The Proposed Directive on Harmonisation of Taxation of Interest Payments

The European level playing field, the global markets and the invisible European citizen

Edmond Israel
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Mission

The Edmond Israel Foundation is a centre dedicated to the research and promotion of ideas of cultural, scientific, political and economic importance in the context of Europe. Its aim is to work both within the framework of a changing Europe and to advance European thinking elsewhere in the world, thereby making a high-quality contribution to the ongoing debates of our times and exploring themes of freedom, social responsibility and cultural identity.

Activities

The following represents a non-exhaustive list of activities of the Foundation:

- the remittance of the 'Vision for Europe' award for outstanding achievements;
- the sponsorship of conferences, seminars, symposiums and workshops;
- the sponsorship of studies and research;
- the sponsorship of internships in financial institutions for promising young professionals;
- the sponsorship and promotion of open or closed essay awards;
- the sponsorship, whether by donation of funds or otherwise, of activities which pursue objectives similar to those of the Foundation.

Board of Directors

André Lussi (Chairman)

André Lussi is President and CEO and member of the Board of Directors of Cedel Group which he joined in 1988. Prior to Cedel Group, André Lussi spent twenty years with Union Bank of Switzerland where he held senior positions in the securities, collateral loans and private banking areas, based in Switzerland, the United Kingdom and the United States. André Lussi is a member of the Board of Directors of TIBCO and of PROMETHEE.

Oscar Lewisohn

Oscar Lewisohn started his professional career in 1962 with S.G. Warburg & Co. Ltd. and was Deputy Chairman 1987 – 1994. He now holds directorships with the Republic National Bank of New York (Suisse), the Soditic Group, the Danish-UK Chamber of Commerce and is an Adviser to Mercury Asset Management Group.

Helmut Haussmann

Helmut Haussmann has been a Member of the German Parliament (Bundestag) since 1976. From 1984 to 1988, he was Secretary-General of the FDP and from 1988 to 1991 Federal Minister of Economics. Helmut Haussmann became a Lecturer of the Faculty of Business Management, Erlangen-Nuremberg University in 1978. Since 1996, he is a Honorary Professor in Management of the Erlangen-Nuremberg University. From 1997 to 1998 he was the Chairman of the Asia-Europe Foundation. Helmut Haussmann holds a diploma and a doctorate in economics.

John Gilchrist

John Gilchrist is Director of Corporate Communications of Cedel Group. He joined Cedel Group in 1990 as Head of Corporate Planning. Prior to Cedel Group, he held senior positions at the London Stock Exchange and a major management consultancy. John Gilchrist has published numerous articles and has chaired and spoken at conferences around the world on wide ranging subjects concerning capital markets.

Thomas Rabe

Thomas Rabe is Chief Financial Officer and a member of the Group Executive Management of Cedel Group. Prior to joining Cedel Group, he has held positions at the European Commission and the law firm Forrester Norall & Sutton (now White & Case). Thomas Rabe has published widely on the EU internal market, in particular on financial services as well as on competition and tax law. He holds a degree and a doctorate in economics from the University of Cologne.

Robert Massol

Robert Massol is Director Human Resources and a member of the Group Executive Management of Cedel Group. He has been with Cedel Group for 16 years and during that time he has held various management positions, mainly in Finance (Treasury, Credit, etc) and as Chief Auditor. Robert Massol holds a Master in Business Sciences from Paris IX Dauphine.

Introduction

I am pleased to present a report commissioned by the Edmond Israel Foundation and prepared by PROMETHEE, a Paris-based think-tank, on the Directive proposed by the European Commission on the taxation of interest payments.

In May 1998, the European Commission, based on a mandate of the Council of Ministers, submitted a proposal for a Directive to "ensure a minimum of effective taxation of savings income in the form of interest payments within the Community". The professional market associations, ISMA, IPMA and banking associations reacted strongly to the proposal, not least because of the inclusion of eurobonds.

Against this background, the Edmond Israel Foundation decided to launch an independent report, based on interviews with market participants and regulators. The report puts the proposed Directive in a more general framework of the changing and globalizing markets and the competitiveness of the EU financial centres.

The main conclusions and recommendations are to:

- Set up a high level group within Europe to reflect upon and make proposals on tax convergence after the euro;

- Engage market participants, notably professional associations such as IPMA and ISMA in a dialogue, also on the treatment of eurobonds;

- Engage the OECD partners in a co-ordinated effort to establish an OECD wide withholding tax, possibly with some regional rate differences that could fit into the global financial infrastructure needed for the smooth functioning of global financial markets.

The Edmond Israel Foundation hopes that the report will contribute to a constructive debate on tax harmonisation and on the creation of a more level playing field in Europe after the introduction of the euro.

I would like to take this opportunity to thank all the interviewees for their valuable contribution.

André Lussi
Chairman of the Edmond Israel Foundation

The proposed Directive on harmonisation of taxation of interest payments

The European level playing field, the global markets and the invisible European citizen

The Edmond Israel Foundation, at the initiative of its Chairman, André Lussi, has commissioned an independent report on the implications for European capital markets of the proposed Directive on the taxation of interest payments in the European Union (COM 98 295). This report has been entrusted to PROMETHEE, an independent non-profit think tank in Paris that has been working on European integration and the global networked economy since 1985.

The report is based on interviews of a number of eminent market participants. It has been directed by Dr Albert Bressand, Managing Director of PROMETHEE who assumes all responsibilities for possible errors or shortcomings.

The purpose of the report is not to pass a judgement but, rather, to seize the present proposal by the Commission as an opportunity for a debate on the next stages of European integration.

In light of the imminent creation of the euro, the report concludes with an assessment of the proposed Directive for the one-trillion dollar per year 'euromarkets' at the interface between European and global finance.

While reflecting on the important debate presently going on between market practitioners, the European Commission and governments, the report also endeavours to look at the agenda on tax harmonisation from the perspective of an essential although often invisible actor: the European citizen.

PROMETHEE is an independent, non-profit think-tank working on the global networked economy and its implications for policy makers and corporate strategies.

Active since 1985, PROMETHEE interacts regularly with research institutions, regulatory agencies and international organisations to understand changing patterns of globalisation, regional integration and global corporate networking. Long-term trends and their implications are identified through a three-tier process of conceptual developments, of strategic conversations and of shared visions, in close co-operation with PROMETHEEE corporate members, a number of leading-edge, global-minded corporations.

Context and objectives of the report

European integration, financial integration and the need for tax harmonisation

Europe is at a turning point and so are global financial markets. In a context of rapid technological change, of deregulation and of cross-border consolidation, the creation of the euro is pushing toward new levels of financial integration, with major implications for other policy domains.

Integration develops rapidly, not only within Europe but also across the Atlantic and globally. In the 'two-currency world' market participants will harness new opportunities for diversification, thereby further blurring the lines between 'domestic' and 'international' markets.[1]

These developments toward ever closer integration are market-driven. Yet, to be sustainable, they require an appropriate regulatory, legal and tax framework. Providing this framework is the responsibility of regulators and political authorities world-wide, with the EU, de facto, in a pace-setting role.

In this respect, after the Single Act, after the 'internal market', after the Stability Pact and the single currency, the time has come to take additional steps toward European integration and notably toward a common approach to taxation. Progress on this front has become necessary for the smooth, sustainable working of the Union at the level of integration already achieved.

The proposed Directive on taxation of interest payments in the EU

At its 1 December 1997 meeting, the Council of Economic and Finance ministers ECOFIN entrusted the Commission with the task of proposing a Directive on the taxation of interest payments in the EU.

The Council left relatively little room for improvisation to the Commission as it has also instructed it to pursue the search for a level playing field through the setting up of a withholding tax on interest payments using the so called 'paying agent' approach in which the tax is collected at the stage of payment to the individual saver rather than at the issuing stage ('debit' approach). As we shall see in Part 1 of this report, these detailed instructions[2] draw lessons from previous, relatively unsuccessful efforts to create and to implement a withholding tax. Drawing lessons from past failures, however, does not guarantee that the new attempt will succeed. Strong criticism has already been voiced.

Outraged market professionals

Of all the aspects of the proposal that deserve to be reviewed and assessed, the most controversial ones have to do with the implications of the proposed withholding tax on wholesale capital market activities and notably on euromarkets.

[1] For an analysis of the integration trends taking us beyond 'interdependence' and 'globalisation' see notably Europe 2012, Globalisation et cohésion sociale : les scénarios luxembourgeois, Albert Bressand, Bruce Scott, Manuel Baldauff, Gérard Hoffman, Léon Helbach and Thierry Wolter, Fondation Alphonse Weicker / Economica, 1997; Strategic Conversations on the Euro at the Vanguard of Global Integration, Albert Bressand editor, prefaces by Jacques Santer and Rolf Breuer, PROMETHEE/Ernst & Young, 1998.

[2] The key points in the resolution by the ECOFIN Council of December 1997 are presented in the Annex of this report.

The Council has given clear instructions not to impose the withholding tax upon institutional investors, yet this has not been seen as implying that the euromarkets should benefit from an across-the-board exemption as had been the case in previous Directives. Rather, the Ministers of Economy and Finance have taken note that a significant proportion of euromarket investors - between 10% and 20% depending on the period and method used to measure - were individual investors rather than professional intermediaries or institutional investors, which has led them to include the euromarkets in the scope of the proposed Directive. Complex procedures have been proposed by the Commission to differentiate between individual and institutional investors to identify their tax residence and to gather the information needed for both the country of residence and the country collecting the tax.

This part of the proposed Directive has been prepared with a quite remarkable lack of consultation with those professional associations representing capital market practitioners and, notably, euromarket participants. In all fairness, one should also observe that the euromarket community for its part may have a long history of underestimating the usefulness of consultation with 'generalist' law makers, preferring to limit communication and exchange of information to a small circle of officials directly concerned with the details of their activities.

Whatever the reason, these professional associations, first among them IPMA and ISMA, are now expressing far-reaching criticism of the procedures contemplated by the proposed Directive. They also express strong doubts regarding the objectives that the proposed withholding tax will achieve and the ease with which it can be circumvented while nevertheless imposing what they see as a quite extraordinary cost on the financial institutions that they represent.

Criticism centres on the contradiction between the complexity of the procedures and the critical importance that capital markets place on efficient, predictable, low cost modes of operations, especially in the one-trillion-dollar-per-year euromarkets that developed in Europe most notably after the 1963 imposition of the equalization tax in the US markets.

The invisible European citizen

The technical part of that debate has now been presented to the informed public in a contrasted enough fashion. There is sufficient experience in the Union with drafting, redrafting, consulting, lobbying and otherwise trading arguments for anyone to be confident that some sort of amended proposal will eventually emerge which will accommodate at least some of the technical concerns expressed by the professional market community.
Our purpose in this independent report is different. We do not aim to defend one specific interest group or professional community against another, be it euromarket practitioners or tax collectors - as they have all the skills necessary to get their points across. Rather, our purpose is to look at these important issues with the eyes of the

invisible public: the European citizen. 'Europe' has become a major defining element of his/her working and living environment and, as of 1 January 1999, citizens of eleven countries have taken the great step toward sharing one single currency, with far-reaching implications.

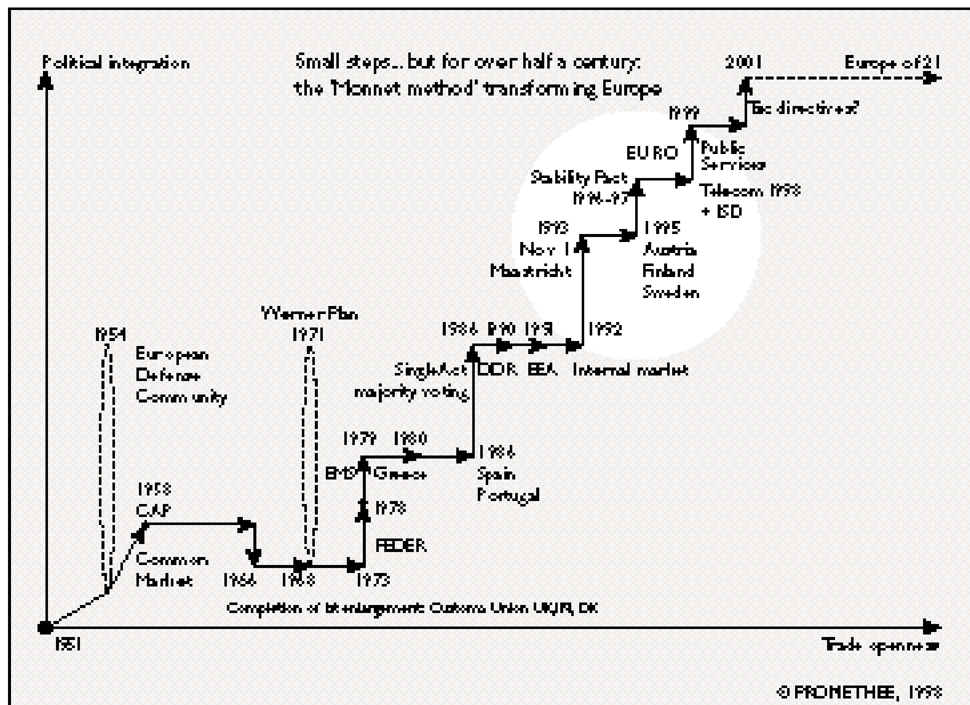
Some of the concerns of European citizens are the same as those of market practitioners, in the sense that getting access to liquid, low cost, efficient capital markets is one of the dimensions of job creation. Other concerns have to do with fairness and social justice, which are key objectives of the proposed Directive. And yet other concerns have to do with the meaning and implications of European integration as such.

Is the proposed Directive solving more problems than it creates, in its attempt to protect this 'invisible European citizen' from the negative effects and job losses of 'harmful' tax competition? Does the Directive identify clearly what is 'harmful' and what is merely 'competition'? Is the proposed Directive a step forward on which future, more ambitious progress will be possible for the Union as a political and economic construct? Will it contribute to lowering the burden on law-abiding citizens by reducing the scope for tax evasion inside the Union itself? And will it deter or enhance tax evasion outside the Union? Is the proposed Directive contributing to 'the competitiveness of European markets on a global scale' as called for in the fourth guideline put forward by the Council? More generally, is the proposed Directive contributing to defining the post-euro agenda in a way that citizens and market participants will understand and benefit from. Such are some of the questions that will still be with us long after the proposed Directive is in place.

The spirit of Monnet and the road beyond the new money

For Europeans, since the late 1950s, moving from one stage of integration to the next has taken place most successfully as a result of the need to provide concrete answers to the problems arising from the integration already achieved. Such has been the essence of the 'Monnet method' that has allowed Europe to move from the Common Market to the 'internal market' and from the European Monetary System (EMS) to EMU, but also from the freedom to move goods across borders to the Schengen agreement on free movement of people and to the freedom to be educated in another EU country and have one's diploma recognised.

The power of the 'Monnet method' lies in its combination of a flexible, step-by-step approach with a sense of priorities and momentum. These priorities in turn must be grounded in a compelling, even if diffuse, sense of European progress, a notion which has acquired a strong social dimension beyond its post-war dimension of peace and stability. Conditions need to be met, however, for the 'Monnet method' to succeed as it has done in the case of the internal market and of the euro, rather than to fail as it did with premature projects in the field of common defence (1954) and of monetary union itself (1971). The objective of the present report is to assess to what extent these conditions are met by the proposed Directive in its present state and, when appropriate, how they could be better met so as to contribute to this long



march toward a 'closer and closer Union' which has changed so many aspects of the working and social life of European citizens.

Five conditions for a positive contribution by the proposed Directive to the long term European integration process

There is a broad agreement on the objectives put forward by ECOFIN at its 1 December 1997 meeting, including on the part of IPMA, ISMA and other critics of the present proposal. No one challenges the need for some form of tax harmonisation - some form would indeed be most welcome by markets - and no one advocates turning a blind eye on tax evasion. This broad agreement has also been clearly expressed during all the interviews with market participants and regulators that we have conducted. Hence the need to look at whether the proposed Directive will take the Union closer to these goals and whether it will do so with reasonable efficiency.

Starting from the explicit objectives of the proposed Directive and moving toward the most controversial aspects of the debate, one can identify five sets of conditions for the project to contribute to - rather than detract from - the 'Monnet momentum'.

- The first set of conditions pertains to the objective of creating a 'level playing field' regarding taxation of interest payments and of eliminating 'harmful' tax competition. In a sense, any form of competition is bound to be harmful to someone -just like the competition of railways was harmful to stagecoaches.

So the issue is to distinguish what is 'fair' from what is not, what belongs in Schumpeter's 'creative destruction' and what amounts merely to bribing investors, savers or workers to move from one country to another. This assessment of 'fair competition' cannot be conducted in the abstract but must relate to the values behind the broader intra-European integration process itself.

- The second set of conditions has to do with the technical means put forward by the proposed Directive to achieve this level playing field and serve these values. Among these technical choices are notably the 'coexistence mechanism', the 'corrective mechanism' and the non-final nature of the proposed withholding tax. They can be sources of positive synergies or, on the contrary, can introduce new obstacles irrespective of the underlying policy objectives and values.

- The third set of conditions are those needed to succeed in the fight against tax evasion, a central objective of the proposed Directive. Success in this point critically depends on keeping in check the risk of capital flight toward non-Union financial centres as well as on the size of the 'loopholes' that the proposed Directive may create inside the Union itself.

- Fourth, a fundamental, though less familiar, aspect of European integration is the need for a 'good fit' between the objectives that Europe sets for itself internally and the challenge of adapting Europe to a globalized world. This is particularly important as the euro will move from being 'simply' the cornerstone of intra-European convergence and integration to join the USD in a still untested two-currency financial and monetary system. Will the proposed Directive help Europe in this transition from the 'European euro' to the 'global euro' or will it contribute to the risks of a 'parochial euro'?

- Last but not least, the link between intra-European and global integration is brought to light vividly by the controversy regarding the impact of the proposed Directive on the euromarkets. These very liquid markets on which close to one trillion USD have been raised through more than 5,000 issues, in 1998 alone, happen to be simultaneously, based in Europe, very important to European sovereign and corporate borrowers as a large and efficient source of funds and global in nature, in terms notably of the financial institutions, currencies and market infrastructures involved.

Outline of the report and executive summary

These five sets of conditions for a successful contribution by the proposed Directive to what one might call 'European Union progress' are addressed successively within the limits of this report in five parts with reference notably to the perspective of the European citizen. The objective, again, is not to be exhaustive nor is it to repeat technical analyses that more qualified organisations can present from their specific professional standpoint. Quite modestly, the purpose of the report is to present a coherent analytical framework in which to debate the conditions under which the proposed Directive - in its present state or after some improvements and changes - could succeed. Success is understood in the broad sense of achieving this complex blend of market objectives and social objectives which give true meaning to the Union for European citizens.

Part 1 begins by looking at the objective of creating a 'level playing field' for taxation of interests payments in the broader context of European integration. After a brief history of the developments that led to the proposed Directive, particular attention is devoted to the objectives of social justice and fairness that give it its political legitimacy. The report discusses notably the various perspectives in which 'fairness' might be defined, not all of which necessarily coincide with the choice made by the German Constitutional Court in Karlsruhe and extended to the Union as a whole in the proposed Directive. In light of the growing awareness of unfunded pension liabilities, it challenges the notion that fairness necessarily coincides with taxing savings at the same rate as salaries and wages, ending with calls for a more sophisticated debate that could open the way to a European perspective on taxes.

The level at which the withholding tax should be set is obviously a key aspect in the 'levelling' of this playing field. The report looks at the rationale behind the Commission's proposal for a 20% withholding tax and at the role played by a 'corrective mechanism' whereby individuals could choose to be exempt so as to be taxed in their country of residence. On this, the report finds that the Commission's efforts to assess the appropriate tax level omits one major source of distortions for the 'level playing field', namely the massive tax exemptions and tax incentives that most Member States have put in place to keep savings in State approved instruments such as 'Livrets A' in France. It also questions the timidity of the Commission in looking at citizens as irrevocably belonging in only one national tax system, at the very moment when they are about to share one single currency and when they already share one supranational Court of Justice, the Schengen freedoms to cross borders without police checks and even the right to vote in local elections of Member States different from their own. Altogether, the proposed Directive appears to identify obstacles to a level playing field in a manner biased toward keeping investors at home.

Part 2 looks at key features that will be central to the success or failure of the proposed Directive, namely the 'coexistence mechanism', the 'corrective mechanism' and the fact that the withholding tax is not intended to be final.

Two options would seem to be easier to implement while also bearing a clearer relationship to the overall European integration agenda:

- The first option would be to make the withholding tax final, thereby acknowledging that citizens of one Member State are also treated as citizens of the Union, able and willing to pay taxes in several countries just like they can vote in local elections in several Member States.

- The second, more traditional, option would be to wait before introducing the withholding tax until Member States have put in place the level of harmonisation between national taxes on interest payments that would make a common EU 'superstructure' much easier to administer. Most probably, this second approach is likely to be more time-consuming. Also, unlike the first approach, it would imply more interference into national tax structures and less subsidiarity.

Hence the strong recommendation in this part of the report to 'cut the Gordian knot' by making the withholding tax final: rather than a complex (and maybe unworkable) bridge between national tax systems, it would become on the side of VAT and excise tax the second element of a truly European tax policy that would continue to evolve gradually in a consensual rather than divisive manner.

Part 3 turns to the element of tax evasion and to the likelihood that the proposed Directive will make possible major progress on this front. The report finds that the proposed Directive will leave open major loopholes, both within the Union itself and in the context of the competition with off-shore centres.

Regarding the intra-Union 'lawful loopholes' the report discusses the implications of the proposed Directive of taxing interest payments separately from other types of financial gains. This may sound simple in a Brussels office, yet swap markets and financial innovation are seen as likely to contribute greatly to the proliferation of 'lawful loopholes' that this fragmented approach entails. This is likely to trigger an abundant stream of technical adjustments and counter-measures by EU tax authorities that could be detrimental to the predictability of the EU tax framework. This risks also to create a permanent climate of suspicion, thereby leading a number of citizens or Member States to question the democratic legitimacy of EU actions in these fields.

As for the 'off-shore loopholes', the report expresses strong doubts as to the practical significance of the hopes put by the proposed Directive in those Member States with 'special responsibilities' over some of these off-shore centres. It also discusses the likelihood - or non likelihood - that Switzerland, home to more than a third of the world's private banking activity, will co-operate in such efforts. The report draws special attention to the new dimension in cross-border investment to be expected from the new stages of Internet-supported financial services and to the massive

technology investments undertaken by some off-shore centres, notably Switzerland, for the purpose of private banking. The encryption and communication technology presently being deployed will provide investors with highly securitized, on-line access to 'companion accounts' open with the Bermuda or Bahamas subsidiaries of banks within or outside the Union's reach, notably by Swiss banks. Baring much more precise negotiations with other OECD countries - first among which Switzerland - such 'double-bottomed' accounts have the potential to defeat any harmonisation that might emerge, not just from the proposed Directive but also from what are expected to be strong EU and German pressures on Switzerland regarding Swiss participation in a withholding tax mechanism.

Altogether, the report challenges the notion that the Directive will produce much in the way of fighting tax evasion and, probably, of generating additional revenue. The risk is then that small investors will feel discriminated against and that the complex procedures contemplated in the proposal will be hard to relate to clear benefits.

Hence the recommendation is to approach tax evasion in a broader context of trust between governments and citizens. Trust is not mandated but can only reflect a two-way process of transparency and accountability in which citizens are addressed not as a 'gang of potential cheaters' but as the ultimate source of purpose and of legitimacy for collective action. Rather than embarking on the low road of mediated denunciations of tax evaders and of 'loophole policing', EU governments have everything to gain by following the high road of shared ethics, of mutual accountability and of shared purpose. After all, taxes are not what is 'owed' to officials and public servants, taxes are what we pay for civilisation.

This implies however that governments continue the progress they have made over the last decades toward financial responsibility and transparency. It also implies that they refrain from introducing new sources of distortion in the field of corporate tax or of capital gains, for instance by putting national debt instruments or giving tax advantages to locally listed securities.

Part 4 looks at the contribution, either positive or negative, that the proposed Directive can make to the global role of the euro, in line with the fourth recommendation in the ECOFIN mandate of 1 December 1997 concerning the need to preserve 'the competitiveness of European financial markets on a global scale'.

The lack of consultation between the Commission and the major professional associations has contributed to the bitterness of the present debate. This represents a striking and ill-advised departure from the usual EU practice. The inward-looking spirit in which the proposed Directive has been drafted can probably be understood in light of the long and difficult road toward EMU that Member States have made the effort to follow. Yet, this Europe-centric perspective has major shortcomings on the eve of the

'two currency world' in which the Union will have to adopt a global perspective. The report concludes that the proposed Directive still reflects a 'European euro' perspective, in some cases maybe a 'parochial-euro' perspective. This at a time when the euro is about to become one of the world's two anchor currencies rather than simply the cornerstone of intra-European integration.

This inward lookingness can be explained in part by the fact that the euro will make the Union less open in terms of trade to GDP ratios if the euro zone is considered as one 'country'. Yet, this will not apply to monetary relations where, on the contrary, massive portfolio diversification should be expected to the tune of 400 USD to 1,000 billion USD over a few years, with the usual pendulum effects.

The report warns therefore against the feeling that the Union needs to pay less attention to the rest of the world after the euro because it is most probably that the opposite will happen in a world no longer defined by trade ratios.

Part 5 calls attention to one essential element in the 'transmission belt' between European and global finance, namely the Eurobond markets - more generally, the fixed income euromarkets. The impact that the proposed Directive can have on the working and localisation of these markets is discussed in the light of their strategic significance for the Union.

Calls for blanket exemptions of the euromarkets notwithstanding, a major difficulty in crafting a more nuanced approach to tax harmonisation is the blurring of the lines that used to separate such markets from the domestic European capital markets. The creation of the euro is indeed disposing of the very notion of 'domestic bond markets'. The report therefore presents the strong reasons behind the refusal by the Commission to exclude euromarkets from the proposed Directive. It then looks at the criteria that had been put forward by the Commission, after in-depth consultation and co-operation with IPMA, in the Prospectus Directive to exclude euro issues. The report finds that these pragmatic criteria based on the cross-border nature of syndication and issuing will no longer be appropriate for markets in euro as the latter will be, by nature, cross-border.

The report then presents the 'consensus' scenario put forward by IPMA, ISMA and a number of other prominent professional associations in August and September 1998 to alert policy makers to the risks of delocalisation of euromarket activities that these associations see as the logical consequence of the proposed Directive in its present drafting. The job losses are expected to be in the order of 11,000 in London and 1,400 in the custody and paying agent activities in Luxembourg and London. But what will be lost is more than highly skilled, well-paid jobs. It is also the position of the Union as the premier gateway into the one-trillion-dollar-markets in USD and in major currencies from the whole world. The irony is that euromarkets will be where many European companies - and quite a few governments - will go to raise capital in euro: does anyone really intend to have them travel to New York or Zurich to find euros under the best terms and conditions?

Defining 'euromarkets' is therefore an essential aspect in any effort to deal with the implications of tax harmonisation for the euromarkets. This should probably be done more in terms of 'wholesale' vs. 'retail' than of 'on-shore' or 'domestic' vs. 'off-shore'. The euromarket community is invited by the report to take the initiative of preparing new guidelines that would allow to tell 'wholesale' from 'retail'. In light of the fact that the two can be highly intertwined - especially when 'high net worth' individual investors are involved - it could be that euromarket firms would gain by separating their own placement process in ways giving greater clarity to this wholesale/retail divide. In any case, such an effort has clearly not been made and no time should be lost, either by the Commission or by market practitioners, in coming up with a typology that citizens can understand and on which regulators can build.

Reaffirming the central objective of further progress toward European integration, the report concludes by putting forward a number of suggestions regarding the final form that the Directive could take.

A first, central recommendation is to take the time necessary for the dialogue and the preparatory work needed for the proposed Directive to avoid at least the major pitfalls that are bound, in its present state, to make it a quite ineffective source of additional income and, yet, also a major headache for European banks and financial institutions. Moving from a confrontational to a 'win-win' perspective is essential at the very moment when the Union has to make the euro a success on the global markets.

Achieving a 'level playing field', dare we suggest, should not take the form of setting up an excessively complex set of procedures that will slow down rather than speed up all the players in that field while also pushing some of them to leave the Union altogether. Beyond the fight against 'harmful competition', the real challenge, in a 'Monnet perspective,' is that the Commission is now called upon to open the field of tax policy for this 'ever closer union' which is the true purpose of all these efforts.

Now is the time for the Commission to administer one critical ingredient for success in the form of yet another illustration of its capacity to think boldly and to catalyse the Council into enlightened, far reaching initiatives. Ours is not a world in which status quo policies provide firm foundations for social progress. The Commission should therefore be encouraged to take the time to consult, to call attention to the emerging post-euro agenda in a positive rather than defensive manner and to have the audacity of breaking half-hearted compromises. Making the withholding tax final would at the same time eliminate many circumvoluted procedures and contribute to citizens looking at the Union as their home beyond the national home. Sometimes, the 'Monnet method' is also about cutting Gordian knots rather than about attaching new strings to help live with it.

Part1

The proposed Directive and the objective of creating a level playing field in European financial markets

In this first part, the report looks at the origins of the proposed Directive and at the lessons learnt from previous similar undertakings in Germany and at the Union level. This leads to discuss some deeper political or philosophical assumptions behind the proposal, notably the concept of 'fairness' that inspired the ruling by the German Constitutional Court regarding taxation of savings. While this notion of fairness is quite widely supported, alternative dimensions should be expected to play an increasing role as part of the broader debate on pensions, retirement and the changing working life that is now gathering momentum.

The level at which the withholding tax should be set is then discussed. Here again, this is done as part of a broader analysis of the European integration process that represents the context and the justification of the proposed 'level playing field' in financial services.

Taxes as the next major dimension of European integration after the euro

It is widely accepted that the degree of integration now achieved within the Union calls for accompanying measures in the field of taxes, beyond those already put in place in 1991 with respect to VAT and the almost complete harmonisation of excise duties. In this sense, the ECOFIN decision of 1 December 1997 mandating the Commission to prepare further steps toward tax harmonisation[3] is strongly supported by all our interviewees as well as by all organisations on record on this topic. This does not necessarily mean that, in its present state, the proposed Directive as presented by the Commission on 20 May 1998[4] is the optimal answer to the ambitious 'terms of reference' put forward by ECOFIN on 1 December 1997.

The first objective of the proposed Directive is to eliminate major tax distortion and to work toward a sufficiently homogeneous tax environment for the internal market to be a genuine 'level playing field' free of what ECOFIN refers to as 'undesirable distortion of competition'. The success encountered in the first major attempt of that type - the one regarding VAT- could be an encouraging one. Yet circumstances are very different.

The VAT precedent and its limits

One may indeed contrast the great difficulties of imposing a uniform tax on interest payments with the much higher practicality of imposing a uniform VAT. The latter is based on largely internal operations as exports are not taxed and can rely on well established collection procedures in place in all Member States.

[3] See Annex

[4] Proposal for a Council Directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community COM (1998) 295 final.

One critical ingredient that made the VAT decision possible - namely a clear, easy way to separate intra-European matters from 'global' matters - is not available when financial services and interest payments are concerned. One cannot hope to create a pure 'internal capital market' clearly separated from 'global' financial market, except at a very high cost to the European capital markets and to the economies that depend on them.

As summarised in table 1, the situation in the various Member States varies greatly and it is unlikely that all countries can be prepared in time for the very ambitious deadline set up in the proposed Directive.

Moving toward tax harmonisation to implement is therefore both a worthwhile, widely supported objective and much more difficult than in the case of VAT. Let us review the reasons that have led to the proposed Directive. We will then try to assess the likelihood that the proposed Directive can meet the objective of creating a level playing field and of facilitating the cross-border investment of savings within the Union as called for by the imminence of monetary union.

1.1. The freedom of capital movements, the German Constitutional Court and the political economy of tax harmonisation

Once barriers to capital movements are removed, differences in tax structures and levels come to the forefront as the major remaining source of distortion in market operation. Indeed, the very notion of 'level playing field' in financial services, especially at the retail level, makes no sense independently of tax structures. In addition to VAT, the Union has made major progress on issues like excise taxes (almost fully harmonized) but direct taxes, individual and corporate, are still vastly different.

One such distortion comes from the fact that

Table 1 Heterogeneous withholding taxes

	withholding tax level	final	partial exemption
Luxembourg	-	-	60'000 / 120'000
Belgium	15%	yes	LUF
Germany	30/35%	no	50'000
France	19,4%	yes (optional)	6'100 / 12'200 DEM
Austria	25%	yes	8'000 / 16'000 FRF
Denmark		-	no
Spain	25%		no
Finland	28%	yes	
Ireland	15/27%		no
Italy	12,5/27%	yes	no
Netherlands	-	-	no
United Kingdom	20%	no	1'000 / 2'000 HFL
Sweden	30%	yes	no
			no

Source 'The taxation of savings', CFE News in European Taxation, May 1997, reproduced in Fernand Grulms, Directeur adjoint de l'Association des Banques et Banquiers, Luxembourg 'La retenue à la source sur intérêts: un état des lieux', Repères, Banque Internationale du Luxembourg, Octobre 1998.

a majority of EU countries do not tax interest payments accruing to non-residents. This is clearly only one aspect of the broader tax harmonisation agenda but political sensitivities contributed to making it visible because it may take only a short trip across the nearest EU internal border for savers to be in a de facto 'haven'. The creation of the euro will remove one major obstacle to taking such investment decisions and will also push many European banks to increase their marketing efforts for financial services throughout the euro countries. In and by itself, this is a major justification for the effort launched by the ECOFIN Council on 1 December 1997 on the basis of a Communication by the Commission of 5 November 1997.[5] This is not the first time however that the Union or some Member States consider such projects and lessons have been learnt from past experiences.

A withholding tax proposal was first put forward within the Union as a whole in 1988 when it was decided that, by 1990, financial markets in Europe would be open and capital control lifted; in 1989, the Commission proposed a withholding tax of 15% on domestic as well as international interest payments that would have left some discretion to Member States for exemptions but that would have applied to financial institutions as well.[6]

Establishing some degree of harmonisation regarding capital gains of all types was seen as a natural component of integrated financial markets for the EU and for the European Economic Area (EEA) which brings it together with Norway, Iceland and Liechtenstein. Banking associations, such as the Luxembourg ABBL, were involved in preliminary discussions.

At the time the idea ran against strong British opposition as well as against a strong German reluctance to recreate the withholding tax debate that had led to a massive flight of capital by hundred of thousands of German individuals. Altogether, Germany, the UK, Luxembourg and the Netherlands voted against the Commission proposal.

The search for an alternative solution, spearheaded by Spain and France, centred around administrative co-operation. This, however, was seen by other Member States as an open-ended notion impinging on major aspects of sovereignty. Hence, the use by Luxembourg of its veto to block 'administrative co-operation' going beyond the judicial co-operation that the Grand Duchy encouraged.

At a time when all European governments tend to give greater salience to the defence of their national interests, it is worth remembering that taxes are one of the fields where the Union has not -or not yet- adopted majority voting. Unanimity is therefore required for a decision to be adopted. A debate on the desirability of moving to majority voting is now going on but raises sovereignty issues of great importance that are seldom dealt with in just a few months.

[5] A package to tackle harmful tax competition in the European Union, COM (97) 564 final.

[6] COM (89) 60 final and OJC 141, 7.6.1989.

The German situation and the 'political legitimacy gap' with other Member States

Many of the recent developments leading to the proposed Directive have their origin in the German situation preceding the recent elections of September 1998. The sudden emergence of the proposed Directive on the agenda and the unusually speedy process that led to its preparation went together with an effort by former Chancellor Kohl to stand himself aloof from what had been perceived as a willingness to put Europe ahead of German national interests. Luxembourg, a financial center known for, notably, its banking secrecy and its private banking activities, has also played a special role in the intra European debate and process.

A key element at the origin of the proposed Directive was that Germany found itself under a national obligation to treat earnings from savings in ways comparable to salary and wage income as a result of a judicial action by a German citizen before the Constitutional Court in Karlsruhe. The Court ruled that Germany had to insure equality of treatment between revenue of capital and labour.

In 1989, Germany had already put in place a withholding tax of 10% which had been a massive failure as millions of Germans had moved money to notably Luxembourg and Switzerland and the German corporations moved their issuing activities to the Dutch West Indies. The measure had been abandoned six months later, which led one citizen to take the matter before the Court.

The judgement by the Constitutional Court placed the German government under the obligation to revisit the issue. As a result, in 1993, Germany opted for a re-introduction of the withholding tax. In the hope to avoid some of the same problems under a modified form, moving from a debit withholding tax toward a paying agent withholding tax. To meet the objective of equal treatment laid out by the Court, the tax was set at the level of 30%, much higher than in the earlier attempt.

German authorities soon reached the conclusion that a purely national approach would be quite ineffective: the German Treasury was counting on 24 billion DEM receipts from this new tax, but only about half of that amount was collected.

The blame was laid upon Luxembourg. Singling out Luxembourg, however, was more a reflection of the direct links that German banks had established between their branches in Germany and the branches that most of them operate in Luxembourg. German tax authorities organised spectacular raids on several German banks in Germany itself, as part of an investigation into the direct support that they may have provided to their customers in opening and operating accounts with their Luxembourg subsidiaries.

What was special about Luxembourg, however, was that it could be accessed so easily through well established German channels deep within Germany: in a broader perspective, the issue is not specific to one country as investors operating on their own

individual initiatives rather than through a local bank are likely to be as easily attracted to Austria and its tax-proof numbered accounts and to neighbouring Switzerland, a country with a 35% market share for private banking or, for that matter, to other countries.

Pressure therefore began to grow on the European Council to consider a European-wide withholding tax. Yet, Germany's former Finance Minister Waigel, just like Belgian's Finance Minister Maystadt - who launched a debate on a 15% European withholding tax on cross-border interest payments - were not in a position to put it in place at the time when their respective countries presided over the EU Council.

Actually, and quite ironically in light of previous controversies, it was the Luxembourg presidency that gathered the energy and political capital needed to put the measure on its rails again. Luxembourg made it very clear through the support given to this objective that a degree of tax harmonisation was needed not just on interest payments but also on corporate taxes. It also made clear that such harmonisation should leave room for the degree of competition without which Europe as a whole will simply align itself on the most costly, least efficient approaches to public finance.

As highlighted by Prime Minister Juncker during the ECOFIN meeting of 1 December 1997, the Luxembourg position was also that 'harmful tax competition' can only be addressed as a whole. It implies notably that common rules regarding taxes on savings be accompanied by symmetrical effort to prevent 'harmful competition' also in the field of corporate taxes, a field in which Ireland raises more than one eyebrow with its decision to move over four years toward a corporate tax of 12.5% only.

One consequence of the sequence of events that led to the proposed Directive is that the German effort to establish a Europe-wide framework in which to implement the decision of the German Constitutional Court creates an 'imbalance of political legitimacy' between Germans and non-Germans. True, many EU countries share the similar principle of treating all sources of income equally. But Germans are clearly not in the position to approach the issue with the same flexibility of other countries, if and when major new considerations - such as those related to pensions which we address below - call for new approaches.

The EU does not have, at this stage at least, the fundamental 'Bill of Rights' that would define and allocate responsibility between the national and the Union level. It would probably be unwise for the other countries to rush into decisions in Brussels without a much deeper dialogue on the various aspects of the issues raised by the development of common elements of a tax policy. As the present debates clearly show, separating interest payments from other tax issues are not really in the cards, politically.

Tax policy is still within the realm of national sovereignty, but the preparation of the

proposed Directive could provide an opportunity to intensify the European debate on some aspects at least of this post-euro agenda.

1.2. Fairness, and the search for its fair definition

The definition for 'fairness' that inspired the German Constitutional Court and that has been carried into the proposed Directive is centred on a comparison between the tax treatment of salaries and wages and of financial gains on investors' savings. Such an approach sounds fair enough as long as the issue is not raised of whether these savings are not, in many cases, what remains of earned salaries and wages once they have been taxed a first time already.

a) Not all interest payments are windfall inheritances: the VAT reference

The implicit reference is indeed to wealthy savers with little more to do than watch their money grow (the French refer to this as 'l'argent que l'on gagne en dormant'). The reality, however can be quite different as millions of today's European citizens worry about the future of the present pay-as-you-go (PAYG) pension schemes.

In this sense, the proposed Directive is dealing with issues too closely related to pensions and savings for this increasingly important perspective to be ignored.

Although law-makers in most countries - the Netherlands and the UK being the exceptions - are slow to adjust, citizens can see that demography is not on their side as far as their future pensions are concerned, and they do their best to put aside money for their old age as a supplement to what they understand will be a shrinking supply of PAYG money. The point can be made therefore that there is nothing inherently fair in taxing the interest payments accruing to this set-aside money as if it were windfall profits or additional salaries/wages. In any case, the issue is of a political nature and defining what is fair involves more complex analysis.

The growing importance of pension considerations in savings decisions is likely to call for new definitions of 'fairness' by reference, this time, to the two ways in which citizens can choose to dispose of the money they have earned; namely by saving it or by purchasing goods and services. The appropriate benchmark for a 'neutral' approach in this case would not be income tax but the value added tax (VAT) collected at the time of consumption. Unlike income tax, VAT is a tax paid on revenues that have already been cleared through the tax system.

If these revenues are saved rather than consumed, one receives interest payments rather than a basket of goods and services, with VAT rather than income tax a natural benchmark. Actually, the case could be made at a later stage that, just like VAT, the tax on savings could distinguish between different types of (differed) consumptions, some being taxed at a low rate (e.g. those invested for pension purposes) while short term bank deposits could be in the higher bracket. Such a debate may sound a little esoteric today, yet there is hardly one country that does not

distinguish between different types of savings. A European debate would be a true contribution

b) Savings, interests, pensions and the changing relation of citizens and society to time

Gradually, all EU governments are coming to realise that unfunded pensions are a time bomb for the national well-being. They realize that this calls for new approaches to the taxation of money earmarked for pensions. The ongoing reassessment by the French 'Gauche Plurielle' government of its own previous opposition to pension funds is simply the most recent example of the thorough rethinking going on, above and across ideological divisions.

One may regret in this sense that the German Constitutional Court approach does not reflect yet this new awareness that citizens are now expected to take the initiative to save for their old age rather than rely on official PAYG schemes.

The same governments calling for high levels of withholding tax are now busy setting up tax exemptions and tax incentives of various types to invite citizens to save money as well as the interests earned on such money. In this sense, they are moving - with good reasons - away from the objective of 'ensuring a minimum of effective taxations of savings income' which ECOFIN mandated the Commission to put at the centre of the proposed Directive.

Of course, in the old economic paradigm, there was a crystal clear difference between money saved to prepare for retirement and money saved simply for being spent later. This difference, let us suggest, is likely to blur at a rapid pace and to call for comprehensive agiornamento.

The rethinking going on regarding pensions is too recent to have already carried to challenging established views and policies that were coherent with the PAYG world and that will not be coherent with the new approach still in the process of being formulated. And yet, which government in Europe today would dare say that they know at what age a given citizen will really 'retire' - or, too often 'be retired' or simply find herself out of the job market?

As long as they save, citizens are deferring consumption and preparing for 'the future'. And, increasingly, this is 'their' future rather than 'the' future as described in official age limits. We are moving from the easily understood succession of school years, working life and retirement toward far more complex 'life experiences' in which citizens need to find new 'balances of work, report and leisure' - forced or chosen. And these new customised life experiences are harder and harder to describe with the words and references inherited from a simpler period when a worker was a worker, a student was a student and a retiree was, quite simply, a retiree.

Life has become more complex for the invisible European citizen and this calls for more sophisticated policy trade-offs. Pension instruments of various types are likely to flourish, and the moment will soon come

when the Union as a whole will be under a strong incentive to come up with the equivalent of the US '401k' tax regime. It is a little unfortunate that the proposed Directive does not offer an opportunity to reflect and to steer policy discussions on what is likely to emerge quite soon as a major dimension of the euro/USD comparison and relationship. This certainly calls, anyway, for a withholding tax set with a broader intellectual perspective than some quasi-automatic comparisons between 'work income' and 'financial income' and for deeper and more informed debates than the one that the short time available has left in the preparation of the proposed Directive.

An obvious additional dimension that would need to be taken into account is the impact of inflation on the real value (as opposed to the nominal value) of this 'virtual basket' of goods and services acquired by the investor in exchange of his or her willingness to defer consumption.

Altogether, the purpose, in the present report is not to make the case for one definition of 'fairness' over another neither is it to present a fully fledged view of the ways in which the Union as a whole should adapt its policies regarding savings in light of the present economic and demographic transformation. It is simply to call attention to the fact that 'fairness' is a very complex and multifaceted notion. Students of John Rawles' Theory of Justice could elaborate better than is possible here on the conceptual and political challenges involved in this quest. Suffice it to say that one should beware of statements such as 'fairness resides in taxing income and interest at the same levels.' Such statements bring together very different notions of work, salary and wage rates, differed consumption, inherited wealth, real interests vs. nominal interests, time and the discount rate reflecting society's inter-generation arbitrages.

Thus, one should be suspicious of the possibility to define 'fairness' and its economic implications across so many important dimensions without deeper analysis and debate. Indeed, unless backed by a thorough analysis of the different trade-offs involved, such statements can be little more than well meaning political sound bites. Hence the strong call this report presents for looking at the proposed Directive as an opportunity to launch a thorough, well informed dialogue.

1.3. Taxes for the level playing field, but at what level?

On the proposal itself, the Ministers of Finance of the EU are expected to continue debating what is the right level for the common withholding tax. The proposed 20% is higher than levels that had been in place in some Member States in the recent past. France is asking to set this tax at 25%. The German withholding tax is set at 30%.

The Commission stresses that it has adopted 'a balanced solution to the problem of setting the rate of withholding tax' not only by taking into consideration the risks of setting it too high, but also by having put in place 'a corrective mechanism enabling the beneficiary, at his own initiative to be taxed according to the rules of his Member State residence'.

Yet, for all these efforts to reach a 'balanced' approach, the level at which the tax is set will quickly become a de facto reference that all countries will have to take into consideration when setting their own national taxes on interests. Three possible approaches would be:

- To set that common reference close to the highest levels experienced in any of the EU Member States, with citizens being reimbursed for what they have to pay abroad in excess of the level in their own country under the 'corrective mechanism'. This approach would serve the quite understandable objective of keeping as much of the savings as possible in the country of residence while accommodating individual situations such as those of European citizens employed or studying in a Member State different from their home country.

- To set the withholding tax at a level conceived first and foremost to contribute to the competitiveness of European financial markets on a global scale, as called for in point 4 of the ECOFIN Resolution of 1 December 1997. In this case, a higher degree of competition inside the Union should be accepted before being labelled 'harmful', with no premium being put on keeping savings within the country of residence. Intra-European competition has always served Europe well when it comes to adapting to higher levels of global competition.

- To treat the withholding tax as an unavoidable concession markets should make to politics and to seek the lowest possible level for that unavoidable concession.

The natural tendency of national exchequers will be to opt for the first approach which preserves their 'rights' over 'their' citizens.

The clear preference of market practitioners will be for the third approach, as it minimises the interference of governments into the smooth working of markets. During our interviews, it was clear indeed that market practitioners would look much more positively at the proposed withholding tax if its level were in the order of 10%. They see this level as the limit under which the proposed tax would not be likely to trigger the delocalisation strategies described below, at least not on a worrisome scale. Below that level, the tax would be offset, in the eyes of investors and intermediaries, by the 'friction costs' associated with moving financial operations abroad or with setting up new channels for receiving interest payments in non-EU jurisdictions.

Let us suggest that both 'polar' approaches one and three fail to meet the test of a true step toward European harmonisation as a contribution to closer and closer integration.

The first one (setting the tax as high as possible) uses the notion of a 'level playing field' as a convenient excuse to keep citizens at home, which is hardly what European integration is supposed to be about. Indeed, although it is coming in the footsteps of the euro, it would succeed in turning the Maastricht criteria on their head by substituting protection against foreign practices to mutual recognition and the search for best practices.

The third approach puts the smooth functioning of markets above that of Europe

as a human community with its social and political objectives. It has clear and understandable advantages for markets but it may also disregard the objectives of European integration by creating capital movements that would give very little meaning to the European level, something increasingly inconsistent with a single currency.

Altogether, we believe that the level of the tax should balance two major objectives:

- Eliminating 'off-shore' pockets within the Union itself by having a tax in place irrespective of which EU country is chosen by an EU individual investor.

- Preserving the role of the Union as a catalyst for change. Much of the economic success of 'Europe' has come from the rational and from the institutional framework it has provided to challenge time-honoured national habits that had become dysfunctional: without 'Europe', French citizens would still need to go to the pharmacist to procure baby diapers (at pharmacist's prices rather than at far cheaper supermarket ones!) and the two million French citizens who rushed to buy shares in France Telecom would still be lectured that overpaying for communication is the best way to create jobs in the information age.

Hence our recommendation to balance these objectives by choosing a level for the tax that preserves a significant incentive for citizens to look on the other side of the border without nevertheless placing them in front of a simplistic 'no tax/high tax' choice.

A reason to insist on preserving a strong incentive to look beyond the border is that there are many tax-free havens inside national borders. Any bank member of the Association Française des Banques will point to the major distortion in competition and efficient allocation of resources stemming from Livret A (a tax-free savings account over which the Caisses d'Epargne have a monopoly). Key elements are presently challenged by DGIV but it nevertheless remains that the 'level playing field' inside national borders leaves much to be done. Similarly, the fact that banks in several countries cannot pay interests on checking account deposits and must provide a number of services for free also represents major distortions. More generally, all Member States have built impressive, sometimes extravagant tax-incentive architectures, not least to attract savings toward the financing of Government debt.

As we have seen, the need to address massive unfunded pension liabilities is likely to lead to more rather than less tax exemptions within the Member States, to the point that the Union-wide withholding tax regime will probably have to offer similar tax exemptions in the not distant future.

Therefore, in addition to the reasons above, a genuine 'level playing field' for financial services in Europe requires significant incentives to balance this bias toward keeping savings at home within easy reach of the national governments.[7] It also calls for going beyond the call for 'a minimum of effective taxation' to acknowledge that an increasing part of savings - whether at home or cross-border - will go toward pension-related instruments. Again, now is more a time to think than a time to dictate.

1.4. The level playing field ...and the convergence game that will be played on it

The US and Swiss examples as well as the discretion left to national governments by the VAT tax harmonisation Directive itself are a reminder that a well working 'internal market' need not imply full harmonisation. An element of competition among the Member States will always be needed to encourage convergence toward best practises rather than 'convergence toward the bottom' (the bottom being, in that case, the lowest levels of disposable income for the private use of European citizens, in other words, the highest level of tax).

After all, the Maastricht criteria required all countries to converge toward the interest rates and the inflation rates of the three best performing countries, in other words toward the lowest rates. They did not set a 'floor' of, for instance, a 6% inflation level and a 5% interest rate, under which no country would have been allowed to go. Convergence toward the most efficient tax system rather than protection of all national systems is what the Maastricht experience would suggest to promote through the Directive.

The term 'harmful' used to describe what the proposed Directive should stand against is a highly subjective one: the economy is not simply about the wealth that already exists, it is also about Joseph Schumpeter's 'creative destruction'. Destruction is bound to be harmful at least in some sense. This, however, is part of a slightly broader agenda than the one we can address here. Many of the practitioners we interviewed stressed how important it is for Europe not to provide a justification for Member States to hide inefficient practices under a blanket of heavy taxes that the same government can then blame, very conveniently, on 'Brussels'. Europe succeeds economically to the extent that it allows Member States to learn from one another and to challenge those of their own national practices that tend to reflect a less open mind, a more self-complacent approach.

A central objective of European integration is to achieve a higher level of prosperity than would be possible in isolation. It is fully accepted now that this implies competition among the private sectors of Europe as well as among former 'natural monopolies'. It would be important for the proposed Directive to state that emulation toward best practices in matters of taxing and spending also contributes to higher standards of living and employment. Such emulation has been central to the process of convergence triggered by the Maastricht treaty. Countries

[7] We find ourselves in agreement with ISMA which also points at the systematic use of tax incentives by national governments.

like Italy, Portugal and Greece have been widely acclaimed for their capacity to manage their public affairs in a more efficient manner as part of the European convergence process and of the search for efficient approach to their important social and public objectives.

Looking back to the first four decades in European integration since the Treaty of Rome, it is clear that Europe has already succeeded on two major fronts - creating an internal market and achieving economic and monetary Union - and that it has done so by accepting higher levels of competition and by converging toward best policy practices (e.g. the German monetary policy) rather than by satisfying itself with some form of merge.

A third major agenda is now taking shape around taxes, savings, pensions and the adaptation of the European 'model' to the new economic, demographic and technological situation.

The Commission has all the capacities it takes to help address this agenda in a forward looking manner, including through a proposed Directive on taxation of interest payments. This will call, however, for additional work and even more so, for a true, indepth dialogue.

Part 2

The coexistence mechanism and the key policy choices of the proposed Directive

After this brief review of the philosophical underpinnings of the proposed Directive and this discussion of the desirable level, let us turn to qualitative aspects of the proposal that our interviews suggest could create major implementation problems. We shall first review briefly the coexistence mechanism and turn our attention then to the non-final character of the proposed withholding tax.

The report argues for making the withholding tax final and presents technical as well as political reasons to do so. The political reasons have to do with the gradual creation of a 'Citizens' Europe' in which loyalty is shared between the national and the European levels like it will be around the euro and like it is already the case through such EU achievements as the Court of Justice, majority voting, the Schengen Treaty and the right of EU nationals to vote in the local elections of other EU countries where they reside. Meanwhile, a brief discussion of the costly failure of an electronic system known as TAURUS aims to alert to the magnitude of the technical risks implicit in the present drafting of the proposed Directive.

2.1. The coexistence principle

An essential aspect of the proposed Directive in political terms is the choice open to all Member States of opting either for full exchange of information or for the withholding tax.

In practice, however, Member States will have no incentive whatsoever to choose that road as it would put them in the role of subordinate tax collectors for other Member States. Collecting the withholding tax and keeping its proceeds is clearly a far more attractive option for host countries. Indeed, the consensus view is that all Member States will choose the withholding tax-approach.

The role of the coexistence model is, at least, a symbolic one to clarify how the withholding tax has been identified as the preferred alternative. This political significance will remain even if all countries choose, as is likely, to adopt the second alternative. Unfortunately, some symbols can be more costly than others. In this case, the fact that the tax is only one of two possibilities contributes:

- To very complex procedures aimed at keeping both options open - to the point of having a 'corrective mechanism' to allow individuals to come back to the first branch of the alternative (providing information on their case through the 'certificate' procedure) even if the country where they earn interest has opted otherwise;

- To prevent the Commission from developing the withholding tax branch of this alternative to the full extent. If this

tax had been recognized as the preferred choice of all Member-States, it could have been conceived and drafted as a major step toward European integration rather than merely a second best choice for Member States not yet ready to open their banking books to other Member States.

Clearly, if it turns out that all Member States choose the withholding tax, which seems very likely, some reassessment of the two-track approach would be essential.

2.2. The reasons for not making the withholding tax final... and the cost for not doing so

A related principle in the proposed Directive is that the withholding tax is merely one step in complying with one's tax obligations, aimed at ensuring that these obligations are not ignored altogether.

Here, clearly, the cost-benefit analysis of such a complex partial mechanism would seem to call for a major reassessment, either by lowering the costs, by increasing the benefits or both. In the view of all interviewees and of this report, one such step is that the withholding tax should be made final, even at the cost of saying that if the 'coexistence model' is king, this is a naked king indeed.

In a nutshell, the Commission is making its proposal hostage to major complexities and uncertainties by insisting on not making the proposed tax final without achieving much more than a symbolic objective of little practical consequence. The Commission's choice for a non-final withholding tax is a natural consequence of the 'coexistence model' whereby, as we just said, the host countries can choose as an alternative to collecting the withholding tax, to make information on interests paid available to the countries of residence of the payee. The fact that the withholding tax is not final implies that complex procedures will have to be put in place so as to conform both with host-country and with country-of-residence tax rules.

The only justification for what will be massively complex administrative procedures is the freedom that the proposed Directive aims to leave to the individual tax payer of having his or her interest earnings taxed in his or her country-of-residence. This may be more attractive if such gains are less taxed in that country or are taxed together with all other sources of income at levels which would then be lower than the 20% withholding tax.

In the words of the Commission itself:

> "From the point of view of this Directive, the withholding tax levied by the Member State in which the interest is paid is not normally a definitive deduction and does not fully discharge the beneficiary's tax liability in his country of residence. The deduction of withholding tax is regarded as a practical means of allowing a minimum of effective taxation of cross-border interest payments in the Community. That objective is also achieved when the beneficiary can prove, by means of a certificate, that he has informed his own tax authorities of the income he is receiving in another Member State: the deduction of withholding tax is not considered necessary in such cases, as it is possible that the income will be taxed in the beneficiary's Member State of residence.[8]"

[8] COM (1998) 295 final, op.cit, page 8

This statement shows, first, that the notion of 'minimum of effective taxation' is a relative one, specific to each individual situation rather than an absolute one as it might sound.

In theory, this objective is extremely well meaning and certainly deserves a lot of support in the 'Citizens' Europe' perspective of this report. A major problem however has to do with the complex procedures that all Member States would need to put in place to make it possible. What this statement really mean is that all tax systems in all Member States must coordinate for each citizen to be taxed in the way that will be considered as fair within his or her country of residence. As our interviews and the IPMA and ISMA works available clearly show, simplicity will not really be the right word to describe the convoluted procedures that will have to be put in place. In addition, as Europeans, we regret that politicians do not envision that citizens could make any other choice than to come back to their Member State of residence, to the exclusion of choosing to be taxed under the rules of the country where they happen to have their deposit and to earn interest payment

The Commission however must be given credit for taking into consideration the freedom of citizens, even if only partially. Yet it would be worthwhile to push this line of reasoning one step further by looking at citizens as belonging both in one Member State and in the Union as a whole.

The pro-integration alternatives to non finality of the withholding tax

In the spirit of Jean Monnet, one should probably ask the question of whether a non-final common withholding tax is really the appropriate next step in the effort toward a level playing field and greater European integration.

This question is all the more urgent if the procedures to have each individual citizen taxed according to his country laws but with procedures in place in 15 countries appears to be extraordinarily complex to implement.

Two other possible options come to mind that could probably serve better the objectives of the proposed Directive:

- A first alternative, the pro-integration one, would be to look at the withholding tax as the first element of a truly European income system. Citizens would be taxed in their own country, of course, but also - as far as interest payments are concerned - they would pay taxes in the Member State where they have their deposits at a commonly agreed level. In other words, they would be treated as citizens of the Union as well as citizens of one Member State. This approach would be comparable to the important political precedent set by the Maastricht treaty as it provides that: citizens of one Member State residing in another one, have the right to vote in local and European elections of other Member States even though they are not citizens of that country. In that sense, the proposed Directive would not be limited to the defensive objective of fighting what is seen as 'harmful tax competition' but after VAT, it would constitute a second important step toward the positive objective of developing, over the next decades, a common tax structure for the Union.

- A second alternative, the more traditional form of harmonisation, would be to begin to harmonise key-aspects of national tax systems regarding interest payments so as to greatly reduce the diversity of situations that will have to be addressed by financial intermediaries as they administer the withholding tax. In this way, the Union would avoid the present situation which looks like putting the cart before the horse by creating a common tax in a greatly heterogeneous system. The common withholding tax would be the crowning jewel of a reasonably harmonised system rather than a complex substitute to harmonisation.

Both approaches would contribute to genuine integration well beyond what the proposed Directive would allow.

The first approach - making the withholding tax final - has the additional benefit of incorporating the objective of subsidiarity in a more open manner and of relying on de facto, market led convergence rather than on administrative measures.

In a longer term perspective, if this first approach were chosen, the withholding tax could be the starting point for a EU wide dialogue on taxes, benefits and pensions. It could also be used like VAT in connection with EU budget as the EU evolves toward a common approach. This, however, is a subject for another report : suffice it to say that an integrating Union will probably not be able to resort to VAT only for its funding over the next half century to come.

2.3. Punitive heterogeneity

Coming back to the proposed approach, one should stress the differences between national approaches to the taxation of interest are so important as to make a non-final common tax the source of a punitive level of heterogeneity when it comes to assessing the specific individual situation. Table 1 in section 1.1. above shows how different the various national systems are at the present stage.

These difficulties are compounded by the complex nature of modern investment vehicles and funds, to the point that banks will have to compute the after tax value of some of these instruments everyday and for each and every Member State, with possible variations according to the individual tax situation of each individual investor.

In some cases, such as zero coupons and discounted securities, the real value of the investment can only be known on redemption day. This will imply ex-post adjustments and partial repayments or additional tax-claims. This will be a complex and costly approach.

Complex procedures, however, are not good or bad per se as the full cost-benefit analysis depends on the purposes served and objectives achieved. Several of our interviewees have deplored that the proposed Directive includes not even the beginning of a cost-benefit analysis of the measures it puts forward.

Procedures as complex as those envisioned in the proposed Directive would probably be proportionate to the benefits if the latter was involved in the creation of a fully fledged

EU-wide income tax system.

In this present case, however, the complexity of the procedures and the costs for intermediaries do not appear to be proportionate to the benefits of what will be only a very partial tax affecting:

- Only tax residents from other EU countries, to the exclusion of nationals and of tax residents of third countries.

- Only the interest part of their savings income, with the possibility for them to dilute or swap their way out of the withholding tax altogether.

- Last but not least, only those savings that EU nationals will deposit outside of their country of residence but within the Union, to the exclusion of third countries such as Switzerland, the Channel Islands or via securitized Internet access on the off-shore screens of some on-shore banks (see Part 3).

With due respect for the technical skills of the Commission, it appears that little of economic significance would be lost (outside of a relatively empty-sounding 'coexistence') if the proposed Directive was greatly simplified by making the withholding tax final. Again, for supporters of European integration, much would be gained by acknowledging that citizens do not 'belong' to their governments: when the same citizens are entitled to cross intra-EU borders without police check-points, can take their own governments to the EU Court of Justice, can vote in local elections in other EU countries and share the same currency, then they can probably begin to pay their taxes to several countries in line with their actual private choices. This decision, therefore, would do more than fight 'harmful competition': it would acknowledge that the Union is also a Europe of citizens.

2.4. Too many birds for one stone: the TAURUS warning

In assessing the potential cost of too complex procedures and preparing the much needed cost-benefit-risks analysis, the Commission may want to reflect on recent failures of large scale IT projects that were designed to serve too many purposes at the same time. One such project was the TAURUS clearing and settlement project in London.

In 1989, the London Stock Exchange launched a new version for its TAURUS project, a central data base to maintain all share records while respecting the various types of relationships that investors and registrars were used to. The project was supposed to be finished by early 1991. After many delays, on 13 March 1993, TAURUS had to be abandoned, at a cost of 400 million GBP, of which 75 million GBP for the stock exchange and the rest for market participants. This had major negative implications for the overall image and standing of the City.

Part of the failure of TAURUS had to do, precisely, with the decision made by the British Parliament and British tax authorities (as embodied in the DTI legal framework of May 1991) to provide the option of holding shares in paper form.

The logic of TAURUS as an electronic system was electronic book-entry and it was realized that preserving a paper option would be mostly symbolic as only a small number of shareholders would still insist upon it. Yet, the whole system had to be designed to accommodate this dual mode of custody, thereby raising the cost and complexity to levels that turned out to be in excess of what the London market and its professional associations could pay.

Reflecting on the TAURUS example (as well as, for that matter, on the difficulties and costs experienced regarding the 'Year 2000') should make clear that huge costs will be the consequence of the effort in the proposed Directive to maintain a link between the withholding tax as collected in the host-country and the tax system of the taxpayer's country of residence. Having to navigate between several different national environments will add at least one order of magnitude to the complexity of the procedures and to the costs they imply in terms of computer programming, clerk training, administrative record keeping, reporting requirements and the like. Yet, the purpose being served by this 'bridge' between tax systems is likely to be mostly symbolic. It aims to preserve the country of residence as the final reference in theory while the reality of the system will be that of a withholding tax entirely kept by the host country.

These efforts to reconcile symbols and reality might lead a student of scientific revolutions (to use Kuhn's famous phrase) to refer to Ptolemy, the Greek-Egyptian geographer. The latter had succeeded in describing quite accurately the trajectories of planets by resorting only to circles. In the views of the time, the circle (our metaphor for full national tax sovereignty) was the only geometric figure deemed appropriate to describe natural movements. The reality of planet trajectories, however, was that of ellipses. By considering a good dozen circles rotating around one another, Ptolemy nevertheless succeeded in preserving the reference to the circle as central figure while accounting relatively well for the ellipse as the true trajectories. Since then calling an ellipse an ellipse has turned to be not just simpler but more efficient in reaching final objectives.

Similarly, the Commission would move much closer towards its objective if they left the good-meaning, 'politically correct' references to the State of residence out of the procedures and treated what will be in most cases a de facto final withholding tax as a de jure final withholding tax. The more so as the Union as a whole is embarked on a political journey that is taking it, even if gradually, from the world of national circles to that of a genuine European ellipse.

Part 3

The contribution of the proposed Directive to the fight against tax evasion

Together with the search for a level playing field, a fundamental reason behind the proposed Directive is the concern by most Member States about the possibilities for tax evasion within the Union itself. As we have seen, this is a key meaning of the phrase 'minimum of effective taxation of savings' in a Union in which savings are often not taxed at the national level when they are invested in certain government approved instruments such as 'livrets A' or unlimited investment in overseas territories
(loi Pons), to take the French tax.

The proposed Directive has allowed to make progress on what was initially a very controversial issue. The fact that all Member States are supportive of common measures to reduce tax evasion is an achievement in itself. Recent debates in the fall of 1998 show that this is now part of a broader policy approach aimed at reducing the burden on workers and to promote job creation by severely limiting the possibility for free riders to evade taxation.

The issue, however, is not about good intentions. It is whether the proposed Directive will be limited to a symbolic role, in view of the ease with which tax evaders simply can continue to evade taxes by moving outside the reach of the Directive. In this third part, we shall try to assess what the proposed Directive makes possible - or the risks that it carries - first, within the jurisdictional limits of the Union and, second, within the global capital markets at large.

3.1. An amazing number of 'lawful loopholes' within the Union itself

An essential element in both the ECOFIN Council's and the Commission's approach is that, to quote the latter: 'The European financial area, the creation of which was made possible by the liberalization of capital movements, cannot deliver all its benefits if savers' decisions are determined by the possibility of avoiding tax instead of being taken in the light of a comparison between investment alternatives based on their intrinsic merits. The need for joint action to eliminate these economic distortions is rendered all the more urgent by the start of the third stage of economic and monetary union, which will further facilitate the cross-border investment of savings'.

Most of the market participants interviewed for this report have stressed the abundance and generous size of the loopholes that the proposed Directive and its chosen procedures make possible within the Union itself. Before discussing these loopholes, however, it is important to remember that the Commission had no choice but to build on the political consensus reached among Member States in ECOFIN after one decade of often intense and bitter debates.

a) Banking secrecy: what the proposed Directive seeks and does not seek

The fact that the withholding tax would provide a permanent alternative to the sharing of information with other Member States ('coexistence model') seems to be considered in banking circles as a reasonable solution to a conflict that had clearly intensified over the last couple of years. Countries like Germany, in the past, have been adamant in protecting the secrecy of their bank-customer relationship from the reach of non-German authorities. The millions of Austrian number-accounts are a clear reminder that the issue is not confined to a couple of small countries.

What Member States accept at the present stage is that judicial procedures can lead to banking information being sought and provided across borders. Even then, prominent judges are on record in their 'appel de Geneve' to denounce the precautions that most countries insist on following with respect to these cross-border judicial actions. Judges wonder, in particular, at the obligation imposed upon them to follow diplomatic channels that can add 6 to 18 month delays to ask the co-operation of their counterpart judges notably in accessing banking information abroad.

In the future, new attitudes may emerge and all Member States may be ready to accept higher levels of cross-border integration regarding Justice and Home affairs. The proposed Directive however, has been drafted in the political context of the time, a context in which protesting against other countries banking secrecy still goes together with a strong resistance to submitting one's own banking system and one's own tax-related judicial procedures to supranational scrutiny and openness.

Even in describing the 'corrective mechanism' open for individuals to seek taxation in their country of residence, the Commission takes care to note that each beneficiary would act 'at his own initiative and without encroaching on the confidentiality of banking information'. Europe, just like Rome, will not be built in one day. Home affairs are, by definition, among the most difficult to address in terms of supranational obligations. Important signals have been provided by the Ministers of Justice and Interior in the fall of 1998 regarding the willingness to make progress.

b) Technical difficulties, costs of compliance and the never-ending-process of financial innovation

Leaving banking secrecy aside, a first set of loopholes for a Directive concerned with one type of financial gains only comes from the difficulty of distinguishing between various types of financial instruments in today's fast moving, highly innovative financial markets.

An obvious difficulty is the treatment of Unit Trusts. The proposed Directive sets a 50% limit below which Unit Trusts would not be considered as paying 'interests' to investors. It is obvious that it will take only a few mergers between interest-paying and non interest-paying Unit Trusts to dilute interest revenues with the right amount of equity revenues so as to 'beat the withholding tax'.

The post-euro period is likely to witness the development of an equity culture that will see the share of debt instruments reduced

relative to that of equity instruments, which will make such dilutions not just convenient for tax purposes but to the taste of many investors interested in combining the predictability of interests and the higher long term returns of equity. A Directive conceived to address only the former is then in great risk of becoming what economists fondly call 'a white elephant'.
The proposed Directive does attempt to deal in the necessary details with instruments like zero-coupons but only succeeds to do so through mechanisms so complex as to render the administrative cost of compliance almost unrealistic.

The Commission has taken the brave risk of using the phrase 'simplicity of procedures' in the following sentence of its developments on the coexistence model:
'The paying agent is clearly the market operator most capable of implementing effectively the measures required by the Directive.

The paying agent can check, using simple procedures and at little cost, whether the interest is paid to an individual and to request that he provides proof of his residence for tax purpose.'

One of our interviewees, however, gave us a preliminary description of the tasks clerks working for the bank that he represented would have to fulfil in relation to the Directive. This includes at least ten elements. It could be that some of these ten items can be 'simple' but, from what our interviewees indicated, even ensuring about the actual fiscal residence of a customer is not something that an untrained bank clerk can do easily. As for knowing whether a corporative entity based in one of the Channel Islands is or is not an individual in disguise, this clearly is not within the scope of the 'simple procedures' that the Commission thinks will suffice for paying agents to meet their new responsibilities. The true alternative is between a higher risk of tax evasion (with customers claiming to be resident in non-EU-countries) or training bank clerks for the quite sophisticated job of paying agent under the proposed Directive.

More importantly, any tax regime is bound to create its own shock-wave of financial innovations. As observed by ISMA, it is conceivable for instance to sell to the general public instruments that do not look like interest-bearing instruments and that nevertheless produce a stream of interests: after all, trading one stream of revenues for another is precisely what the Swap market is about.

Here, the size of the technical loopholes made possible by the present drafting of the proposed Directive will soon emerge as a major source of frustration for tax authorities. While the proposed Directive has been prepared with the simple world of the early 1990s in mind, paying agents of the next decade will have to deal on a large scale with such things as the 'reverse convertibles', the 'asset backed securities', the 'repackaged bonds'. Yet one should expect that this frustration will be partially resolved through a long process of improvements and additional measures in the great tradition of the political economy of taxation. As always, it is not obvious that regulators will be able to keep

pace with the process of innovation. As the precedent of NOW accounts in the US shows, it is usually financial innovation that carries the day.

Without looking at it as a fundamental weakness of the proposed Directive, one should nevertheless acknowledge that the technical quality of the drafting is not as high as prudence might have suggested. Clearly, some price has been paid for the sake of having a fully-fledged proposal on the table ahead of dates important to some Member States, in this case the German elections of September 1998.

3.2. Delocalisation of investment toward non EU countries[9]: the cost of delaying an OECD wide approach

The 'paying agent' principle, as we observed, was selected in reaction to the failure of the other approach used in the case of the German withholding tax of 1989 namely the debit approach ('retenue débiteur').[10]

Yet, the paying agent principle is far from fool-proof: a short trip by EU investors to Switzerland (a country which belongs neither in the EU nor in the European Economic Area (EEA) although it is conveniently situated at the geographic centre of the Union) will be sufficient to preserve the very possibilities of tax evasion that the proposed Directive seeks to eliminate.

a) Can the Union enlist Swiss and off-shore support?

A thorough discussion of the issue of market relocation should not be, however, limited to the perceived immediate effects of the measure. One should also take into account the various strategies and policies that the government and private actors may put in place to try to assuage the negative consequences of the measures.

EU tax authorities certainly consider that the fight against tax evasion does not stop within the EU. On the contrary, the proposed Directive explicitly calls for diplomatic action and for negotiations with other financial centres.

The Swiss tax code could be adapted at some point in the future to take into account these strong pressures from the EU. Indeed, Swiss financiers and policy makers informally interviewed for this report have voiced the opinion that European and notably German pressures will be such as to make Swiss participation in the withholding tax scheme unavoidable. This could take place quite naturally as part of (or on the side of) the ongoing negotiation between Switzerland and the EU regarding the free trade agreement, or possibly, the re-opening of negotiations concerning the membership of Switzerland in the EEA. Such optimistic views about convergence with Switzerland, however, should be taken with a pinch of salt in light:

- Of the time it will take to make progress on issues that are at least as sensitive for Switzerland as the trucking issues that have already absorbed so much energy and passion over so many years of EU-Swiss negotiations.
- Of the precautions already being taken by a number of Swiss banks to provide

[9] The risk of delocalization of financial firms is addressed in Parts 4 and 5.

[10] The latter put the burden of tax collection on the issuer which led German companies to issue out of the Dutch West Indies. The German government ended up paying more on its own domestic market than corporate issuers in the off-shore market!

some clients with 'companion accounts' with their Bermuda, Bahamas or Cayman Islands affiliates. Such accounts would be outside the reach of even a Swiss withholding tax and yet, only one key-stroke away from the present Swiss account.

b) The politically correct near off-shore

In a spirit of 'glasnost', one should also acknowledge the element of wishful thinking apparent in the provision of the proposed Directive requesting Member States with specific responsibilities in 'off-shore areas' to work toward geographic extension of the proposed Directive.

The UK has no constitutional power that would enable it to send more than a courtesy letter to the Virgin Islands, the Cayman Islands and the Channel Islands. Moreover, this type of relationship is rather rewarding. Similarly, the inability of the French Parliament to end the massive loophole enjoyed by its own wealthy tax payers by putting some ceiling on the astonishing tax havens granted to French overseas 'departments' and 'territories' ('loi Pons') does not set a good precedent, even if French authorities have recently put significant pressure on Monaco[11] in connection with a couple of highly visible money laundering suspicions.

c) Technology, encryption and Internet bring off-shore centres to European screens

In the past, one could consider that such safe havens were beyond most people's reach as the man or woman in the street could not feel comfortable dealing with the Bermudas or Bahamas. Information technology, however, is bringing the off-shore world pretty close to the shores as it can take little more than a click of the mouse to move from a EU banking screen to a Bahamas or Bermuda one. The real obstacle is the banking secrecy law of these off-shore centres, but some of them - Bahamas for

Countries	Territory Art. 227	Territory Custom	Territory VAT	Territory Excises	Territory Capital rights	Territory Social tax
Monaco	No	Yes	Yes		Yes	No
Madeira	Yes	Yes	Yes	Yes	Yes	Yes
Canary	Yes	Yes	No	No	Yes	Yes
Islands						
Channel	No	Yes	No	No	No	No
Islands						
Gibraltar	Yes	Yes	Yes	Yes	Yes	Yes
Isle of Man	No	Yes	Yes	Yes	No	No
West Indies	No	No	No	No	No	No
Netherlands	No	No	No	No	No	No
Aruba						

Source KPMG, Etude sur la fiscalité dans l'Union Européenne, mai 1997, page 21

[11] 475 of the 500 persons strong police force in Monaco are French and French magistrates serve as judges. A 1963 convention forbids French citizens who become Monaco residents to enjoy Monaco tax-exempt status and requires them to report to a special tax office in Menton. Sociétés civiles under Monaco law however enjoy complete opacity as to the identity of their owners. Also, French magistrates have found it difficult to carry some instructions to the point or at the speed they would have considered desirable as the final word clearly does not belong to them.

instance - now include the exception clauses allowing on-line account consulting and management.

In this respect, EU authorities would be well advised to take notice of the recent measures taken notably in Switzerland to make this screen-based geography safe and comfortable. The Big Three Swiss banks invested 120 million dollars in 1997 to 'export the geopolitical advantage of their privacy laws world-wide directly on the Internet'.[12]
The technology deployed is provided by R3 Security Engineers, a Zurich company acquired in June 1998 by Entrust Technologies, a leader in public-key infrastructure systems. 128-bit data encryption and randomly generated codes changing every 60 seconds provide on-line clients with the type of security previously associated with large, wholesale fund transfers.

d) The need for ex ante rather than ex post negotiations at OECD

In many ways, in the absence of significant new initiatives, the withholding tax is likely to fail to deal with tax evasion as a deliberate, planned behaviour. It will also serve the useful purpose of discouraging residents of intra EU-border regions (e.g. Belgians living close to the Netherlands and vice versa) to travel a few kilometres to open euro-accounts not subject to tax. This is however much less than what could be achieved.

More specific discussion of what Member States are really committing to and of what can and cannot be done in this respect would be a precondition for the proposed Directive to have any chance of curbing tax evasion as it already exists. The only type of evasion that the proposed Directive would curb otherwise is that of border region and other 'opportunistic' tax evasion (e.g. opening account in a Member State where one is stationed for work). The proposed Directive is likely to leave untouched, or even could exacerbate most planned forms of tax evasion. Ideally, one could hope that the level-playing field that market participants and regulators seek to promote could be achieved through agreements on world standards as has been the case for other aspects of financial operations with the BIS prudential ratios. Work in the OECD context, as stressed by all our interviewees, is absolutely essential. The Commission does not disagree but takes a somehow optimistic view that other OECD countries will quite naturally converge toward the EU approach once the latter is in place.

Clearly, working toward an OECD-wide code of conduct should not be seen merely as a follow-up to the proposed Directive that can be postponed at little cost: this benign neglect will lead tax evaders to leave EU markets ahead of the proposed Directive.

The code of good conduct to be discussed at OECD level should include specific measures regarding 'double bottomed accounts', to avoid having OECD accounts as windows for non-OECD accounts. Some clear signals should also be given that OECD countries considering leaving the Club as one Channel Island is considering - would loose major goodwill and benefits. One such measure could be to consider that any corporate entity incorporated in a tax-rogue centre (e.g. an OECD centre leaving the OECD) would be considered liable to a 20% withholding tax for all operations inside the

[12] Source: Doug Dannemiller, Tower Group, Newton, Mass. (USA). For details, see American Banker, 17.7.98 p.12

Union. Raising the issue would at least allow to see how serious Member States are about tax evasion.

The above considerations do not imply that the proposed Directive is not a worthwhile undertaking but it does suggest that rushing it through may quickly backfire as the public becomes aware of the loopholes available to wealthy investors and as tax authorities need to come back repeatedly with technical fixes. The former would lead small savers to take a cynical view of what they could perceive as a two-tier approach to social justice. The latter would be a source of something markets tend to dislike even more than taxes: uncertainty.

3.3. The need to anchor the proposed Directive in a long term positive strategy for the Union

While the EU Ministers of Finance can be trusted to make good progress on the technical agenda before the proposed Directive is finalised, a deeper weakness resides in the partial approach to tax matter taken by the proposed Directive. To put it bluntly, tax evasion is not just about evasion, it is also about taxes.

a) The need for a comprehensive approach

The proposed Directive is part of a package of three initiatives that also include a code of conduct on corporate business and a proposed Directive on intra-group interest and royalty income. But the overall package is of a defensive nature as it aims to fight against harmful tax competition.

If the objective is really to establish a genuine level playing field, the proposed Directive should probably not be implemented as a stand-alone measure. It does not seem very rationale, for instance, to extend a number of tax-haven measures almost at the same time as the Directive is being drafted.[13]

More generally, the discussion of what should be the priorities for tax harmonisation could be intensified: in this respect, the call by Luxembourg to address corporate taxes as a matter of equal priority is still very relevant. Recent initiatives in Denmark regarding holding companies suggest that the 'standstill agreement' among Member States not to introduce new sources of distortion is the most pressing agenda vying for attention.

b) Citizens ready to be led but not to be drawn blindly

Harmonisation of taxes is not a 'business as usual' agenda, even for the post-euro Union. Again, it is a tribute to the Monnet method that such issues can be put on the table before the euro has even materialised. But 'putting an issue on the table' should not be like throwing the dice: after several 'narrow escapes' in their relations with the European voters in a number of Member States, the pro-integration political leaders of the EU would be well advised to draw the lessons from the bitter 'Maastricht debate' of a few years ago and from the frustrations that it brought to light.

A key-lesson from this debate was that public opinion can indeed be led - in the great Monnet tradition - but that the public has less and less appetite for being drawn blindly. Voters are demanding their due share of transparency, clarity and a sense of long-term perspective.

[13] Moves to make the corporation tax rate the same for companies in Dublin's International Financial Services Centre (IFSC) as in the rest of the Irish economy have led to a new tax regime being agreed between the Irish government and the European Commission. Reinsurance 8.9.1998 p.7

Once they share a common currency, citizens of the 'euro' countries can probably be persuaded that it is now in their interest to share additional elements of tax and financial policy as they have done already with VAT. On this account, setting ambitious objectives is both possible and desirable.
But the voters will be asking for more than a set of technical fixes to the immediate problems of their respective tax authorities. In particular, they will want a better understanding of the basic principles, the fundamental 'philosophy' guiding this long march toward a common tax and financial policy. Failure to do so would probably be leading many individual investors and bank clerks to denounce the Brussels technocrats.

In the long run, it seems difficult - and ill advised - to approach fiscal matters from the revenue side only. Member States do not 'own' citizens and their money: they are merely entrusted by their citizens with responsibilities that they must discharge fairly and efficiently. Talking about the levels and nature of expenses is the second half of any meaningful fiscal debate.

The 'level playing field' that the proposed Directive seeks to establish is not a technical notion when the field is Europe, our common Europe. 'Levelling' cannot be carried out without some notion at least of the type of economic and social landscape Europeans are trying to set for themselves.

In this sense, as we already suggested, the term 'harmful' used in the proposed Directive risks to substitute an a priori value judgement to what should be a fully fledged political process.

In the wake of the recent French and German elections, the Union is blessed with a very high degree of de facto political convergence, with thirteen countries governed by a Social Democrat or left wing government. Yet, at the same time, the Union as such is not - not yet? - a political Union. Hence, governments of today would be enlightened not to use the European administrative process to 'lock in' political change in ways not respectful enough of the democratic process within countries themselves.

In general, the strength of the Monnet process is precisely to use 'administrative measures' to 'lock in' changes toward a more open, more tightly integrated Europe. But the political gains thereby 'locked in' have to do with the state of relationship among Member States rather than with the political choices internal to one country. Voters and the public at large already resent what they perceive as an effort to restrict their capacity to make political choices.

c) The need not to frighten away the present 'out' countries

As for the citizens of the three 'out' countries other than Greece, they can be expected to scrutinise even more intensely the integration dynamics fostered by the euro and its implications for sovereignty.
The euro is merely an 'Etape' on the road toward this 'ever closer union' mentioned in the preamble of the Maastricht Treaty. Having partially 'opted out' of the latter, the UK, Sweden and Denmark are bound to be quite suspicious of anything sold to them as 'technical' co-operation if what is at stake is really the tax system itself. Those who

question the legitimacy of EU integration will not be convinced by a set of technical considerations on the need for instance to reduce 'harmful' tax competition. They will want to know what additional elements of sovereignty are transferred to the Union and the other Member States and for what positive purpose.

As insurgents proclaimed in the Boston harbour 'no taxation without representation'. This suggests that a debate on the level of taxation, even if lively and complex, is better than a 'technocratic' approach.

If politicians fail to create a shared sense of direction, the proposed Directive may go in history as the moral equivalent of the infamous 'cheese Directive' in which guardians of the internal market are perceived (rightly or wrongly) as compelling people to change the way they eat because this will make it easier to administer the internal market. All this while far more important issues, regarding for instance the quality of animal feeds, turn out to have been left unaddressed.

In this respect, and quite aside of the euromarkets issue, the emphasis put by ISMA on the link between taxes and democracy should be taken very seriously indeed. Taxes are not a tax-collector-only matter, they are a shared social concern.

3.4. From the negative agenda of tax collectors to the positive agenda of European cohesion

Even if this involves substantial delays, the proposed Directive should be presented and discussed in ways that do not suggest that governments look at tax-payers mostly as evaders and cheaters. A positive approach of shared objectives and mutual trust is what the Monnet method calls for.

Europe is not a continent of cheaters: on the contrary, unlike other parts of the world, it is a continent where it is widely understood that 'taxes are what we pay for civilisation' or, in more mundane terms, for social cohesion and progress. European voters can be addressed as sophisticated and understanding people rather than as a gang of mischievous tax-evaders. The purpose of European integration is not Michel Foucault's 'surveiller et punir' but Jean Monnet's 'partager et construire'.

Hence in an intra-European perspective, the proposed Directive may well appear, once tested in the national political arenas, as either too much or too little. Too much if sharing tax sovereignty and setting in place highly complex process has no higher purpose than distrust of tax-payers. And too little if its ambition is really, as it should be, to lay the foundation for the next stage in this historic endeavour to create one European economic, civil and political society.

Taxes are a central element of the social contract. The voters on the other side of this contract have a right to be addressed by their Ministers of Finance and tax collectors in this spirit of democratic responsibility rather than in the technocratic jargon of loopholes closing and "harmful" competition. This is even more important when, as we have seen, few loopholes will really be closed. Even if

unchanged in its technical wording, the proposed Directive will succeed or fail depending on the relationship it will establish with a broader agenda encompassing issues of social justice, fiscal discipline and the role of government.
In this perspective, the work done and the debate already conducted around the proposed Directive is a very useful beginning. But it is only a beginning.

Having played a key role in unlocking the two most significant initiatives toward a common tax-policy in 1991 and 1997, Luxembourg certainly has a role to play in calling for this informed debate on the general principle of the still-to-be-born common tax and financial policy. Rushing the proposed Directive through to meet this or that "deadline" is clearly less important than inviting the citizens of Europe to a democratic debate on which the legitimacy of this policy will eventually depend.

Part 4

Parochial euro vs. global euro

An essential dimension in assessing the quality of preparation and the implications of the proposed Directive has to do with its impact on European capital markets. This is clearly where the controversy is raging at the present moment.

In a nutshell, the case being made by IPMA, ISMA and other major international associations of market practitioners is that the proposed Directive will drive a very significant part of euromarket activity out of Europe toward New York (wholesale activities) and Switzerland (retail and custodial activities).

Part of the protests voiced by these important and respected associations could be expected as it is in their mission to lobby for the best possible business environment for their members. Yet two observations of a more general nature come to mind. They have to do, first, with the worrisome lack of communication between euromarket professionals and the Commission and, second, with the lag in "cultural perceptions" on the part of European policy makers who are still focused, quite understandably, on the "euro-for-Europe agenda" just a few weeks before the euro turns global.

In short, the dangers to which this report would like to draw attention in this fourth part are benign neglect (section 4.1.) and euro-parochialism (section 4.2.).

4.1. EU policy makers and market practitioners: the risks of mutual benign neglect

First, the unusually abrupt tone used in some of the documents prepared by the euromarket community[14] does suggest that an important task of communication has not been carried out, neither by the Commission as originator of the proposed Directive nor by these professional associations in an earlier period as part of their ongoing role in representing their members, at least not at the level that the present debate would have warranted.

It was striking to see that a well attended conference in Brussels around notably the Commissioner in charge of the proposal had brought together many prominent members of the financial community for a full day of panels, but that none of these distinguished invitees came from the capital market associations most directly involved.

This, in itself, should be a source of concern and of remedial action by both parties. At the risk of making enemies on both sides, we shall venture the following:

- The Commission should become aware not just of the amazingly low level of consultation that has accompanied such an important project but also of the fact that this failure to consult was grounded in the low priority given to capital market considerations in its euro-related work.

- For its part, an association like IPMA may want to reflect upon one candid finding that it shares with the public in its 10th anniversary document: the surprising discovery that the dialogue in which it had

[14] In its position paper of 4 September 1998, ISMA states that in spite of the obvious importance of the proposed Directive for capital markets "not a single relevant organisation appears to have been consulted ... the Commission's method of consultation seems to have been to read some reports published during the previous twelve months about a completely different set of high-level proposals ... without taking the basic precaution of consulting the people who will be involved in making (the Directive) work on a day-to-day basis". (ISMA, op.cit. p. 3)

engaged the Commission a couple of years ago regarding the Prospectus Directive was both very unusual on its part and very useful. The time is no longer when "euromarkets" could be treated by market practitioners as something so global and flying so high above ground that time spent with 'generalist' policy makers, beyond a small circle of Treasury officials, would be time lost. Time spent by euromarket experts sharing views with non-specialists and with the public should be seen as time well spent.

These two communities of dedicated and knowledgeable professionals should be warmly encouraged to overcome the bitterness in their present relationship to establish and keep alive a thorough, in-depth communication process: the benign neglect in which they have been holding one another is in nobody's interest.

The volatility of the markets exacerbates the potential cost of belated or incomplete communication: while a currency like the euro does not rise or fall like Alcatel shares (minus 40% in one day!), the EU and market practitioners active in the EU would certainly benefit from more professional communication and from the capacity to listen to one another before, rather than after problems develop.

4.2. From 'the European euro' to 'the global euro'

Beyond these communication failures, another cultural revolution is still waiting to happen. For almost one decade now, national and European officials have devoted tremendous energy and skills to the creation of the euro as the flagship project for European integration. This was, by nature, an inward-looking process with an agenda of intergovernmental Conferences (the two IGCs of the early 1990s), of national debate over the ratification of Maastricht and of efforts to meet the demanding convergence criteria. In all these instances, the Union was its own, ambitious self-reference.

The long march toward the euro has been a very successful endeavour, which makes it even more difficult for Europeans to realise that their common currency must now succeed and prove its worth again, as a new-born major currency for the global economy. In this sense, the proposed Directive clearly suffers from looking at the task ahead as one of merely completing what has been achieved. The reality is more likely to resemble a new beginning and a new challenge.

The absence of the UK from the group of core euro countries reinforces this tendency by continental countries to look at the post-euro agenda in a slightly parochial or, at least, defensive, perspective. In all fairness, from the standpoint of British interests, one could also observe that this is clearly one concrete example of the costs for the UK waiting until new steps toward European integration no longer stand a reasonable chance to fail before embracing them.

An essential although often invisible aspect of international politics lies in the capacity to set the agenda: from this perspective, the proposed Directive reflects what we called in another work the "KernEuropa scenario" and its tendency to inward-lookingness on the continent and on the other side of the Channel. This clearly departs from the

Pan-European Monetary Union scenario and its combination of deeper integration and open global competition that our previous report found far more positive for Europe.

Preparing for massive flows of portfolio diversification Like any convertible currency, the euro will be open to a whole range of forces, including potentially destabilising ones that will often take Europeans by surprise.

The first set of forces that will express themselves in the markets at unprecedented levels are those of portfolio diversification. The pent-up demand for non-USD assets is enormous as a large numbers of non-European investors saw little real alternative until now to the depth and liquidity of USD markets.

According to Fred Bergsten, who uses notably the results of analysis by J.P. Morgan, diversification out of the USD into euros can range between 400 USD and 1,000 billion USD. Part of this will be accounted by Central Banks who will look for a more balanced distribution of their reserves (to the tune of something like 100/300 billion USD diversification) but the major part will be accounted by asset managers world-wide who will further accelerate the diversification of the trillions of USD holdings under their management. There is a strong risk that this tide of portfolio diversification will trigger, at first, euro overvaluation. And there is also a strong risk that changes in the macroeconomic environment, business cycles and return prospects could then lead, in a second phase, to abrupt and excessive devaluation of the euro.

Watching today's financial markets makes such a scenario easy to imagine: it should not take a long speech to alert policy makers to the huge risks implied by the tendency of markets to overshoot in one direction and, a few months later, in the other direction. Guarding against such risks should clearly be a central preoccupation today.

Preserving the pool of good-will essential to the global co-ordination process now called for mastering risks of such magnitude will call for in-depth, trustful co-operation with US monetary authorities, notably in the G7 context and capital market practitioners, through informal channels that the EU should hasten to strengthen.

In times of crisis, it takes little to create misunderstandings, even if under other names. A number of recent US editorials regarding what 'the Commission' might do with the euro and the risk of turning the G7 into a 'managed finance' bureaucracy are a reminder that the pool of good-will is not infinite. The recent political changes in Germany make it even more important to preserve the overall framework for trustful co-operation as policies on both sides of the Atlantic may become more divergent.

In this context, the level of suspicion and misunderstanding between EU officials and market practitioners illustrated by the IPMA/ISMA papers should be taken as a serious warning that the EU may be beginning to draw upon its pool of good-will before even having to use it! Since 1993, markets have been supportive of the creation of the euro. They have not done so out of altruism.

A capacity by market practitioners to understand what policy makers are trying to achieve and to relate to it positively is a significant ingredient in creating and maintaining the most valuable assets of all, the real currency of last resort: trust.

Having the euromarket financial community up in arms, talking of leaving Europe would not be the most auspicious beginning for the euro. The proposed Directive needs, at the very least, to be well explained to the markets. But the surest way to diffuse anxiety and 'procès d'intention' would be for the EU to shift from its present 'tax collector mood' to a 'monetary and financial architect mood'.

Altogether, the search for a level-playing-field inside the EU cannot be separated from the search for a global level playing field and from the permanent search by markets themselves for the most efficient modes of operation. One may recall indeed that the 'Common Market' of 1968 was in good synergy with the search for higher levels of trade openness in the context of the Kennedy Round. Similarly, it was no coincidence that the European 'internal market' of 1992 and the global negotiations of the Uruguay Round also went hand in hand. In a field more closely related to the euro, the success of the EMS facilitated - and benefited from - whatever progress could be made in the G7 context (Plazza and Le Louvre agreements as well as day-to-day pragmatic co-operation among Central Banks). It is good to remember that Europe either succeeds internally and externally or fails on both accounts.

Part 5

The euromarkets and the stray bullets of the proposed Directive

In this last part we now turn to markets that have come to play an essential role in global capital movements today, namely the euromarkets. Europe enjoys the strategic advantage of having these markets 'on its shores'. This may sound as a surprising expression as these are clearly off-shore markets. Yet, the euromarkets are indeed in Europe if one looks at the jobs, at the concentration of skills and at the infrastructures that Europeans provide to operate them. And having such assets in Europe gives EU issuers - governments notably - the capacity to access these major sources of funds more easily and in better terms.

We will look therefore briefly at what euromarkets are, emphasising that the once clear-cut distinction with domestic market has blurred already and will vanish with the euro.

We will then turn to the technical issue of gross-up and early redemption clauses. Suggesting that they will eventually turn out to be manageable can add to present levels of uncertainties. Similarly, we will look at the role of bearer bonds in the working of the euromarkets and at the implications of banning them.

Most importantly, we will look at the risks that the 'parochial euro' approach carries when it comes to these one-trillion-dollar-per-year markets. We will present the 'consensus scenario' arrived at by IPMA, ISMA and other professional associations regarding the risks of delocalisation of these markets toward the US and Switzerland. It is not obvious that EU governments have understood the full implications of such a scenario that would see their key financiers having to take the Concord and follow US procedures rather than take the Eurostar and stay within the European sphere of influence when in need of money.

In conclusion, we will indicate elements of an agenda for the international dialogue without which the proposed Directive could harm Europe far more than today's 'harmful tax competition'. This will be done in relation to the intra-European agenda of 'Citizens' Europe' as canvassed in Part 1 of this report. These twin dialogues - the intra-European dialogue on the next agenda and the international dialogue on global financial governance - can make the proposed Directive the opposite of a missed opportunity: the beginning of a new decade of European integration in the great Monnet tradition.

5.1. National capital markets, international markets and euromarkets

The problems raised by the euromarket community cannot be seen as a side problem for the proposed Directive, to be dealt with by technical adjustments only: doing so would ignore that the Union is now coming to the global markets with a brand new currency and that the fate of that currency will depend on capital markets and no longer simply on macroeconomic policy.
International markets have always had a

major influence on Europe. They are now becoming an essential arena in which the prestige, well-being and even the political momentum of the Union is at stake. There is a need to step back and relate the intra-European developments of the proposed Directive to international markets.

When assessing the impact of the proposed Directive on European capital markets and financial institutions, one should begin by noting that there are three types of international markets on which global finance has come to depend, two of which are completely outside of EU reach while the third one is located in Europe yet operating almost as if off-shore:

- First, US based markets. After the second World War, they have developed rapidly with the benefit of being localised in a strong, stable country. Markets usually develop in the shadow of a strong prosperous nation: the 'Yankee bond market' is a good illustration. While the US is clearly the undisputed superpower in military, diplomatic and technology matters, it happens however that US capital markets do not enjoy a similar pre-eminence although a number of initiatives point in that direction.

- Second, the Japanese market, which at one point appeared as extremely well positioned but which has never developed as a fully-fledged international market. This reflects notably the inward-looking perspective often followed by Japanese regulators. It also reflects worries to see the internationalisation of the Yen lead to a higher Yen (a perspective actually encouraged, for opposite reasons, by the US-Japanese Sprinkel-Oba Commission in the early 1980s). In the present period, this market has clearly ceased to be a significant hub for the global financial economy, which does not mean, of course, that Japan does not feature prominently on global financial equations of demand and supply of funds. On 9 December 1998, however, the Ministry of Finance made public a report advocating a more active role and, maybe, a reassessment of the withholding tax on Japanese bonds held by non-residents.

- Third, the euromarkets. In 1963, the Kennedy Administration set in place the Interest Equalization Tax (IET) in light of domestic preoccupation, thereby triggering the development of the euromarkets well beyond the limited role they had played until then.

As this brief typology of international markets suggests, the central reference for a discussion of the role of euromarkets are the other international markets, in practice the US ones. As Europe moves from the 'European euro' to the 'global euro', this relationship between euromarkets, other international markets and domestic European markets is bound to be a major influence on the new global market structure that will emerge after the euro.

Yet, a key-aspect of the proposed Directive is that it does cover the euromarkets just like it covers the national markets of the European Union. The ECOFIN mandate did include considerations on the 'competitiveness of European financial markets on a global scale' but this can be seen in a narrow sense that does not include considerations of how the overall global market structure will evolve

and of whether this will reinforce or weaken the role and influence of Europe on global finance. Such a narrow view is perfectly understandable in light of the 'European euro' approach we have described. But it is highly surprising at the very moment when the Union is taking a radical and bold step to increase its role in global finance. There are indeed important political currents, in the Gaulist tradition as well as in the socialist one, that tend to look at the euro as Europe's answer to the USD. One is a bit puzzled to see these same political currents take a benign view of where global finance is conducted.

It is unfortunate therefore that euromarkets are addressed in the proposed Directive in passim, almost by inadvertence. The sums at risk in these markets dwarf almost any other flow that Commission action may influence; and this clearly calls for a well thought, well informed approach in the interest of the Union.

This does not mean however that an easy formula is at hands: there are indeed powerful reasons that led the Commission not to exclude euromarkets from the proposed Directive.

A first reason is the share of individual investors in the holding of euro-securities. The fact that eurobonds are held in the bearer form is another reason that limits control and that renders tax authorities suspicious of euromarket activities. These are genuine issues that cannot simply be assumed away. In addition, there are complex technical considerations referred to as 'gross-up' and 'at par redemption' that create clear and precise dangers in the proposed Directive and that cannot be left out of the discussion.
Let us therefore discuss the traditional reasons - the role of individual investors and the bearer bond issue - and the technical ones before turning to the radical changes that the euro will introduce. Only then can one come back to the risks we have just mentioned and to the ways in which they could be addressed, even in the absence of a magic solution.

5.2. Individual and institutional participants in the euromarkets

In some sense, this European tax initiative is perceived in these de facto off-shore markets as an extraterritorial application of EU law, with the risk that de facto off-shore markets may be pushed off-shore de jure as geographic location.

The proposed Directive crosses that symbolic and legal line because it rightly observes that individual investors can hold eurosecurities and receive interest payments as a consequence. It is understandable that the Commission finds it logical not to exempt the euromarkets as it would otherwise open another major loophole in an already less than watertight mechanism. In so doing, however, the Commission finds itself, even if partially, in the role of de facto regulator for markets which have developed first and foremost around the absence of regulation. One can understand therefore just as well the anxieties and fierce opposition that the proposed Directive can raise with euromarkets participants.

The proposed Directive does not ignore the risks that tax collection procedures can create for wholesale markets. It attempts to deal with those risks by granting a waiver to institutional participants so that they can conduct their activities free of taxes.

The controversy, however, rises from the fact that the paying agent approach chosen by the ECOFIN Council does not provide the clear cut protection from tax collection interference in these wholesale markets. This is because the paying agent can only determine at the last minute and through quite complex procedures whether the money is being paid to an individual or to an institutional investor. A whole line of reporting, control and record keeping must therefore be in place.

It is the unanimous feeling of the market practitioners that meeting this requirement will deprive euromarkets based in Europe from one of their essential assets, namely the extreme flexibility and unregulated nature of their operations. According to IPMA, this will also imply costs in the order of 20 basis points that are in no way inconsequential in today's highly competitive markets.

This being said, the respective share of individual and institutional investors in the holding of euro-securities is not easy to assess.

Placement is completely decentralised, which makes it impossible to measure precisely what type of instruments are held by what type of investors and where. Statistical knowledge of the fixed-income euromarket tends to be limited to its overall size and trends. The fact that eurobonds are held in the bearer form is another reason that limits statistical information. Nevertheless, one may estimate that individual investors have accounted for about 10% of placement in recent years, a figure probably higher if one looks at the 3.6 trillion USD of outstanding debt. In its memorandum submitted to the European authorities, IPMA conducts rough analysis that lead to look at 10% as a plausible measure of the importance of private investors in today's euromarkets. Higher figures are sometimes quoted.

Coming back to the tax evasion issue discussed in Part 3, one should note that wealthy individual investors have the possibility to create a corporate vehicle to hold these securities. A number of them will probably continue to do so, through entities incorporated in notably Switzerland, Jersey, Guernsey, the Cayman Islands or the Bahamas. It will not take long for small investors to become aware of this capacity for outright escape from the withholding tax above a certain level of wealth: as said above, this could only reinforce the feeling that tax authorities talk loud and strong against the small and the weak and turn a blind eye to the wealthy and the well connected.

5.3. Banning bearer bonds?

Another consideration of importance in assessing the reasons for, and the impact of the proposed Directive is that eurobonds can be held in the bearer form.

The driving force behind bearer bonds is the demand in the primary market. A bank member of the issuing syndicate will ask for a certain proportion of the securities to be delivered to it in bearer form and the rest in registered form.

Benelux countries and Germany are the markets with significant bearer bond activity. In Germany when there has been bearer as well as nominative forms of the same issues, the bearer bonds carried a lower rate which indicates that they are less costly to administer and place.

Bearer securities, by contrast, are almost absent in the US markets although street name certificates (written to Mr Smith or equivalent and pre-endorsed) can be used as a proxy. Japanese's institutions also insist from time to time to receive securities in bearer form.

The proposed Directive will have a particular impact on bearer bonds, to the point that it is not sure that they could still be issued in Europe.

This could certainly be considered as a favourable development from the perspective of tax collection if - and only if - other major international financial centres can be persuaded not to create bearer-bond markets nor to increase the size of existing markets of that type.

In this sense, a 'global ban' on bearer bonds could be envisioned, requiring all securities to be deposited (just like, for instance, securities can only be held in France in book entry form via some financial institution). If such is the objective of the Commission, this should be explicitly stated, if only to be carried out with a reasonable chance of not simply pushing the issue of such bonds out of the Union.

For such a ban to work, it is essential to obtain a US commitment to stay within present US practices rather than to alter them fundamentally in favour of bearer bonds. But such a pact of non-aggression does not go without saying and the opportunity that the EU will create for other financial centres is a very large and very tempting one indeed.

It is slightly imprudent for the proposed Directive not to address these issues more explicitly. Promoting a OECD wide "code of conduct" regarding bearer bonds -possibly an outright ban - is necessary if one does not want the proposed Directive to be read by non EU countries as a standing invitation to capture business away from an inward-looking Union. Countries that have pioneered the full dematerialisation of securities such as France and Denmark could play a role in putting this code of conduct on the agenda.

5.4. 'Gross-up' and early redemption clauses

A technical cause for worries in the market community has been the possibility that the creation of the withholding tax would trigger 'gross-up' and 'early redemption' clauses that are a standard feature of eurobond and medium-term-notes issues.

Such clauses provide that payments to the investor will be made without deduction of any tax levied by the country of the issuer. If the law of that country imposes such a tax, the issuer can be obliged to 'gross-up', namely to pay what it takes to leave the after tax payment unchanged, except in the case when the payment is made to a person 'connected' to that country or able to invoke some tax exempt status. Meanwhile, the issuer is often given a right, subject to certain conditions, to redeem the whole issue at par if a withholding tax is imposed and additional payments are to be made. The present low levels of interest rates would obviously make early redemption at par an attractive option for issuers, creating unexpected losses for EU investors. Yet the wording of these clauses varies from issue to issue and would call for case-by-case assessment.

The 'paying agent' procedure contemplated in the proposed Directive already reflects an effort by the Commission to minimise the number of cases when such clauses could have to be invoked.

Altogether, drawing on preliminary sampling by ISMA the following estimate of the potential effects of these clauses was described by market practitioners in the following terms:

"Given the Directive's focus on paying agents, and because the gross-up clause is only triggered if the withholding tax is imposed under the law of the issuer's country, it appears that gross-up clauses would only be triggered in the case where the issuer and paying agent are present in the same Member State. Approximately 20% of EU issues meet this condition. The result of this exercise suggests that approximately 4-5% of outstanding EU issues appear likely, at least technically, to be callable if the Directive was to be implemented in its current form, and in a further 0.5 to 5% of cases there would be significant uncertainty about the legal position which, at best, will have an adverse impact on such bonds' value. Based on the average value of the principal outstanding on EU issues, at worst approximately 114 billion USD of borrowing by EU issuers could be affected by call/redemption difficulties." [15]

'Grand fathering' outstanding issues is one possibility, although it would create a two-tier market of 'pre-Directive issues' and 'post-Directive ones', with some "pre-Directive" papers still around in the year 2029. Some technical fix can probably be found and the true cost of the 'gross-up' debate may be in the more subtle form of bad memories left by the uncertainty this debate is already creating.

5.5. Blurring the lines: euromarkets and markets in euros

The technical issues we have just discussed appear solvable, provided a much more intense and trusting dialogue is established. But they are only part of the picture. What is now at stake is the very definition of euromarkets.

[15] A submission by The City of London Group, op. cit., p. 4.

At first, euromarkets were clearly and completely 'off-shore', with US banks as major participants. Using a currency outside of its jurisdiction of origin was still unusual. Yet, gradually, what was initially a fully off-shore market has influenced national practices and procedures, thereby beginning to blur the line between 'domestic' and 'euro' markets. The French Treasury, for instance, has endeavoured to bring back part of the euro-franc business to the French market without changing its 'euro' nature.

The creation of the euro is a very significant development in this respect as it will present domestic and euromarkets with a set of common challenges that will need to be addressed from all these markets at the same time, in ways that may be even more closely intertwined. In any case, the 'domestic' markets of the euro countries will disappear. The creation of the euro will introduce a radical change indeed by making each and every 'domestic' capital market of the euro countries an international market.

This blurring of the lines between 'international', 'euro' and 'domestic' is probably one of the reasons why the euromarkets are covered in the proposed Directive. In the words of one of our interviewees 'the definition of euro-currency are numerous [34 by this person's own count!]; yet they all miss one crucial element : the role of taxes'.

For the regulators and practitioners whom we interviewed, it seems clear that, until now, the absence of taxes has been a precondition for the existence of a 'euromarket'. In this sense, if the absence of taxes defines euromarkets, there may be some 'chicken and egg' element in the call for an exemption of euromarkets from the proposed Directive: the question might be better asked in the form of what types of financial activities, at what stage of the value chain, are better left completely untaxed.

5.6. The need to reassess the definition of euro-securities used under the Prospectus Directive

The problems raised by this blurring of the lines, at least in their pre-euro form, had been addressed in a co-operative manner between the Commission and IPMA when drafting the Prospectus Directive. The results of this intense and successful process of consultation have been summarised by IPMA in the following manner:
They raised a problem that had up to then been merely an academic conundrum, namely: What is a Eurobond?

Practitioners had grappled with the problem of defining the essence of such a security for years with no precise consensus emerging. For IPMA to win an exemption for euro-securities from the requirements of the Prospectus Directive it first had to demonstrate to the European Commission what a euro-security was. The negotiations took 18 months and a formula was eventually developed that satisfied both sides. That definition is as follows:

Euro-securities shall mean transferable securities which:

- Are to be underwritten and distributed by a syndicate at least two of the members of which have their registered offices in different states.

- Are offered on a significant scale in one or more States other than that of the issuer's registered office.

- May be subscribed for or initially acquired only through a credit institution or other financial institution.

As a result of IPMA's work in this area, euro-securities which met the above criteria were exempted from the Directive, thereby avoiding the severe damage that would have occurred in the absence of such an exemption.

This high mark in co-operation appears now, however, as a fragile one. Obsolete in its letter, it still holds promises in its spirit however.

The initial view that euromarkets were very different is challenged even more by the euro. Baring a return to exchange controls, there can no longer be a purely domestic issue.

One can still distinguish by currencies, although Swap markets blur these basic differences as the currency denomination of the issue does not determine the currency that is actually used by the investor. Markets for sovereign and corporate debt in the euro zone will be seamless, there will be no way of separating domestic from international or 'euro'.

When it comes to new issues, even under the Prospectus Directive, the procedure to qualify as a 'euro-security' is an ad hoc one and often boils down, in one of our interviewees' words, to asking one's lawyer who, usually, will then look at whether these securities are intended to be offered in several countries through an international syndicate. Issuers must then go through a cumbersome process in each country to be exempted, which is done therefore in a spirit of self regulation.[16]

Before the euro, one might still have maintained the fiction that a French franc issue was intended for French investors only, at least as a principle. Even then, however, such attempts to narrow the investing public would have translated into lower prices for the securities, which meant that, in reality, most French franc issues had euromarket features.

One procedural possibility could be to use the existence - or lack thereof - of a prospectus to define whether an issue should be regarded as a 'euro security'. According to the market practitioners whom we interviewed, this however is not very practical in light of the way business is conducted: underwriting faxes go out immediately upon announcement of an issue, requiring acceptance within 24 hours; the whole issue is then placed in 48 hours before a formal prospectus is actually issued as there does remain the need for a document with the necessary details, waivers, disclaimers and the like. The existence of a prospectus or lack thereof does not help much in separating 'euromarkets' from other markets.

[16] Equities of course are different as they are issued and traded in a stock exchange.

The desire by European and national authorities to exercise control might lead however to distinguish between issues brought to the market by European banks alone, by mixed syndicates of European and non-European banks and by completely non-European syndicates.

It is not obvious however that such distinctions would serve a very useful purpose. What matters more is the distinction between wholesale and retail and a new IPMA/Commission report appears urgently needed. It is unfortunate that it seems so much at odds with the present state of affairs.

5.7. The euromarkets and the 'parochial euro' perspective

As we have seen, the opinion of most of our interviewees is that the European 'market of markets' - to borrow the phrase from NASDAQ - will see euromarkets combine ever more tightly with markets in euros. In this context, one would imagine that many energies in Brussels would be devoted to making sure that this 'market of markets' is ready to withstand the shock of the 'euro Big Bang' and to serve the financial needs of Europe at the highest levels of efficiency, integrity and adaptability.

The relevant scenario to describe present trends however, as our interviews with market practitioners suggested, is the one we had called 'KernEuropa' in a previous publication on the future of European integration[17], in which the trend for EU policy makers is to assume that the external environment has propensity to adapt to the internal model chosen by the Union rather than the reverse. In this Europe-centric 'KernEuropa' scenario, the euro is not seen so much as one of the two global currencies of the early twenty first century than as the cornerstone of a process of harmonisation with strong defensive overtones.

Euromarkets then tend to be seen more as a residual variable than as an asset that the Union could endeavour to mobilise.

To some extent, the existence of euromarkets may even be seen, in this scenario, as part of the problem rather than of the solution as some of their characteristics may be attractive to tax evaders. Swiss banks have been acquiring a substantial part of euro-issues for inclusion in the portfolios they manage as part of their private banking activities; the fact that euro issues can be held in non-registered bearer form is unlikely to facilitate tax collection from outside. So one could imagine that 'loosing the euromarkets' to New York and Zurich is greeted if not with relief at least with some 'Schadenfreude.'

On the whole, however, it would seem that the euromarkets have been ignored rather than targeted by the proposed Directive. For reasons having to do notably with the lack of communication described above, market practitioners find themselves caught in the crossfire. This lack of an explicit strategy regarding what the Union can and cannot do with euromarkets is, at best, a missed opportunity on the eve of the creation

[17] Europe 2012 : Globalisation et Cohésion Sociale, op. cit.

of the euro. At worst, it could turn out to be a fatal weakness in a strategy conceived around an inward-looking agenda at the very moment when financial integration is going to reach unprecedented levels.

5.8. The consensus scenario on the impact of the proposed Directive on euromarkets

Looking at the proposed Directive in its present state, one is under the impression that Europeans assume that there is simply no alternative for market participants but to remain in Europe. If such were the implicit assumption, it would run against a set of strong and deeply held values and priorities that distinguish the euromarket community. By contrast, the worst case scenario is one in which the wholesale market moves back to the US and significant parts of the retail market move to Switzerland.

The information we gathered through our interviews and the independent analysis that we present on 'the unipolar moment' and the way US authorities may react to the euro clearly suggest this scenario is more likely to materialise than an inward looking Commission seems ready to consider.

a) The views of market practitioners

IPMA is extremely concerned that the proposed Directive will have a significant adverse impact on the international capital markets in Europe. According to a report by Lombard Street Research Ltd, 112,000 people worked in the international securities and related sectors in Greater London in 1995. If only 10% lost their jobs or moved to New York or Switzerland because a significant portion of the Eurobond market relocated, over 11,000 top quality jobs would be lost, probably irretrievably. In IPMA's words:

"On a worst case basis, the EU will lose the largest fixed income market in the world and London will lose its role as the leading international finance centre."

Firms active in fixed-income securities are also active in equities; should they begin to repatriate their fixed-income business toward the US, there are reasons to fear that part of their equity business would follow.

Indeed, as observed by one of our interviewees, "the prospect of cumbersome and costly procedures and the uncertainties associated with their planned introduction will increase the tendency of market participants to begin searching for the exit sign out of the EU."

London is not the only affected financial centre in the EU. Luxembourg is also very much in the firing line for those aspects of euromarket operations on which it excels. As observed by IPMA: 'it estimated that approximately 1,400 people are employed in the paying agency function in the EU, predominately in London and Luxembourg. Since the retail portion is the more labour intensive, a large portion of those jobs is likely to leave London and Luxembourg.

The retail sector is most likely to move to Switzerland. Switzerland already has a well developed infrastructure for raising capital for foreign borrowers and servicing issuers and investors. Swiss banks figure among the biggest custodian banks.'

Already, since March/April 1998, Swiss banks report that funds are coming in at unprecedented levels and the practitioners we interviewed clearly think that delocalisation has begun.

The stakes are high. Assuming that about 10% of Eurobonds are owned by retail customers with about a third of them EU residents, IPMA assesses that the shift in assets toward notably Switzerland could be in the order of 50 billion USD if only half of these investors adapt their paying agent or custody arrangements to shelter themselves from the Directive.

b) Evasion, avoidance and the clash of tax doctrines

At this point, one may want to remember that the English language distinguishes much more clearly than the proposed Directive between 'tax evasion' - an illegal move - and 'tax avoidance' - the selection of the best possible legal arrangement.

The French administrative culture includes the polar opposite of this semantic distinction. Not only is 'avoidance' usually translated by 'évasion' and evasion by 'fraude' but, regarding French laws themselves, the theory and jurisprudence of 'excès de droit' imply that a French citizen can be denied the benefit of existing French laws if the tax authorities consider that he or she has used them too cleverly and to an excessive advantage. With respect to international taxation[18], it is the French doctrine to consider that foreign taxes lower by more than 30% than equivalent French taxes constitute a 'régime fiscal privilégié' which leads to a list of tax havens (paradis fiscaux) of more than 70 countries. This should lead to a quite generous definition of 'harmful competition' that 70 countries at least - many in Europe - will not immediately share.

In this sense, two deep current of political and legal thinking will probably conflict, one in which 'public interest' is the sum of private interests - the American tradition - and another in which 'public interest' can be of a altogether different nature from private interests with the three branches of government responsible for protecting the greater collective good from the lower private passions and expectations. Both traditions have value and it is certainly not our purpose here to choose one over the other as both have inspired remarkable achievements.

Let us simply observe that the proposed Directive may underestimate the depth of dialogue that will be needed for European convergence to really take place on matters like these. Harmonisation is also about convergence of the mind and it would be a pity if the proposed Directive replaced what could have been one indepth dialogue with a defensive, 'kernEuropean' attack on foreign tax approaches as harmful as long as they depart substantially from one's practices. Diversity of perspectives and capacity to learn from one another, such are the real European assets.

[18] See for instance Sylvie Camus et Sabine Pereira, 'Le projet de loi de Finances et la lutte contre la fraude et l'Èvasion fiscales', Les Echos, 10 décembre 1998, p. 53.

c) The case of Luxembourg bond listings, the Zurich trump cards and the Bahamas and Cayman initiatives

Luxembourg lists about 3,500 issues from 90 countries, about two thirds of which are bonds. It offers therefore an important example of the impact that the proposed Directive could have on the positioning of European financial intermediaries in global finance.
Most of the issues quoted on the Luxembourg stock exchange are not directly affected by the proposed Directive because these are 'global bonds' registered with Cedelbank or Euroclear as 'global certificates'. They are transferred to other investors in book-entry form.

This being said, even registered global bonds can be acquired by investment funds which can then issue bearer bonds. In addition, these securities are intertwined. So, if the securities subject to withholding tax stop being quoted in Luxembourg and are transferred to another exchange it is likely that other securities will follow.

Exchanges have been created recently in Bahamas, Guernsey and the Cayman Islands with the explicit objective to compete with Luxembourg.

Similarly, as we have seen, the Swiss market has put in place in July 1998 the necessary procedures and infrastructure to become a very active market for eurobonds with only the Swiss stamp duty providing some relief from competition to EU financial centres. It is to the credit of the Swiss market to have gone far and fast on the preparation of the euro and to have positioned itself strategically at the core of finance in euro through a full merger between the Swiss and German derivative markets.[19] Playing the stamp duty trump card could now make Zurich an even more essential centre for the euro, the euro-euro and many of the benefits that the Union is seeking for itself through its bold currency initiative.

The risks of delocalisation against which IPMA and ISMA have been warning the Commission are already becoming part of the competitive strategy of other financial centres. Clear signals are needed quickly as to the degree of awareness in the EU about these capital market issues and as to the willingness to act before it is too late.

One might venture that nothing will really be lost if issues listed in Luxembourg leave the Grand Duchy to be tested in one of these new exchanges. Taking such a view comes indeed quite naturally in the 'parochial-euro' or 'KernEuropa' perspective we have described. It is not the case however for the 'global euro' perspective that this report would like to encourage, be it only because 1 January 1999 will see the end of 'the euro for Europeans only' and the rise of the euro as a true, major currency of global reach.

When an issue is quoted in Luxembourg or elsewhere in Europe this is done following the model of the European Directives. This capacity for Europe to see its legal system widely used internationally is an important aspect of the search for a balanced relationship with the US markets.

[19] See 'Close to the euro and close to the world', strategic conversation with Jörg Fischer, chairman Swiss Exchange and chairman EUREX, in The euro at the Vanguard of Global Integration, PROMETHEE / Ernst & Young, Paris, 1998.

d) The one-currency US culture gradually evolving to become multi-currency: likely reactions by US banks to the measures envisioned in the proposed Directive

The attitude and strategy of US market participants will be absolutely critical to the future of euromarkets. It should not escape careful observers of the capital markets that convincing US banks to relocate in the US is not an impossible task.

There are reasons however for US institutions to be and to stay in Europe. US banks have been limited so far by their 'one-currency culture' and so have US financial centres. Even the DEM could not be seen as a currency that US domestic markets should treat as a major instrument. The euro will change this however. As it emerges as the second pillar of a two-currency world, the euro can no longer be treated as a matter for international experts only. It will become part of the basic market tool box.

All market participants we talked to were of the opinion that US banks would take a much more dynamic attitude to building positions of strength for the new finance in euro compared to their previous attitude toward non USD activities. Creating the premier 'euro-euro' market out of New York is certainly an objective; a number of them are already considering. It would be a windfall opportunity for them to benefit from a self inflicted retreat from euromarket activities by London and associated European centres.

As noted by IPMA: 'The United States and in particular the American investment banks would like to recapture the USD sector of the Eurobond market and repatriate it and all of the jobs associated with it.'

e) The unipolar moment... and the moment of truth for euromarket localisation?

The choices US banks will face will have to be addressed at a period in time that Charles Krauthammer has labelled 'the unipolar moment', namely the moment when the US is the only power enjoying simultaneously economic, technological, political and military supremacy.

The presence of the one-trillion-USD-per-year euromarkets on European shores is one of the few significant exceptions to this pattern of absolute supremacy. There would be little hesitation on the US side - at political and regulatory level as well as in financial circles themselves - to grab what Europeans would serve on a silver dish and with the best of all intentions.

Indeed, from a US perspective, the timing could not be better as the creation of the euro as the second anchor currency for the world would clearly represent a significant challenge to this well established pre-eminence. Anyone who has followed the debate on international standards and the competition between the US FASB and the European supported IASC can realize how important it is to be in the position of gate-keeper to the world's premier pool of liquidity and the benefits of being able to have one's national standards adopted as global standards.

It is unfortunate that the euro-centric mood still prevailing - at least for a few weeks or months - has prevented the Commission from even looking into this invisible yet essential agenda of standard-setting for the forthcoming two-currency world.

f) The costs of loosing the euromarkets

Letting the euromarkets leave again for the US (where the New York International Financial Centre can serve as a ready-made support structure for off-shore activities) would amount to depriving Europe of the influence that it has now achieved on one of the critical interfaces between global and domestic finance .

An aggravating consideration is that what Europe could loose would not be easily recovered. The fact that the Commission does not envision to take the time to see how the euro establishes itself on global markets before launching this major challenge to Europe's role in global finance is a bit surprising. One certainly sympathises with the need to meet deadlines of various types - be they elections or mandates - but one trillion USD worth of issues is not a light consideration either.

As illustrated by the recent repatriation of trading activities regarding the bund contract from the LIFFE futures market in London to Eurex Deutschland in Frankfurt, it does not take long to create the impression that a market has moved elsewhere. Bringing it back rapidly then becomes a very ambitious proposition indeed. The strength and clout of the US today, as an economy and as the superpower of last resort, would render such an effort to repatriate the euromarkets even more elusive.

The risks of delocalisation of euromarkets is the most vivid illustration of how the EU might inadvertently deprive itself of key strategic assets for the euro. IPMA and ISMA make very clear through their reactions to the proposed Directive that this risk must be taken very seriously: after all, the euromarkets left the US shores in 1963 in reaction to the imposition by the US of the now abandoned Interest Equalisation Tax.

According to the analysis conducted or quoted by IPMA, such delocalisation of euromarkets' activity would mean the loss of about 11,000 jobs in London and of many other supporting jobs in London and Luxembourg. This may be overlooked by other Member States as a problem for those financial centres only. Such a view, however, would neglect that by loosing the euromarkets, Europe would loose access to a remarkable pool of state-of-the-art financial expertise. It would also loose a strategic opportunity to use the transmission belt of the euromarkets at the advantage of the European perspective on global finance.

At a time when the US markets and the US regulators are trying to position themselves at the heart of global finance, what is needed is a balanced relationship between the USD and the euro. Keeping the euromarkets in Europe would be one important contribution toward achieving such a balance. As made the case by PROMETHEE recently, the European Union is not a laggard in globalization. On the contrary, the Union is exploring new patterns of integration going well beyond the standard combination of free trade and the free flow of capital. The Union would be very legitimate in calling other major public and private actors in a joint effort to lay the foundation for successful financial integration in the 21st century.

Conclusion

The way forward.

Proposal for actions inside the Union and within the OECD

Removing harmful tax distortions and 'fighting tax evasion' are worthwhile, important objectives but they can take a highly technical form and are mostly of a negative or defensive nature. Already, thinking in terms of 'fair competition' is more in line with the post euro agenda. Europe is not built on distrust of the other but, on the contrary, on mutual recognition and in-depth dialogue.

As the euro comes to life, political leaders have the responsibility to present the European citizens with a new set of widely shared, positive objectives for the next stages of European integration. Steps toward harmonisation of taxes clearly belong in this agenda, yet they should aim not just at addressing the concerns of tax collectors but, as explicitly as possible, at meeting the needs of the corporations, financial institutions, investors and workers who are intended to be the true beneficiaries of the proposed Directive. It is unfortunate therefore that, until now at least, the proposed Directive has probably over-emphasised the concerns of the tax-collector community - which are inward-looking by their very nature - at the expense of the concerns of market participants and intermediaries - which are outward looking, also by nature.

Setting up a high level group...

In this spirit, this report recommends setting up a high level group within Europe to reflect upon and make proposals on tax convergence and capital market implications after the euro.

... to serve as catalyst for a dialogue on post euro integration

One of the objectives of this group would be to engage market participants, notably professional associations such as IPMA, ISMA and EBA in a dialogue on the changing relationship between wholesale and retail markets and on the search for the appropriate ways to draw the line between them. Such a distinction could serve the function of the definition now obsolete given of 'euro-securities' in the Prospectus Directive. More technical issues (gross-up and redemption) could also be covered, although it is likely that this is already being done. As we have seen, bearer bonds are a more important issue in need of some clarification and shared thinking.

This dialogue would lay the ground for a Directive that would meet its social and tax objectives in ways not detrimental to the European capital market industry. Without prejudging what this high level group might conclude, the present report leads to some suggestions that might be considered.

Suggestions for a simpler and more 'European' Directive

The emphasis should be on the following features that can already be considered as needed for the directive to be a the same time less costly to administer and more in line with a European integration dynamics:

- First, the withholding tax should be final so as to make it simple and also to make it European in inspiration rather than merely defensive.

- Second, it should be set at a level low enough to compensate for the bias in today's national tax systems toward keeping savings at home.

- Third, a perspective should be open for an evolution toward a VAT type of structure, with agreed levels of withholding taxes for agreed types of investment. Differentiated tax levels would facilitate the funding of pensions in ways comparable to what Member States do at home, with the possibility of zero level withholding tax for the type of pension-related investment that are (or that will become in some years) tax exempt in the Member States.

- Fourth, it should include a 'post-euro' set of guidelines to separate retail from wholesale activities, exempting the latter entirely. This in turn calls for in-depth work and, maybe, some reorganisation of placement activities by financial firms themselves so as to adapt their internal procedures, control and reporting to the blurring of the lines between domestic and global.

Agenda for the indispensable international dialogue

Aimed at the removal of tax distortion and at the fight against tax evasion, the proposed Directive can be the catalyst of the much needed international dialogue on financial stability.

In their efforts to achieve the objective set forth in the proposed Directive, the leaders of the Union should also look at the latter as one building block toward a more resilient international architecture for the forthcoming two-currency world.

The OECD is mentioned by almost all market participants - and notably by all our interviewees - as the logical forum for any meaningful debate and decision on a withholding tax that could stand a chance of not transforming rapidly into a major source of lost investment and lost financial market activity for the EU. Actually, the OECD has already a long experience with the issue which it first approached in the form of a proposal to reform international withholding tax regime as far back as 1976.

There is something a little surprising in the Commission's view that going alone is a good way for Europe to show the way and be followed quickly thereafter by an OECD-wide consensus: the European tradition would seem to be that consensus is built rather than announced or presupposed. More importantly, capital markets are the kingdom of "ratchet effects": once liquidity is lost, it does not come back easily as it is in the nature of liquidity to feed on liquidity.

By letting the prized eurobond market cross the Atlantic and the Alps, the Commission's proposal would bet that discussions among OECD experts could undo what market forces would have done and repatriate the lost business, the lost liquidity and the lost leading-edge skills to the Union. This is a brave view indeed of the power of OECD working parties! An ex ante approach would clearly be more in the EU interest than an ex post one.

Steps in this direction could include:

- Engaging its OECD partners and notably Switzerland in a co-ordinated effort to establish an OECD-wide withholding tax, possibly with some regional rate differences, that could fit into the global financial infrastructure needed for the smooth functioning of global financial markets.

- Providing enough incentives, of the positive and negative type, to prevent some smaller countries to leave the 'OECD Club' as some have recently been reported to be considering.

- Requiring OECD countries to achieve the necessary transparency with respect to the links established through their banks with related parties in non-OECD financial centres in the form for instance of 'double-bottomed' bank accounts.

- Encouraging and rewarding the evolution of the off-shore world toward a common ethics in such fora as IOSCO and BIS.

This international dialogue would be the counterpart to the intra European.

Taking ´the global euro' into consideration in the timing of tax initiatives

It is likely that these internal and external dialogues will require a couple of years of in-depth work and dialogue before providing the platform on which a revised proposal for a Directive can be based. This would come as a disappointment to advocate swift initiatives against 'harmful tax competition' in the field of interest payments. This disappointment, in the view of this report, should be assuaged however by two considerations:

The first consideration is that the standstill agreement on 'harmful tax competition' can very much be enforced, as it has actually begun to be, while this common approach is developed. Judging by the debate of the fall of 1998, it seems that the most immediate concern of Member States concern corporate taxes. Measures such as those envisioned in Denmark to attract holding companies (by replicating a Dutch-style tax environment!) are a clear illustration of what is at stake. In no way therefore would EU governments be simply turning a blind eye to what they perceive as harmful tax competition if they focused on the enforcement of this agreed standstill while progress is being made along the lines advocated in this report.

The second consideration is that there is something much worse than delayed action: outright failure. The technical complexity of the procedures to be put in place has been clearly underestimated, with the risk of ending up the way the TAURUS project ended when it had to be abandoned as too costly and too complex. Such a failure to implement the announced proposal would deal a serious blow to European momentum and would do so at the very moment when the creation of the euro is making success a strategic imperative for the Union. As we have seen, in addition, this risk of failure has been accepted at the cost of not exploring pro-integration approaches such as making the withholding tax final. Such alternatives are readily available to make the proposal workable while also taking a quantum leap toward 'Citizens' Europe.'

Altogether, the Commission should be complimented for having acted swiftly within the relatively narrow mandate set by the ECOFIN on 1 December 1997. Yet, it should also be alerted to the fact that, in this specific context, this is either too much or too little boldness. Too much in light of the major risks lightly accepted for the sake of relatively limited benefits. Too little in light of the agenda already taking shape to move Europe beyond the single currency toward elements of a genuinely common tax policy. The latter would look at the people of Europe not as potential tax evaders but as those citizens who have really made possible the Union of today by the far reaching changes they have accepted and encouraged for their collective good.

Annex

Key elements of the framework set by ECOFIN Council in its 1 December 1997 decision regarding harmful effects of tax competition and taxation of savings

To ensure a minimum of effective taxation of savings income within the Community and to prevent 'undesirable distortion of competition', the Council calls upon the Commission to present a proposal for a Directive on the taxation of savings. The Council considers that the following points might form a basis for that proposal:

- The scope of such a Directive could be limited to interest paid in one Member State to individuals who are resident in another Member State.

- As a first step toward effective taxation of savings income throughout the Community, such a Directive could be based on the 'coexistence model', under which each Member State would either operate a withholding tax or provide information on savings income to other Member States. A Member State might combine the two.

- Any withholding tax on interest payments made to residents of other Member States could, in principle, be levied by the paying agent. The arrangements for checking the residence for tax purposes of beneficiaries should 'not be too cumbersome'.

- The provisions of such a Directive should take into account the need to preserve the competitiveness of European financial markets on a global scale.

The Council should review the issue before adopting such a Directive.

In May 1998, based on this resolution, the Commission issued the current proposed Directive under the title 'Proposal for a Council Directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community'.

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