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Pointmaker

THE TOBIN TAX REARS ITS UGLY HEAD, AGAIN

JOHN CHOWN

WITH A FOREWORD BY LORD LAWSON OF BLABY

SUMMARY

- Proposals for an EU-wide Financial Transactions Tax (FTT) were successfully vetoed by the British Prime Minister in 2011.
- Similar proposals are now being implemented by the European Commission in eleven Member States under a process known as the Enhanced Cooperation Procedure. These proposals are intended to come into force on 1 January 2014 (although it now seems that there may be a year's delay).
- These proposals could cause much unnecessary damage to a crucial UK industry, both financially and bureaucratically.
- Much of the impact of an FTT would fall on UK financial services. The Commission has made it clear that the FTT will apply to financial institutions both within the FTT zone and outside the FTT zone if a transaction is with a counterparty that has its headquarters in the zone. A transaction made in the City of London by, say, Deutsche Bank would therefore be liable to the FTT.
- Much of the tax collected by the UK tax authorities from economic activity here might well not accrue to the UK, which will also suffer from the loss of tax revenue as the direct and indirect costs of FTT on profits and earnings. Section 6 below gives some frightening figures. All this from a tax that the UK has already vetoed.
- The Treaty of Lisbon is clear that tax legislation can only be introduced with the unanimous consent of all Member States. The UK Government is therefore now challenging the FTT proposals in the European Court of Justice. The proposal was introduced in a remarkably untransparent way and was surely an abuse of process.
- This is welcome but not nearly enough. Even if the legal appeal is successful, the FTT may well be introduced before the case is heard, leading to major uncertainty and significant costs for financial services companies based in the UK.
- The UK Government should therefore take – urgently – other measures to ensure that the FTT is not implemented as currently planned.

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FOREWORD

In the burgeoning debate over whether the UK would benefit from leaving the European Union there are those who argue that we cannot afford to do so as EU membership is of vital importance to the City of London.

Certainly, the success of our massive financial services industry is of the first importance to the British economy, and should continue to be so once it has been cleaned up in the wake of the culpable recklessness of all too many UK bankers during the Blair-Brown years.

But the truth of the matter is that, so far from EU membership being of benefit to the UK financial services industry, it is rapidly emerging as perhaps the greatest single threat to its future success.

John Chown's admirable analysis of the coming EU Financial Transactions Tax brings this out very clearly.

It is in fact part of a wider picture. So far as the financial services sector is concerned, the EU is currently engaged in a frenzy of misconceived regulatory activism. The motivation for this is threefold. In addition to the innate hunger for power of a European bureaucracy untrammelled by democratic accountability, there is a desire to punish the banks and others held responsible both for the excesses that led to the 2007-8 banking crisis (largely true) and for the ongoing Eurozone crisis (wholly false). And on top of this, there is in some quarters a desire to cut the City of London, a more important financial centre than the rest of Europe put together, down to size.

In the insurance sector the coming EU regulation, known as Solvency II, has been variously described by the mild-mannered Andrew Bailey, Chief Executive of the Prudential Regulation Authority, the relevant part of the Bank of England, as 'shocking', 'lost in detail and vastly expensive', and 'frankly indefensible'.

As John Chown demonstrates in this paper, the coming EU Financial Transactions Tax is, if anything, even worse. Designed both to punish the bankers and to raise money for the EU budget, its principal effect will be to drive financial business away from the EU (including the UK) to more hospitable jurisdictions elsewhere.

Belatedly conscious of this danger, the EU is now attempting to extend the FTT so that any transactions involving Eurozone securities of any kind, wherever they are conducted, are caught by the tax. This extraterritoriality may well be illegal: it is clearly unenforceable. And the US has already made clear that it will have none of it.

The position of the UK, within the EU, is more difficult. The present coalition Government has already announced that it intends to challenge the legality of the FTT proposals in the European Court; but the outcome is uncertain.

There are only two world-class financial centres: London and New York. That it should be considered in the interests of Europe to drive business away from London, to the benefit of New York is both perverse and unacceptable. John Chown and the CPS have performed a valuable service in drawing attention to this complex but important issue.

Lord Lawson of Blaby
May 2013

1. INTRODUCTION

Proposals for a Financial Transactions Tax (or Tobin Tax) have resurfaced. Originally proposed by the European Commission in September 2011[1] it was vetoed by the Prime Minister in the December 2011 meeting of the Council of Ministers. As this proposal was clearly a tax, and as tax issues can only be agreed unanimously, that should have been the end of the matter.

But it now looks possible that a new form of FTT will be implemented in some parts of the EU from as soon as 1 January 2014. And the concern is that this new FTT will have a significant impact throughout all of the EU, most of all perhaps in the UK.

Why has this happened? This tax, it must be recognised, has a strong populist appeal. Its proponents believe, wrongly, that it would collect a great deal of money from the banks and other financial institutions which should take only part of the blame for the economic difficulties of the western world. This money, it is then claimed, could be used to benefit all sorts of favourite causes. These include poverty relief in the Third World (the Robin Hood Tax campaign), green causes (various Green parties), "infrastructure finance" (President Hollande), or the EU budget (the Commission, which says that contributing FTT to *Fonds Propre* would "offer great potential for growth enhancing public spending"). In the misguided words of the Commission:[2]

"Through the FTT, the financial sector will properly participate in the cost of re-building the economies and bolstering the public finances of the participating Member States. The proposed Directive will reduce the number of divergent national tax regimes in the EU, will generate significant revenues and help to ensure greater stability of financial markets, without posing undue risk to EU competitiveness."

2. THE NEW PROPOSAL

Last year, at the Council of Finance Ministers meetings in June and July 2012, the British Government, with some support from other Member States, made it clear that they would veto any attempt to re-introduce an FTT.

But on 28 September 2012, eleven countries[3] submitted a proposal to the Commission to proceed with an FTT under the "Enhanced Cooperation Procedure."[4] This new FTT proposal, in the Commission's own words, "mirrors the scope and objectives of its original FTT proposal of September 2011,"[5] and therefore would impose a levy a 0.1% on stock and bond trades and a 0.01% charge on derivatives trades. The new proposal estimated that the amount raised would be between €30 billion and €35 billion a year compared to the €57 billion a year estimated in the original EU-wide

1 European Commission, *Proposal for a Council Directive on a common system of financial transaction tax and amending Directive*, 28 September 2011.

2 See European Commission, *Taxation of the financial sector* at http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/

3 Austria, Belgium, Estonia, France, Germany, Greece, Portugal, Spain, Italy, Slovakia and Slovenia.

4 The Enhanced Cooperation Procedure (ECP) allows a minimum of nine EU member states to establish advanced integration or cooperation in an area within EU structures but without the other members being involved. As of February 2013 this procedure is being used in the fields of divorce law and patents.

5 European Commission, *Taxation of the financial sector,* op. cit.

proposals. (The Commission still admits that the tax would "only" damage the EU economy by 0.5% of GDP, or €64 billion a year, i.e. significantly higher than the expected yield even on their own questionable assumptions of both. The outcome gap will certainly be wider.").

The proposals then wound their way through the Brussels bureaucracy. On 23 October 2012, the Commission asked the Council to authorise the Enhanced Cooperation Procedure for the FTT. The European Parliament gave its consent to on 12 December 2012; and on 22 January 2013 the EU Council adopted a decision – passed under Qualified Majority Voting – authorising the eleven countries to go ahead with implementing the FTT under the Enhanced Cooperation Procedure.

It should be noted that the above procedure was marked by an extraordinary lack of scrutiny. Indeed, at no stage in the above procedure was a Draft Directive actually available for consideration. As the Commission admitted when in December 2012 it published an explanation of why its proposals met the Treaty on the Functioning of the European Union (TFEU) requirements, a Draft Directive would only be "published in due course".

3. WILL THE UK BE AFFECTED?

A key part of the new proposals is that they include a "residence principle" and an "issuance principle". These are designed to avoid a relocation of trading activity to countries that are outside the FTT-zone. This means the tax would apply to trades where at least one counterparty is located in the FTT-zone and to transactions where the underlying financial instrument is issued by a FTT-zone member, regardless of where trading counterparties are located.[6] As the House of Lords EU Committee pointed out in a letter to Greg Clark MP, Financial Secretary to the Treasury:[7]

"The current proposals would mean that under the new issuance principle financial transactions between two states not participating in the FTT but trading shares that emanate from one that does (i.e. British and American traders buying/selling shares in Volkswagen) would be subject to an FTT levy."

There is still a great deal of confusion as to how the proposed tax will actually work.[8] But what is clear is that, despite the UK having vetoed the previous proposals, economic activity in the UK will be taxed. But the UK Government will not receive any of the revenues which will instead be paid to the FTT-zone tax authorities.

4. A GENERAL CRITIQUE OF THE FTT

The FTT is regarded by most economists as a bad tax whether imposed nationally or globally.[9]

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6 For more details of how the FTT might work, and the damage it could do, see ICAP, *Financial Transactions Tax,* April 2013.

7 27 March 2013. See http://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-economic-and-financial-affairs-and-international-trade-sub-committee-a/news/ftt-scrutiny-updates-treasury-corresponde/

8 For details on some of the outstanding issues, see "Making sense of the FTT's tangled web", *Financial News*, 1 May 2013 at http://www.efinancialnews.com/story/2013-05-01/eu-questions-and-answers-on-ftt-financial-transactions-tax

9 For more details on the inherent flaws of the FTT,, see the previous paper by the same author, *Time to Bin the Tobin Tax,* Centre for Policy Studies, 2012.

For example, last year the French Government introduced its own version of an FTT. It has been calculated that this has already led to a 26% decline in equity turnover and a relative reduction in activity from a 17% share of European equity trading to 12%.[10]

Although the proposed rates seem low (0.1% on transactions and 0.01% on derivatives) this is a cascade tax which is far more damaging than a simple stamp duty (see Section 6). Moreover, the derivatives tax is charged on the principal amount of the transaction rather than the option money actually paid: indeed in evidence given to the 2011 House of Lords Committee, it was shown that a prohibitive 22% on a short-term hedge could be charged.

It will also affect *bona fide* financial services far more than the "bad" activities it seeks to prevent. Where it impacts on the bona fide activities, it will add to business costs and will reduce the taxable profits of financial institutions and their bonus earning employees. This means that the gross yield of the tax will be partly offset by lower tax revenues from personal and corporate tax. The loss of revenue will be borne by a different taxing authority from the recipient of the FTT revenues. So the proposals would cause heavy losses to the UK Exchequer, as well as to the financial community.

5. THE "NON-PAPER"

On 16 April 2013 the signatories to the ECP submitted a "non-paper" (EU jargon) asking some questions. When this was leaked, the Commission said it was "not embarrassed" and that they would comment after the meeting on 22 May. This has now taken place and FTT was only one of many subjects discussed, We have yet to see any comments, but reports suggest that the Commission is still determined to go ahead. There were disputes, and the proposal may be delayed for a year – but with anything to do with tax "the devil is in the detail". The ECB has now offered to help with design to avoid some of the damage to the banking system. This may well be helpful in the taming the worst features of a bad tax, but they are unlikely to attempt to abolish it.

Although the signatories raise some interesting questions, they do not really cover the "who pays?" question. Some are administrative and procedural, important but not immediately relevant, the key ones being:

- ***Application of double tax agreements and effective exchange of information***. The Americans are certainly taking this one seriously.
- ***Government bonds and their impact on national debt.*** They make the intriguing point that the Commission "impact assessment" argues that "for each Euro potentially to be spent on higher interest rates the government would receive more than three Euros in return in the form of higher FTT revenue".
- ***Duration of bonds***. They point out, correctly, that the tax formula does not take into account the duration of bonds and create an "inappropriate burden" on short-term bonds. They also say that the measure would have "negative effects on the financing capability of companies" mentioning "difficulties in receiving funding from the banking sector. There is definitely a case for encouraging peer to peer lending and other means of bypassing banking intermediaries for any such efforts would be deterred by the

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[10] See http://tabbforum.com/opinions/ftt-migraines-in-milan-could-cripple-european-equities

administrative hassle of becoming involved with the FTT.

- ***The definition of pension funds***. The Dutch who had expressed an interest had already said that they want these to be exempt. Even if they were, this would presumably only apply to the initial transaction – they would still be caught by the cascade element.

6. WHO WILL BEAR THE TAX?

The Commission hopes (optimistically) to raise €30 billion to €35 billion but that is not the whole story. We now have to ask three questions:

- What is the real cost to the Community?
- Who will bear this cost?
- Who will receive the net revenue?

The taxpayer suffers not only the tax but the compliance cost imposed which in this case will be particularly high. Governments, and not necessarily the governments ultimately receiving the tax, will also have compliance costs.

Taxes can damage and distort markets – a major loss in this case. They can, sometimes, influence behaviour positively, but to the extent to which FTT discourages "bad" behaviour, it won't raise revenue.

The U.S. has a general rule that in appraising an expenditure project one must generally add 25% for these extra costs. Different taxes are analysed: incidental damage ranges from 10% to 60%. The FTT will come high on this test. The Commission says that the FTT would "only" damage the economy by 0.5% of GDP – i.e. twice the projected yield.

Much of the tax collected will come from taxpayers whose taxable profits will be reduced by these direct and indirect costs, substantially reducing the net yield to governments.

As well as raising revenue, FTT is expected to create appropriate disincentives on "transactions which do not enhance the efficiency of financial markets." Elementary fiscal and tariff economics shows that the more successful it is in achieving this, the less revenue it will collect.

Financial services, at their best, perform a valuable service in mobilising investment and transferring risk to those wishing to bear it. Of course, there have been substantial abuses, particularly recently. But can we tax the latter without destroying the former? No, for an activity to be taxed, precisely defined legislation is needed and if you can achieve that, you can simply legislate or regulate against it.

And which inappropriate transactions are the proposals attacking? The most harmful practice is mis-selling and surely this would not be deterred by the first stage tax which will simply be passed on to the unfortunate customer. This practice needs to be, and is being, attacked by regulation.

Market makers, speculators and high-speed traders do not (too much) mind taxes on their net profits. But they cannot operate with a tax flow salary on gross transactions. They would seek to move their activities outside the EU and if they were prevented from doing this they would close down. Either way, it would surely remove a large part of the expected revenue.

So most of the revenue of FTT would come from genuinely beneficial financial services. Those liable will either be end-users or financial intermediaries. Let us look at each in turn.

End-users would include pension funds, mutual funds and private individuals, who would therefore have to bear part of the cost. Others would be corporate and business users, and for them it would reduce taxable profits not only by the amount of tax paid, but by the distortion it created to rational investment, borrowing and hedging decisions. Financial intermediaries would also normally (not always) be taxpayers but not necessarily in the country collecting the FTT or in the EU at all.

In addition, the taxable profits, and even more highly taxed bonuses, would be reduced not only as described above but by the substantial administrative costs imposed on them. The original proposal actually assumed that the FTT revenue would accrue to Brussels much of which would be a transfer of tax revenue from the countries concerned, notably including the UK. This may have been at least partly avoided but we must surely be on our guard."

Generally, is there any sense in going out of our way to impose another tax on the banking sector? If that were the aim of the proposals, then it would be more efficiently achieved by taxing the banks directly. But would even this be a coherent when a substantial part of EU bank capital is owned by the public purse, and banks need to be recapitalised?

The public would shed few tears if the effect was to be collected from bonuses and other individual earnings, but as these are more heavily taxed than company profits, the loss of tax revenue would be greater.

7. STAMP DUTY

The FTT is sometimes wrongly compared to other transaction taxes which in fact do relatively little damage to financial markets. For instance, the UK imposes a 1% stamp duty on security transactions but this is only applied when there is an actual change of ownership: risk-spreading transactions are not caught.

Its virtue is that it is a simple tax to collect – but it still does some damage. Any such tax tends to reduce competition between intermediaries raising the cost to users of markets.

In the UK, this has been particularly noticeable in the housing market where Stamp Duties have risen markedly. There is little incentive to reduce commissions. Indeed there is evidence that the effect of the higher duty on turnover means that agents feel able to charge more. One estate agent specialising in selling expensive properties to Russian oligarchs has reported that the new 15% stamp duty has made little difference to sales – and no downward pressure on commissions.

In the US, there is an SEC charge of 0.25% which, it is said, does little harm. However it only collects about $1 billion (compared to the €30 billion to €35 billion the European Commission is hoping for from the FTT).

8. LEGAL ASPECTS

The British Government filed a legal challenge on 18 April before the ECJ.

The most important question is whether, why and how a tax agreed between a group of members under the Enhanced Cooperation Procedure can be imposed, against their will, on activities conducted by other EU members, and indeed outside the European Union altogether. Yes, if a bank in London, New York or Singapore wants to do business in, or with a customer within the ECP zone that (possibly subject to double tax agreements, a point which the US is particularly watching) is fair enough.

The Commission, extraordinarily, wants to go further. Algirdas Šemeta, the EU Commissioner for taxation, Customs Union, Anti-Fraud, Audit and Statistics, has said:[11]

"We have been particularly careful in the design of our proposal to provide strong measures to mitigate relocation risks and tax avoidance effects".

He went on to say that this would affect:

"…financial transactions carried out by financial institutions established in the EU wherever they intervene in these transactions… to put it simply one would have to abandon their entire EU client base to escape the tax".

This is counter to Article 113 of the Treaty on the Functioning of the European Union (TFEU). This requires unanimity on tax measures. The wording is short, and straightforward:

"*Article 113*
The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition."

11 "Financial Transactions Tax: The Way Ahead" Speech to the Danish Parliament, 19 March 2012.

The proposals in the February 2013 draft directive include the assumption that they will apply throughout the EU. They argue that broadening the scope would be within the ECP rules. But it cannot be right, within what is not even a properly constituted Federal Union, for a minority of members to introduce a tax which will impact on other States.

The TFEU on enhanced cooperation begins with the following two articles which also seem straightforward.

Article 326
"Any enhanced cooperation shall comply with the Treaties and Union law.

Such cooperation shall not undermine the internal market or economic, social and territorial cohesion. It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them."

Article 327
"Any enhanced cooperation shall respect the competences, rights and obligations of those Member States which do not participate in it. Those Member States shall not impede its implementation by the participating Member States."

9. CONCLUSION

The potential dangers of an FTT to the UK financial services industry have been widely analysed. But what should be clear is that even an FTT brought in under the enhanced co-operation procedure could cause significant and lasting damage to the UK financial services industry.

The British Government is now challenging the proposals in the European Court of Justice. But, while welcome, this is not nearly adequate:

for as long as the case moves through the legal process, so there will be uncertainty as to which jurisdictions, which financial institutions and which activities might or might not be liable to an FTT.

In addition, there is no FTT collection mechanism currently in place: it will be up to the financial institutions themselves to act as the collection agents. This will require huge changes to all IT, legal and tax systems in all financial services companies in every jurisdiction of the EU. Faced with such a cost and burden, how many companies would choose to relocate?

And it is probable that the UK's case will not be settled before 1 January 2014 (the date on which it is planned to introduce the FTT). Even if it is successful in arguing its case, huge damage would have already been done to the UK financial services industry. Even it is successful, the bureaucratic burden of reimbursing the tax paid on the millions of trades in the interim would be extraordinarily complex.

It is therefore essential that the British Government, together with other countries which are opposed to the FTT (primarily Ireland, Luxembourg and Sweden), acts quickly to ensure that the proposed FTT is not introduced.

THE AUTHOR

John Chown is a co-founder of the Institute for Fiscal Studies and a specialist in the taxation of financial markets. He was invited to give evidence on the Financial Transactions Tax to the House of Lords Select Committee and is the author of *Time to Bin the Tobin Tax* (Centre for Policy Studies, 2012).

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