

RESPONSE ON EU PROPOSAL FOR A FINANCIAL TRANSACTION TAX

JOHN VELLA, CLEMENS FUEST AND TIM
SCHMIDT-EISENLOHR



OXFORD UNIVERSITY CENTRE FOR BUSINESS TAXATION
SAÏD BUSINESS SCHOOL, PARK END STREET,
OXFORD, OX1 1HP

The EU Commission's Proposal for a Financial Transaction Tax

John Vella, Clemens Fuest, Tim Schmidt-Eisenlohr*

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Few legislative proposals could be more popular at this time than those for new taxes on the financial sector. Proposals for Financial Transaction Taxes (FTT), in particular, appear to have struck a chord. In the UK, the Robin Hood Tax campaign, which calls for an FTT, has received backing from a substantial and motley group of individuals and bodies, as well as considerable media coverage.¹ Clearly, however, the FTT's appeal extends beyond these interest groups and their supporters. The French and German governments openly called for an EU-wide FTT² and the European Commission (the Commission) put forward a proposal (the Proposal) for an FTT to come into effect on January 1, 2014, thus adding momentum and concreteness to the debate.³

Calls for different forms of FTTs have been made numerous times over the years. Most famously, James Tobin proposed a tax on foreign exchange transactions which came to be known as a "Tobin Tax".⁴ Tobin's proposal was aimed primarily at curbing exchange rate volatility. In time, however, this tax and its name were appropriated by different interest groups which proposed that the tax be used as a source of funding to deal with issues including poverty, international development and environmental concerns. There is thus some heterogeneity in the types of taxes that fall under the heading of FTT and the aims they pursue.

The Commission's proposal comes at a time when the knock-on effects of the financial crisis are being acutely felt. Growth in the EU is "coming to a virtual standstill",⁵ the eurozone debt crisis is raging on with no obvious solution in sight and protests aimed at the financial sector are mushrooming around the globe.⁶ An FTT might have immediate appeal in these circumstances. However, it still behoves the authorities to identify and justify the objectives it is meant to achieve, and to establish whether the FTT is the best instrument to achieve them.

*Senior Research Fellow, Director of Research and Research Fellow at the Oxford University Centre for Business Taxation respectively.

¹ The Robin Hood Tax available at: <http://robinhoodtax.org/>. [Accessed October 26, 2011]. Individual supporters range from Bill Gates to the Archbishop of Canterbury.

² By letter dated September 9, 2011, the French and German finance ministers wrote to the European Commission in support of a FTT.

³ *Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC Brussels*, COM(2011) 594 final, (September 28, 2011), ("Proposal"). All the documents relating to the Proposal are available at:

http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm. [Accessed October 25, 2011].

⁴ J. Tobin, "A Proposal for International Monetary Reform", (1978) *Eastern Economic Journal*, 4 (3-4). J. M. Keynes was an earlier proponent of a tax on financial transactions, and Tobin recognised his influence in this regard. For more detail on the different proposals see T. Matheson, "Taxing Financial Transactions: Issues and Evidence", IMF WP/11/54, (March 2011), available at: <http://www.imf.org/external/pubs/ft/wp/2011/wp1154.pdf>. [Accessed November 3, 2011].

⁵ EU Commission, *Interim Forecast*, September 15, 2011. Available at http://ec.europa.eu/economy_finance/articles/eu_economic_situation/pdf/2011/2011-09-interim-forecast-final_en.pdf. [Accessed November 3, 2011].

⁶ Financial Times, "Wall St protests spread to global stage", October 14, 2011.

The main contention of this note is that an FTT is not the best available instrument to achieve the objectives set out in the Proposal. Rather perplexingly, this much can be established merely by relying on the Impact Assessment⁷ (IA) produced by the Commission to accompany the Proposal.

Criticism of the instrument chosen to achieve an objective is often mistaken for criticism of the objective itself. The writers are thus keen to emphasise that, whilst they raise questions on some of the objectives, they believe that the main objective of raising further revenue from the financial sector is justifiable for a number of reasons which will be discussed further below. The writers simply maintain that there are better instruments than the FTT for achieving the revenue raising objective as well as the other objectives pursued by the Proposal. In this context an important weakness of the FTT is that it does not seek to address any of the commonly recognised causes of the crisis such as excessive leverage or inadequate liquidity coverage.⁸

The Commission's proposal is a result of an interesting process. In September 2009 the G-20 asked the IMF to "...prepare a report ... with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system."⁹ The IMF proposed two taxes, a broad balance sheet tax (this has come to be known as a "Bank Levy") and a Financial Activities Tax (FAT). The FAT, essentially a tax on the sum of the profits and remuneration of financial institutions, is really a "family" of taxes with three rather different "family members". FAT 1 can be seen as a substitute for VAT as its tax base includes wages plus profits, FAT 2 is a tax on supernormal wages and profits ("economic rents") in the financial sector; and FAT 3 is designed to discourage risk taking by including within the base only "very" high wages and profits. The IMF also considered an FTT but noted that it gave rise to a number of issues and thus concluded that an FTT "does not appear well suited to the specific purposes set out in the mandate from G-20 leaders."¹⁰ Despite this conclusion, some countries, notably France and Germany, have not relented in pushing for the adoption of an FTT at a global level. Canada, the US, Australia and others remain opposed to it.¹¹

At an EU level, the Parliament¹² and the European Council¹³ have called for studies on the FTT and the Parliament has also backed its adoption.¹⁴ In October 2010, the Commission considered the introduction of a FTT and a FAT in a preliminary examination and concluded that "there is greater potential for a Financial Activities Tax at EU-level".¹⁵ A comprehensive IA into both tools was then

⁷ *Impact Assessment, accompanying the document 'Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, Vol. 1'*, SEC(2011) 1103 final, (September 28, 2011), (IA Vol.1). The Commission's proposal was accompanied by a voluminous impact assessment made up of 19 volumes. "Impact Assessment" or "IA" shall be used to refer to these documents as a whole.

⁸ See Independent Commission for Banking, *Final Report - Recommendations*, (September 2011), available at <http://bankingcommission.independent.gov.uk/> [Accessed November 3, 2011]; Financial Services Authority, *The Turner Review: a regulatory response to the global banking crisis*, (March 2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf [Accessed November 3, 2011]; more broadly see R. G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, (New Jersey: Princeton University Press, 2010).

⁹ IMF, *A fair and substantial contribution by the financial sector – Final Report for the G-20*, (June 2010), available at <http://www.imf.org/external/np/g20/pdf/062710b.pdf>. [Accessed November 3, 2011].

¹⁰ IMF, *A fair and substantial contribution by the financial sector – Final Report for the G-20*, above fn. 9, 19.

¹¹ Reuters, "EU calls for global tax, Canada says can block it", October 5, 2011, available at <http://www.reuters.com/article/2011/10/05/eurozone-tax-idUSN1E7940VN20111005> [Accessed November 3, 2011].

¹² Resolutions adopted on March 10 and 25, 2010.

¹³ Following meetings on March 10, 11 and 25, 2011.

¹⁴ Resolution adopted on March 08, 2011.

¹⁵ *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee of the Regions, Taxation of the Financial Sector*, COM(2010) 549 final, (October 7, 2010), 8, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0549:FIN:EN:PDF>. [Accessed

launched and its results were eventually published together with the Proposal on September 28, 2011. Three months before the IA was published, the Commission put forward a separate proposal for a system of own resources of the EU which includes the introduction of an FTT.¹⁶ The UK is said to be “bitterly opposed” to an FTT unless it is adopted by other G-20 countries.¹⁷

This note critically examines the Commission’s proposal for an FTT, and proceeds as follows. Part I briefly describes the FTT proposed by the Commission. Part II considers the objectives set out in the Proposal and asks whether the FTT is the best instrument to achieve these objectives. Part III concludes.

I. Design

The proposed FTT was designed¹⁸ with an eye to known weaknesses in FTTs.¹⁹ As shall be seen, this is primarily done by ensuring that its scope is broad along a number of dimensions. The tax applies to three types of financial transactions: purchases and sales of a financial instrument; transfers between entities of a group of the right to dispose of a financial instrument as owner and equivalent operations implying the transfer of the risk associated with the financial instrument, and the conclusion or modification of derivatives agreements.²⁰ Such transactions are caught whether they are carried out in an organised market or over-the-counter. Crucially, “financial instruments” is here defined broadly, and includes, amongst others, transferable securities, money market instruments, repurchase agreements (repos), units or shares in collective investment schemes, structured products and derivatives.²¹ This extensive coverage is necessary as otherwise the close substitutability of financial instruments would allow for simple avoidance.

The FTT only comes into play if one of the parties to such a financial transaction is a “financial institution”. Whilst this narrows the scope of the tax, it is again broadened because a financial institution is deemed to be a party to a transaction if it is acting for its own account, for the account of other persons, or in the name of a party to the transaction;²² and the term “financial institution” covers a wide spectrum of entities, such as credit institutions, pension funds, Undertakings for Collective Investment in Transferable Securities (UCITS), investment firms and alternative investment funds.²³

Whilst generally broad in scope, the Proposal also contains a number of exclusions which attempt to “focus” the effect of the tax. Transactions on primary markets both for securities (shares, bonds) and for currencies are excluded “so as not to undermine the raising of capital by governments and companies”.²⁴ Day-to-day financial activities such as the lending and borrowing activities of private households and enterprises, insurance contracts, mortgage lending and payment transactions are also excluded²⁵ in an attempt to minimise the impact of the FTT on households and Small and Medium

November 3, 2011].

¹⁶ *Proposal for a Council Decision on the system of own resources of the European Union*, 29.06.11, COM(2011) 510 final. The documents relating to this issue can all be found at: http://ec.europa.eu/budget/biblio/documents/fin_fw1420/fin_fw1420_en.cfm. [Accessed November 3, 2011].

¹⁷ Financial Times, “Warning of unintended outcomes of Tobin tax”, October 05, 2011.

¹⁸ This note looks primarily at the FTT proposal from a policy perspective. For this reason, this section only provides a brief outline of the main design features of the proposed FTT. For a more comprehensive description and technical analysis of the proposed FTT see S. Lane, “Analysis – The Financial Transaction Tax proposals”, (2011) *Tax Journal*, 1095, 12.

¹⁹ Proposal, above fn. 3, Art.4.

²⁰ Proposal, above fn. 3, Art.2 (1).

²¹ Proposal, above fn. 3, Art.2.

²² Proposal, above fn. 3, Art.1 (2).

²³ Proposal, above fn. 3, Art.2 (7) contains a full list.

²⁴ Proposal, above fn. 3, Art.4.

²⁵ Proposal, above fn. 3, Art.4.

Enterprises (SMEs) not actively investing in financial markets.²⁶ Other exclusions include: transactions with the European Central Bank,²⁷ the Central Banks of Member States,²⁸ and the European Financial Stability Facility.²⁹

As shall be seen in some detail below, one of the main weaknesses of an FTT which is not adopted globally is its susceptibility to avoidance through relocation. The proposed FTT employs a residence principle to counter this risk, meaning that the FTT applies if one of the parties to a transaction is a financial institution “established” in a Member State.³⁰ A financial institution is established in a Member State if it authorised, has its registered seat, its permanent address, its usual residence, or a branch³¹ in that Member State.³² If both financial institutions involved in a transaction are established in Member States they each pay the tax to their respective Member State.³³ If one of the parties is a financial institution established in a Member State and the other party is a natural person or a non-financial institution then only the financial institution is subject to the tax. If both parties are financial institutions but only one is a financial institution established in a Member State, they are still both subject to the tax.³⁴ Finally, if a natural person or a non-financial institution established in a Member State³⁵ is a party to a transaction with a financial institution established outside the EU, the financial institution is still subject to the tax, which must be paid in the Member State in which the natural person or non-financial institution is established.³⁶ The coverage of the residence principle is thus extensive, however, it does not eliminate relocation risk. One very simple mode of relocation springs immediately to mind. Significant players in the financial markets have subsidiaries in all major financial centres such as New York, Tokyo, Singapore and Hong Kong. Two active market participants avoid the tax completely by carrying out transactions through subsidiaries located in these jurisdictions. This might even suggest that the larger, more established market participants will be able to avoid the tax with greater ease than smaller, less established ones. Other, more inventive, routes around the tax will surely be found.

The rate of the tax is to be set by each Member State, however it cannot be less than 0.01 per cent for financial transactions related to derivative instruments and 0.1 per cent for all other transactions.³⁷ The writers note, however, that if both parties to a transaction are financial institutions they each have to pay the tax. Indeed, such is the design of the tax, that multiple charges may be due.³⁸ For example, if a financial institution purchases an option to buy equities from another financial institution, they both pay the tax when the option is bought/sold, and, at least, again if the option is exercised and the equities are bought/sold. Furthermore, it is to be noted that the FTT on derivatives is charged on the nominal amount involved,³⁹ which can thus create much higher effective tax burdens.⁴⁰

²⁶ Proposal, above fn. 3, Art.5.

²⁷ Proposal, above fn. 3, Art. 1 (4)(b).

²⁸ Proposal, above fn. 3, Art. 1 (4)(d).

²⁹ Proposal, above fn. 3, Art. 1 (3)(a).

³⁰ Proposal, above fn. 3, Art. 3.

³¹ If a financial institution has a branch in a Member State, it is only deemed to be established in that Member State in respect of transactions carried out by that branch. Proposal, above fn. 3, Article 3(1)(e).

³² The definition of “establishment” is technically broader. Financial institutions that do not qualify under any of these grounds can be deemed to be established in a Member State, however, this is ignored for the moment to keep the explanation as simple as possible. It will be taken into account and explained below.

³³ Proposal, above fn. 3, Art. 9.

³⁴ In such a case, the “non-EU” financial institution is also deemed to be “established” in the Member State of the “EU” financial institution and both pay tax in that Member State - Proposal, above fn. 3, Art. 3 (1)(e).

³⁵ Proposal, above fn. 3, Art. 9 (4).

³⁶ Again, in such a case the “non-EU” financial institution is deemed to be “established” in a Member State – Proposal, above fn. 3, Art. 3 (1)(e).

³⁷ Proposal, above fn. 3, Art. 8.

³⁸ For other examples see Lane, “Analysis – The Financial Transaction Tax proposals”, above fn. 18.

³⁹ Proposal, above fn. 3, Art.6.

⁴⁰ See the example given in the IA. *Commission Staff Working Paper Impact Assessment Accompanying the*

II. Objectives and Instrument Choice

The Commission justifies the Proposal mainly as a reaction to the financial crisis and as an attempt to make the financial sector pay for the costs it has imposed on the rest of the economy in the context of the crisis. More specifically, the Commission refers to the following four objectives of introducing an FTT;⁴¹ the Proposal aims:

1. to raise revenue from the financial sector,
2. to create disincentives for transactions that do not enhance the efficiency of financial markets,
3. to avoid a fragmentation of the internal market that might be caused by uncoordinated tax measures of the Member States and, last but not least,
4. to demonstrate how an effective FTT can be designed and implemented, generating significant revenue and paving the way towards a coordinated approach beyond the EU.

Most of these objectives are related to basic functions and principles of tax policy. This includes the objective of revenue raising (objective 1), achieving a fair distribution of the tax burden (this seems to partly drive objective 1 as shall be explained below), internalising the costs of certain activities which give rise to negative externalities (objective 2) and the objective of avoiding undesirable distortions between different sectors or countries caused by differing tax burdens (objectives 1 and 3). Objective 4 is slightly less conventional and refers to the perspective of introducing the FTT globally.

There is a large literature on the impact of various types of FTTs, which yields different and partly contradictory results regarding the impact of the tax.⁴² The IA published by the Commission builds on existing research but also adds new insights. The Proposal explains that, after analysing the FTT and the FAT and various design features, the IA “concluded that an FTT was the preferred option.”⁴³ This statement will surprise attentive readers of the IA since the analysis contained therein does not obviously lead to this conclusion. In fact, the results of the IA do not always support and indeed partly contradict claims made in the Proposal, as will be shown further below.

The writers will consider each of the objectives in turn.

1. Raising revenue from the financial sector

(a) Justifications

The objective of raising revenue is of course the most important objective of tax policy in general. The Proposal justifies this objective on three grounds:

- (i) to ensure that financial institutions make a fair contribution to covering the costs of the recent crisis,
- (ii) to ensure a level playing field with other sectors from a taxation point of view and
- (iii) to create a new revenue stream for the EU.

document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, Vol. 12, SEC(2011) 1102 final, (October 21, 2011), 21 - 22. In the simple example given by the Commission the effective tax rate reaches 22% when calculating the tax paid on the actual price paid for the instrument.

⁴¹ Proposal, above fn. 3, Art.2.

⁴² For an overview see T. Matheson, [above](#) fn. 4.

⁴³ Proposal, above fn. 3, Art.4.

The objective of raising revenue may be also justified on the ground that certain financial institutions enjoy an implicit state guarantee.

(i) Ensuring that financial institutions make a fair contribution to covering the costs of the recent crisis

Here the idea is to claw back some of the money that was spent on rescuing banks during the financial crisis and also some of the broader costs associated with it.⁴⁴ This justification is reasonable because financial institutions undoubtedly played a significant role in causing the crisis. A number of difficulties do arise, however, when seeking to achieve this objective. First, care must be taken to ensure that the incidence of the tax is actually borne by the particular entities from which the tax is meant to be clawed back. As will be noted below, FTTs are especially problematic in this regard. Given this, it is doubtful whether the FTT will have the desired distributional effects. There is the danger that the FTT will be sold to the public as a tax which punishes those who are responsible for the crisis while the true incidence falls on the consumers of financial services. Other tax instruments such as, for instance, the FAT (or at least one version of it) are more likely to be borne by those earning rents in the financial sector.

Secondly, even if we set aside the concern that the FTT might in fact be borne by consumers of financial services and assume that it is borne by the financial institutions or the connected individuals at whom it is targeted, it is far from clear whether any would be paid by those financial institutions, let alone individuals, who were responsible for the financial crisis. Some institutions and individuals who were responsible for the crisis have since left the scene. Furthermore, as the FTT target a broad spectrum of financial institutions, it will also be levied on institutions and individuals who bore none of the blame. There are limits to these points. Clearly the “bad guys” have not all gone, and the “good guys” also benefited from the State intervention. Indeed, without such intervention the system as a whole might (would?) have collapsed.

All in all, the conclusion reached here is that this is a good justification to raise further revenue from the financial sector. However, an FTT does not appear to be the best available instrument to raise such revenue.

(ii) Ensuring a level playing field with other sectors from a taxation point of view

The central contention here is that the financial sector is under-taxed, relative to other sectors of the economy, because certain types of financial services are exempt from VAT. If true, this provides another justification for raising further revenue from the sector through a new tax. Viewed in another way, a further tax on the financial sector is required to avoid undesirable distortions when compared with other sectors of the economy.

The overall effect of the VAT exemption, however, is ambiguous. The exemption reduces the tax burden on services to consumers but it also increases the tax burden on transactions with businesses. Some studies do suggest under-taxation, however they are not without difficulty and so uncertainty does remain around this issue. The IA states:

“[t]he extent to which applying VAT to the financial sector (and its clients) would raise additional tax revenues and – consequently – the extent to which the exemption constitutes a tax advantage for the financial sector is *an unsettled empirical question*.”⁴⁵

The IA reviews some estimates of the potential tax advantage and presents a new estimate which suggests an advantage in the range of 0.11 per cent and 0.017 per cent of GDP. The IA is careful in stressing that “all these estimates are very rough approximations and should be interpreted with

⁴⁴ EU Member States have provided aid and guarantees worth €4.6 trillion to the financial sector thus far. J. Barroso, *European renewal – State of the Union Address 2011*, Strasbourg, (September 28, 2011), available at: http://ec.europa.eu/commission_2010-2014/president/pdf/speech_original.pdf. [Accessed November 4, 2011].

⁴⁵ IA Vol.1, above fn. 7, 14.

caution.”⁴⁶ It then concludes cautiously: “...the VAT exemption for a large share of financial services is an important issue. It *possibly* results in a preferential treatment of the financial sector compared with other sectors of the economy as well as in distortions of prices.”⁴⁷

In any event, even if it is taken for granted that the sector is under-taxed because of this exemption it still would not be clear why an FTT would be the best way to correct this.

In fact, the IA states:

“[t]he transaction taxes as discussed in this paper are not really effective to compensate for the VAT exemption for mainly two reasons. The major part of the exemption is due to the margin based business of the banks when receiving deposits and granting credit. The transaction proposals discussed here explicitly exempt depositing and loans from the tax base. For this reason the FTT would not capture the value-added sufficiently. There is no connection to the EU-VAT system, which aims at a neutral and non-cascading taxation and to the value added of the services involved in the trading or creation of products.

*The FAT and namely the addition-method FAT could be more effective in addressing the VAT exemption in the sense that the tax base has similarities to the VAT base. However, the integration of VAT and FAT is complicated and poses a number of unresolved problems.”*⁴⁸

A further option would be simply to bring an end to the VAT exemption. The IA does not analyse this option as it is being considered in the context of the general reform of the European VAT regime currently underway.⁴⁹

(iii) To create a new revenue stream for the EU

The Proposal is not clear on what use will be made of the funds raised by the FTT. It appears that the revenue might be split between the Member States and the EU.⁵⁰ The Commission certainly views the FTT as a potential new revenue stream for the EU, and has suggested an FTT for this purpose in a proposal issued on June 29, 2011 (Own Resources Proposal).⁵¹ A central concern of the Own Resources Proposal is to reduce the EU’s reliance on contributions by Member States and replace those contributions with new own sources of funding. The Own Resources Proposal is accompanied by a staff working paper⁵² (SWP) which examines a number of possible new financing sources including an FTT, an FAT, auctioning revenue from the EU Emission Trading System, a charge related to air transport, a new VAT, an Energy Tax, and an EU Corporate Income Tax. Ultimately the Commission favoured an FTT and a new VAT.⁵³

⁴⁶ IA Vol.1, above fn.7, 14 (emphasis added).

⁴⁷ IA Vol.1, above fn.7, 15 (emphasis added).

⁴⁸ IA Vol.1, above fn. 7, 34-35 (emphasis added).

⁴⁹ IA Vol.1, above fn. 7, 29.

⁵⁰ “The proposal would create essentially a new revenue stream for the Member States and the EU budget...” Proposal, above fn. 3, 11.

⁵¹ *Proposal for a Council Decision on the system of own resources of the European Union*, above fn. 16.

⁵² *Commission Staff Working Paper, Financing the EU Budget: Report on the Operation of the Own Resources System Accompanying the document Proposal for a Council Decision on the system of own resources of the European Union*, SEC(2011) 876 final, (June 29, 2011), (SWP).

⁵³ *Proposal for a Council Decision on the system of own resources of the European Union*, above fn. 16, 5. It is interesting to note that, whereas the Proposal envisages the FTT to be introduced by January 1, 2014, the Own Resources Proposal envisages the FTT own resource to be introduced by January 1, 2018 at the latest. This is explained as follows: “[t]he timing of introduction of these new own resources reflects the time needed for completing the legal framework, and adopting and implementing the relevant legislation.”

It is not at all obvious why the EU should be funded by the financial sector to a larger extent than by any other sector. Furthermore, given the volatility and uncertainty surrounding the tax base of an FTT, it certainly does not constitute an obviously stable and secure source of funding upon which a budget can rely. It is interesting to note the Commission's conclusion that an FAT would rely exclusively on national administration for its collection and management and thus "would seem less suitable as an own resource".⁵⁴ The writers can only wonder about the extent to which the preference of an FTT over an FAT as an own resource played a part in the Commission's general preference for an FTT.

In any event, separate proposals are expected to set out how the Commission proposes the FTT could be used as a source for the EU budget.⁵⁵ It will be particularly interesting to see the relationship between the FTT raised in a particular Member State and any resulting deduction in that Member State's national contributions to the EU budget. Since a high percentage of the revenues generated by the FTT would come from the UK, whether or not the reduction to the UK contribution to the EU budget would be equivalent to the revenue collected in the UK from the FTT is extremely important. Finally, the writers also note that the Proposal requires Member States to repeal national FTTs currently in existence.⁵⁶ Given that the UK would thus have to repeal its Stamp Duty on shares, which is forecast to raise £3.3 billion in 2011-2012,⁵⁷ the detail on what is to be done with the FTT revenues becomes all the more important.

(iv) To compensate for the implicit state guarantee

Certain financial institutions benefit from an implicit government bailout guarantee.⁵⁸ The failure of these institutions can generate system-wide contagion. This scenario can have such devastating effects that states have no real choice but to intervene and bail-out the relevant institution. This is the "too big to fail" problem. Market participants are aware of this implicit guarantee and its expectation creates moral hazard. It leads to a lower cost of capital for these institutions (through underpriced debt finance), and, in turn, excessive profits. Steps have been taken, and further proposals have been put forward, to remove, or at least, reduce this implicit guarantee and to give credibility to the threat of failure. The introduction of bank resolution regimes,⁵⁹ and the Vickers proposals for ring-fencing and loss-absorbing capital in the UK all strive toward this objective.⁶⁰ However, the need for future bail-outs can never be excluded completely. Indeed, the UK Banking Act 2009 contains provisions dealing expressly with bail-outs.⁶¹

⁵⁴ SWP, above fn. 58, 4.

⁵⁵ Proposal, above fn. 3, Art.11.

⁵⁶ Proposal, above fn. 3, Art.12.

⁵⁷ HM Treasury, *Budget 2011*, HM 836, 92, available at: http://cdn.hm-treasury.gov.uk/2011budget_complete.pdf [Accessed November 4, 2011].

⁵⁸ There have been attempts at measuring this guarantee. See for example A. Haldane, "The \$100 Billion Question", (March 2010), available for download at: <http://www.bankofengland.co.uk/publications/news/2010/036.htm> [Accessed November 4, 2011].

For an overview of this issue and these attempts see Independent Commission for Banking *Final Report - Recommendations*, (September 2011), above fn.8, 286-289.

⁵⁹ See P. Brierley, "The UK Special Resolution Regime for failing banks in an international context", Bank of England, Financial Stability Paper No. 5 – July 2009, available at: http://www.bankofengland.co.uk/publications/fsr/fs_paper05.pdf [Accessed November 4, 2011].

⁶⁰ Independent Commission for Banking *Final Report - Recommendations*, (September 2011), above fn. 8.

⁶¹ See Banking Act 2009 ss 228 – 231.

Despite the benefits it provides, financial institutions do not pay for the guarantee. A further tax on the financial sector can thus be justified as compensation for the guarantee. Of course, this raises the question as to whether a guarantee for some institutions should lead to a tax on the sector as a whole. One way of dealing with this issue is to ensure that the tax is borne, or primarily borne, by the institutions that are more likely to be bailed-out. An FTT is not suited for this purpose because it taxes financial institutions indiscriminately, even if they are not likely at all to be bailed-out. A better tax for this purpose is the Bank Levy. The UK bank levy, for example, only targets banks above a certain size and thus does not burden banks that will be allowed to fail.⁶² Furthermore, the amount of the levy is calculated on a measure of a bank's riskiness,⁶³ meaning that the riskier a bank is on this measure, and the more likely it is to require a bail-out, the more tax it pays.

(b) General considerations on the FTT as a revenue raiser

Each of the four justifications for raising further revenue gives rise to specific considerations as to instrument choice. Three other issues must be considered about the general use of an FTT as a revenue-raiser. These issues are thus relevant independently of the specific justification for raising further revenue from the financial sector.

First, there is the fear that FTTs may be avoided by moving transactions to financial centres outside the EU. Secondly, it has been argued that other instruments could raise revenue from the financial sector at lower costs to the economy as a whole. Thirdly, there is the danger that the incidence of an FTT falls on final consumers.

These issues are well known, and the arguments surrounding them are well rehearsed. The question is whether the Commission's proposal is successful in addressing them. In each of these cases it is striking that the IA does not seem to offer much support for an FTT.

(i) Threat of avoidance through relocation unless FTT is global

The IA defines relocation risk broadly as including both "moving the relevant activities to jurisdictions where they are taxed less" and also "shifting to products/suppliers outside the scope of taxation within the same jurisdiction."⁶⁴ In its October 2010 Communication the EU Commission concluded: "[i]n the light of the analysis undertaken to date, FTT appears less suitable for unilateral introduction at EU-level since *the risks of relocation are high and would undermine the ability to generate revenue.*"⁶⁵

Does the IA allow for a different conclusion on relocation risk? After reviewing the issue the IA concludes:

“[a]gainst this background, *it is difficult to make unequivocal conclusions* on the exact size of the elasticities and relocation risks (*although there are strong risks of relocation*). Our

⁶² Finance Act 2011, Sched. 19.

⁶³ The measure used by the UK levy does not give a complete picture of a bank's riskiness because it focuses primarily on the capital side and (largely) ignores the asset side.

⁶⁴ IA Vol.1, above fn. 7, 47.

⁶⁵ *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee of the Regions, Taxation of the Financial Sector*, above fn. 15, (October 7, 2010).

revenue simulations consider a relocation of securities markets by 10%, a relocation of spot currencies by 40% and a relocation of derivatives instruments of 70% or 90% ...”⁶⁶

Overall, the predictions are thus rather gloomy, with the prediction on the OTC derivative markets being particularly so. The IA notes that “the application of the tax in this highly mobile market will be difficult and reduce the taxable base significantly... the tax base could largely disappear leaving no substantial revenue.”⁶⁷

The IA thus employs two scenarios to calculate expected FTT revenues with a predicted decrease in derivative trading of 70 or 90 per cent, respectively. No explanation is given as to why these two numbers are picked. The IA cites the example of Sweden, where, following the introduction of an FTT, the trading in futures on bonds fell by 98 per cent within the first week of the application of the tax. In the light of this experience and the fear that the tax base could largely disappear the particular figures chosen might be seen as not being large enough. If the Swedish experience is indeed to be taken seriously and 98 per cent instead of 70 per cent or 90 per cent of the tax base is lost, this should reduce predicted tax revenue 15 or 5-fold respectively.

Reading through the Proposal and the IA the writers cannot but feel that a double standard is being applied in the consideration of this issue. When considering subsidiarity and arguing for the need to introduce the tax at an EU level rather than at a Member State level, great emphasis is placed on the mobility of financial services and the need to avoid the possibility of relocations.⁶⁸ When considering the consequences of adopting the tax at an EU level despite the lack of agreement at a global level, this issue appears to bear less weight. Clearly the concerns should apply with equal force.

(ii) In pure revenue-raising terms, there are more efficient instruments than a FTT⁶⁹

One important issue is whether instruments are available which would extract the same level of tax revenue from the financial sector at lower costs for the economy as a whole. One widely debated candidate is the FAT. The IA investigates this issue and concludes:

“[t]he analysis of macroeconomic impacts (and the relocation issues mentioned above) suggests that the *economic distortions related to raising revenue could be lower with a FAT compared to an FTT*. Model simulations indicate that the short-term effect of a 5% FAT on GDP could be limited to around 0.10% while the long-term effect is simulated to reach about half a per cent (deviation of GDP from its long-run baseline), against annual tax revenues of around 0.2% of GDP. On the other hand, a stylised transaction tax on securities (STT), where it is assumed that all investment in the economy are financed with the help of securities (shares and bonds) at 0.1% is simulated to cause output losses (i.e. deviation of GDP from its long-run baseline level) of up to 1.76% in the long run, while yielding annual revenues of less than 0.1% of GDP.”⁷⁰

⁶⁶ IA Vol.1, above fn. 7, 47 (emphasis added). The IAES goes on to state “[s]uch disappearance could be seen as positive if the activities targeted are considered as harmful. To the extent that High-Frequency Trading is considered as harmful, one has to bear in mind it is estimated to be about 40% of total transactions.” This point is considered below.

⁶⁷ Commission Staff Working Paper Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, Vol. 12, above fn. 40, 22.

⁶⁸ “...it is useful again to refer to the example of Sweden ... which clearly shows the limits of a unilateral introduction of such a measure given the high mobility of the sector.” IA Vol.1, above fn.7, 24.

⁶⁹ On this point see, also, IMF *A fair and substantial contribution by the financial sector – Final Report for the G-20*, (June 2010), above fn. 9, 21.

⁷⁰ IA Vol.1, above fn. 7, 33.

According to the analysis, therefore, from a GDP perspective the FAT dominates the FTT. Obviously, these results have to be seen in the light of the macroeconomic models used to derive them. One problem in the analysis is that the two instruments discussed are not used at rates that would generate the same tax income. Given different predicted tax revenues and differential negative effects on GDP, it is very hard to compare the instruments in a meaningful way.

Interpreting these results is made even more difficult by the fact that the assessments of the FAT and the FTT are based on two completely different macroeconomic models. Furthermore, both models seem to be very inadequate in evaluating potential output losses and overall effects. Consider the shortcomings of the FTT evaluation model: it does not model a derivatives market nor does it take evasion or relocation into account.⁷¹ This model thus abstracts from fundamentally important issues, raising questions as to whether any of its predictions are useful for policy analysis. Furthermore, by not modelling the contribution of the financial sector to GDP it might miss some important effects.

There are thus serious concerns about the models used in the IA. We can set that aside and turn to the results reached in the IA as quoted above. On the basis of an ad hoc approach, the IA takes into account mitigating factors and finds that, in the best scenario, the negative output effects of an FTT might be reduced to 0.53 per cent of GDP. These results suggest that other, more efficient revenue raising instruments are available, in particular the FAT.

At a more fundamental level, a weakness of the FTT is that it taxes business-to-business transactions and distorts production decisions. It is a basic principle of optimal taxation that tax systems should be designed so that a distortion of production decisions is avoided.⁷² Taxes like the standard VAT or the income tax achieve this to a large extent.

(iii) Incidence

The IMF has noted that the FTT's real burden may fall largely on final consumers rather than the earnings in the financial sector.⁷³ Along the same lines, the IA concludes:

“[a]s far as the FTT is concerned, *a large part of the burden would fall on direct and indirect owners of traded financial instruments*. Moreover, levying the tax on secondary markets generates cascading effects, which might have non-transparent consequences, and thus make incidence more complex. In fact, if business transactions are non exempt, the tax will be cascading through the production process and affect the price of non-financial products and services.”⁷⁴

If this is the case, it would raise serious doubts about the Proposal's claim that private households and SMEs not actively investing in financial markets “would hardly be affected”⁷⁵ by the proposal.

⁷¹ “First, there is no derivative market in the model and it is assumed that STT is effectively implementable and enforceable. Therefore, the model cannot be used to answer questions about the taxation of derivatives; it cannot be used either to study changes in the market structure...[s]econd, we use a closed-economy model. This does not allow us to assess cross-border capital mobility and the relocation effects of the STT neither.” *Commission Staff Working Paper Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*, Vol. 16, SEC(2011) 1102 final, (October 21, 2011), 41.

⁷² P. Diamond and J. A. Mirrlees, “Optimal Taxation and Public Production”, (1971) *American Economic Review* Vol. 61(1), 8-27.

⁷³ IMF *A fair and substantial contribution by the financial sector – Final Report for the G-20*, (June 2010),, above fn. 9, 20.

⁷⁴ IA Vol.1, above fn. 7, 53.

⁷⁵ Proposal, above fn. 3, Art.5.

In the case of the FAT, in particular the FAT types 2 and 3, it is much more likely that the economic burden of the tax falls where it is intended to fall. This is because the FAT taxes excessive wages and profits generated in the financial sector. The possibilities and the incentives to pass on the tax are more restricted in this case.

2. *Creating disincentives for transactions that do not enhance the efficiency of financial markets*

According to the Commission, the Proposal wants “to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures aimed at avoiding future crises.”⁷⁶

Whilst this might give the impression that the FTT will deal with known causes of financial crises, it certainly does not target any of the accepted causes of the recent crisis, such as excessive leverage and insufficient liquidity coverage. These known causes of the past crisis could be targeted through other corrective taxes such as bank levies along the lines suggested by the IMF or taxes on very short-term liabilities.⁷⁷

Turning to market efficiency, the FTT does not discriminate between “good” and “bad” transactions, and so whilst it might act as a disincentive for transactions that do not enhance market efficiency it will also act as a disincentive for transactions that do. Furthermore, there is no agreement as to which transactions are good and which are bad.

High frequency trading (HFT) appears to be a specific target of the proposed FTT, and it is certainly an issue which currently worries regulators.⁷⁸ As the Commission itself concedes, however, “the empirical economic literature is still *rather inconclusive* on effects from this trading form in terms of increased volatility or price deviations.”⁷⁹

Not only does the IA raise questions about this objective, it also raises questions on the use of a transaction tax to obtain it:

“[t]he short-term trading the STT is meant to eliminate is not proven to be detrimental to price recovery. Neither is there a clear link between short-term trading and long-run cycles of asset mispricing (bubbles). On the contrary, the instruments which led to the 2008 financial crisis do not belong to the set of frequently traded instruments. Moreover, asset bubbles have historically also occurred in markets with high transaction costs (real estate), suggesting that a low-rate STT will not prevent them in the future”.⁸⁰

Finally, the writers note that, as the IA points out,⁸¹ these practices are being targeted by EU regulation. By the end of 2011, the European Securities and Markets Authority is expected to issue guidelines for trading platforms, investment firms and competent authorities to address the challenges

⁷⁶ Proposal, above fn. 3, Art.2.

⁷⁷ See E. Perotti and J Suarez, “Liquidity Insurance for Systemic Crises,” *CEPR Policy Insight* No. 31, (February, 2009) and E. Perotti and J. Suarez, “Liquidity Risk Charges as a Macro-prudential Tool, *CEPR Policy Insight* No. 40, (November, 2009), both papers are available at: http://www.cepr.org/default_static.htm[Accessed November 4, 2011].

⁷⁸ See, for example, A. Haldane, “The race to zero”, speech given on July 8, 2011, available for download at: <http://www.bankofengland.co.uk/publications/news/2011/068.htm> [Accessed November 4, 2011].

⁷⁹ IA Vol.1, above fn. 7, 16 (emphasis added).

⁸⁰ *Commission Staff Working Paper Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*, Vol. 16, SEC(2011) 1102 final, (October 21, 2011), 34.

⁸¹ IA Vol.1, above fn. 7,16.

of an highly automated trading environment, including HFT.⁸² The Commission is to address HFT through its proposed revision of the Markets in Financial Instruments Directive (MiFID), which it only tabled on October 20, 2011.⁸³ It is not clear why an FTT is required in conjunction with this regulation to deal with this issue.

3. Avoiding a fragmentation of the internal market that might be caused by uncoordinated tax measures of the Member States

With respect to this objective the Commission argues that the proposal wants “to avoid fragmentation in the internal market for financial services, bearing in mind *the increasing number of uncoordinated national tax measures being put in place*”⁸⁴ and reminds us that “[s]everal EU Member States have already taken divergent action in the area of financial sector taxation. The purpose of this proposal is to provide a common European approach to this issue that is consistent with the internal market.”⁸⁵

The Commission is certainly right in pointing out that Member States are introducing uncoordinated national financial sector taxes. But these are not transaction taxes! Ten Member States introduced bank levies which differ in base, rate and rationale, and which give rise to double taxation issues. An EU-wide FTT would not address the lack of co-ordination on these levies. Taxes on certain financial transactions also exist at a Member State level, but these have not been introduced recently. One is left with the impression that there may be some sleight of hand in the presentation of this objective.

4. Paving the way towards a global introduction of the tax

Regarding this point the Commission argues:

“[t]he present proposal also substantially contributes to the ongoing international debate on financial sector taxation and in particular to the development of a FTT at a global level. ... The present proposal demonstrates how an effective FTT can be designed and implemented,

⁸² See ESMA, *Consultation paper - Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities*, ESMA/2011/224, (July 20, 2011), available at: http://www.esma.europa.eu/index.php?page=consultation_details&id=186 [Accessed November 4, 2011].

⁸³ *Proposal for a directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council*, COM(2011) 656 final, (October 20, 2011) and *Proposal for a regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories* COM(2011) 652 final, (October 20, 2011), available at: http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm [Accessed November 4, 2011].

⁸⁴ Proposal, above fn. 3, Art.2.

⁸⁵ Proposal, above fn. 3, Art.3.2. “The main rationale for the EU action is that the functioning of the Internal Market would be hampered if Member States decide to act unilaterally in this field. At least 12 Member States have introduced or, are analysing the possibility of introducing, bank levies on financial institutions. This uncoordinated introduction of taxes on the financial sector fragments the EU financial market, distorts competition and increases the risks of relocation of the financial activities both within and outside the EU...[i]t must therefore be concluded that EU action would respect the subsidiarity principle since the policy objectives cannot be sufficiently achieved by actions of the Member States, and can be better achieved at EU-level.” *Commission Staff Working Paper Executive Summary of the Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*, SEC(2011) 1103 final, (October 28, 2011), 3.

generating significant revenue. This should pave the way towards a coordinated approach with the most relevant international partners.”⁸⁶

The US and other countries have been adamant in saying that they are not interested in adopting an FTT. So the question arises whether the introduction of an FTT in the EU or a subset of EU Member States would increase or decrease the incentives for other countries to follow. Determining whether or not that is the case is clearly difficult. One should note, though, that recent economic research on tax havens has led to the result that closing down a limited number of tax havens increases the incentives of the remaining havens to preserve their status.⁸⁷ The reason for this is that the declining number of tax havens reduces competition between them and increases their “profit” from offering tax haven services. Although it is not clear whether these arguments carry over to the case of the FTT, it is worrying that there does not seem to be a clear foundation for the claim that the introduction of an FTT in the EU will make its global introduction more likely.

III. Conclusion

Overall, the FTT proposal submitted by the Commission raises a number of concerns. Whilst some of the objectives pursued by the Proposal are reasonable, others are questionable. More importantly, in the light of the Commission’s own IA the writers can only conclude that more targeted and more efficient instruments should and could be used to achieve these objectives. These include a levy on risk-adjusted liabilities of banks which would make financial institutions pay taxes which are somewhat related to the implicit bailout guarantee which they enjoy, a FAT to tax excessive rents in the financial sector, and various forms of regulation.

⁸⁶ Proposal, above fn. 3, 3.

⁸⁷ See K. Konrad and M. Elsayyad, “Fighting Multiple Tax Havens”, Cesifo Working Paper 3195 (2010), available at: <http://www.cesifo-group.de/portal/pls/portal/docs/1/1185292.PDF>. [Accessed November 4, 2011].

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