Brussels, 15 November 2004

# BACKGROUND[1]

## *ECONOMIC and FINANCIAL AFFAIRS COUNCIL*

## Brussels, 16 November 2004

*The Council will be preceded as usual by a meeting of the **Eurogroup**, on 15 November at 19.00, focusing on the economic situation, the rise in oil prices, the review of the Stability and Growth Pact and budget data provided by Greece.*

*A press conference will be held after the Eurogroup meeting, as from 21.00.*

*The Council is due to discuss the review of the **Stability and Growth Pact**, identifying areas where further work will be necessary with a view to enabling the review to be concluded next year. It will examine the issues raised by revisions by **Greece** of the data it had previously provided for assessment of its budgetary situation.*

*The Council will discuss the Commission's proposals for modifying the EU's system of own resources under the EU's **financial framework** for the 2007-13 period. It will adopt conclusions on the findings of the high-level group on the Lisbon **economic reform strategy**.*

*And on financial services, the Council is due to reach political agreement on **cash controls** at the EU's external frontiers to combat terrorist financing and to adopt conclusions dealing in particular with **securities markets regulation**.*

*The Presidency will hold a press conference at the end of the Council. An intermediate press conference may take place before or after lunch.*

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*Three further meetings will take place in the margins of the Council:*

- *Ministerial breakfast on differences in welfare levels in the EU and the United States;*
- *Ministerial dialogue with the EU candidate countries*
- *Lunch meeting with the EFTA countries on ageing populations*

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**1** This note has been drawn up under the responsibility of the Press Office

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**Lisbon economic reform strategy**
**- Follow-up to the European Council**

The Council will discuss the findings of the high-level group advising the Commission on its preparations of the mid-term review of the economic reform strategy laid down at Lisbon in March 2000, following the presentation made to the European Council on 4 November by the group's chairman, Mr Wim Kok.

The European Council invited the Commission to bring forward proposals by the end of January so as to enable it to provide renewed impetus to the Lisbon strategy by concluding the mid-term review at its 2005 Spring meeting.

The Council is due to adopt conclusions highlighting the following priorities:

- Focusing on growth and employment in order to achieve the objectives of the Lisbon strategy;
- Reforms aimed at accelerating employment and productivity growth;
- Political ownership and leadership;
- The central role of the Broad Economic Policy Guidelines and of multilateral surveillance;
- Increasing accountability.

**Stability and Growth Pact**
**- Review of the Stability and Growth Pact**

The Council will discuss the review of the EU's Stability and Growth Pact on the basis of a note prepared by Presidency and the President of the Economic and Financial Committee (EFC). It is expected that it will give the EFC a mandate for further work so as to enable the Council to hold a policy debate with a view to concluding the review of the Pact during the first half of next year.

The review of the Stability and Growth Pact is being conducted in the light of a communication issued by the Commission in September, assessing the Pact's role, after five years of implementation, in the co-ordination of the Member States' budgets. This follows the Court of Justice's ruling on 13 July in case C-27/04 (Commission against Council) that clarified respective roles in application of the fiscal framework.

The Commission's communication examines how the Stability and Growth Pact could respond to shortcomings experienced so far through greater emphasis in recommendations on economic developments and through increased focus on safeguarding the sustainability of public finances. It assesses how the instruments for EU economic governance could be better interlinked in order to enhance the contribution of fiscal policy to economic growth and support progress towards realising the economic reform strategy that the European Council set at Lisbon in March 2000. The communication also suggests possible improvements in enforcement of the fiscal framework.

At an informal meeting at Scheveningen on 11 September, Ministers identified the following elements for further work on the Pact's review:

- The Pact has proven its usefulness in anchoring budget deficits, e.g. compared to the levels seen during slowdowns in the past and compared to other regions, it has contributed to low inflation and low interest rates.

- The 3 percent deficit and the 60 percent debt criteria in the Treaty remain of paramount importance.

- A rules-based system remains the best guarantee for commitments to be enforced and for all Member States to be treated equally. Ministers agree that the Treaty should not be changed and that changes to the regulations should be minimised, if necessary at all.

- In strengthening and clarifying the Pact, due consideration should be given to strengthening its economic rationale and implementation.

- To ensure the credibility of the framework, the rules should at the same time remain transparent and simple. The following elements, amongst others, should be analysed:

  1) The preventive arm of the Pact should be strengthened,
  - first, a more symmetrical approach to fiscal policy through budgetary discipline in good times with the objective of gradually achieving budgetary surpluses;
  - second, through practising peer pressure and peer support at an early stage of budgetary deviations;
  - third, through transparent budgetary figures and growth assumptions, so as to identify and correct budgetary deviations in a timely manner.

  2) The focus on debt and sustainability should be enhanced,
  - first, the debt ratio should be sufficiently diminishing if it is above the reference value, approaching the reference value at a satisfactory pace;
  - second, in the assessment of whether Member States have reached sustainable public finances, the future costs of ageing should also be taken into account;
  - third, Ministers agreed to look into the issue of debt sustainability and the possible statistical implications of pension reforms.

  3) Under the excessive deficit procedure, when assessing compliance with recommendations, a distinction should be made between measures taken and economic forecasting errors.

  4) Within the fiscal framework, budgetary policies need to set the right priorities towards structural reforms, innovation and competitiveness, in support of the Lisbon agenda to promote economic growth and employment creation.

**- Revisions of Greek budget data**

The Commission will provide the latest information regarding revisions by Greece of the data it had previously provided for the assessment of its budgetary situation, including for the years 1997-99 during which Greece joined the euro.

The Council will examine the reasons for these revisions and the issues raised by them, pending a more general discussion at its meeting on 7 December on statistical issues related to budgetary notifications under the Stability and Growth Pact.

At the informal meeting at Scheveningen on 11 September, Ministers issued a statement expressing concern at the size and scope of the Greek revisions and emphasising that reporting of budgetary statistics should not be vulnerable to political and electoral cycles. They requested the Commission to present by June 2005 a proposal for minimum standards for statistics.

On 21 October, the Council adopted conclusions acknowledging the efforts of the Greek authorities in working with the Commission to clarify the issues and stressing that similar revisions of budgetary data must not occur again.

**Financial services**
- **Report on financial integration**
- **Securities markets regulation**

The Council will examine a report on financial integration that it requested from the Financial Services Committee at its 2 June meeting in order to prepare further discussion of future priorities during the first half of next year. It is due to adopt conclusions.

The Council is due to adopt conclusions reviewing experience in implementation of securities market regulation under the so-called Lamfalussy approach introduced by the European Council at Stockholm in March 2001. The draft conclusions note that introduction of the new framework has been successful and has so far met its objectives.

The aim of the Lamfalussy approach is to regulate securities markets in a way that is sufficiently flexible to be able to respond to both market developments and regulatory standards and to speed up decision-making, so as to ensure the EU's competitiveness in this area whilst respecting the requirements of transparency, legal certainty and institutional balance. The European Council called for a review of the new framework before the end of 2004.

The Council will also adopt, without discussion, conclusions on cross-border clearing and settlement of securities transactions, following the consultation held by the Commission on the basis of a communication that it published in April. It will welcome the Commission's intention to present an impact analysis of each of the main elements of the regulatory proposal on clearing and settlement that it expects to present during the second half of next year.

**EU financial framework for 2007-13**

The Council will hold a policy debate, on the basis of a questionnaire from the Presidency, on the Commission's proposals for modifying, under the EU’s financial framework for the 2007-13 period, the system of own resources for the financing of the EU budget and the mechanism used for the correction of budgetary imbalances.

The Commission's proposals consist of a draft Decision on the own resources system, a draft Regulation on the correction of budgetary imbalances and a report on operation of the own resources system.

As concerns the new financial framework, the Presidency's aim is for the European Council to define, at its meeting on 17 December, principles and guidelines for further work aimed at achieving political agreement next year. The Council in its General Affairs configuration (as the preparatory body for the European Council) has overall responsibility for the negotiations, although the particular interest of the Economic and Financial Affairs Council is recognised.

The Council's debate is intended to provide input for the principles and guidelines to be defined by the European Council. The Presidency's questionnaire raises the following issues:

- What is the view of Ministers on the functioning of the current system of own resources?
- Which are the potential improvements to the current system that Ministers have in mind?
- What is the view of Ministers on the proposal by the Commission to work towards introducing a tax-based resource?
- What is the view of Ministers on the functioning of the current correction mechanism? What is the view of Ministers on the proposal of the Commission to correct excessive budgetary imbalances within the system of own resources?

<u>Own resources</u>

As regards own resources, the Commission considers that although the current system has provided sufficient and stable financing for the Community, it lacks transparency and provides only limited financial autonomy. The Commission proposes three options for the future:

- Maintaining the present system unchanged;
- A GNI-based system that would involve abolishing the VAT resource;
- A system financed by tax-based resources.

The Commission concludes in favour of a system using a larger share of tax-based resources and using a more limited GNI resource (maximum 40% of the budget) as the residual resource. It proposes not to create a new tax but to use a percentage of specific existing national taxes, either a share of energy tax or of VAT or corporate income tax. Almost all delegations have reservations regarding a system that would be financed by tax-based resources; a large number would prefer a purely GNI-based system, arguing that it is the most simple and fair possible.

<u>Correction of budgetary imbalances</u>

Concerning the correction mechanism, currently used for the United Kingdom budget rebate, the Commission proposes to generalise the correction of excessive net budgetary burdens on individual Member States on the basis of the decision taken at the European Council at Fontainebleau in 1984.

The mechanism would apply when the budgetary balances of net contributors to the EU budget exceed 0.35% of their GNI; they would be refunded at a maximum rate of 66% to be reduced automatically if it exceeds a maximum refund volume of 7.5 billion euros. All Member States would participate in the financing of the total corrections and transitional measures would be provided for the UK and other Member States for a period of four years.

This political issue is likely to be dealt with in the context of an overall agreement on the new financial framework.

**Cash controls to combat terrorist financing**

The Council is expected to reach a political agreement on the proposal for a Regulation on controls of cash entering or leaving the Community.

The Regulation is aimed at improving the effectiveness of Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering – which is currently under review in order to better combat terrorist financing – by providing a common system for cash controls at the EU's external frontiers.

It is also aimed at implementing the recommendations of the Financial Action Task Force on Money Laundering set up at the initiative of the G7 at a summit at Paris in 1989.

Discussion is likely to concentrate on the issue of the threshold above which natural persons would be required to declare cash when crossing the EU's external frontiers. While some delegations are requesting a threshold below or equal to 10 000 euros and others could agree to a threshold of 10 000 euros, some delegations would prefer to keep the threshold of 15 000 euros set the the Commission's proposal. The Commission could however accept a 10 000 euro threshold.

The issue of recording and processing of information is also outstanding. The proposal requires that information provided in written, oral and electronic declarations be recorded and processed by national authorities. One delegation maintains a reservation with regard to the mandatory requirement to record oral information.

The draft Regulation is based on articles 95 and 135 of the Treaty (Parliament-Council co-decision procedure, qualified majority required within the Council). The Parliament adopted its opinion in first reading in May 2003.

**VAT - Business obligations - Reduced rates**

The Commission will present proposals aimed at simplifying business obligations relating to value-added tax.

The objective is to ease VAT compliance for businesses that have no base in Member States where they carry out their activities, by using, amongst other things, a "one-stop shop" and an extension of the current reverse charge system for declaring VAT. Under the Commission's proposals, when a trader carries out taxable transaction in a Member State where he is not established:

- either the customer would account for the VAT under the reverse charge mechanism and the trader would have no obligation to fulfil in the Member State of taxation;
- or the trader would be liable to pay the tax and could, if he so chooses, make a VAT declaration under the one-stop shop scheme, i.e. in the Member State of establishment.

The proposals consist of:

- a draft Directive amending Directive 77/388/EEC with a view to simplifying VAT obligations;
- a draft Directive laying down detailed rules for the refund of VAT provided for in Directive 77/388/EEC for taxable persons not established in the country but in another Member State;
- a draft Regulation amending Regulation 1798/2003 as regards administrative co-operation arrangements in the context of the one-stop scheme and the refund procedure for VAT.

Under "other business", the Council will also examine the issue of reduced VAT rates, at the request of the French delegation.

The Presidency has endeavoured to refocus work on this issue, in order to break the deadlock reached in the Council on a proposal made by the Commission in July 2003, but its contacts have so far revealed no change in the positions of delegations.

The Commission's proposal provides for a general review of reduced VAT rates, including an extension of the use of reduced rates, inter alia for restaurant services. It is unacceptable to many delegations, either because it puts into question zero rates and parking rates, or because it is too generous as regards the scope of application of reduced TVA rates to the detriment of revenue intake, or because it does not provide the possibility to apply reduced VAT rates to specific supplies such as compact disks, buildings, environment-friendly equipment and labour-intensive services.

**European Action for Growth**

The Commission, under "other business", will brief the Council on implementation of the European Action for Growth launched by the European Council last December in order to improve European competitiveness and employment and the enlarged EU's growth potential through higher investment in both physical and human capital.

Complementing the economic reform strategy laid down by the European Council at Lisbon in March 2000, the Action for Growth covers material as well as immaterial investments in two broad areas:

- trans-European network infrastructure (TENs) including transport, telecommunications and energy;
- innovation, research and development, including environmental technology.

The Action for Growth assumes the part-financing of projects from national budgets, in particular by optimising the use of existing public resources, a contribution from the EU and the European Investment Bank (EIB) and enhanced coordination between all sources of financing. The mobilisation of private resources to finance qualifying projects is a central element of the Action.

The European Council in December invited the EIB to implement financial instruments aimed at leveraging private capital, Member States to complement the Action by national measures and programmes, and the Commission to redirect expenditure where appropriate towards growth-enhancing investment in physical and human capital and knowledge.