reliefs for charities

March 1991 Budget

1. Standard rate of VAT raised from 15% to 17½%
2. Reliefs for charities

March 1992 Budget

1. Reliefs for charities and handicapped persons

March 1993 Budget

1. VAT at 8% on domestic fuel and power - came into effect in 1994

November 1994 Budget

1. Second hand goods - extension of margin scheme & new 2.5% rate on art imports
2. Passenger transport - clarification of zero-rating

November 1996 Budget

1. Reliefs for charities (donated goods & zero-rated purchases) tightened

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[8] Items 4 & 5 came into effect in 1990, but were announced at time of 1989 Budget.

The table below shows those categories which are zero-rated at present, and the estimated revenue cost of zero-rating these items, rather than charging the standard rate:[9]

Value-Added Tax[10]

Zero rating of :	**1995-96**	**1996-97**
	£ million	
Food	7400	7550
Construction of new dwellings[11]	2150	2200
Domestic passenger transport	1350	1450
International passenger transport	1150	1200
Books, newspapers and magazines	1150	1200
Children's clothing	750	800
Water and sewerage services	900	900
Drugs and medicines on prescription	700	750
Supplies to charities[12]	200	200
Ships and aircrafts above a certain size	450	450
Vehicles and other supplies to disabled people[13]	200	200
Lower rate on domestic fuel and power[14]	1350	1350

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9 HM Treasury, *Tax Ready Reckoner & Tax Reliefs*, July 1996 p.11

10 Of these tax expenditures and reliefs, some are mandatory or permitted under the EC 6th VAT Directive and some are derogations from the Directive.

11 These figures are particularly tentative and subject to a wide margin of error.

12 Costs exclude zero-rating of items appearing higher in the list and reduced rate on domestic fuel and power.

13 Costs exclude zero-rating of items appearing higher in the list and reduced rate on domestic fuel and power.

14 An estimate of the cost of the difference between the standard rate of VAT and the rate of 8 per cent introduced in April 1994.
The total revenue raised from VAT on domestic fuel and power is estimated to be £1,100 million for 1995-96 [HC Deb 13.2.97 c.313W].

II. Harmonising VAT - the first steps (1973 - 1977)

There is a striking contrast between the harmonisation of tax law across Member States for direct taxes and for indirect taxes. Tax harmonisation in the direct sphere is very limited. In general, the Treaty of Rome does not cover direct taxation, though under Article 92, which deals with EC rules on competition, the Commission is given a limited authority to consider the taxation of business. However, harmonisation of indirect taxes has been seen for some time as vital to the creation of a Single European Market, as the Treaty of Rome recognises.

Article 99 of the Treaty states that "the Council shall, acting unanimously on a proposal from the Commission ... adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market." To date, the harmonisation of VAT has proceeded furthest, partly because VAT is central to the operation of a single market, partly no doubt for the fact that the duty rates on alcohol, tobacco and mineral oils vary considerably across the EU, reflecting differing national priorities.

Though the first steps toward harmonising the VAT systems of Member States were taken in the late 1960s, it was the **sixth** EC VAT directive (77/388/EEC), adopted on 17 May 1977, which marked a turning point in establishing common rules for VAT in each Member State. In effect, Member States agreed on common criteria for the VAT base. Article 13 of the sixth directive lists those goods and services which must be exempt from VAT. The UK, just like other Member States, cannot alter this list of exempt supplies; it could only be amended by a subsequent EC directive.

The current UK law is contained in the *VAT Act 1994*; schedule 9 to the Act lists exempt supplies, under a series of categories, namely,

- Land
- Insurance
- Postal services
- Betting, gaming and lotteries
- Finance
- Education
- Health and welfare
- Burial and cremation
- Trade unions and professional bodies
- Sports competitions
- Works of art, etc
- Fund raising events by charities and other qualifying bodies

Estimates of the cost of exempting these supplies are given below:[15]

Exemption of:[16]	**1995-96**	**1996-97**
	£ million	
Rent on domestic dwellings[17]	2850	3000
Rent on commercial properties	1300	1300
Private education	1000	1050
Health services	400	450
Postal services	400	450
Burial and cremation	100	100
Finance and insurance[18]	50	50
Betting and gaming and lottery[19]	650	700
Small traders	100	100

Though the sixth VAT directive dealt with just the VAT base, rather than the rates of VAT charged, it did have implications for the UK's zero rates of VAT. Article 28(2) of the sixth directive allowed Member States to maintain "reduced rates and exemptions ... which are in force on 31 December 1975 and which satisfy the conditions stated in the last indent of Article 17 of the second council directive of 11 April 1967". Article 17 refers only to exemptions maintained for "clearly defined social reasons and for the benefit of the final consumer."[20]

As a result the UK was allowed to continue to charge its zero rates of VAT, under these criteria. Of course, all Member States are governed by these directives on decisions they take on the scope of VAT, and - under the terms of later amendments to the sixth directive - on decisions taken about their VAT rates. That said, only the UK and Ireland now use a zero rate of VAT to any significant degree. Details of the VAT rates charged in other Member States on those supplies which are generally zero-rated in the UK were given in a recent written answer, reproduced overleaf:[21]

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15 HM Treasury, *Tax Ready Reckoner & Tax Reliefs*, July 1996 p.13. Of these tax expenditures and reliefs, some are mandatory or permitted under the EC 6th VAT Directive and some are derogations from the Directive.

16 The estimates shown are net of any revenue loss that might arise from removing VAT exemption. Where an exempt trader provides goods or services to registered traders whose output is standard rated, there is likely to be some revenue gain to the Exchequer from the exemption. The taxable supply of the registered trader is likely implicitly to include an element in respect of the value-added tax by the exempt trader and this element will be liable to VAT.

17 These figures are particularly tentative and subject to a wide margin of error.

18 The estimate includes an element for the indirect charges financial institutions make to their customers through charging higher interest rates to borrowers and paying lower rates to lenders; in practice identifying such indirect charges for VAT purposes would be extremely difficult. Because of the large volume of transactions between these sectors, the sum of individual estimates will differ from the joint estimate provided here.

19 Although most betting and gaming are exempt from VAT, £1.6 billion was raised from betting, gaming and lottery duties in 1995-96 and it is estimated that £1.7 billion will be raised in 1996-97.

20 Article 17 envisages these exemptions will come to an end when fiscal frontiers between Member States come to an end: ie, when "the charging of tax on imports and the remission of tax on exports in trade between the Member States are abolished" - technically speaking, a move from a destination system to an origin system (the distinction is discussed in more detail below).

21 HC Deb 15.10.96 cc 834-836W

Mr. Spearing: To ask the Chancellor of the Exchequer if he will publish a table showing for each member state of the European Community the rates levied by value added tax on food in shops, household fuel, children's clothing, books, newspapers and magazines, public transport, water and sewage services, newly constructed homes, second-hand homes and the standard of tax most recently adopted; when the current VAT agreement expires; and what remunerations have been received from the Commission concerning its services or continuation for any stated period.

Mr. Oppenheim *[holding answer 14 October 1996]:* The information about VAT rates is set out in the table. The current EC VAT agreement (the sixth VAT directive), and so the provisions governing the VAT rates detailed in the table, have no expiry date. In the absence of any unanimous agreement upon 'definitive' VAT regime, the existing provisions continue to apply automatically and without time limit.

VAT rates on various goods and services in the EC

Percentage rate of VAT

Member state	*Foods in shops*	*Household fuel*	*Children's clothing*	*Books*	*Newspaper and magazines*	*Public transport*	*Water and sewage supplies*	*Homes*		*Standard rate*
								New	*Second-hand*	
Austria	10	20	20	10	10	10	20	20	Exempt	20
Belgium	6	[1]21	21	6	6	6	[2]21	12	Exempt	21
Denmark	25	25	25	25	[3]25	[4]Exempt	[5]Exempt	25	Exempt	25
Finland	17	22	22	12	22	6	22	22	Exempt	22
France	[6]5.5	20.6	20.6	5.5	2.1	5.5	[7]20.6	20.6	Exempt	20.6
Germany	7	15	15	7	7	[8]15	[9]15	Exempt	Exempt	15
Greece	8	18	18	4	4	8	[10]18	18	Exempt	18
Ireland	[11]0	12.5	0	0	12.5	Exempt	21	12.5	Exempt	21
Italy	[12]10	[13]10	16	4	4	[14]10	19	[15]19	19	19
Luxembourg	3	[16]12	3	3	3	15	15	Exempt	Exempt	15
Netherlands	6	17.5	17.5	6	6	6	[17]17.5	17.5	Exempt	17.5
Portugal	[18]17	[19]17	17	5	5	5	[20]17	[21]Exempt	Exempt	17
Spain	[22]7	16	16	4	4	7	7	16	Exempt	16
Sweden	12	25	25	25	6	12	25	25	Exempt	25
UK	[23]0	8	0	0	0	0	0	0	Exempt	17.5

[1] A reduced rate of 12 per cent. applies to coal and peat.
[2] A reduced rate of 6 per cent. applies to the supply of water.
[3] A zero rate applies to magazines.
[4] Transport on regular services is exempt, but on chartered buses is taxable at 25 per cent.
[5] Exemption only applies to water in connection with the letting of a house or premise; otherwise the standard rate of 25 per cent. applies.
[6] Sweets, chocolate, margarine and vegetable fat are subject to the standard rate of 20.6 per cent.
[7] A reduced rate of 5.5 per cent. applies to sewage services.
[8] A reduced rate of 7 per cent. applies to transport which takes place within a town or where the distance does not exceed 50 km.
[9] A reduced rate of 7 per cent. applies to supplies of water.
[10] A reduced rate of 8 per cent. applies to sewage services.
[11] Chocolates, sweets, biscuits etc. are taxable at 12.5 per cent.
[12] A reduced rate of 4 per cent. applies to basic foodstuffs such as bread and pasta; a rate of 16 per cent. applies to items such as lobsters and oysters.
[13] A 16 per cent. rate applies to coal.
[14] Transport between towns which are less than 50 km apart is exempt.
[15] A reduced rate of 4 per cent. applies to certain social housing.
[16] A 12 per cent. rate applies to wood, oil and coal.
[17] A reduced rate of 6 per cent. applies to the supply of water.
[18] A reduced rate of 12 per cent. applies to unprepared foodstuffs.
[19] A reduced rate of 5 per cent. applies to electricity and oil.
[20] A reduced rate of 5 per cent. applies to the supply of water.
[21] A reduced rate of 5 per cent. applies to certain constructions of housing by building co-operatives.
[22] A reduced rate of 4 per cent. applies to certain basic foodstuffs.
[23] The standard rate of 17.5 per cent. applies to confectionery, crisps, ice cream, chocolate etc.

In June 1988, the European Court of Justice (ECJ) found that certain zero-rated supplies in the UK were not being made for "clearly defined social reasons and for the benefit of the final consumer", including a number of supplies made to industry, such as sewerage, water, civil construction, and fuel and power. The UK was required to bring in amending legislation - included in the *Finance Act 1989* - so that these supplies became standard-rated on 1 July 1990.[22] A good summary of the case was given in a long written answer in October 1993:[23]

Mr. Spearing: To ask the Chancellor of the Exchequer under which paragraphs of treaty articles and consequential directives obligations are placed on Her Majesty's Government to make VAT charges in respect of *(a)* building repairs, (*b*) items of safety equipment hitherto exempt and (*c*) non-domestic building and civil engineering projects; in each case what communications he received from the Commission or the European Court in relation to these or similar obligations; and in what manner the purport of each communication was reported to Parliament.

Sir John Cope: Article 99 of the treaty of Rome (treaty establishing the European Economic Community) allows for the EC Council of Ministers to adopt provisions for the harmonisation of legislation concerning VAT and other indirect taxes. The sixth Council VAT directive (77/388/EEC), which was adopted in accordance with this article, provides the framework for the application of VAT in all EC member states, including the United Kingdom's zero rates. The vires for the retention of the United Kingdom's zero rates of VAT are contained in article 28.2 of the EC sixth VAT directive, which refers to article 17, last indent of the EC second VAT directive (67/228/EEC). This states: "Such measures may only be taken for clearly defined social reasons and for the benefit of the final consumer". The European Commission began infraction proceedings against the United Kingdom in 1981 alleging that some of the United Kingdom's zero rates did not comply with these conditions. The European Court of Justice supported the Commission where the supplies were made to businesses, but rejected the Commission's argument where the supplies were made direct to individuals. Item (a) Building repairs have never been subject to the zero rate, and their taxation was not affected by the result of this judgment.

For items (b) and (c) listed above the correspondence between the Commission/European Court of Justice and the United Kingdom on this matter is as follows:

19 October 1981:
the Commission informed the United Kingdom that its zero rates did not in its opinion conform to the provisions of the EC sixth VAT directive under the provisions of article 169 of the treaty of Rome;

25 February 1982:
the United Kingdom defended its zero rates in a letter to the Commission;

4 September 1984:
the Commission sent a reasoned opinion to the United Kingdom;

2 December 1987:
the Advocate General's opinion was published on the case; and

21 June 1988:
the Court issued its judgment.

Pleadings in infraction proceedings are strictly confidential to the parties in dispute. This point was discussed by the then Secretary of State for Employment, Lord Young of Graffham, in response to a question from Lord Stoddart of Swindon in October 1986, *Official Report, House of Lords,* 16 October 1986, columns *910-13*.

The content of the judgment itself was communicated to Parliament in a speech made by the then Economic Secretary to the Treasury, the right hon. Member for St. Albans (Mr. Lilley), on the date of the judgment, *Official Report,* 21 June 1988, columns 969-87.

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22 Notably, the Court found that the supply of fuel and power to **domestic** customers satisfied the criteria set out in the sixth directive, and, as a consequence, the UK was able to continue to charge a zero rate of VAT on these supplies.

23 HC Deb 18.10.93 cc 6-7W

III. The Single Market & harmonisation (1977 - 1992)

At present VAT is levied throughout the EU on the "destination" principle: that is, it is collected in the country where the goods and services on which it is charged are actually consumed. This practice is based on the idea that as VAT is a tax on consumption, it should be collected by the country where the consumption took place, and its receipts should then benefit that country's national finances. As a consequence, exports within the EU have always been zero-rated for VAT, and imports have been charged VAT at the rate of the country concerned.

In June 1985 the Commission published its strategy for establishing the Single European Market - *Completing the Internal Market* (Com(85)301 final) - setting 1 January 1993 as the date when frontier controls between Member States would be abolished. In this, the Commission argued that if border-crossing transactions within the EU were to be treated just as transactions within a Member State, certain changes had to be made to VAT:

- The "destination" system should be replaced by an "origin" system, whereby goods would be charged VAT by the country in which they were produced.

- A Community clearing system would be set up, so that revenue would continue to accrue to the Member State where goods and services were consumed (ie, conforming to the destination principle).

- VAT rates across Member States should be harmonised, to lessen the risks of fraud, tax evasion, and distorted competition.

These proposals proved very controversial, particularly for fears that the clearing house system would inadequately compensate countries which imported a lot from other Member States, and for the fact that harmonisation might mean the loss of many existing tax reliefs in individual States. In October 1989 the Council agreed that although the introduction of an "origin" system might be desirable, it presupposed conditions which could not be met before 1 January 1993.

In December 1991, VAT directive 91/680/EEC was adopted, amending the sixth VAT directive, so that the Single Market might still go ahead. It was agreed that from 1 January 1993, VAT on purchases from other Member States would become payable at the time of acquisition, rather than the time of import. All sales to private individuals, and to those businesses either exempt from VAT, or unregistered for VAT, would be taxable in the supplier's Member State. Sales to VAT registered traders in other Member States would continue to be zero-rated in the country of origin, and taxed in the country of destination. Customs authorities would use information provided by registered traders in collecting VAT, and, as a consequence, would no longer need to stop exports and imports at national frontiers.

In addition, certain specific transactions involving those not registered for VAT would continue to be taxed under the destination principle.

The Council also agreed that this compromise system should only last for a "transitional period". During this time, the Commission should work on proposals for a definitive system, based on the origin principle, which it should present no later than the end of 1994. If the Council unanimously agreed on these proposals by the end of 1995, then they would come into effect no later than ***31 December 1996*** (called the "transitional period"). If the Council could not agree on a new origin system by this date, then the transitional regime would continue to operate, until such time as they did.

Agreement on harmonising VAT rates was reached in June 1991, and incorporated in directive 92/77/EEC of 19 October 1992, which amended the sixth directive accordingly. In brief, all Member States:

- must apply a standard VAT rate of 15% or more from 1 January 1993.

- have the option of applying one or two reduced rates, no lower than 5% to certain specified goods, as listed in Annex H of the directive.

- are able to continue charging any lower rates, including zero rates, that had been in place on 1 January 1991 for the duration of the "transitional period", assuming these rates were in accordance with Community law.

For those Member States who had reduced rates in force on 1 January 1991 covering items which were not in Annex H, provision was made for the use of a "parking rate" - between 12% and their standard rate - rather than the immediate imposition of the standard rate. This allows those countries who wish to reduce the scope of their reduced rates to move gradually towards standard-rating them. Separate provision was made in the directive for Member States to apply a reduced rate to supplies of natural gas and electricity, should they so wish, "provided that no risk of distortion of competition exists" (Article 12(3b), as amended).

The UK secured a special right to bring any of its zero rates into a reduced rate band, even if they were not in Annex H (under Article 28(2b), as amended). As a consequence the UK has been able to charge the reduced rate of 8% for domestic fuel and power on supplies of fuel oil, coal, and peat (since they are not covered by the provision dealing with supplies of natural gas and electricity).[24] Children's clothing and footwear is not listed in Annex H and, without this provision, the UK would have to standard-rate these supplies if it ever decided to end zero-rating them. To complete the picture, it was also agreed that the UK could maintain its zero rates, at least until the end of the transitional period; ie, until 31 December 1996 at the earliest. Annex H of the directive is reproduced on the following page:

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[24] Following the abolition of the zero rate on these supplies which took effect from 1 April 1994.

ANNEX

'ANNEX H

LIST OF SUPPLIES OF GOODS AND SERVICES WHICH MAY BE SUBJECT TO REDUCED RATES OF VAT

In transposing the categories below which refer to goods into national legislation, Member States may use the combined nomenclature to establish the precise coverage of the category concerned.

Category	Description
1	Foodstuffs (including beverages but excluding alcoholic beverages) for human and animal consumption ; live animals, seeds, plants and ingredients normally intended for use in preparation of foodstuffs ; products normally intended to be used to supplement or substitute foodstuffs
2	Water supplies
3	Pharmaceutical products of a kind normally used for health care, prevention of diseases and treatment for medical and veterinary purposes, including products used for contraception and sanitary protection
4	Medical equipment, aids and other appliances normally intended to alleviate or treat disability, for the exclusive personal use of the disabled, including the repair of such goods, and children's car seats
5	Transport of passengers and their accompanying luggage
6	Supply, including on loan by libraries, of books (including brochures, leaflets and similar printed matter, children's picture, drawing or colouring books, music printed or in manuscript, maps and hydrographic or similar charts), newspapers and periodicals, other than material wholly or substantially devoted to advertising matter
7	Admissions to shows, theatres, circuses, fairs, amusement parks, concerts, museums, zoos, cinemas, exhibitions and similar cultural events and facilities
	Reception of broadcasting services
8	Services supplied by or royalties due to writers, composers and performing artists
9	Supply, construction, renovation and alteration of housing provided as part of a social policy
10	Supplies of goods and services of a kind normally intended for use in agricultural production but excluding capital goods such as machinery or buildings
11	Accommodation provided by hotels and similar establishments including the provision of holiday accomodation and the letting of camping sites and caravan parks
12	Admission to sporting events
13	Use of sporting facilities
14	Supply of goods and services by organizations recognized as charities by Member States and engaged in welfare or social security work, insofar as these supplies are not exempt under Article 13
15	Services supplied by undertakers and cremation services, together with the supply of goods related thereto
16	Provision of medical and dental care as well as thermal treatment in so far as these services are not exempt under Article 13
17	Services supplied in connection with street cleaning, refuse collection and waste treatment, other than the supply of such services by bodies referred to in Article 4 (5)'

It is worth emphasising that directive 92/77/EEC allowed Member States to ***continue*** charging any lower rates, including zero rates, in place on 1 January 1991. As a consequence, no Member States is allowed to reintroduce a zero rate which, though in force on 1 January 1991, has been abolished subsequently. In the UK's case, this applies to domestic supplies of fuel and power.

Naturally most attention in this country is paid to the aspects of the directive which directly affect the UK. Even so, it is worth noting one aspect of this agreement: no Member State can, under any circumstances, introduce a new zero rate; though there is limited provision for those countries whose standard rate was below 13% at 1 January 1991 to charge a rate below 5% on certain supplies.[25]

A summary of these rather complicated rules is given in section VII of this paper.

At the time, the then Chancellor, Norman Lamont, summarised the Government's view on this agreement in a written answer:[26]

> I believe that this is a very good agreement for both the United Kingdom and the Community. For the United Kingdom it fully safeguards our zero rates; it will not require us to change any of our tax rates; it will not prevent future Governments and Parliaments from taking a different view about VAT if they want to; and it shows quite clearly that our Community partners have recognised our concerns. For the Community it provides Governments and businesses with the assurances needed to plan for the abolition of all fiscal frontiers from 1 January 1993.

Though, as mentioned above, the sixth directive allows for this transitional regime to continue to operate in the absence of any unanimous agreement, it does contain one lacuna: Article 12(3)(a) of the sixth directive requires the Council to agree by 31 December 1995 on a minimum standard rate to apply from 1 January 1997. In the absence of any agreement, the current minimum standard rate would lapse, and Member States would be free, in principle, to set whatever rate they wished. To meet this contingency, the Commission submitted the draft EC directive 4192/96 in February 1996 to ensure the standard minimum rate continued to be 15% for a further two years: from 1 January 1997 to 31 December 1998. The draft contained the more controversial proposal that a new maximum standard rate of 25% be agreed, to apply for the same two year period.

HM Customs & Excise issued an explanatory memorandum on the draft on 12 February 1996, and on 28 February, the Select Committee on European Legislation published its conclusion that the draft raised questions of political importance though, in their view, it did not merit

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[25] At the time, the UK's standard rate was 15% - introduced on 18 June 1979; it was increased to the current rate of 17½% with effect from 1 April 1991.

[26] HC Deb 25.6.91 cc 422-424W

further consideration.[27] As part of this report, the Committee noted the Government's views on the draft:[28]

> "In practical terms the proposal has limited policy implications for the UK since it will not require the UK to alter its standard rate of VAT. That said, the Government's policy view on the two elements of the draft proposal is as follows.
>
> With a view to the continued effective operation of the Single Market, the Government can accept a time-limited extension of the minimum standard rate of VAT.
>
> However, the Government rejects the Commission's arguments in favour of the creation of a 'standard VAT rate band' through the introduction of maximum standard rate. The Government does not accept the Commission's suggestion that there is a possibility of 'structural imbalance and distortions of competition' in the absence of a 'rate band' reflecting the current range of standard rates across the Community. Nor does the Government accept that such a 'rate band' is necessary as a prelude to a move to a definitive system.
>
> The Government believes that the Commission's own explanatory memorandum prejudges the debate on a definitive system by assuming the adoption of an origin principle for such a system (i.e. taxation, for intraCommunity trade, in the country of origin rather than the country of destination as at present), and the need for 'fairly rigorous approximation' of VAT rates. The Government does not accept either of these assumptions. Both the basic principles of any definitive system and the implications of any such move must be thoroughly examined as and when the Commission produces its ideas.
>
> The draft proposal does not make any changes to the reduced rates provisions of the Sixth VAT Directive, nor does it affect in any way those provisions which safeguard the UK's zero rates."

Following this, at the meeting of European Finance Ministers (ECOFIN) on 2 December, Ministers were presented with an amended text of this draft directive, shorn of the more controversial of its two proposals (the introduction of a new maximum rate), to which they agreed.[29] In a recent written answer on this meeting, the Chancellor confirmed that "the council agreed to maintain the existing minimum rate of VAT of 15 per cent throughout the Community, again subject to a UK parliamentary scrutiny reserve."[30]

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27 Select Committee on European Legislation, *Eleventh Report from the Committee* ..., 28 February 1996 HC 51-ix 1995-96 pp xliv - xlvi

28 *op.cit.* p.xlv

29 Council Directive 96/95/EC - adopted on 20 December 1996

30 HC Deb 4.12.96 cc 648-649W

IV. Moves toward a definitive system (1992 - 1996)

As mentioned above, it was intended initially that the derogations to the sixth directive, as contained in directive 92/77/EEC, would come to an end with the end of the transitional period itself, on 31 December 1996. Article 28(l) of the sixth directive foresaw the Commission bringing forward its proposals for a definitive VAT regime by 31 December 1994, on which the Council could come to an agreement by 31 December 1995, so that they might come into effect on 1 January 1997.

The process has been subject to considerable delay. Indeed, no specific legislative proposals have yet been made by the Commission. In the absence of any new agreement, the transitional arrangements described above may continue indefinitely. The wording used in Article 28(l) is quite clear on this point: "The period of application of the transitional arrangements shall be extended automatically until the date of entry into force of the definitive system and in any event until the Council has decided on the definitive system." This point was underlined by the then Paymaster General, David Heathcoat-Amory, in a 'will-write' letter in July 1995:[31]

> As far as any move to a definitive VAT system is concerned, the sixth VAT directive, as amended, provides the current transitional system will continue beyond the nominal end date of 31 December if unanimous agreement on a definitive system has not been reached ... Given the delay in the issue of the Commission proposals, and the fact that negotiations will be protracted, the timetable for any move to a definitive system will be significantly extended.

For some commentators, this delay has not been unexpected. One tax practitioner writing in *Accountancy Age* in October 1994 argued that, the 31 December 1996 deadline notwithstanding, any agreement on a definitive system would be some time in coming:[32]

> At the end of the day, the real point to bear in mind is this: the deadline of 1 January 1993 was real because the member states were committed, under the Single European Act, to the abolition of fiscal frontiers from that date. The deadline of 1 January 1997 is an artificial one set by the Council, but with the proviso that if the transitional system is not ended, then it will continue more or less indefinitely. Previous attempts by the Council to bind itself to a strict timescale have not worked - the course of least resistance is to continue any transitional period unless it is clear that it is not working, or has broken down. It is a fair bet that a modified system of the transitional system will still exist at the end of the century.

In an article published in *Taxation* in September 1994, the author argued that the most likely scenario for VAT harmonisation was that the UK would gradually get rid of all its zero rates. The use of zero-rating on a significant scale was contrary to the philosophy of Community VAT: a harmonised system which does not encourage distortion of competition across the

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[31] 'Will-write' letter in answer to HC Deb 19.7.95 c.1257W

[32] "Tax in transition", *Accountancy Age*, 27 October 1994

internal market. In addition, the Government's argument that zero rates are necessary for social reasons had been weakened for two reasons; first by the Government's own decision to abolish the zero rate on domestic supplies of fuel and power, and second, by the option provided in EC VAT law of charging reduced rates on any supplies presently zero-rated:[33]

> If [the Government] appears willing to abolish certain zero rates purely for fiscal reasons, does this not undermine the case for retaining the remaining zero-rates, given that this is supposed to be based on the argument of social need? By the same token, where a zero rate is presently applied, and the reason is given as social, it would be difficult to justify going from the zero rate to the standard rate where the option of a reduced rate is open to the UK ...
>
> Moving all the UK zero rates into a reduced rate of 5 per cent would bring at least an extra £5 billion to the Exchequer. This is precisely what Portugal has done with its (admittedly fewer) zero rates. With the possible exception of some targeted zero rates for the handicapped and charities serving them, a reasonable prediction is that by 1 January 1997 most of the UK zero rates will have been abolished in favour of a reduced rate of 5 per cent.[34]

Under the provisions of Articles 12 and 28 of the sixth VAT directive, the Council is required to review every two years, on the basis of a report from the Commission, the scope of the list of goods and services to which a reduced VAT rate may be applied. In January 1995 the first such report was published.[35] An explanatory memorandum issued by Customs at that time summarised the Commission's findings:[36]

> The Commission concludes that the position with regard to VAT rate approximation is generally satisfactory in that no significant distortions of competition or deflections of trade have resulted from differences in VAT rates between Member States. There is therefore no justification for introducing major changes to the scope of the reduced rate list, nor is there any reason to amend the provisional VAT rates which are due to be phased out at the end of the transitional period. Although numerous representations have been received from trade and other interests to include their particular goods and services in the reduced rate list the Commission feels that such broader issues of rate coverage will be better addressed in the context of conclusions on the VAT definitive system.

At the ECOFIN Council in October 1994 Member States agreed that to justify any change in the transitional VAT regime, any new VAT system would have to be demonstrably better than the existing system.[37]

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33 "Major VAT changes ahead?", *Taxation*, 22 September 1994

34 Though there has been relatively little press discussion of the issue subsequent to this piece, a rather more technical analysis of the future prospects of VAT harmonisation was given in the October 1996 issue of *Economic Policy*: Michael Keen & Stephen Smith, "The future of VAT in the EU", *Economic Policy*, no.23 October 1996 pp 373 - 420

35 EC CONS DOC 4079/95, 20 January 1995

36 HM Customs & Excise, *Explanatory Memorandum on (a) a Commission report on the approximation of VAT rates in the Community ...*, 20 February 1995

37 HM Customs & Excise, *Explanatory Memorandum on ... Commission Communication on a work programme for progression to a new common system for VAT for the Single Market*, 25 September 1996

A definitive regime would have to meet four conditions:

- it must represent a fundamental simplification of the system with no distortion of competition;
- it must reduce burdens on businesses and administrations;
- it should ensure the right revenue reaches the right Exchequer at the right time; and
- it should create no increased opportunity for fraud.

In addition, the UK has its own fifth condition:

- the ability to maintain those zero rates in force at the time the definitive system is adopted.

However, as mentioned, the Commission has not brought forward any **specific** proposals for a definitive system as yet. The most recent development has been the publication of a 'communication' by the Commission in July 1996, proposing that legislative proposals be brought to the Council over the next four years.[38] Indeed the Commission suggests it should not present proposals to deal with a final round of harmonisation in VAT rates until mid-1999. It concludes by saying, "clearly, this timetable in no way prejudges the date of adoption of the various measures by the Council. Nevertheless, the Commission will in any case ensure that the new measures enter into force not less than two years after their adoption by the Council, in order to allow economic operators and administrations enough time to introduce the new system smoothly."[39]

In October the Select Committee on European Legislation summarised this document, and the Government's response to it:[40]

The proposal

8.4 This document does not present specific proposals for new legislation on VAT, but represents the Commission's response to the conditions set out by the ECOFIN Council and consists of a general overview of the subject together with a work programme and timetable for achieving a new common system of VAT.

8.5 In its document, the Commission says that it very quickly became clear that the implementation of the ECOFIN criteria and objectives could not be achieved simply by amending the tax rules introduced for the transitional period but that, instead, detailed work would have to be carried out on the very principles of the operation of the entire common system of VAT. The Commission concludes that the existing transitional system is too complex and no longer suited to modern business practices. There are, the Commission says, too many derogations and divergences from the application of the general rules, causing lack of legal certainty and obstacles to trans-national economic activities.

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38 COM(96) 328 final, 22 July 1996

39 *op.cit.* p.34

40 European Legislation Select Committee, *Twenty Ninth Report* ..., 16 October 1996 HC 51-xxix 1995-96 pp xxii-xxiii

8.6 After examining the alleged deficiencies of the transitional system in greater detail, the Commission concludes that any new system of VAT will have to satisfy the following criteria:

- it must abandon the segmentation of the single market into 15 tax areas;
- it must be simple and modern so as to rise to the challenges of the 21st Century;
- it must guarantee equal treatment of all transactions carried out in the Community;
- it must ensure effective taxation and guarantee proper monitoring thereby maintaining the level of VAT revenues.

Characteristics

8.7 The Commission suggests that in the proposed definitive VAT system there should be no distinction between domestic and intra-Community transactions and that all transactions carried out within the Community should be taxed on the basis of taxation in the country of origin.

8.8 The Minister explains in his Explanatory Memorandum[41] that the key elements of the new system would be:

- a single place of registration, taxation and deduction of input tax for each business in the EC;

- a new mechanism to decide the place of supply of goods and services;

- a mechanism for redistribution of VAT revenues between Member States - not based on fiscal declarations by businesses but on the basis of macro economic analysis of consumption;

- a very substantial degree of harmonisation both of tax rates and of the tax base (to ensure neutrality of competition, uniformity of application and simplicity);

- common interpretation and application of the rules to be achieved by making the existing advisory EC VAT Committee into a regulatory body and using qualified majority voting and directly applicable Regulations (rather than Directives) to make progress.

8.9 The Commission considers that it would be premature at this stage to present proposals for legislation but submits a provisional timetable for the changeover to such a new common system of VAT. The timetable or work programme is annexed to the Commission's Communication.

The Government's views

8.10 In his Memorandum,[42] the Minister tells us:

"The UK endorses the need for modernisation and further simplification of the existing EC VAT system but does not believe that this requires as radical an approach

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[41] HM Customs & Excise, 25 September 1996

[42] *ibid.*

as that suggested by the Commission. In particular the UK does not support further harmonisation at the EC level of, for example, VAT rates; nor the idea that qualified majority voting might be adopted instead of the current unanimity voting base. The UK believes that the subsidiarity principle must be rigorously applied, particularly so as to maintain the maximum degree of flexibility available to Member States within the overall framework of the EC VAT system. Key UK interests which the Government is determined to protect in any forthcoming debate on reform of the EC VAT system include our existing zero rates (in that any new system must make provision for those zero rates in force at the time of any change), and unanimity as the voting base. The UK will play a full and constructive role in the discussions and believes that it is important to subject all ideas/options to detailed analysis, in particular to determine the comparative costs and benefits of different approaches. The scope for simplification and deregulation will be fully explored in consultation with businesses and others likely to be affected. The UK will continue to press for the Community to focus its efforts on specific changes which address current problems."

8.11 The Minister told us in his Memorandum that the Council was expected to be asked to give its preliminary views on the Commission at the next formal ECOFIN Council meeting on 14 October 1996.

Details of the ECOFIN meeting on 14 October were given in a written answer some days later. As part of this, the Chancellor noted the following:[43]

> Commissioner Monti presented the Commission's work programme on VAT. Over the period to 2000, the Commission plans to bring forward a series of proposals to overhaul the current EC VAT arrangements to allow tax authorities to collect revenue and tackle tax avoidance with greater certainty. There was no discussion of this item.

Apparently, this has been the one occasion to date that the Commission's communication has come to Council:[44]

> **Mr. Rowlands:** To ask the Chancellor of the Exchequer on how many occasions Finance Ministers have discussed the European Commission document COM (96) 328: "A Common System of VAT"; and if he will make a statement.
>
> **Mr. Oppenheim:** None. The European Commission's programme for a common system of VAT, outlined in document COM(96)328, has not been discussed by EC Finance Ministers, although it was briefly presented - for information only, and with no debate or discussion - by Commissioner Monti to a meeting of the Economic and Finance Council in October 1996.

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43 HC Deb 24.10.96 c.5W

44 HC Deb 29.1.97 c.237W

V. The future for VAT harmonisation (1997 -)

Recently, a great deal of attention has been paid to the Commission's communication *A Common System of VAT*,[45] and the implications it may or may not have for the UK. By way of an example, part of a recent *Sunday Telegraph* article by the journalist Christopher Booker is quoted below:[46]

> It is exactly a month since I reported on our politicians' extraordinary silence over what I called 'the biggest time-bomb in British politics'. This was a European Commission document COM (96)328, discussed in Dublin in December by Mr Clarke and his fellow EU finance ministers, entitled 'A Common System of VAT'. As instructed by the 'Sixth VAT directive', the Commission now proposes to complete the Single Market by imposing a uniform VAT system throughout the EU, with taxing powers handed over by national governments to the officials of a VAT Committee in Brussels.
>
> VAT will thus be the first European Union tax. The officials alone will decide VAT rates (a minimum 15 per cent) and which items are to be taxed. The money will be collected by Brussels, some retained and the rest then doled out to member states, not according to how much they contribute, but under some bizarre formula based on 'statistics of consumption'.
>
> Financially this will hit Britain peculiarly hard, because we have so far been allowed by Brussels to exempt many more items from VAT than anyone else. We should be forced to impose it not just on food, at a cost of £7 billion a year, but on books and newspapers, bus and train fares, children's clothes and new houses (at least £30,000 on a £200,000 house). The handing over to unelected officials of Parliament's tax-raising powers would be the biggest surrender of sovereignty yet. And it seems clear from the Commission paper that Brussels hopes to introduce its new VAT system by majority voting, so Britain will have no veto power to stop it.

Strictly speaking, of course, the supplies listed in the *Sunday Telegraph* article are charged the zero rate of VAT, rather than being exempt from tax. From the discussion in earlier pages, one can see that, in fact, there is ***no*** requirement under EU law to oblige the UK to get rid of any of its zero rates of VAT by any specified date.

Even so, it is notable that in this document, COM 328/96, the Commission foresees one of the key elements in a definitive VAT system would be "a very substantial degree of harmonisation both of tax rates and of the tax base (to ensure neutrality of competition, uniformity of application and simplicity)."[47] Clearly, this may have led some commentators to argue the UK will be encouraged to reduce the scope of zero-rating in future, though - of course - there is no question that the UK could be required to do so.

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[45] COM(96) 328 final, 22 July 1996. This document is discussed at length in the preceeding section.

[46] "Notebook: The new tax that both parties want to keep secret", *Sunday Telegraph*, 19 January 1997

[47] European Legislation Select Committee, HC 51-xxix 1995-96 pp xxii-xxiii - as reproduced above.

The Exchequer Secretary, Philip Oppenheim, made these points with admirable precision in a recent series of written answers:[48]

> **Mr. Porter:** To ask the Chancellor of the Exchequer what estimate he has made of the increase in the costs of *(a)* housing, *(b)* travel, *(c)* books and newspapers, *(d)* children's clothes and *(e)* food after 2005 when the definitive system of VAT is introduced in the EU; and if he will make a statement.
>
> **Mr. Oppenheim** *[holding answer 21 January 1997]:* No such estimate has been made. No agreement has been reached to introduce a definitive system of VAT in the European Community from 2005 or any other future date.
>
> **Mr. Porter:** To ask the Chancellor of the Exchequer what are the EU Commission's plans for VAT after 2005; what decisions have been made about the United Kingdom's transitional system of VAT after 2005; what is the definitive system to which the Government have already agreed; and if he will make a statement.
>
> **Mr. Oppenheim** *[holding answer 21 January 1997]:* In July 1996 the European Commission produced a suggested programme for a common system of VAT, or "definitive system", to apply throughout the European Community. This programme contains no specific legislative proposals, but outlines a series of steps which the Commission proposes should be taken toward the creation of a common system. An explanatory memorandum on the Commission's proposals was submitted to Parliament last September.
>
> Any change to the EC VAT system requires the unanimous agreement of member states, and the current transitional regime continues automatically in the absence of an agreement upon a definitive regime. Discussion of the programme within the EC has so far been very limited, and no decisions have been made about the programme itself or about the future shape of the VAT system. Contrary to recent assertions in the press, the Government have agreed no changes, whether from 2005 or any other date.
>
> **Mr. Porter:** To ask the Chancellor of the Exchequer if he will list the goods and services to be subject to a VAT rate above 0 per cent. after 2005; what exemptions from VAT will be abolished; when he agreed such changes with his EU counterparts; and if he will make a statement.
>
> **Mr. Oppenheim** *[holding* answer *21 January 1997]:* I have agreed no such changes. The current EC VAT regime - including its provisions for the United Kingdom's zero rates, and those in respect of exemptions - cannot be changed without the unanimous agreement of member states, and so will automatically continue to apply in the absence of any agreement to amend it.

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[48] HC Deb 24.1.97 cc 791-792W

Recently the Commission has published work on the overall future for all taxation in Europe. In March 1996 the Commission issued a working paper on taxation for the Verona ECOFIN Council (13 April 1996).[49] Although taxation was recognised as an important element of the Single Market, the paper placed limited emphasis on harmonisation, despite some commentators' assessment of it as much more direct and action-minded than previous policy papers. Indeed, it was argued "there is no issue of harmonisation per se", though it suggested harmonisation measures would be put forward "where appropriate".

By contrast, far more attention was paid to the ways of combatting the erosion of the tax base, which would have an impact on Member States' ability to meet the financial criteria of EMU's final stage. The Commission also argued that action was required to eliminate taxation barriers to the Single European Market.

To further discussion of this paper, the Verona Council established the 'High-Level Group on Taxation', comprised of personal representatives of ECOFIN Ministers. During the year the Group met 4 times. In October, its chairman, Mario Monti, the Commissioner responsible for the internal market and taxation, published a personal report summarising the work of the Group, and his proposals for the way forward.[50] One theme of Commissioner Monti's report was the operation of tax competition across the EU, where Member States bid down tax rates for mobile factors such as capital and internationally mobile business, which, in turn, forced them to increase taxes on less mobile bases such as labour.

In December the European Legislation Committee scrutinised the report, finding it of legal and political importance, though it did not recommend its further consideration, "given the nature of the report and the absence of draft legislation."

In its comments, the Committee made mention of the issue of tax competition:[51]

1.4 The report expresses the view that tax competition, where Member States bid down tax rates for mobile factors such as capital and internationally mobile business, is reducing tax revenues. This leads to Member States being forced to increase taxes on less mobile bases such as labour. The report contends that the effective taxation of investment income has been endangered by movement of investments between Member States and outside the Union purely for tax purposes.

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[49] *Taxation in the European Union*, SEC (96) 287, 20 March 1996; reprinted in *Agence Europe*, 3 April 1996 ["Monti Memorandum on fiscality submitted to finance ministers in the run up to the informal Ecofin Council Meeting on 12/13 April in Verona"]

[50] *Taxation in the European Union - Report on the Development of Tax Systems*, COM(96) 546 final 22 October 1996; reprinted in *Agence Europe*, 4 December 1996 ["Second 'Monti Report' on joint action envisaged in the field of taxation"]

[51] Select Committee on European Legislation, *Fifth report - Documents considered by the Comittee ...*, 4 December 1996 HC 36-v 1996-97 p.xxix

The Committee gave details of the Government's response to this report:[52]

1.13 In his Explanatory Memorandum, the Chancellor comments first on the question of subsidiarity. He says:

> "The report emphasises that proposals for Community action in taxation must take full account of the principles of subsidiarity and proportionality. However, the document is based on the premise that, in order to complete the Single Market and to address fiscal erosion, greater co-ordination of tax policy at Community level is required. The UK and other Member States have called on the Commission [to] match its proposals to evidence of Single Market failures stemming from the divergent tax systems, or to evidence of fiscal erosion which cannot be traced to unfair tax competition (which ought to be addressed by the state aid rules). In the area of concern to the UK - on alcohol and tobacco excises where the UK does sustain some loss of revenue - there are no Commission proposals, whilst in areas where there is no evidence of a problem, the Commission has made proposals. In that context, several of the proposals for tax harmonisation are in conflict with the principle of subsidiarity which dictates that action should only be taken at the Community level if the objectives of the proposed action cannot be sufficiently achieved by the Member States. On specific proposals, the report signals the Commission's intention to bring forward a new interest and royalties Directive which the Government considers to be contrary to the subsidiarity principle."

1.14 On the wider policy implication of the report, the Chancellor says:

> "On the general issue of tax competition, the Government considers that it is a legitimate policy objective for countries to seek to attract investment by making their tax systems as competitive as possible, if this is done by making their tax regimes fair and open. Unfair tax competition through artificial tax niches or incentive schemes of limited applicability is a different matter which ought to be addressed through existing competition and state aid rules - the UK is actively involved in consideration of the problem of unfair tax competition via discussions in OECD (Organisation for Economic Co-operation and Development). As long as it is recognised that only unfair tax competition needs to be addressed, the Commission's intention to clarify and improve the consistent application of the Community rules including the state aid rules is welcome ...

Though the report did not discuss VAT in great detail, the Chancellor did pick up on the view that excise duties and VAT were among the areas where the Commission, and some Member States, considered divergent tax systems hindered the formalisation of the Single Market: "On VAT, the Government agrees that further simplification and modernisation of the VAT system is needed but does not believe that this requires as radical approach as that suggested in the Commission's programme for a new common system of VAT [ie, COM(96) 328 final, 22 July 1996]."[53]

One of the recommendations of the Monti report was that the Council might endorse the continuation of a Tax Committee, chaired by the Commission, to allow Member States and

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52 *op.cit.* pp xxxi-xxxii

53 *op.cit.* p.xxxii

the Commission to share information and review taxation policies, as the following press article explains:[54]

> The European Commission would like to see the creation of a permanent group on fiscal policy that would eventually develop a code of good practice for the Member States. It could resolve some of the problems due to the extreme slowness of the process of tax harmonisation in Europe, in which traditional legislative methods appear inadequate. In a Communication on the development of tax systems that it was expected to unveil on October 22, the Commission singles out the erosion of certain tax bases as a major problem that must be solved before any other ...
>
> The draft report indicates, not surprisingly, that taxation has undergone major structural changes in recent years, marked by increasing fiscal and parafiscal pressure on revenue from work, with lower taxation of other factors of production. One of the major causes of these changes is said to be the gradual erosion of certain tax bases 'due to excessive or harmful tax competition'. The report cites the mobility of company tax bases at international level, which threatens to distort the allocation of economic resources and cut into the tax revenue of other countries. 'Although there is no measurement of the overall impact of fiscal erosion, there is some evidence that investment income has been endangered by movement of investments between Member States or outside the Union for tax purposes', the draft report says.
>
> To put a halt to this erosion, the members of the high-level group recommend the creation of a 'fiscal policy committee' coordinated by the Commission. This committee should have a strategic vision of fiscal policies, should facilitate the identification of some key initiatives (legislative and other) and should protect the 'Member States' prerogatives in the area of tax recovery', the Commission's draft report indicates. It would 'lay the foundations for a general agreement on taxation at Community level (...) such an agreement could, for example, establish guidelines for a code of good conduct to ensure that fiscal policies are targeted to promote the EU's important objectives while protecting tax bases against disloyal tax competition'.
>
> The meetings of the high-level group revealed that most of the Member States are in favour of Community action to combat fiscal erosion, as they fear that it could compromise the achievement of vital Community objectives. However, as the Commission's draft report explains, 'the high-level group is not in favour, in general, of setting minimum taxes or tax bases at present, even to reach a minimum level of real taxation within the European Union'. In any case, the Commission does not consider the harmonisation of tax systems 'a goal in itself' and would prefer a 'pragmatic and realistic approach aimed at increasing the effectiveness of the Member States' defences against the gradual fiscal erosion of their tax sovereignty by markets'. The Commission proposes to unveil initiatives for the purpose of:
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> * defining common standards in certain areas (code of good conduct)
> * enhancing cooperation among tax authorities in the fight against fraud
> * better coordinating national measures to discourage unfair tax competition
> * clarify Community competition rules (particularly as concerns state aid).

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54 "Economic and monetary affairs: taxation - commission calls for code of good practice", *Europe Info.Service*, 23 October 1996

In its response, the Select Committee noted the Government's view of this suggestion:[55]

> The Government is content to participate constructively in the tax committee where Member States may share experiences, but considers that substantive proposals should continue to be handled through usual Council procedures.

The Monti report was discussed at the ECOFIN meeting on 11 November, and the continued existence of the Tax Committee agreed to.[56]

Since then, the Committee does not appear to have published anything further, though support for the principle of a 'code of conduct' in matters of tax competition appears to be gaining ground. Both France and Germany appear particularly concerned about the issue. In December Mr Jürgen Stark, a state secretary in the German finance ministry, mentioned that proposals for a 'fairer' European tax structure were being prepared in Bonn, to deal with the use of 'tax havens' in countries such as the UK, Ireland, the Netherlands and Belgium.[57] Following the ECOFIN meeting of 28 January, the German finance minister, Theo Waigel, and his French counterpart, Jean Arthuis, called for a 'code of conduct' to be agreed, to prevent unfair tax competition across the EU. Both ministers were keen to emphasize that decisions on tax would remain subject to unanimity. Apparently Mr Waigel is to publish a report on tax policy in the near future.[58]

More recently, Commissioner Monti has stated that the Commission plans to elaborate, together with the Member States, a good conduct guide as well as a reinforcement of cooperation between states to fight fiscal fraud:[59]

> The European Commission last week revealed plans to work with member states on guidelines to stop tax competition and strengthen cooperation against fiscal fraud. In a speech to a parliamentary committee in Luxembourg, European tax commissioner Mario Monti said there was consensus on the need for measures to prevent the erosion of the tax base and thus a fall in tax receipts. 'More and more each member state is a fiscal competitor, or even a tax haven for its neighbours. Such measures will be as important as the respect of the convergence criteria and the stability pact in gauging the success of the euro,' he said. 'In this respect, the Commission plans to elaborate, together with the member states, a good conduct guide as well as a reinforcement of cooperation between states to fight fiscal fraud.' Certain members express more and more their worries over tax competition in the savings area, he said, adding that he is concerned by capital market distortions from different taxes on interest.
>
> 'I am convinced that the introduction of a minimum withholding tax on interest in all member states, as proposed by the Commission since 1989, would strongly contribute to resolving this problem,' he said. Monti said that while he understood worries over traditions on confidentiality of bank transactions

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55 Select Committee on European Legislation, HC 36-v 1996-97 p.xxxii

56 Statement on ECOFIN meeting on 11.11.96 [HC Deb 15.11.96 cc 359-360W]

57 "Bonn minister attacks 'unfair' EU tax havens", *Financial Times*, 23 December 1996

58 "EU-wide tax code urged", *Financial Times*, 28 January 1997; "EU ministers open fire on tax poachers", *Financial Times*, 31 January 1997

59 "EC moves to prevent erosion of tax income", *Accountancy Age - Reuter Textline*, 13 February 1997

> there is also a need to maintain the competitiveness of these banks against those outside the EU. 'I estimate that a good general willingness should allow the EU to find a minimal solution on taxing interest, while at the same time protecting the interests of financial markets and banking traditions.' On other tax issues, Monti said the Commission will continue to try and set up a new VAT system, and a regime to limit tax paid on interest and royalty payments between companies in a group.

To conclude this section, it is worth noting perhaps that Commissioner Monti, in a recent statement on EU tax harmonisation, argued that economic and monetary union did **not**, in itself, involve any additional requirements regarding taxation.[60]

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[60] "Partial EU tax harmonisation unwise", *Reuter Textline*, 20 January 1997

VI. Harmonisation & the European Court of Justice

The discussion so far would suggest that the UK could use its veto on ECOFIN, to delay agreement on a new EC VAT directive, until a new derogation was agreed to allow it to continue to use its zero rates. It has been argued by some that if the UK did this, it would be construed as holding up the harmonisation process, vital for the proper functioning of the internal market: an act ruled out by the Treaty of Rome specifically. The European Commission might then take the UK to the European Court of Justice (ECJ), to force it to abandon its zero rates. During Oral Questions on 27 January 1997, Sir Teddy Taylor asked the following question of Roger Freeman, Chancellor of the Duchy of Lancaster:[61]

> **Sir Teddy Taylor:** To ask the Deputy Prime Minister if he will review the co-ordination of Government Departments in respect of the provision of information on Government policy on the European Union.
>
> **Mr. Freeman:** We have no plans to carry out any such review.
>
> **Sir Teddy Taylor:** Does my right hon. Friend not share my concern and alarm that, throughout the recent big row about value added tax on food, no reference has been made to the fact that, under article 28.2 of the sixth directive, which, incidentally, was approved by the Labour Government, a right to continue a zero rate ended on 31 December 1996 and has continued only by a legal ploy, which is likely to be challenged at the European Court? Would it not be fairer to the electors if the Government and the Opposition were to make it abundantly clear to the people of Britain, instead of putting up silly posters, that there is a real danger that we shall shortly have to pay VAT on food and on children's clothes irrespective of who wins the general election?
>
> **Mr. Freeman:** I very much regret that I cannot agree with my hon. Friend's analysis. I am sure that he is sincere, but there is no imminent danger of VAT being put on food.

Indeed, Sir Teddy had made this argument before in July 1993, when he was answered by the then Paymaster General, Sir John Cope:[62]

> **Sir Teddy Taylor:** To ask the Chancellor of the Exchequer if he will seek the agreement of the European Commission that it will not seek to challenge in the European Court the opinion of Her Majesty's Government that they have full entitlement to retain zero rates for VAT after 31 December 1996; and if he will make a statement.
>
> **Sir John Cope:** There is no need for the Government to seek such an agreement. At ECOFIN on 24 June 1991, all member states agreed that, under transitional

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[61] HC Deb 27.1.97 c.6

[62] HC Deb 19.7.93 c.29W

> arrangements to last at least until the end of 1996, member states which at I January 1991 applied to certain goods and services zero rates for VAT in accordance with the provisions of Community law in force, would have the option of retaining them. The sixth VAT directive 77/388/EEC, as amended by Council directive 91/680/EEC, provides that the transitional period will continue beyond the end of 1996 if there is not unanimous agreement on the definitive VAT system to operate from that date. The United Kingdom has made it clear that one of the conditions for such an agreement must be our right to retain zero rates.

The legal basis for the inception of legislation in the area of indirect taxes is provided under Article 99 of the Treaty of Rome:

> The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and functioning of the internal market with the time limit laid down in Article 7a.

Article 7a was added to the Treaty of Rome by the *Single European Act 1986* (though termed Article 8a at the time). It states that, "the Community shall adopt measures with the aim of progressively establishing the internal market over a period expiring on 31 December 1992 ... 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."

Although the *Single European Act* extended the use of qualified majority voting by the Council in legislative decision making, taxes remain one area where unanimity is still required (which is one reason for the considerable time taken in adopting legislation). Given that Article 99 refers directly to the Council's responsibility to establish such harmonisation as "is necessary to ensure the establishment and functioning of the internal market", could the Commission take the UK to the ECJ for breaking its obligations under the Treaty of Rome? Certainly, the Commission has the power to take any Member State to the ECJ if it fails to implement EC legislation, under Article 169 of the Treaty.[63]

Article 99 refers directly to the unanimous decisions of ECOFIN, and makes no reference to any wider obligation on Member States, beyond that implied in their adherence to those VAT directives ECOFIN agrees on. As a result, it seems unlikely that the EC would take the UK to the ECJ for its position over a definitive VAT system; though technically speaking, of course, a definitive answer to this question would require the ECJ's decision. Notably, the text does not go on to give a precise definition of "harmonisation"; the word is defined in

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[63] As it did in 1988 when the ECJ found that the UK was in contravention of the sixth directive by zero-rating, amongst other supplies, fuel and power supplies to industry.

relation to the 'establishment and functioning' of the internal market which, one could argue, began on 1 January 1993.

This concern was raised in January 1993, during the debates on the *European Communities (Amendment) Bill 1992/93*. Andrew Smith put down a probing amendment, to delete Article 99 from the Bill. He suggested that some people took Article 99 to mean that the UK was committed to abolishing its zero rates in the interests of the Single European Market, though he himself did not. Sir John Cope, the then Paymaster General, argued that this was missing the point:[64]

> [The amendment] implies that deleting Article 99 ... might somehow lead to an end to the derogations that permit the United Kingdom to have its various zero rates. But it is the sixth directive and its children which embody the agreement to the continuation of our zero rates. If, which no hon. Member on either side of the House is suggesting, we deleted Article 99 and did not replace it, it might be said that there would then be no vires for the sixth directive, and that would include both the agreement to continue our zero rates and, for that matter, the part of the agreement under which otherwise we could not have the zero rates.

He went on to argue that this fear was based on a misconception of the word "harmonisation":[65]

> It is perhaps necessary to make a musical analogy when discussing this issue. People sometimes confuse harmony with unison. When musical instruments or singers play or sing in unison they use the same notes. Harmony involves different notes that blend with each other to create a pleasing overall sound. It is the notion of different notes leading to harmony that we seek in the tax system, rather than the unison or unity which is sometimes mistakenly mentioned in these discussions. Tax harmonisation does not mean that every Member State has to have the same tax system or rate. The differing systems should be able to work together, and that is what we have been thinking all along.

Nigel Spearing followed this line of reasoning in a number of PQs in October 1993.[66] In his responses, Sir John made the same distinction between the Treaty - which allows ECOFIN to adopt harmonisation proposals - and the sixth VAT directive, as amended - which actually establishes Member States' obligations, in terms of their separate VAT systems.

In section IV of this paper, mention was made of the report the Commission is required to make, under the provisions of Articles 12 and 28 of the sixth VAT directive, on the approximation of VAT rates in the Community. The Commission's conclusions from its first

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64 HC Deb 28.1.93 c.1236

65 *op.cit.* cc 1238-1239

66 HC Deb 18.10.93 cc 6-9W

report, issued in January 1995, are reproduced below. Despite its enthusiasm for further harmonisation - seen in its desire that Member States themselves "take action to reduce the number of rates generally applied" - it is notable that the Commission found "there have been no significant distortions of competition or deflection of trade brought about as a result of excessive disparities in VAT rates as between neighbouring Member States":[67]

> This report sets out to fulfil the reporting obligations placed on the Commission by the Council when adopting legislation on VAT rate approximation in 1992. In fulfilling these obligations, the Commission wishes at the same time to provide the Council with an adequate assessment of the functioning of the VAT rates regime in the framework of the transitional VAT regime during the first two years of a Community without internal frontiers. The Commission thus hopes that the report will enable the Council to take a view as to whether the VAT rate arrangements are operating as originally intended in the absence of border controls or whether any amendments are necessary.
>
> Based on such information as is available, the Commission believes that the position is generally satisfactory with regard to the functioning of the new system of VAT rate approximation. No significant changes in cross-border purchasing patterns have been found. Similarly there have been no significant distortions of competition or deflection of trade brought about as a result of excessive disparities in VAT rates as between neighbouring Member States. The Commission concludes that in these circumstances there is no justification at present for introducing major changes to the essential level or structure of the new rates system or to the scope of the reduced rate. In addition, the Commission concludes that the provisional VAT rate provisions currently in force do not need to be amended for the time being given that these measures are due to be phased out by the end of the transitional period. If Member States were themselves to take action to reduce the number of rates generally applied this would facilitate discussions on the introduction of the definitive VAT regime. The debate on this and other VAT-related issues will be taken up in the context of the Commission communication on the introduction of the definitive regime.

More recently, during the debate on the economy in October 1996, the Chancellor, Kenneth Clarke, underlined that VAT harmonisation was not the same as a uniform VAT system:[68]

> I am not in favour of a uniform rate of VAT. I am sure that we would be against that, as I am sure would most other Member States. No one would want a uniform level of VAT throughout western Europe. I am in favour of minimum levels; otherwise, attempts are made on either side of a border to win markets in particular goods by attracting customers.

Recently there has been some discussion as to whether the UK could cut the rate of VAT on domestic supplies of fuel and power, from the current rate of 8% down to 5%, in the light of the Labour Party's commitment to do just this.[69]

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67 EC CONS DOC 4079/95, 20 January 1995 p.20

68 HC Deb 30.10.96 c.674

69 First announced by the Shadow Chancellor, Gordon Brown, on 2 October 1995 at the party's annual conference: "Brown aims to cut VAT on fuel to 5%", *Times*, 3 October 1995

In his March 1993 Budget the then Chancellor, Norman Lamont, announced the Government's intention to abolish the zero rate of VAT on domestic supplies of fuel and power, in two stages. From 1 April 1994 to 31 March 1995 supplies would be charged VAT at the transitional rate of 8%. From 1 April 1995 they would be charged the standard rate. The Chancellor gave three reasons for introducing VAT on fuel and power - to widen the VAT base, to raise additional revenue in the medium term and to encourage energy conservation.[70] Previously these supplies had been zero-rated since the introduction of VAT in 1973.

It should be emphasised that the decision to end the zero-rating of these supplies was the Government's alone; the UK was not forced to take this step under EU law, as some have suspected. The abolition of this zero rate was implemented by section 42 of the *Finance Act 1993*. Further legislation would not have been required to ensure supplies became liable to the standard rate on 1 April 1995. However, in January 1995 the Government was required to introduce amending legislation following its defeat on the Budget Resolution vote relating to VAT on domestic fuel, so that these supplies have continued to be charged the 8% reduced rate.[71]

The ability of Member States to charge reduced rates of VAT was discussed in section III of this paper. There is provision under EC VAT law for all Member States to charge a 'reduced rate' of VAT - between 5% and 15% - on "supplies of natural gas and electricity provided that no risk of distortion of competition exists", under Article 12(3b) of the sixth VAT directive (77/388/EEC).[72] Article 12(3b) goes on to state, "a Member State intending to apply such a rate, must, before doing so, inform the Commission. The Commission shall give a decision on the existence of a risk of distortion of competition. If the Commission has not taken that decision within three months of the receipt of the information a risk of distortion of competition is deemed not to exist."

A similar provision does not cover supplies of 'solid' fuel - such as fuel oil, coal, and peat. As a consequence, when the UK abolished the zero rate of VAT on all domestic supplies of fuel and power, it employed a separate provision in the sixth VAT directive - Article 28(2b) - which permits it to bring any of its zero rates into a reduced rate band. As mentioned before, no Member State may introduce a new zero rate nor reintroduce a zero rate once it has been abolished.

This would suggest the UK could charge a 5% rate on domestic supplies of natural gas and electricity provided this did not distort competition. It was reported recently that in the Commission's view doing this would not be 'within the spirit of the transitional arrangements', and, as such, might result in this decision being legally challenged.[73] Clearly a definitive

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[70] HC Deb 16.3.93 c.183

[71] Section 21 of the *Finance Act 1995*, which amended the *VAT Act 1994* accordingly.

[72] Indeed Ireland, Italy and Luxembourg do this in practice: HC Deb 15.10.96 cc 834-836W.

[73] "Labour plan to cut VAT on fuel faces threat from EU", *Guardian*, 15 February 1997

answer to this question lies with the ECJ itself, but one wonders if the possibility has been rather overstated in the press.

The Commission has answered this question twice in recent years: in September 1994, and November 1995.[74] On the first occasion, it stated simply that the sixth VAT directive "permits Member States, under certain conditions, to apply a reduced rate of VAT, which may not be less than 5%, to supplies of natural gas and electricity."[75] On the second occasion, the Commission used the opportunity to refer to the wider aim of greater harmonisation in VAT rates; the answer is reproduced in full below:[76]

> *Question No 90 by Barry Seal (H-0748/95)*
>
> Subject: VAT on domestic fuel
> Would there be any European Union opposition to a future British Government reducing VAT on heating fuel from 8% to 5% in order to help the elderly and people on low incomes?
>
> *Answer*
> Those Member States which, at 1 January 1991 and in accordance with Community law, exempted supplies of fuel and power from VAT, with a refund of the VAT paid at the previous stages (i.e. zero-rated), or applied reduced rates lower than 5% are, on a transitional basis, entitled to continue to apply those zero-rates or to apply a reduced rate, which may not be less than 5% (Article 28(2)(b)). At present, the taxation of heating fuel in the UK is based on this provision.
>
> However, the general position in Community legislation is that Member States should apply a standard rate of VAT, which may not be less than 15%, to the supply of domestic fuel and power. The above-mentioned transitional arrangements (which will anyway finish when the definitive VAT system for the internal market comes into force) were agreed in order to enable Member States, for a certain time, to keep the status quo. This does not mean that a zero-rate cannot be changed. But it is evident that, if changes were to be made, they could only have as their aim further harmonization, i.e. taxation at the standard rate. Thus, the earlier decision of the UK government to give up the zero-rate and to apply a reduced VAT rate of 8% to heating fuel instead of the zero-rate, is in line with the wording and the underlying ideas of the transitional provisions.
>
> Conversely, any possible move by the British government to reduce the VAT rate on heating fuel from 8% to 5% would go against the objective of further harmonization and would not be within the spirit of the transitional arrangements.
>
> If any such request were to be received from the British Government, the Commission would examine it against this background.

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74 Apparently the journalist responsible for the *Guardian* piece cited above based his article on the second of these answers, and a personal briefing from an official in the office of Mario Monti, the Commisioner with responsibility for taxation.

75 EP written question E-1771/94 OJC 24 30 January 1995

76 EP written question H-748/95 OJ Annex 4-470 13-17 November 1995

It is notable that the Commission do ***not*** state that they believe that this move would be illegal under European law. One suspects the Commission's choice of words may have a good deal to do with its wish to see better progress toward a definitive VAT system.

VII. Appendix: VAT rates - the current EU rules

The two diagrams below summarise the transitional arrangements for VAT harmonisation under the Sixth EC VAT Directive, as amended. These are taken from January 1993 issue of *VAT Monitor*, published by the International Bureau of Fiscal Documentation.

FIGURE 1: VAT RATES AFTER 1992: MAIN RULE

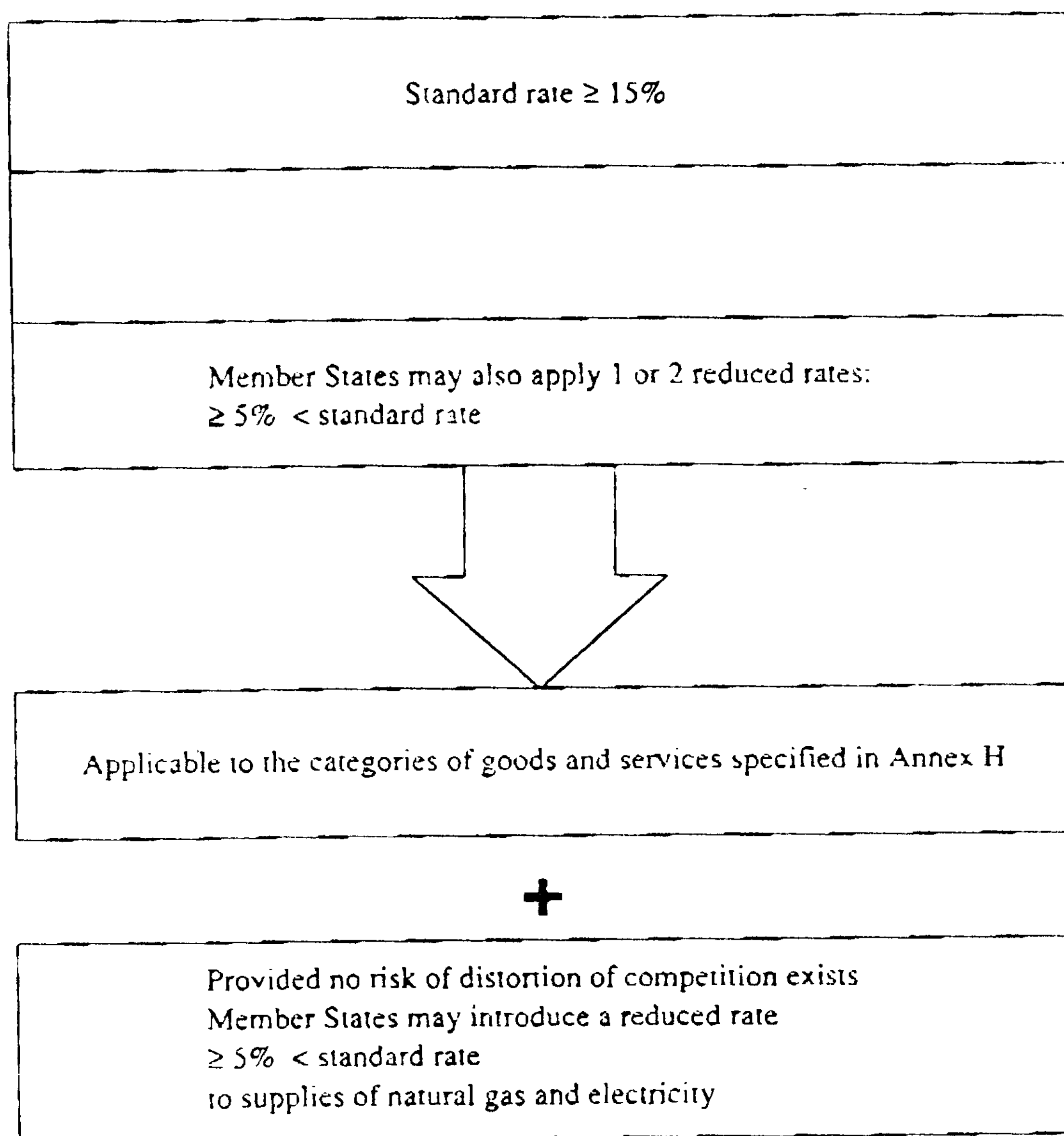
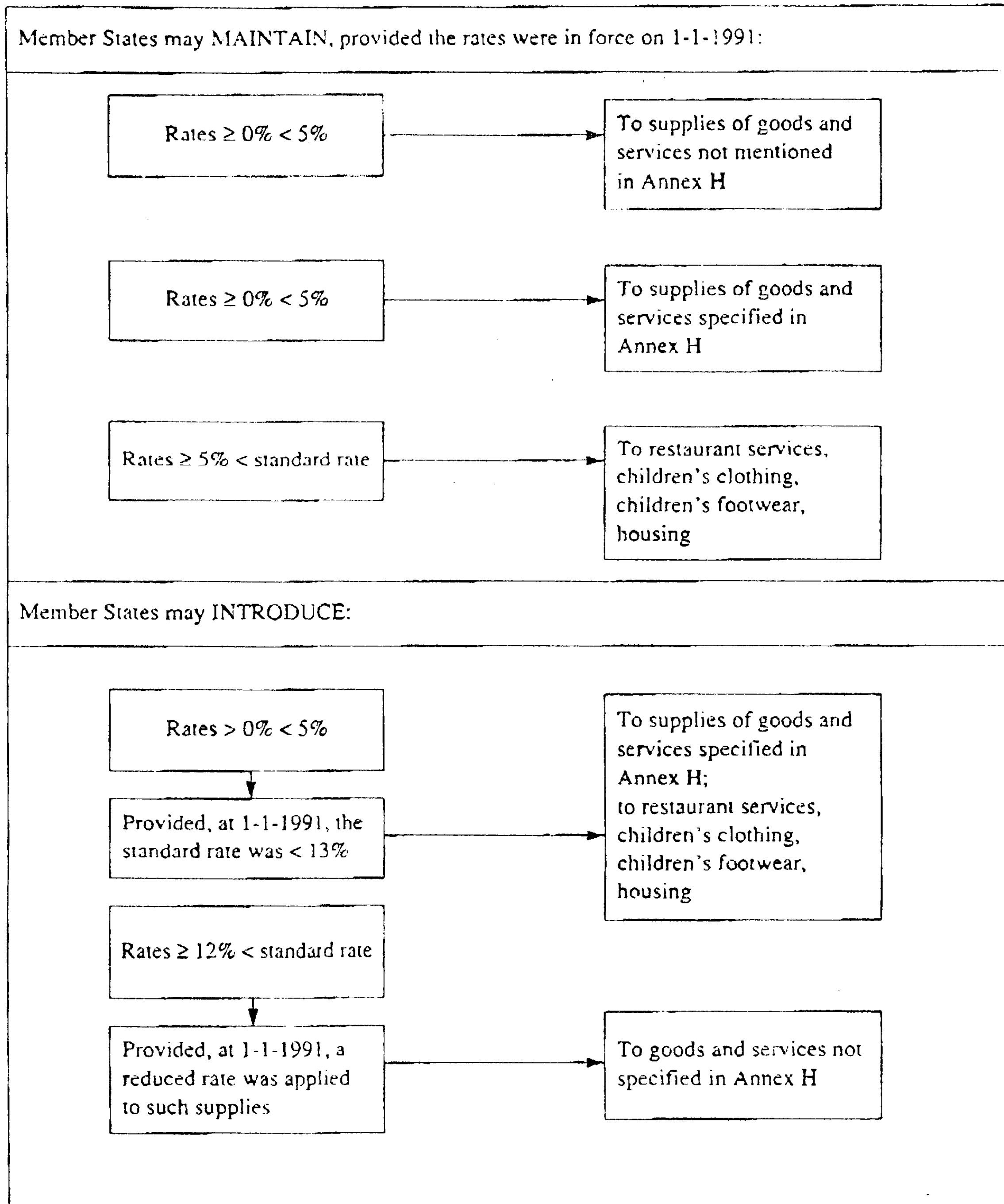


FIGURE 2: REDUCED VAT RATES AFTER 1992: TRANSITIONAL ARRANGEMENTS



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