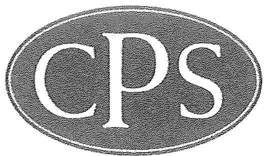

Centre for Policy Studies

SERIOUS DAMAGE

The Impact of the Withholding Tax on the City of London

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THE POINTMAKER

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SUMMARY

The City of London plays host to the largest bond market in the world. Over US$3 trillion are traded there every year and over 100,000 highly-skilled professionals work in the bond market and related support services.

This market is a great asset, not only for Britain but also for the European Union. The London bond market is the most efficient source of capital for both companies and for Governments in Europe and beyond.

However, this great trading asset is now under threat, not so much from competitive pressures (although they exist and are increasing) but from the imposition, by the European Union, of a hostile tax régime.

The European Commission has put forward a Draft Directive that would impose a special tax – the Withholding Tax – on interest paid to individuals in member states of the European Union from other member states. This Directive would, in its current from devastate the London bond market and drive it to offshore centres.

The proposal was published on 20 May 1998 as COM (1998) 295. On 10 February 1999 the European Parliament voted in favour of with the proposal. The Directive has the support of 13 of the 15 Member States and the European Parliament. Only the UK and Luxembourg are opposed to the Tax.

The Draft Directive is now on the agenda of the ECOFIN meeting to held on Monday 15 March 1999. This meeting will also consider, *inter alia*, the UK's budget rebate; the future of Duty Free shopping within the EU; and the harmonisation of energy taxes.

The final decision on the Draft Directive rests with the Council of Ministers. Any one member state can veto it. However, the veto is seen as the weapon of last resort. The present UK Government is known to be reluctant to exercise its right of veto, as this undermines its stated aim of 'co-operation rather than confrontation'. It is also probable that the further enlargement of the EU will depend on all Member States relinquishing their right of veto. The existence of the veto does not therefore give long term reassurance that a similar measure may be passed in the future.

Efforts to advance a similar Directive were made during the Belgian Presidency of the EU in 1993. However, on that occasion, the UK Government immediately signalled its opposition and no Draft Directive was advanced.

The Tax will do nothing to combat tax evasion, but would in its current form devestate bond markets in London and Luxembourg

The Withholding Tax has been inspired by the need to combat tax evasion in continental Europe where strict banking secrecy laws have enabled private investors to evade payment of tax on the interest earned on their investments.

The proposed Withholding Tax will, however, do nothing to combat tax evasion. Other forms of financial instruments and arrangements will quickly be developed which will meet the demand for investments which pay personal investors gross interest.

However, the Withholding Tax Directive would, if implemented in its current form, devastate bond markets in the EU, and particularly in the City of London and Luxembourg.

While the existence of the bond market in London is an undeniable asset to the UK, it is also a fragile asset:

- the market is highly mobile. Japan, the US and Germany have all introduced a withholding tax in the last 30 years and have seen their bond markets move to financial centres which enjoyed a less hostile tax regime as a result;
- the market is highly concentrated. Ten financial institutions were responsible for nearly two-thirds of all bonds issued in London in 1998. None of these institutions is British-owned. They can – and will – consider moving their London operations if they feel that they are suffering from an unsympathetic regulatory regime;

- strong competition between the major financial institutions means that the profit margins for those institutions responsible for the issuing of bonds are paper thin. Even minor changes in the tax and regulatory environment will therefore have a disproportionate effect on the market.

Since the Draft Directive was tabled, Switzerland has taken significant measures to attract the international bond market:

- a law exempting non-Swiss domiciled investors from stamp duty is expected to be passed within the next three weeks;
- in late January, the Swiss Stock Exchange opened offices in the City of London: it has already had some notable success in encouraging companies engaged in bond trading to move to Zurich;
- billions of dollars have already been transferred from Luxembourg banks to Swiss banks.

The Draft Directive also has numerous technical flaws. Just one of these (the clause which forbids 'grand-fathering' of existing bonds) will, if not rectified, cause chaos in the markets and lead to the loss, or 're-distribution' of more than £12 billion of UK pension fund and life assurance assets.

The fact that the Draft Directive has been tabled raises important questions about the degree to which the UK Government will defend the interests of the City of London

In addition, the fact that the Draft Directive has been allowed to be tabled raises important questions about the degree to which the UK Government is prepared to defend the interests of the City of London. The handful of financial institutions which dominate the market will have received and understood a simple message: that the retention of the bond market in the City of London no longer enjoys the highest support from either the EU or the British Government. These institutions will now be sceptical of the security of London as a financial centre.

If the major players of the bond market were to relocate out of London, the City of London would lose its status as one of the three great financial centres in the world.

CONCLUSIONS

In the last few weeks, British Ministers have given assurances that the Withholding Tax will be vetoed. Patricia Hewitt MP, Economic Secretary to the Treasury, stated to the that:

We will not agree to any directive certainly in its current from that applies to eurobonds.

Statement to the House of Commons Treasury Select Committee, 26 January 1999

Lord McIntosh of Haringey, the Treasury Spokesman in the House of Lords, stated that:

If the final draft directive of the European Commission were to be in the form of a withholding tax, and in particular a withholding tax which included eurobonds or any tax which affected our economic interest and our financial markets, we have the right to, and would, veto it.

Hansard 15 February 1999, Column 459

In addition, the Paymaster General, Dawn Primarolo MP, stated on 4 March 1999 that:

The Government's position on the draft directive on taxation of savings, which is under discussion, is very clear... we have made it very clear that we will not agree to anything that damages competitive markets.

Hansard, 4 March 1999, Column 1208

However, there is a possibility that the British negotiating position on the Withholding Tax may be compromised to secure, say, the continuation of the British rebate. Any such compromise is unacceptable.

The following broad outcomes of the ECOFIN meeting are possible:

OUTCOME 1

The UK Government may allow the Draft Directive to be approved in its current form, in return for assurances on, say, Duty Free Shopping or the continuance of the UK budget rebate.

Impact on the Market: the immediate implosion of the bond market. By not allowing the 'grandfathering' of existing bonds, gross-up and early redemption of bonds will be triggered, so sending the bond markets will into chaos. Up to £75 billion of UK investments will be affected overnight.

Message Sent to the City: the UK Government is not prepared to defend the interests of the City, leading to immediate plans to withdraw all bond activity.

This is not an acceptable outcome.

OUTCOME 2

The Draft Directive may be approved with the amendment that existing bonds be exempt from the Withholding Tax.

Impact on the Market: this would create a two-tier market, with existing and future bonds being traded on a different basis. Incentives would be created to move new bond issues off-shore. The jobs of 1,400 paying agents and 5,000 custodial agents would be lost permanently. A significant proportion of bond trading would move to more friendly regulatory regimes. Estimated permanent loss of jobs: 10,000.

Message to the City: the UK Government is prepared to accept short-term, insecure compromises. Major financial institutions would have been given an incentive to leave London.

This is not an acceptable outcome.

OUTCOME 3

A decision might be deferred to a future ECOFIN meeting. This would mean a further six to nine months of uncertainty.

The Message to the City: the UK Government is not prepared to take strong action to defend the interests of the City of London.

A deferral of the decision is therefore not acceptable.

OUTCOME 4

The Eurobond market might be exempted from the terms of the Withholding Tax. This would require a tight definition of a Eurobond, and there would inevitably be cases that unfairly fell just outside the definition.

The Message to the City: as private continental investors can easily move their savings into alternative bond market vehicles which will qualify as exempt from the Withholding Tax, the original motivation behind the Withholding Tax will remain. The major financial institutions will not be reassured and will consider the attractions of moving bond operations outside the EU.

This not an acceptable outcome.

OUTCOME 5

The Withholding Tax Directive may be dropped in return for an agreement to share information on interest payments made to EU citizens.

Impact on the market: all bond trading would be conducted through off-shore subsidiaries, thus side-stepping the terms of the proposal. The jobs of paying agents and custodial agents would be lost permanently. A significant proportion of bond trading would move to more friendly regulatory regimes. Estimated permanent loss of jobs: 10,000.

Message to the City: the UK Government is prepared to accept short-term, insecure compromises leading to a review of the desirability of the City by the major financial institutions. This is not an acceptable outcome.

OUTCOME 6

The UK Government vetoes the Withholding Tax.

Message to the City: short-term reassurance that the UK Government is prepared to exercise its right to defend the interests of the City. This is the only acceptable short-term option.

The UK Government must secure binding assurances that no such tax proposal will ever be put forward again

However, the use of the veto may not be seen as providing the bond market with the medium-term security it requires. Thus it is not only essential that the UK Government exercises its veto. The UK Government must also demonstrate that it is prepared to defend the interests of the City more vigorously. To this end, it must secure binding assurances from its European partners that no such tax proposal will be put forward again.

CHAPTER ONE

THE FRAGILITY OF THE EUROBOND MARKET

'Whatever the fate of the Withholding Tax directive, the fact of its initiation and the political support it has received has sent a clear message to the wholesale financial markets. The retention of the international bond market in London is not seen as enjoying the highest priority within the European Union. The major players in international finance, now global, mobile and relatively few, will have received and understood this message. When historians come to write the history of the post-war rise of the City of London to its present position as the world's leading financial centre, this directive will be cited as the point when the trend reversed and the activity began to slowly migrate to other centres.'

Stanislas Yassukovich CBE Former Deputy Chairman of the London Stock Exchange and Chairman of Merrill Lynch Europe

THE MOBILITY OF THE MARKET

Global financial markets, as a whole, are highly competitive. They are also highly mobile: the re-routing of financial business to alternative financial centres is almost costless (and will become even more so as electronic trading becomes more widespread). Thus heavy-handed domestic regulatory arrangements can easily have the effect of moving business to more lightly controlled markets.

The bond market is particularly vulnerable. In the key area of issuing and underwriting bonds, two-thirds of all business was handled by just ten financial institutions in 1998. All of these companies are foreign-owned and have subsidiaries throughout the world. It is relatively simple for them to move their bond operations from one country to another. It should not be forgotten that these institutions have no particular loyalty to London. If the costs of new regulations become burdensome in one country, they will start to look for more accommodating locations elsewhere.

'The European capital market would offer a serious competitive disadvantage if a withholding tax were imposed'

PROFESSOR RICHARD DALE

These institutions base their bond operations in London because it is seen to be a good place to do business. London enjoys three competitive advantages:

- a critical mass of professional expertise;
- a highly liquid market;
- a time zone which straddles that of the US and Japan.

However, these advantages are temporary and mobile. Should the market start to drift to competing locations, they will quickly disappear.

In a recent study, Professor Richard Dale has demonstrated the mobility of financial markets. Looking at the experience of Germany, Japan and the US, he has shown how withholding taxes in these countries have driven the domestic bond market to jurisdictions with a more favourable regulatory and tax regime. He found that:

Consequences of Regulatory Impositions on Financial Markets, Professor Richard Dale, Corporation of London, October 1998

- until 1984, the US authorities applied a 30% withholding tax on interest paid by US issuers to non-resident investors (one of the main contributing factors in the original growth of the Eurobond market);
- the Japanese domestic bond market has been handicapped by a 20% withholding tax. Foreign borrowers have therefore preferred to raise funds on the Euro-yen market rather than the samurai bond market and Japanese borrowers have tended to favour international bonds at the expense of domestic bonds.
- in 1987, the German Government announced the introduction of a 10% withholding tax on domestic investment income. This led to a dramatic shift out of German domestic bonds by foreign investors: net purchases of DM23 billion in 1987 were followed by net sales of DM9 billion in 1988. The damage inflicted on the domestic German market was sufficiently severe to force an embarrassing about-turn within four months of the tax taking effect.

Professor Dale's conclusion is simple:

The European capital market would offer a serious competitive disadvantage if a withholding tax were imposed.

The Swiss Stock Exchange already expects to capture 10% of the bond market within

THE GROWING ATTRACTIONS OF SWITZERLAND

At the same time as the European Union is considering imposing the Withholding Tax, the Swiss authorities are actively marketing Zurich as an alternative to London: in January 1999, the Swiss Stock Exchange announced that it expected to win a 10% share of the bond market within two years – before taking into consideration the impact of any Withholding Tax. Steps taken include:

- Stamp Duty (which can account for 40% of the cost of trading on the Swiss Stock Exchange) is expected to be eliminated by 1 April 1999;
- the Swiss Stock Exchange opened its first representative office outside Switzerland in London in January 1999;
- a trading platform with an integrated clearing system linking the market with the main European clearing houses for the international bond market has been established;
- the Swiss Stock Exchange plans to begin electronic repo trading by the summer of 1999.

These moves have already met with some success with a significant number of medium-sized, foreign-owned firms announcing plans to relocate to Zurich.

CHAPTER TWO

THE WITHHOLDING TAX: HOW IT WORKS

HOW THE WITHHOLDING TAX WOULD WORK

Individuals can earn interest by depositing money in bank accounts, by lending it directly to companies or by buying bonds that pay interest.

Eurobonds are the central issue in the debate over the European Union proposal. A Eurobond is a bond issued outside the home market of its currency: for example, a US dollar bond issued in the Netherlands Antilles. These bonds are actively traded: they may change hands several times over their lives.

To illustrate the problems that may arise, we will use the following simplified example of a Eurobond:

i. A company needs $10m on 1 January 2000 and will pay 5% annual interest.
ii. It will repay the $10m on 1 January 2020.
iii. It issues bonds for $10m, split into 1,000 separate bonds of $10,000 each. Some are bought by individuals resident in Germany and the rest by companies. The investors are the bond-holders. They can however sell their holdings during the 20-year period, and the buyers then become the bond-holders.
iv. The issuing company gets a London-based bank to pay the interest to the bond-holders. This bank pays $250,000 of interest each 1 July and $250,000 each 1 January. It pays the money to whoever then holds the Eurobonds.

The directive would apply tax whenever interest was paid from one European Union member state to an individual resident in another

member state. The tax would be imposed in the state that the interest was paid from. Relating this to the Eurobond example, there are several important points:

- The two states would have to be different. In this example, we have interest paid from the UK to Germany.
- The recipient would have to be an individual, not a company. What is more, the recipient would have to receive the interest for himself, not on behalf of someone else. Interest payments to companies would not be affected.
- The tax would not be the final tax on the interest: it would only be a withholding tax, a provisional amount of tax. Take a withholding tax rate of 20%, and consider the effect on two German taxpayers, each holding $20,000 of bonds and therefore getting interest of $1,000 a year:
  i. The first taxpayer is not liable to tax in Germany because he has very little income. He would receive only $800 from the UK, but he could recover the $200 tax suffered from the UK authorities.
  ii. The second taxpayer is liable to tax at 50%. His total tax liability on the interest would be $500, but $200 tax would have been deducted in the UK. He would only have received $800. He would therefore have to pay a further $300 to the German authorities. They would retain the $300 but the UK authorities would retain their $200.

AN ALTERNATIVE TO THE WITHHOLDING TAX

The Draft Directive includes an alternative to the Withholding Tax: a European Union member state could choose not to impose the Withholding Tax, by opting for disclosure. Under this option, when interest was paid, the payer (the London bank in our example) would have to disclose the name of the individual receiving the interest to the tax authorities in the country of residence. They could then ensure that the interest was fully taxed in that country.

However, this option of disclosure has a major disadvantage. A member state which took this measure would not be able to collect any tax on interest paid to residents of other states; and it would not get any information on its own citizens from other states that were withholding tax. It would therefore lose money in several different ways.

Even if a member state did choose to impose the Withholding Tax, the tax would not apply where the recipient of the interest produced a certificate from his own tax authorities. The certificate would confirm that he had declared the interest that he would be getting. It is however unlikely that people would bother to get such certificates, or that the extra paperwork would be welcomed by banks paying the interest. The certificates would also have to state the amount of interest in advance: that is impossible for some Eurobonds, which pay interest that varies with market rates.

CHAPTER THREE

WHY THE TAX IS BAD FOR BONDS

The Draft Directive has generated a storm of protest. This is not because all withholding taxes are bad. The UK imposes a 20% withholding tax on bank and building society interest paid to individuals: if gross interest of £100 is due, only £80 is credited to the account and the other £20 is sent to the Inland Revenue. Withholding taxes can and do work when the investor-base is stable and known (as in the case of bank deposits); they do not work when, as in the case with bonds, the investments change hands frequently and are anonymous.

> Withholding taxes can and do work when the investor base is stable and known (as is the case with bank deposits); they do not work when, as is the case with bonds, the investments change hands frequently and are anonymous

The Withholding Tax gives rise to two major difficulties in respect to bonds. One is the administrative burden. The other arises from the terms of issue of Eurobonds. The difficulties could, probably, be avoided in practice, but at great cost to London and Luxembourg (the two main European centres for interest payment) and with no benefit to any part of the European Union.

The withholding tax could be avoided but at great cost to Luxembourg and London and to no benefit for the European Union

THE ADMINISTRATIVE BURDEN

A bank deposit is stable: the bank knows who the customer is and where he lives. Eurobonds on the other hand can and do change hands frequently. Returning to our example, the London bank wants to pay $250 to each holder of a $10,000 Eurobond on 1 July 2001; it does not want to have to check whether the bond-holder is an individual resident in another European Union member state. If it did have to check, it would have to do so every 1 January and 1 July as there would be no guarantee that the Eurobonds were still held by the same individuals that had held them six months earlier. Similarly, an Italian individual buying a $10,000 Eurobond in March 2001 would like to know that he will get $250 in cash on 1 July. He does not want to have to check whether the interest will be paid by a London bank (in which case withholding tax of $50 might be held back from him) or by a bank outside the European Union (in which case there would be no withholding tax).

It would be difficult for banks to check the residence of all bond-holders. The Draft Directive includes complicated rules to decide whether someone resides in a member state. Their address is certainly not a reliable guide: someone living in Canada, for example, would count as resident in a member state if he happened to be a French citizen. Banks would also have no way of knowing whether an individual was receiving interest for himself (in which case withholding tax would apply) or on behalf of someone else (in which case it would not apply).

Eurobond markets work most easily when there are no withholding taxes: everyone knows what they will pay or receive, on what dates, without having to take into account where the person on the other end of the transaction (the recipient or the bank paying the interest) is based.

The fact that Eurobonds are easily tradeable keeps the cost of borrowing down for companies

It is essential that Eurobond markets work smoothly and are active, with a healthy market in Eurobonds every day. This is a key reason why people are willing to buy Eurobonds: they know that they can sell them at any time, at a price reflecting market interest rates, and will not have to hold them until they mature. The fact that people can sell Eurobonds easily keeps the price of borrowing down for the companies and Governments issuing them – an essential element if a market economy is to flourish.

CHAPTER FOUR

PROBLEMS WITH THE DRAFT DIRECTIVE

THE FEARS OF EARLY REDEMPTION OF BONDS

To guard against the risk of a withholding tax being introduced, nearly all Eurobonds include 'gross-up clauses'. These mean that if a withholding tax is introduced, interest payments must be increased so that investors still get the same amount of cash. Thus if an investor was due $250 of interest and a 20% withholding tax was introduced, he would have to be paid $312.50. After deducting withholding tax of $62.50, this would leave $250 cash for the investor.

An increase in the gross interest payable would increase the cost to the company that issued the Eurobond. To protect the issuing institutions, Eurobonds that include gross-up clauses also include redemption clauses: if the gross-up clause takes effect the issuer has the right to redeem the whole of the bond issue at par (in our example, for the $10,000,000 that would be payable at the end of the 20-year term).

Redemption is at this fixed figure of par, regardless of the current market price of the Eurobonds. If interest rates had fallen since the Eurobonds were issued, the market price would be above par and bond-holders would be forced to redeem their bonds for less than the market price. Thus bond-holders would suffer a sudden and unexpected loss. An issuer wishing to redeem bonds in this way could raise the money to pay for them simply by issuing new bonds at current, lower, market rates.

Returning to our simplified example, suppose that by 1 January 2001 interest rates had fallen from the 5% applying at the time of issue to

4%. On that day someone bought $100,000 of bonds for the market price: with a 4% interest rate and 19 years to maturity, this is $113,784. The next day, following the introduction of the withholding tax, the issuer decides to redeem all the bonds at par. The unlucky bond-holder thus spends $113,784 one day and gets only $100,000 back the next day: an immediate loss of $13,784. The issuer, on the other hand, will gain because he will be able to issue new bonds at only 4% interest instead of being committed to paying 5% for the next 19 years.

A potential loss of £12 billion for UK pension and insurance companies

As interest rates have been coming down in recent years, it is very likely that bond-holders would suffer this kind of arbitrary loss unless action were taken to avoid it. The Association of British Insurers estimates the potential loss at £12 billion

Association of British Insurers Submission to the House of Lords European Communities Committee, 23 February 1999

The disruption to the market would be enormous, because redemption clauses do not allow issuers to redeem only those bonds affected by a withholding tax - in this case the individuals. The issuer has to redeem the whole of the bond issue or none of it. If only one bond-holder were to insist on grossing-up, that would entitle the issuer to redeem the whole issue (which he would gladly do if interest rates had fallen since issue). Despite heavy lobbying from the City of London for an exemption for existing bonds, no such exemption has, as yet, been gained. It is argued most bond-holders are companies or non-European Union individuals. This misses the point: redemption of a whole bond issue would be triggered if only a tiny minority of the bonds were in the hands of European Union individuals.

It is not possible to conduct an orderly market subject to the risk of such arbitrary losses . The Draft Directive would suddenly change the terms of deals that bond issuers and bond-holders had entered into in good faith.

THE LACK OF CONSULTATION

The European Commission does not appear to have consulted companies active in the financial markets when drafting the withholding tax directive. This is in marked contrast to the UK Inland Revenue, which does consult industry experts when planning a measure that is likely to have a significant effect. It did so, for example, with the new rules on transfer pricing and on controlled foreign companies, both enacted in 1998.

The result of this lack of consultation is that the Draft Directive will not work in principle. It is also full of technical defects. The International Securities Markets Association took four pages to list these defects. They include such fundamental matters as the definition of the country of residence of an individual and of interest.

International Securities Market Association position paper, 4 September 1998.

The problem of defining interest is particularly noteworthy because it shows how little the authors of the Draft Directive understand

bonds. Many bonds are straightforward: they are issued for a fixed amount (say $10,000), redeemed for the same amount several years later, and pay interest each year in the meantime. The amount payable on redemption is the capital and the amounts paid each year are interest. But not all bonds are so straightforward. The extreme case is the 'zero', a bond which pays no interest. The bond-holders get a return because the bonds are issued for much less than the amount payable on redemption. An investor might buy a bond for $6,139 but be able to redeem it in ten years time for $10,000. That would give a return equivalent to 5% compound interest. Such bonds are issued for perfectly good commercial reasons: for example, the issuer may be using the funds for a project that will not generate much income in the first few years, so that there will be no money to pay interest, but will generate a large gain at the end of ten years.

If a bond is a 'zero', paying no interest, one might expect that the Directive to have no effect: after all, it only applies to interest. But that would make a mockery of the directive: there could be two different bonds, effectively giving the same rate of return to the same people, one subject to withholding tax and the other not. The Draft Directive therefore requires a difference between the issue price and the amount payable on redemption to be treated as interest. The Withholding Tax is to be applied to this difference at the end of the term. Take the example in the last paragraph. With a withholding tax of 20% the bank paying the investor at the end of the ten years would withhold ($10,000 - $6,139) x 20% = $772, and would pay out only $10,000 - $772 = $9,228.

If a bond remained in the same ownership throughout its life from issue to redemption, that would make some sense. The investor, instead of receiving interest and suffering withholding tax every year, would receive the entire return and suffer all of the withholding tax at the end of the bond's life. But Eurobonds do not remain in the same ownership throughout their lives. They are freely traded, with the prices of zeros generally rising over their lives.

Suppose that our example of a zero is only sold once, eight months before maturity, and by that time interest rates have fallen. The bond is sold for $9,800. The original owner makes a profit of $9,800 - $6,139 = $3,661 over nine years four months, which is equivalent to 5.1% a year. The second owner makes a profit of $200 over eight months, equivalent to 3.1% a year. Both owners make profits on the bond instead of getting interest over their periods of ownership. If the bond had not been a zero but had paid regular interest instead, both would have suffered some withholding tax. But under the Draft Directive as it applies to zeros, all of the Withholding Tax would fall on the final owner. He would only receive $9,228 on redemption and would have to recover the $772 of withholding tax.

The incidence of the withholding tax would also be completely arbitrary. If a bond with a ten year life were held for nine years eleven months by a company, and then sold to an individual, withholding tax would apply to the whole profit even though only a small part of it had arisen in the hands of an individual. Conversely, an individual could buy a bond on issue and sell it to a company just before maturity, thus

avoiding the withholding tax altogether. The withholding tax is supposed to be aimed at individuals, but when applied to zeros it would all too often miss its target.

The only alternative would be for the banks which have custody of bonds during their lives to apply withholding tax on each sale of a bond by an individual resident in another European Union member state. Withholding tax would then be levied on the 'interest' attributable to the period for which that individual had held the bond. But that 'interest' would not necessarily equal the profit the bond-holder had made, because the 'interest' accrues steadily over the life of the bond while the market price fluctuates with market interest rates. Returning to our example above, the 'interest' that accrued over the first nine years four months at 5% was $3,541, but the actual profit made by the first bond-holder was $3,661. More seriously, for the second bond-holder, the 'interest' at 5% over eight months was $320, and withholding tax would be computed on this amount, even though his actual profit was only $200.

Thus a Withholding Tax makes no sense in the context of freely traded zeros. But it would be inequitable to apply it to interest-bearing bonds and not to zeros. The only way out of this dilemma is not to apply it to freely traded bonds of any description.

CHAPTER FIVE

THE IMMEDIATE DESTRUCTION OF JOBS

It will be straightforward for major financial institutions to side-step the Withholding Tax. It would only apply when interest was paid from one European Union member state to an individual in another state. Issuers cannot control the location of bond-holders, but they can choose where to pay interest from. They would merely have to pay interest from somewhere outside the European Union.

Thus in the months between any announcement that the Withholding Tax was to be introduced and its coming into force, all interest payment business that currently takes place in London and Luxembourg would be transferred outside the European Union, probably going mainly to Switzerland and the United States.

Much of the interest payment business in London is conducted by large United States banks. They also conduct other business in London, particularly the custody of assets for overseas investors. The range of business conducted in London makes it worthwhile to maintain offices in London. But if one element of that business, the payment of interest on Eurobonds, had to leave London, it might not be worth maintaining London offices for the remaining business. That too would leave. The UK would lose thousands of jobs, as well as significant profits and tax revenues. The International Primary Markets Association estimates that 1,400 people are employed in paying interest in the European Union. The London Investment Banking Association adds that in the UK alone, the asset custody business that would also be at risk employs 5,000 people and earns annual revenue of $1bn.

Submission by the International Primary Markets Association, 26 August 1998

Submission by the London Investment Banking Association, September 1998

Even if the withholding tax were withdrawn after a couple of years, the business and the jobs lost would not come back to London

While destroying so many jobs, the Withholding Tax would have achieved little because it would have been wholly avoided on Eurobonds. And, even if the Withholding Tax were withdrawn after a couple of years as a failure, the business lost would not come back to London. There would be little reason for it to do so. In addition, the reputation of London as a place where a deal once done is safe from being undone would have been damaged. Banks would think twice about returning to London as they would fear that they might have to leave again within a few years at the next twist of European policy.

CHAPTER SIX

THE ORIGINS OF THE PROPOSAL

Given that the Withholding Tax proposal has such obvious disadvantages, and will not achieve its objective, it is surprising, perhaps, that it has got so far. The main driving force behind the proposal is German concerns over tax evasion by German citizens. This concern has, at the European level, been conducted in terms of arguments about the distortion of the single market.

The driving force behind the Draft Directive is German concern over tax evasion by German citizens

GERMAN TAX EVASION

The German Government has had a long-standing problem with some of its citizens. They take money out of Germany and deposit it in other countries. Luxembourg is the favourite country because it is next door and has strict banking secrecy laws. There the money earns interest. That interest is taxable in Germany, but it is hard for the German authorities to trace the interest because the banks paying it are outside the German jurisdiction. Some German citizens fail to declare the interest earned on their tax returns, knowing that their failure to do so is unlikely to be detected.

Bonds are a particularly attractive form of investment for those considering evading tax. As they are issued in bearer form, the identity

of the beneficial owner is not known by the interest payer. In addition, the interest is paid gross.

Every state suffers some tax evasion, and there is no reason to suppose that Germans are less honest than other nationalities. But the German authorities have a special need to act against this form of tax evasion. The German Constitutional Court has required the Government to ensure a proper balance between the taxation of employment income and the taxation of savings income. That balance would be achieved if German tax laws were thoroughly enforced. But they are not being enforced in relation to savings income, and evasion of tax on savings income is much easier than evasion of tax on employment income. If the Withholding Tax were introduced, the German Government could comply with the court ruling.

The Withholding Tax would not, however, be effective. As already explained, it would not in practice apply to Eurobond interest because interest would be paid from outside the European Union. It would not even be effective against interest from simple bank deposits. Although Luxembourg would no longer be a suitable destination for the funds of German tax evaders, Switzerland and Liechtenstein would be.

The European Union recognises the problem: at the meeting of finance ministers on 1 December 1998, it was agreed to speak to the governments of Switzerland, Liechtenstein, Andorra, Monaco and San Marino. They will be asked to introduce withholding taxes But they will have no reason to comply.

Council Press Release 13462/98 (Presse 422)

THE SINGLE MARKET ARGUMENT

Explanatory Memorandum to COM (1998) 295

The European Commission's published argument for a Withholding Tax does not mention Germany's difficulties. Instead it speaks of economic distortions caused by the non-taxation of cross-border interest. An investor who has an opportunity to evade tax, and who is prepared to do so, will take the opportunity. He will therefore prefer to put money in countries without withholding taxes: that is, his choice of country in which to save money will be swayed by tax-evasion opportunities. This is the market distortion that worries the Commission.

The argument does not stand up to scrutiny. Market distortions involve subsidies to industries or restrictions on consumer choice. Thus a government might decide to attract savings from elsewhere by paying its banks to offer artificially high interest rates or by preventing its own citizens from exporting their funds. Those would be real market distortions. But if a government simply decides not to tax interest being paid to foreigners, knowing that the interest should be taxed under the laws of the recipient's country, that is not a market distortion. Markets are governed by rules, including rules on taxation, and in arranging an undistorted market we must assume that people will obey the rules. If we could not assume that, it would be impossible to arrange an undistorted market at all. People would not only not pay their taxes: they would not keep their contracts, they would intimidate competitors and they would distort competition in many other ways.

A saver who obeys the rules will have to pay the same tax whether he deposits his money in his own country or in another one. However, he may, on occasion, have a preference for being paid interest gross, particularly when he can offset the gain against any tax liabilities he may have. He may also prefer interest to be paid gross for the legitimate cashflow benefits. But it will mainly be dishonest savers who will particularly favour countries without withholding taxes. There is a fundamental difference between arranging an undistorted market, on the basis that people will obey the rules, and policing those rules. The Withholding Tax is about policing.

It would in any case be a useless policeman, and would therefore not be effective in stopping the misnamed 'market distortion' caused by tax evasion. This is because the world outside the European Union would be outside its scope. Instead of tax evaders favouring, for example, Luxembourg over Germany as a home for their savings, they would simply favour (say) Switzerland over both countries.

THE FINAL WORD

The Draft Directive should be dropped, and never resurrected. Dropping it would not only avoid introducing a tax that would be avoided with great ease but at great cost to London and to Luxembourg. It would also be consistent with the wider trend to eliminate withholding taxes in the interests of well-functioning markets. The UK Government, for example, removed the domestic 20% withholding tax on interest on Government securities (gilts) to facilitate the new gilts repo and strips markets. These markets give investors more opportunities to do the deals that really suit them, and also reduce the Government's cost of borrowing. The European Union has also been active in removing withholding taxes on interest paid between companies. It would be perverse to go the other way and introduce a Withholding Tax on interest paid to individuals.

There are alternatives to scrapping the proposal, but none is satisfactory. One would be to exempt Eurobonds from the Withholding Tax. Another option would be to say that the tax should only apply to Eurobonds issued after the directive comes into force. This would avoid the triggering of grossing-up and redemption clauses, but interest payment business for new bonds would never come to London or Luxembourg. There would also be a distortion in the market, with some bonds preferred by investors simply because they were old enough to be exempted from Withholding Tax.

The Withholding Tax would not work and would do great damage. The UK should certainly veto it if it gets to a vote of the Council of Ministers. A veto, and a binding assurance that such a measure will not be put forward again, would not just be a victory for the UK. It would

be a victory for Europe. As the tax would be easy to avoid (by moving business outside the EU), a veto would cost the other member states nothing. Instead it would benefit them. Decisive action against the tax would make it clear that Europe wants to remain a good place to do financial business. That could only help Europe in the competition for its share of the ever-more-mobile financial markets.

The Withholding tax would be both damaging and ineffectual

The Withholding Tax would be both damaging and ineffectual. Not only would it be a sledgehammer to crack a nut: the hammer would miss the nut and come down squarely on our toes.