Brussels, 3 October 2008

BACKGROUND [1]
ECONOMIC AND FINANCIAL AFFAIRS COUNCIL
Tuesday 7 October, Luxembourg

The Council will focus on the economic situation, including the events which have recently affected the financial markets, and will examine how to respond.

It will be preceded by a meeting of the ***Eurogroup,*** *on Monday 6 October starting at 17.00.*

On Tuesday, during a working breakfast starting at 8.30, ministers will discuss the economic situation and developments on the financial markets, and the remuneration of senior business executives. There will be a quick briefing on the forthcoming IMF and World Bank annual meetings and the president of the Eurogroup will give an account of the previous evening's discussions.

Meeting from 10.00, the Council will prepare the discussions of the October ***European Council*** *as regards the* ***economic situation****, the* ***financial markets situation****,* ***financial supervision*** *and the* ***price of oil****. It should also issue a statement on the* ***remuneration of senior business executives****.*

The Council will also need to reach agreement on new solvency rules for ***insurance companies*** *("Solvency II" Directive).*

It will also seek agreement on measures designed to combat ***VAT fraud****, and will hold an exchange of views on the impact and benefit of* ***reduced VAT rates****.*

Ministers will then have lunch with their counterparts from the southern shore of the Mediterranean and will hold a ***Euromed*** *"economic and financial affairs" meeting from 15.30 to discuss the FEMIP fund (Euro-Mediterranean Investment and Partnership Facility).*

Press conferences

- following the Eurogroup meeting *(Monday, from 20.00)*;
- at the end of the Council meeting, before lunch *(Tuesday, from 13.00)*;
- following the Euromed meeting (*Tuesday, from 17.00)*.

The press conferences and public events can be watched on video on:
http://www.consilium.europa.eu/videostreaming

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1 This note has been drawn up under the responsibility of the press office.

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Preparation for the October European Council

The Council will prepare the discussion of the European Council on 15 and 16 October as regards the economic situation, the financial markets, financial supervision and the response to the volatility in commodity prices, particularly of oil.

To do so, it will draw on the discussions of Ministers and Governors of Central Banks held at an informal meeting in Nice on 12 and 13 September, and on other discussions held since the European Council meeting in June.

- **Economic slowdown**
- **Economic and monetary union, ten years on**
- **Remuneration of senior business executives**

The Council should adopt conclusions that will serve as a basis for a debate in the European Council on the coordinated response to be made by the EU to the economic slowdown.

The text will incorporate the messages agreed in Nice by the Ministers and Governors, and elements relating to a Commission communication of May 2008 on *"EMU@10"*, examining the successes and challenges after 10 years of Economic and Monetary Union.

The Council should also adopt conclusions on the remuneration of senior business executives.

As regards the economic situation, the unfolding of events day by day makes it particularly difficult to make any specific analysis. The draft conclusions will therefore touch on the main principles to be followed in order to steer through the crisis and take stock of the measures undertaken in the framework of a "roadmap" drawn up by the Council in October last year and updated on 14 May.

The conclusions note that, even though the European economies are better equipped than in the past to face up to this slowdown, thanks to the reforms carried through in recent years, the prospects for growth in the short term remain relatively gloomy. Nevertheless, the recent fall in the prices of energy and foodstuffs, the high level of which had done much to fuel inflation, and the economic slowdown should contribute to easing inflationary pressures in the coming months.

The strategy to be adopted by the Member States could be based on the following objectives:

- at the macroeconomic and structural levels, to ensure that there are national policies in place designed to support sustainable growth;
- to restore confidence on financial markets and avoid an excessive credit squeeze for SMEs in the EU;
- to contribute to a more favourable environment at external level.

With regard to *"EMU@10"*, the Commission communication proposed improvements in relation to the governance of the euro area *(9385/08)*. On this point, the draft conclusions suggest some lines of approach for further discussions.

On the question of the remuneration of senior business executives, the draft conclusions take note of the public debate which has started up in a number of Member States on the levels, structure and transparency of such remunerations.

In a market economy, it rests with company shareholders and social partners to set the level of remunerations. Nevertheless, national authorities have a role to play in defining a suitable regulatory framework and in encouraging good practices. Hence the Council should in particular insist on two aspects: the fact that remunerations must be consistent with effective performances and secondly that these remunerations must be subject to scrutiny by company shareholders and supervisory bodies.

The draft conclusions note that, in view of the trend in the remuneration of senior business executives in recent years, the efficacy of certain provisions requires additional examination and, possibly, the adoption of measures at national level. In 2004, the Commission issued a recommendation addressed to Member States, and it could prove necessary for this to be updated.

– **Situation of the financial markets and financial supervision**

The Council should adopt conclusions on financial stability and financial supervision.

The text, which well be sent to the European Council, is based on a document circulated by the Presidency following the informal meeting in Nice.

The draft conclusions confirm the commitment to respond to the financial-market situation, on the basis of a "roadmap" drawn up by the Council in October of last year and updated on 14 May. It is important both to respond to the current unrest and to take steps to prevent a future crisis, or to curb its impact.

The draft also reports on progress on the convergence of supervisory practices, as set out in a roadmap on the Lamfalussy process regarding the regulation and supervision of financial services, also updated on 14 May. As regards in particular the supervision of cross-border financial groups, it aims to specify the division of roles between the authorities of the State of "origin" (supervisor of the country of the head of the group) and the authorities of the "host" State (supervisors of the group's subsidiaries).

– **Volatility of the price of oil and other commodities**

The Council will examine a report from the Presidency, drafted in cooperation with the Commission, on the political response to be made to the current volatility of the price of oil and other commodities.

The report, which will be sent to the European Council as a follow-up to its discussions in June, assesses the situation on the oil markets and the measures to be taken in the short and medium-term. A report will also be made to the December European Council.

At its meeting on 19 and 20 June, the European Council stated its concern at the continual rise in oil and gas prices and at the social and economic impact. It asked the French Presidency, in cooperation with the Commission, to study the feasibility and the impact of measures designed to limit the effects of the explosion in oil and gas prices and to report back to it at its October meeting.

It asked the Member States, the Commission and the European Investment Bank (EIB) to support measures to encourage household and industrial investments that favoured energy efficiency, the use of renewable energy sources and a more environment-friendly use of fossil fuels. It also asked Member States and the Commission to speed up the implementation of a 2006 action plan on energy efficiency and to give thought to re-examining it.

In addition, a Commission communication of June 2008 suggested lines of approach on the way in which Europe will be able to adapt to higher oil prices *(10824/08)*.

In July the Presidency drew up a "roadmap" addressed to the Economic and Financial Affairs Council (Ecofin) identifying three subjects that fell within Ecofin's sphere of competence, namely:

– the functioning of markets;
– the role of financial instruments designed to improve energy efficiency, promote the use of renewable energy sources and encourage the more environment-friendly use of fossil fuels; and
– the feasibility and the impact of measures likely to alleviate the effects of the rise in the price of oil.

The Presidency's report builds on the work already undertaken within the ECOFIN Council and complements the work undertaken in other Council formations.

It notes that high oil prices are set to prevail in the medium and long term in the face of continued strong demand from emerging economies and supply constraints. In order to contribute to reducing market volatility, the EU is determined to increase their transparency by strengthening the communication of information. In particular, a legislative proposal from the Commission laying down the principle of a weekly publication of commercial stocks in the EU, mirroring the situation in other major economic areas, is expected in November. Secondly, targeted, short-term measures are being taken at national level to alleviate the effects of the rise in the price of oil on the most vulnerable.

As regards energy efficiency, the report identifies the ways in which the EIB's financial instruments can contribute to the European Union's overall action, and suggests to the European Council that it invite the EIB to take new measures.

As regards mitigation of the effects of the oil-price surges, it takes stock of the measures, particularly fiscal ones, taken by Member States. It lays emphasis on short-term support for those hardest hit by the price rises.

Solvency of insurance companies – "Solvency II"

The Council will be required, on the basis of a compromise proposed by the Presidency and pending the Opinion of the European Parliament, to work out a general approach to a draft Directive setting new solvency rules for insurance companies ("Solvency II" Directive).

If agreement is reached on the text, the Council's general approach will serve as a basis for the Presidency to continue negotiations with the Parliament, with a view to reaching agreement on the Directive at first reading, before the end of the current parliamentary term.

As the existing solvency rules are well out of date, the proposal is intended to establish a new framework for EU regulation and supervision. It involves the recasting of 14 insurance directives into one legal text.

The objectives are to increase integration of the EU insurance market, to strengthen protection of policyholders and beneficiaries, to enhance the competitiveness of EU insurers and reinsurers and to encourage improved legislation in this sector.

The main outstanding political question to be put to ministers concerns organisation of the supervision of insurance groups, where these are present in several Member States, and the allocation of responsibilities between the authorities of the State of "origin" (supervisor in the country of the head of the group) and the authorities of the "host" State (supervisors of group subsidiaries).

The proposal is based on Articles 47(2) and 55 of the Treaty, which stipulate that the Council is to act by a qualified majority, in codecision with the European Parliament; the Parliament's Opinion at first reading is expected in November.

Combating VAT fraud

– Reducing the timeframes for declaration of cross-border transactions

The Council will be required, on the basis of a compromise proposed by the Presidency and pending the opinion of the European Parliament, to agree on a general approach on measures proposed in order better to combat VAT (value-added tax) fraud connected with cross-border transactions.

The purpose of the proposals concerned is to amend Directive 2006/112/EC on the EU's VAT system and Regulation (EC) No 1798/2003 on administrative cooperation in tax matters to allow for information on cross-border transactions to be collected and shared more rapidly among Member States.

Every year, VAT fraud costs Member States more than EUR 100 billion. It most often takes the form of fraud circuits known as "VAT carousels", which target cross-border transactions. The free movement of goods makes good cooperation between Member States all the more necessary in order to combat this fraud. In November 2006, the Council agreed to establish a strategy to supplement at EU level the efforts being made nationally. In June 2007, it requested the Commission to propose legislative measures to strengthen the VAT system and decided to give those measures a high priority.

In this context, the proposals make provision for the timeframes for declaration of cross-border transactions and for transmission of such information between Member States to be reduced from three months to one month.

The Presidency compromise, which seeks to avoid the administrative burden on undertakings becoming excessive, focuses accordingly on supplies of goods, which are the principal conduit for "carousel" fraud.

It lays down that transactions are in principle to be declared for VAT purposes on a monthly basis, while leaving Member States the possibility of authorising operators – in the case of supplies of goods by small-scale operators and the provision of services – to continue to submit recapitulative statements on a quarterly basis. The compromise provides also for an assessment by the Commission of the way these options are functioning.

Certain delegations, however, expressed reservations on this compromise, and the Council will also have to settle the question of the threshold of what constitutes a "small-scale" operator. The compromise lays down a threshold of EUR 50 000 (excluding VAT) per quarter for cross-border supplies.

Further discussion is also needed on harmonisation of the provisions governing liability for VAT on services, the aim of which is to ensure that such transactions are declared by the seller and by the buyer during the same tax period.

The proposals are based on Article 93 of the Treaty, which stipulates that the Council is to act unanimously and after consulting Parliament; Parliament's Opinion is expected in December.

– **"Eurofisc" early-warning system**

The Council will be required to adopt conclusions on establishing an informal structure ("Eurofisc") to step up cooperation between the tax authorities of the Member States in combating VAT (value-added tax) fraud.

This concerns notably an early-warning system comprising the exchange of information on operators suspected of fraud.

At present, exchanges of information between the Member States mainly take place pursuant to Regulation (EC) No 1798/2003 on administrative cooperation in VAT matters. There is also an informal system launched by Belgium and supported by the Commission, but this system has no legal basis and certain large Member States do not participate.

The Eurofisc system would therefore be designed to remove these drawbacks; the draft conclusions lay down guidelines and invite the Commission to incorporate them in the revision of Regulation (EC) No 1798/2003 announced for this autumn.

Reduced VAT rates

Following a discussion on 13 September at an informal ministers' meeting in Nice, the Presidency announced its intention to close the debate on reduced VAT (value-added tax) rates at the October Council and to examine a proposal for a Directive on the subject at the Council meeting on 4 November.

In this context, the Commission, responding to a request expressed at the informal meeting in Nice, will present to the Council an assessment of the effects of the reduced VAT rates on the economies and budgets of the Member States.

The Council will hold an exchange of views on the impact and usefulness of reduced VAT rates. The discussion should also throw light on further proceedings, particularly at the meeting in November in the case of the legislative proposal.

Under the current rules, Member States are required to apply a standard VAT rate of at least 15 %. Derogations are granted in certain cases and for certain Member States, in particular:

– permanently reduced rates of VAT for a limited list of staple goods and services, including food products, energy products for heating and lighting, water supplies, pharmaceutical products, books, newspapers and magazines and public transport. The list is set out in Annex III to Directive 2006/112/EC;

– temporarily reduced rates applicable to certain locally supplied labour-intensive services (minor repair services, refurbishment of private homes, window cleaning and cleaning of private homes, home care services, hairdressing). These derogations were extended until the end of 2010 by Directive 2006/18/EC;

– other derogations of limited duration under the respective Acts of Accession of Member States which joined the EU in 2004. These derogations were extended until the end of 2010 by Directive 2007/75/EC.

In recent years, the Council has been unable to reach an agreement to stabilise the rules on reduced VAT rates. However, following a compromise in January 2006, the Commission was invited, under Directive 2006/18/EC, to commission a study by an independent body.

The study, carried out by the firm *Copenhagen Economics ApS*, assesses the potential impact – on job creation, economic growth and the functioning of the internal market – of reduced rates applied to locally supplied labour-intensive services. The findings are set out in a communication published by the Commission in July 2007 (*11695/07 + ADD 1*).

On the basis of the study, the Commission considered that a new framework would be necessary to rationalise and simplify the use of reduced rates, while leaving Member States a certain flexibility.

Last December, the Council agreed to conduct a discussion of principle in 2008 on the economic impact of reduced rates and on whether they were an appropriate instrument for achieving sectoral policy objectives. It also took note of the Commission's intention to present a proposal for a Directive on the most pressing questions (in particular locally supplied services).

This proposal was approved by the Commission in July.

The positions of delegations diverge over the leeway which Member States should have when setting reduced VAT rates. The following points emerge from the discussions:

– impact on the internal market is deemed an important criterion;
– some delegations call for greater leeway than that currently provided for;
– some fear a fall in revenues;
– some stress the need to ensure equality between Member States.

CO_2 – Emission allowance trading after 2012

Under "Other business", the Council will discuss, at the request of the Polish delegation, the prevention of excessive indemnity-price volatility under the CO_2 gas emission allowance trading scheme, which is being defined for the period 2012-20.