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Rt Hon Greg Clark MP
Financial Secretary
HM Treasury
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26 March 2013

Dear Greg.

EMs 6442/13 and 15390/12: Financial Transaction Tax

Thank you for your Explanatory Memorandum 6442/13, dated 19 March 2013, on the proposal for a Council Directive implementing Enhanced Cooperation in the area of Financial Transaction Tax, and for your letter, dated 24 February 2013, on EM 15390/12: a proposal for a Council Decision authorising Enhanced Cooperation in the area of Financial Transaction Tax. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 26 March 2013. This followed an oral evidence session with Manfred Bergmann, Director of Indirect Taxation and Tax Administration, DG TAXUD, European Commission; John Vella, Senior Research Fellow, Oxford University Centre for Business Taxation; and Richard Woolhouse, Head of Tax and Fiscal Policy, CBI, held on 19 March 2013, and your own appearance before the EU Select Committee at its meeting on 13 March. We also received written evidence from Rebecca Healey, Senior Analyst, TABB Group.

The scrutiny process

We regret that we have to complain once again about failures in the scrutiny process in relation to this important proposal. The Commission proposal was published on 14 February and an EM was due on 4 March 2013. Yet it was not received until 19 March, over two weeks late. This meant that we were not able to take it into account in our evidence session on 19 March, and, given the paucity of information you provide in relation to your concerns on subsidiarity, means that it will not be possible for us to give due consideration to the use of the Reasoned Opinion procedure before the deadline of 16 April. In your appearance before the Select Committee you argued that it was not possible to provide the EM until "we have sufficient clarity from the Commission as to what is proposed and we have made our assessment of the likely implications". This does not justify your failure to produce an EM on time in relation to a proposal of such magnitude. As the Cabinet Office *Guidance for Departments on Parliamentary Scrutiny of European Documents* states, the nature of the document is not an acceptable reason for the late production of EMs, and if the UK policy has not been agreed or there are other areas of uncertainty, the EM should say so while giving as much information as is available at the time. You have failed to provide such

information on time, in spite of our having made clear to you our frustration about previous shortcomings in relation to your handling of the Financial Transaction Tax proposals, both in our letter of 11 December 2012 and at your appearance before the Sub-Committee on 5 February 2013. We are disappointed that the anticipated improvement in standards at HM Treasury that we were told at that meeting was now taking place has not been borne out by subsequent events. So long as these shortcomings persist you are failing in your duty to this House under the Scrutiny Reserve Resolution.

Notwithstanding these difficulties, we have heard important evidence on the proposal for a Financial Transaction Tax under the Enhanced Cooperation procedure, in particular in terms of the serious implications for the UK and other non-participating Member States, which we would be grateful for your views on.

The detail of the proposal

We share your concerns that "there has been insufficient clarity as to what the proposal is and what its impacts might be". Both the CBI and Mr Vella complained about the lack of detail in the Commission's proposal. Mr Vella told us that there remained significant gaps in knowledge in terms of the effect of the tax. In his view, some of the calculations in the Impact Assessment gave the impression of having been written "on the back of an envelope". Our March 2012 report, *Towards a Financial Transaction Tax?*, drew attention to the poor quality of the Impact Assessment pertaining to the original proposals, and we are disappointed to find that the situation has not improved.

Mr Woolhouse drew particular attention to the lack of detail on the means by which the tax would be collected. In his view, the broad range of assets that would be brought under the scope of the proposal meant that it would be difficult effectively to monitor collection of the tax. He pointed to the massive system changes that would need to be made to collect the tax if it was to become operational by January 2014, as the Commission envisages. The Commission conceded that the proposal was silent on the question of collection as well as the costs that might accrue, because it had not at this stage been deemed necessary to seek to harmonise systems of collection. However, Mr Bergmann suggested that the collection model as used in relation to the UK Stamp Duty, for instance making use of trading platforms and electronic transactions, was being examined closely.

In defending the lack of detail, the Commission told us that there was a three stage process: first, the design of the tax; second, how to collect it; and third, how to spend it. Mr Bergmann told us that discussions on the second and third stages would follow in due course, and it would be a choice for Member States whether revenue collected was used as an Own Resource for the EU budget. You confirm that the Commission has proposed separately that a portion of the revenue could constitute a new Own Resource for the EU budget, resulting in a corresponding reduction of the national contributions of participating Member States, although agreement to this proposal will not of itself establish the new Own Resource. As we explain below, this raises the deeply unpalatable prospect that an FTT imposed on a financial institution resident in a non-participating Member State such as the UK would reduce the national contribution of a participating Member State.

We are astonished by the paucity of thinking exhibited by the Commission. Detailed assessment of all aspects of such a tax, including the method of collection and the use of potential revenue, must be undertaken as a matter of urgency before further steps towards its implementation are taken. We urge you to make this point as negotiations progress.

The proposal is particularly weak in relation to two other issues: the impact of the new issuance principle, and the impact on non-participating Member States, including the UK.

The issuance principle

The Commission has proposed to supplement the existing residence principle with a new issuance principle, whereby financial instruments issued in a participating Member State will be taxed when traded, even if those conducting the transaction are outside the FTT zone. The Commission told us that the issuance principle was a key element of the enhanced cooperation proposal, and constituted the main change from the original proposal. Mr Bergmann explained that it had been introduced after the European Parliament made clear that the safeguards against relocation needed to be strengthened. He estimated that the addition of the issuance principle would bring a further 3-4% of trades within the scope of the tax – the other 95% would already be covered by other criteria. He also noted that the newly-enacted FTTs in France and Italy were based on the issuance principle, and said that it bore similarities with the way in which the UK Stamp Duty operated. He suggested that the order of criteria might be adjusted during negotiations, with the issuance principle gaining precedence.

Mr Vella agreed that the issuance principle was intended as an anti-avoidance measure, but feared that it went far beyond what was justified to meet this aim. He gave the illustration of the tax applying when a UK pension fund purchased German shares from a US bank. He agreed that the UK Stamp Duty was based on the issuance principle but pointed out that it affected a much narrower set of financial institutions. In his view, the use of the issuance principle in this way was unprecedented and risked being non-compliant with customary international law, under which a genuine link with the transaction being taxed needed to be demonstrated. The key determinant of compliance, in his view, was the objective that lay behind the tax. He also argued that the Impact Assessment should have provided more accurate data on the potential impact of the issuance principle.

How would you respond to the concerns about the issuance principle that have been raised? Do you agree that it goes beyond what it necessary to deter avoidance measures?

The impact on non-participating Member States

We are particularly alarmed at the lack of detail about the implications of the proposal for non-participating Member States. The Commission told us that the implications for non-participating Member States would be minimal, and that in any case it did not perceive any negative effects for non-participants, including the City of London. We share your concerns that the Commission Impact Assessment provides only very limited detail on how the proposal will impact on non-participating Member States. We note in particular your concern about the lack of detail on the contribution to the tax take expected from non-participating Member States, the economic impacts on non-participants, and the impact on the existing tax base of non-participants. We share yours and Mr Vella's disappointment that there was no detailed analysis of the impact on non-participants in the Impact Assessment. We find this to be an unacceptable omission, suggesting that the Commission has failed in its duty to the 16 Member States who have thus far chosen not to participate in the tax, yet may be significantly affected by it. We welcome your assurance that this is "an issue that the UK will proactively raise in future discussions". What steps are you taking to ensure this failure is remedied as a matter of urgency?

The impact on the UK

You confirm that the UK will not participate in the enhanced cooperation FTT. Yet we have consistently pointed that the implications of such an FTT for the UK could still be significant. Mr Vella agreed, and told us that there would be both negative and positive effects. There could be a negative effect on the financial activity and profitability of UK-based firms, but on the other hand the UK might benefit from some relocation, both of entities and capital. The Commission has expressed the hope that, since financial operators would only be able to avoid the FTT if they were prepared to relocate and relinquish their clients and businesses in the 11 participating Member States, and given the relatively low headline rates of taxation, relocation could be limited. However, Mr Vella perceived clear advantages for financial institutions within a participating Member State operating in the UK. We find that considerable uncertainty remains about the impact of the FTT on the UK. In the absence of such an assessment by the Commission, what analysis have the Government undertaken on the impact of this tax on the UK?

We also sought clarification in terms of the obligation on UK authorities to collect the tax. Our March 2012 report stated that, in relation to the original proposal, UK financial institutions entering into financial transactions with financial institutions in participating Member States would still be liable for the FTT, which could be collected through EU mutual assistance for the recovery of tax or as a result of provisions of joint and several liability. We found that, in the event of a transaction between a bank in a participating Member State and a bank in the UK, tax authorities in participating Member States could request the UK tax authorities to collect the FTT from the UK institution: the legal basis for the request would be the EU regime for mutual assistance on tax matters, and such requests would have to be met. More likely the participating tax authorities would rely on the provisions of the proposal imposing joint and several liability on the bank in the participating Member State. Knowing this, the bank in the participating Member State would be likely to ensure, through its contractual relations with the UK bank, that it would be indemnified by the UK bank.

When we put this to the Commission, Mr Bergmann told us that there would be no legal obligation on UK tax authorities to collect the tax. He made the comparison with arrangements in relation to the UK Stamp Duty, where non-UK financial institutions such as a German bank or Japanese investment firm pay the tax when they purchase a UK share, but where their authorities are not obliged to collect the Duty. He said that tax authorities in the UK or the US, for example, might be invited to collect the tax, but it would be entirely voluntary. Mr Bergmann stated that, in theory, the financial institution in the participating Member State could be required to pay the tax twice. The likely effect of this burden on such an institution might be taken into account in any transaction activity, but there would nevertheless be no obligation for UK firms.

Notwithstanding the Commission's evidence, it remains our understanding that UK financial institutions which are counterparties to financial transactions with an EU established financial institution would have to pay the tax, and it could be collected either from the EU financial institution on the basis of joint and several liability or through the mutual assistance regime. Similar procedures would apply in relation to tax which is imposed on the basis of the issuance principle. Indeed there may be far-reaching adverse consequences for UK resident financial institutions. This is illustrated by the case of a financial transaction involving German shares between a US and a UK financial institution. Under the issuance principle this would give rise to FTT upon both parties payable to the German tax authorities. Given that collection of this tax from the US financial institution may be difficult, the proposal would

enable the German tax authorities to impose joint and several liability for both instances of the FTT upon the UK financial institution and recover the whole amount using the EU mutual assistance regime. This would undermine Mr Bergmann's evidence that there would be no difference in the effect of the tax on London as compared to New York and Hong Kong. The consequences of this would be serious indeed and must be resisted. Do you share our understanding of the obligation that would be placed on UK authorities to collect the tax? If so, what steps are you taking to resist the proposal? We urge you to do all you can to resist this measure in Council, and, if necessary, at the European Court of Justice.

Further, as we outline above, the proposal that a portion of the revenue could constitute a new Own Resource for the EU budget raises the spectre that an FTT imposed on a financial institution resident in a non-participating Member State such as the UK would reduce the national contribution of a participating Member State. Do you agree that UK businesses will, in effect, be subsidising the budgetary contribution of participating Member States? If so, what steps are you taking to resist the proposal, both in Council negotiations, and, if necessary, at the European Court of Justice?

In the light of such important issues, we are alarmed at the complacency shown by the Government in relation to this proposal. You are aware that we have repeatedly raised concerns about the quality of the Government's analysis of the FTT and your responses to our concerns, since our original report was published a year ago. We warn against any perception that, because the UK will not participate, the reverberations of an FTT would not be felt here. We are perplexed by your repeated failure to provide any detailed analysis of a proposal that holds such serious implications for the UK, and we urge you to undertake such analysis, and share it with this Committee, as a matter of urgency.

Neither is the UK alone in choosing not to participate in the FTT – at present, 16 Member States have chosen not to do so, from both inside and outside the euro area. Many of these Member States have historically been sympathetic to the UK's position in relation to financial sector legislation. What discussions have you had on these questions with other non-participating Member States? What steps are you taking to work alongside like-minded Member States to give voice to our concerns? Such close cooperation is urgently needed if the worst consequences of this proposal are to be avoided.

We are equally alarmed that the UK financial sector has not taken the likelihood of an FTT being implemented seriously. The CBI conceded that the political will amongst many in the EU in support of the proposal had been underestimated. They also stressed the importance of the Government remaining engaged in the debate on the FTT in the weeks ahead. Mr Bergmann told us that the UK would remain involved in the negotiations until the vote was cast by participating Member States, and we welcome your own statement that the UK will exercise its right under the Treaty to fully and proactively participate in discussions on the design of the enhanced cooperation FTT going forward. What steps are you taking to ensure that the UK is able to exert a positive influence on these discussions?

The impact on subsidiaries

We also asked about the impact on London-based subsidiaries of financial institutions with headquarters in a participating Member State. Mr Bergmann told us that "it depends on what their business is", but that if the subsidiary was undertaking business which had no economic link to the territory of participating Member States, then no tax would be due. However, other witnesses suggested that there was some uncertainty about the impact on subsidiaries.

You state that an FTT zone financial institution's branches worldwide will be subject to an FTT on all relevant transactions. So, for example, French and German banks' London and New York branches will be fully subject to the FTT on all their securities and derivatives businesses. Is it your view that the proposal as drafted is clear in terms of the effect on subsidiaries based outside the FTT zone?

The impact on economic growth

One of the concerns in our original report was the potential deleterious effect on economic growth. Your EM states that the Commission's most recent analysis suggests that the FTT will not lead to any job losses, whereas the original proposal predicted the loss of 500,000 jobs, and that this proposal is estimated to have a -0.28% impact on EU GDP, compared to -1.76% in relation to the original proposal. You state that the difference stems mainly from revised economic modelling, and that the Commission estimates that spending FTT revenues on growth-enhancing public investment could have a positive impact on GDP of between 0.2 and 0.4%. The Commission also estimates that revenue of €31 billion a year will be generated.

When we asked our witnesses about the potential impact on economic growth, Mr Vella said that a negative impact on growth was inevitable – the question was rather by how much. He was concerned that the modelling used by the Commission contained significant flaws, and that, whilst the Commission had acknowledged criticisms of its original modelling, it did not appear to have addressed the concerns that had been raised. For instance, it only made calculations on the basis of a tax on securities but not derivatives, and it assumed a closed economic model (and therefore did not take account of potential relocation effects).

We note the TABB Group's analysis that the FTT introduced in France had a negative impact on trading in the shares of smaller firms. We also note recent reports that trading in Italian stocks through the desks of major banks dropped sharply amid a wider fall in volumes after Italy introduced its own FTT. Mr Woolhouse argued that an FTT would be bad for growth, and suggested that SMEs could be disproportionately affected because of the impact on liquidity. On the other hand, Mr Bergmann argued that only 10,000 out of 20 million EU-wide SMEs were involved in the kinds of transactions that would be caught by the tax.

In our last report, we expressed alarm at the degree of criticism to which the Commission's Impact Assessment was subjected. We also concluded that, at a time of ongoing financial crisis and at best fragile economic growth across the entire EU, a new tax which could have a substantial detrimental impact on EU GDP should be resisted. Notwithstanding the Commission's revised figures, we remain concerned that an FTT will inevitably have a negative impact on economic growth. We are equally sceptical about its claims that spending FTT revenues on growth-enhancing public investment could have a significant positive effect on GDP. We remain alarmed at the degree of criticism to which the Commission's modelling has been subject. Assessment of the impact of proposals of such importance as this must be based on rigorous analysis, or else all assumptions that follow will be flawed. What assessment have you made of the potential impact on economic growth of the proposal, and in particular on SMEs?

The impact on "irresponsible trading"

One of the Commission's aims, both in its original proposal and in the enhanced cooperation proposal, was to "temper irresponsible trading" and create "appropriate disincentives for

transactions that do not enhance the efficiency of financial markets". Mr Bergmann told us that this was a secondary aim of the proposal compared to the need to harmonise tax arrangements and to ensure that the financial sector made a contribution to the costs of the financial crisis. However, Mr Woolhouse objected to what he saw as the philosophy underpinning the proposal that some financial activity, such as trading in derivatives, had no economic utility. Mr Vella told us that the Impact Assessment was unclear as to the impact of the proposal on High Frequency Trading.

The impact of High Frequency Trading on financial markets remains contentious. The desirability of seeking to discourage such activity is a matter of considerable debate, and the potential impact of the FTT proposal on such activity is less certain still. In the context of this debate we welcome the publication of the recent *Foresight* project. What update can you give us on the Government's own thinking on HFT and its effect on financial markets? What analysis have you undertaken of the potential impact of the FTT proposal on such activity, and by extension on financial markets as a whole?

The potential for a global tax

One of the stated aims of the original proposal was "to contribute to the ongoing international debate on financial sector taxation and in particular to the development of an FTT at global level." The Commission once again expressed the hope that an enhanced cooperation FTT could pave the way for a tax at global level if it was able to show that the model worked. In Mr Bergmann's view, the 11 Member States represented a 'critical mass', including the four largest economies in the euro area, representing 90 per cent of the euro area economy and one-sixth of the global economy. In his view, it would be difficult for other global financial centres to avoid the tax. However Mr Woolhouse was certain that the US would never introduce such a tax, and indeed would view it with hostility as an extraterritorial tax, even more so than in relation to the original proposal for an EU-27 FTT. He cited a letter from American trade bodies stating that "these novel and unilateral theories of tax jurisdiction are both unprecedented and inconsistent with existing norms of international tax law and long-standing treaty commitments", and warned that it could have potential negative consequences for the US-EU trade deal. Furthermore, Mr Vella argued that there would be a positive incentive for such countries as the US not to introduce such a tax, in order to benefit from the potential relocation of economic activity.

In our last report, we concluded that, given the palpable lack of appetite for the introduction of a tax amongst other nations, most notably the USA, the Commission's argument that an EU-wide FTT would pave the way for the introduction of a global tax was wholly unrealistic. Given that the continued opposition to this tax in the US shows no sign of abating, this remains our view. Indeed, given that the enhanced cooperation procedure will at present involve only 11 Member States, the uphill battle that the Commission faces has got even steeper. Given potential US hostility to the proposal, we also fear the potential implications for the EU-US trade negotiations. What discussions have you had with US counterparts about the potential impact of the tax, in particular in terms of the implications of the issuance principle? What urgent steps are you taking to alert our partners in the US to the concerns and implications shared between our two nations regarding the FTT proposal? What is the position of the US Government on the proposal?

The enhanced cooperation criteria

Taking all of this into account, we also sought to consider whether the proposal met the criteria for use of the enhanced cooperation procedure. The Treaty on the Functioning of the European Union requires that enhanced 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." Enhanced cooperation must also "respect the competences, rights and obligations of those Member States which do not participate in it".

Mr Vella stated that a full analysis of the impact of the proposal on non-participating Member States should have been made available before the vote on the enhanced cooperation procedure took place. You state that the Government made clear at the January 2013 ECOFIN that you would abstain in any vote on the use of enhanced cooperation because the UK was not assured that the proposal would respect the single market and respect the competences of non-participating Member States. We also note that the Government tabled a Minute Statement stating that they could not support the proposal as it was not possible to take the view that the conditions set out in TFEU were fulfilled. Did you discuss your negotiating position with other non-participating Member States? Did they share your position? In light of your concerns (which we share), why did you decide not to vote against the proposal? We also observe that the 14-15 March 2013 European Council Conclusions note that "the work on the enhanced cooperation on a financial transaction tax is advancing." What part did the Prime Minister play in these discussions? Did you advise him on the serious implications of the proposal for the UK and its financial sector?

Mr Vella also expressed doubt as to whether the proposal met the criteria for the enhanced cooperation procedure to be used. He argued that it would create distortion of competition: for instance in the case of a German and a UK bank competing for a UK customer, the German bank would be placed at a competitive disadvantage. He conceded that distortions would be reduced amongst the participating Member States, but stressed that they would be increased in terms of the single market as a whole. Mr Vella also pointed out that the Commission conceded that some double taxation was bound to occur, although its Impact Assessment did not go into much detail. Having said that, he was uncertain how the European Court of Justice would respond to any legal action concerning the use of the enhanced cooperation procedure. He pointed out that enhanced cooperation had only been used twice before and had only been challenged once (by Italy and Spain in relation to patents). In that case, only the opinion of the Advocate General had been set out – the Court itself had not yet reached a decision.

Mr Bergmann told us that the Commission did not believe that an enhanced cooperation FTT would create any significant degree of distortion. He stressed the distinction between introducing a new tax and seeking to harmonise existing taxes. He argued (in contrast to Commissioner Šemeta, who, in his appearance before us in relation to the original proposal made clear that it was not the Commission's primary aim) that the primary purpose of the proposal was to harmonise the operation of a Financial Transaction Tax across the 11 participating Member States. The alternative would be the operation of 11 separate FTTs. In his view, therefore, the proposal would enhance the single market. He also stressed that some double taxation was inevitable so long as the tax did not operate at EU-27 level, because non-participating Member States would be free to introduce their own FTT. However, he emphasised that the risk of double taxation was limited, given, for example, that only the UK currently operated a Stamp Duty. However, Mr Woolhouse was sceptical

about the Commission's argument that this was not a new tax, because the national FTTs in France, Italy and Spain would not have arisen had the Commission not been considering implementing such a tax.

In your evidence to the Select Committee, you stated that the Government were reserving their position on whether they would contemplate taking legal action. However we note that you said that "it would be unwise to rule it out". You state that the UK will continue to raise concerns in terms of compliance with EU law and the Single Market, and whether the extraterritorial effects prejudice non-participating Member States, and potential problems over double taxation and enforceability. What further details can you provide us of your concerns? What further consideration have you given to the case for a legal challenge?

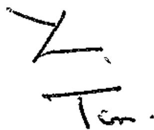
Taking the evidence that we have heard into account, we believe that the proposal fails to meet the criteria for enhanced cooperation, and in particular the requirement to respect the competences, rights and obligations of those Member States which do not participate in it. It is particularly unacceptable that a full analysis of the impact of the proposal on non-participating Member States was not made available before the vote on enhanced cooperation took place. We exhort you to take urgent legal advice on the case for a legal challenge at the European Court of Justice.

Subsidiarity

Your EM also states that the Government have concerns that introducing an FTT through enhanced cooperation does not meet the conditions of subsidiarity. However you provide no further detail of your concerns. Our initial analysis is that there is a stronger case for arguing that the proposal fails to meet the criteria for enhanced cooperation than that it does not meet the subsidiarity principle. However, we require clarification from you of the Government's concerns in order to reach a considered position. In what ways do you believe that the proposal fails to meet the principle of subsidiarity?

We invite a response to this letter by 16 April 2013. In the meantime we will hold EM 6442/13 under scrutiny and clear EM 15390/12 from scrutiny.

I am copying this letter to William Cash MP, Chair of the Commons Committee; Sarah Davies, Clerk to the Commons Committee; Paul Hardy, Legal Adviser to the Commons Committee; Les Saunders, Cabinet Office, Kunal Patel, Robert Douglas, Thomas Kenny and Gary McMillan, International Tax Strategy & Co-ordination, HM Treasury.



The Lord Boswell
Chairman of the European Union Committee