THE ARGUMENT AGAINST AN EU FINANCIAL TRANSACTION TAX

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Background

The European Commission has adopted a proposal for a financial transaction tax (FTT). This essay considers the extent to which an FTT is a suitable instrument to achieve the objectives set out in the Commission's proposal. If accepted by the EU's Council of Ministers, the FTT would come into effect 1 January 2014.

FTTs are nothing new. UK stamp duty, which still exists today, was first introduced in 1694. In 1972 James Tobin proposed a currency transaction tax on all spot conversions with the specific aim of stabilising global exchange rates. This gave rise to the term "Tobin tax", which is now used to describe a wider range of taxes levied on transactions in certain financial assets.

The general purposes of FTTs are to curb the volatility of financial markets and create a system of equitable taxation. However, historical examples of FTTs have had mixed results in successfully achieving those objectives.

FTTs are now very much back on the political agenda against the backdrop of the recent financial crisis and the economic hangover still keenly felt within the European Union (EU). Public opinion is generally in favour of the introduction of an FTT. A recent Eurobarometer poll found that 65% of European citizens are in favour of an FTT.

Scope

The FTT will apply to financial transactions involving a financial institution if at least one party is established in the EU.

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The FTT has a purposely broad design. It has wide scope in terms of the types of transactions and financial instruments caught, applying to both organised markets and over-the-counter (OTC) trades. The tax applies to the purchase and sale of a financial instrument. Sale and repurchase (repo) agreements, reverse repurchase agreements (reverse repo) and securities lending of financial instruments are captured. The repo/stock loan point is important to note. Recent research argues that transaction taxes reduce trading volume, thus decreasing market liquidity. One of the commonly accepted causes of the global financial crisis, in addition to excessive leverage, was inadequate access to liquidity. Repos are used to raise cash. Reducing repo activity makes raising cash harder, which adds to the problem of cash liquidity in a financial crisis. Therefore, it seems that an FTT exacerbates rather than solves the problem. It is worth mentioning that these transactions are excluded, subject to certain conditions, from existing transaction tax regimes in United Kingdom, Ireland, South Africa and Hong Kong. Perhaps more telling is that such temporary sale of shares not leading to a definitive acquisition have been carved out of the proposed French FTT to take effect from 1 August 2012. The conclusion or modification (and therefore presumably early termination or novation) of derivatives agreements are subject to the FTT. Lastly, and in the context of group transactions only, “the transfer….of the right to dispose of a financial instrument as owner and any equivalent operation implying the transfer of the risk” is also included in the definition of ‘financial transaction’. However, the exact purpose of this provision is not clear.

‘Financial instrument’ is defined by reference to Section C of Annex I of Directive 2004/39/EC of the European Parliament and the Council and also includes structured products. The Commission proposed that the FTT have a broad base in order to reduce the risk of simple avoidance. However, notable omissions are consumer products, such as mortgage lending and retail credit, which have been ring fenced in order to minimise the impact on “most day-to-day financial activities relevant for citizens and businesses”. This may appear surprising to some given the involvement of such products in contributing towards the global financial crisis.

The FTT has an obvious focus on financial institutions and this term is also widely defined in order to avoid circumvention. It includes banks, credit institutions, insurance companies, collective investment funds and pension funds. The definition can also capture non-financial entities if financial transactions constitute a significant part of its overall activity, either in terms of volume or value. The FTT does not apply to the European Financial Stability Facility, Central Counterparties (to preserve regulatory efforts), national and international Central Securities Depositaries (not considered to be trading) and the Central Banks of Member States (but not other central banks). The counterparties of exempt entities may still be subject to FTT. The absence of any form of intermediary relief, as found for example in UK Stamp Duty, in conjunction with the inclusion of derivatives into the taxable base, ensures that investors, particularly institutions, are less able to circumvent the tax.

The most obvious weakness of the proposed FTT is that, in the absence of adoption at the global level, its territorial application based on a residence principle incentivizes the relocation of parties and transactions. The United States opposes a global FTT. Unless this position changes, there is little prospect of the FTT successfully achieving its objectives. Within the EU itself Bulgaria, Czech Republic, Great Britain, Malta, Netherlands and Sweden are opposed to an EU FTT. It is the last of these Member States that provides an illustrative example of a failed financial transaction tax. In the 1980s, Sweden introduced taxes applicable to equity, fixed income and derivative transactions. Despite extremely low rates of tax, bond trading volume fell 85% in the first week and there was a subsequent 98% fall in futures trading. Meanwhile 30% of all Swedish equity trading moved offshore. The tax was eventually abolished in 1991 and trading volumes have gradually returned to the Swedish market. The main design problem of the Swedish system was that it only applied to local brokers. Foreign investors could avoid the tax by moving their trading offshore while domestic investors reduced the number of their trades.

The Commission's FTT will bite if at least one party is established in the EU. For financial institutions, place of establishment is determined by testing, in order of priority, its Member State of authorization, incorporation, residence, branch or Member State of its counterparty in the case of a non-EU financial institution. Place of establishment for non-financial institutions means place of incorporation and/or branch location. Each financial institution party to a financial transaction pays in its own Member State. Each party is jointly and severally liable for the tax, which raises an interesting question on how exactly the FTT will be collected from non-EU financial institutions. Such is the jurisdictional scope of the FTT that, similar to the Swedish experiment, the FTT would be relatively simple to avoid by moving taxable transactions outside of the EU.

Member States are free to set their own rate of tax subject to minimum levels – 0.01% for derivatives and 0.1% for all other financial instrument transactions. In practice, Member States may not set the tax at excessive rates in order either to avoid incentivising relocation within the EU or mitigate relocation of a Member State's national financial industry. A recent example of this has been seen in France where a domestic FTT will be introduced from 1 August 2012 and which will be analysed later in this essay. However, at this juncture, it is interesting to note that the French FTT has little in common with the Commission's proposals other than the specified rates. The Commission's FTT is payable by each taxable party to the transaction. The 0.01% tax rate on derivatives is applied to the notional amount while the 0.1% tax for financial instruments is levied on purchase price or, if greater, market value. The market value aspect has the potential to cause valuation difficulties with respect to illiquid instruments. The lack of an intermediary or market maker exemption also has the consequence that the tax effectively cascades and it would be naïve to presume that the tax would not be passed on to the end user, be that a pension fund, a charitable foundation, investment fund or an individual.

FTT is chargeable at the point at which the parties enter into the transaction. For transactions conducted on organised markets, the tax will be collected at execution by the exchanges or central counterparties. For OTC transactions, the tax would be collected by the financial institution and paid within a period, suggested by the Commission, of three working days. The aim is to prevent an unjustifiable cash-flow advantages accruing to the financial institution. However, this is an extremely short timeframe. Existing examples of the collection of tax on OTC transactions in Poland and UK have longer periods to pay the tax of 14 days and one month respectively. Every person liable for payment of FTT is required to submit a return of transactions to the tax authority in their Member State by the 10^{th} of each month.

Member States cannot maintain or introduce financial transaction taxes other than the EU FTT. This provision has an obvious cost to the UK where Stamp Duty, even during the economic crisis which saw reduced share prices and trading volumes and also despite a relatively narrow application to financial instruments, generated in excess of $3bn in annual revenue.

Policy Goals

The Commission's proposal has been introduced against the backdrop of an economic crisis, which it is believed that the financial sector helped create yet simultaneously benefited from substantial governmental protection. The general objectives of the FTT are defined as:

1. 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;
2. to ensure that financial institutions make a fair contribution to covering the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view;
3. to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures aimed at avoiding future crises.

The proposal also raises the possibility of the FTT being used to promote common rules for the introduction of the tax at a global level and as a means of directly financing the EU.

The Commission believes that the proposed tax will generate significant revenues even if the amount has proven difficult to estimate. Previous reports suggest that the Commission's initial estimate was in the region of €10 billion per annum. The Impact Assessment arrives at a central estimate of €37 billion per annum. The official press release quotes an approximate number of €57 billion per year.

There is evidence that the Commission got its economic model and assumptions wrong. The Commission's 'closed economy' model does not take into account the economic cost of relocation, which seems odd given the highly mobile nature of both capital and the financial services sector itself. Even if the Commission's assumptions and best case scenario of a long term 0.53% reduction of GDP growth are accepted, the FTT appears gloriously inefficient given that the majority of the revenue it generates would be offset by the negative output effect. If the assumptions are adjusted to reflect more realistic scenarios affecting Member State revenues, such as the abolition of existing stamp duties, reduced corporation/employment tax receipts, falls in capital gains taxes and the tax cost of relocation, then the very likely overall effect is that the FTT would be revenue negative for the EU.

The Commission firmly believes that the financial sector was a major cause of the crisis and therefore should make a fair contribution to public finances. According to the impact assessment, Member States supported the financial sector to the tune of around €4.6 trillion and it seems justified that the financial institutions responsible share the burden.

However, even if the above statement is accepted, the wisdom of taking much needed capital out of the private sector and placing it in the hands of the EU instead of focusing on policies that promote growth during a time of the economic uncertainty has been questioned by commentators, politicians and trade associations alike. This is especially apt given the lack of clarity over exactly what the proceeds of the FTT would be used for and in light of the EU's continual failure to have its own financial accounts signed off by auditors.

There may also be some merit in the argument that the financial sector already makes a significant contribution by way of corporate tax payments, irrecoverable VAT and employment taxes. A recent report by PwC estimated that the total tax contribution of the financial sector in the UK represents 11.2% of total government receipts for all taxes. The results of a survey conducted on the total tax contribution of the financial services sector within the EU would make for interesting reading, especially if it also considered employee-based taxes to provide a bigger picture of the wider economic contribution of the financial sector.

The problem is that an FTT is ill-suited for the purpose of increasing the tax burden of financial institutions even if this is considered a suitable policy goal. The financial sector would not bear the cost. It is reasonable to assume that the tax will be passed on to the end user in much the same way that consumers currently bear the cost of existing transfer taxes and stamp duties. It is difficult to reconcile this outcome with the stated aims of the Commission's proposal.

The position of the International Monetary Fund in this area is enlightening. The IMF has proposed both a financial activities tax (FAT) and a Bank Levy/balance sheet tax as preferable to an FTT, which "does not appear well suited to the specific purposes set out in the mandate from the G-20 leaders". FAT is calculated by reference to bank profits and excessive remuneration. A Bank Levy is a tax on financial institutions' balance sheets (typically on liabilities with certain exemptions to encourage behavioural change). The Commission's impact assessment considered a FAT along with the FTT and "concluded that an FTT was the preferred option". However, it is not obviously clear how this preference was established. The impact assessment itself suggests that a FAT would be the more efficient revenue raiser whilst having a smaller impact on GDP growth. As a FAT also includes remuneration it is arguably more suited to a tax on financial institutions where compensation levels are generally high. When both taxes are judged against the three criteria of effectiveness, efficiency and policy coherence as laid out in the impact assessment the results lean towards the introduction of a FAT.

Returning to the theme of under-taxation of the financial sector, the proposal also contends that the current VAT exemption applicable to financials services leads to a tax advantage versus other sectors. Notwithstanding that the link between VAT and an FTT is not entirely clear this post-crisis thesis appears to lack empirical data, which even the Impact Assessment recognises. Recent research by PwC suggests that removal of the exemption would not lead to any significant increase tax revenues and could even result in a net decrease in tax revenue for the EU of up to €7 billion per year. There may be valid reasons for ending the VAT exemption but under-taxation of the financial sector does not appear to be one of them and thus this undermines a main argument put forward for the FTT.

The third policy goal of the FTT underlines the Commission's view that automated transactions undertaken by high frequency trading accounts are undesirable financial market transactions that should be penalised. High frequency trading has come in for particular attention in the proposal, which is intriguing as there is a lack of evidence that the financial crisis was caused by such transactions. The FTT would significantly curb high frequency trading at least for those hedge funds that reside within the EU. It is therefore expected that, providing they can find liquidity in European securities outside of the geographic scope of the FTT, high frequency trading funds would simply relocate. Given that firstly taxation is considered to be a poor substitute for regulation and that secondly high frequency trading will also be subject to upcoming EU regulation, it begs the question of why the Commission feels this special focus of FTT is required.

Conclusion

The objectives of the FTT proposal may be considered worthy but the Commission's focus and chosen instrument are flawed. Simply put, the FTT does not address the issues raised by the financial crisis and is easily circumvented by basic tax planning. The economic cost of an FTT to the EU would be devastating and much greater than suggested by the impact assessment. The impact assessment itself is contradictory with numbers that are created in a vacuum. The Commission should reconsider exactly what it wants the tax to do. To generate tax revenue generally? To specifically tax the financial sector? Or to modify the behaviour of financial institutions? If the answer to any of these questions is in the affirmative, then it is submitted that more effective methods are available.

Recent Developments

France, one of the main supporters of the FTT, has recently put forward a proposal to introduce a domestic financial transaction tax. Although the move has been seen by many as an attempt by President Sarkozy to demonstrate leadership in this arena ahead of the presidential elections in April, the draft bill is interesting for several reasons.

France is the first Member State to set forth its own legislation in the area so since the Commission's proposal was published. Many points are to be clarified before the tax comes into force but other than the tax rates used and the targeting of high frequency transactions (albeit on a narrower, domestic basis), the French FTT has surprisingly little in common with the Commission's instrument. The exemptions available for intermediaries acting as market makers and liquidity creation by stock lending and repo give it a distinct UK Stamp Duty flavour.

The tax will take effect from 1 August 2012 with the first returns and payments due in November. By this time the country may have a new leader. Sarkozy's main political rival, and election favourite, François Hollande is not against a French FTT but prefers an EU-wide tax. It remains to be seen whether French appetite for an EU-wide FTT is diminished now that they have their own national measure.

Perhaps the fact that the French FTT is so limited in scope indicates that a period of reflection has led the French government - previously a leading supporter of the EU FTT proposals - to recognise some of the difficulties with the tax set out above.