



EU ECONOMIC AND FINANCIAL AFFAIRS AND INTERNATIONAL TRADE SUB-COMMITTEE

Financial Transaction Tax Oral and written evidence

Contents

The Alternate Investment Management Association Limited (AIMA) – Written evidence.....	1
The Association of Private Client Investment Managers and Stockbrokers (APCIMS) – Written evidence	13
Association for Financial Markets in Europe (AFME) – Written evidence	14
Association of British Insurers (ABI) – Written evidence.....	22
The Association of Corporate Treasurers (ACT) - Written evidence.....	30
AVIVA PLC - Written evidence.....	36
BlackRock - Written evidence	43
British Bankers Association (BBA) - Written evidence.....	56
The British Land Company - Written evidence.....	71
British Property Federation (BPF) - Written evidence	73
The Charity Tax Group - Written evidence	77
John Chapman- Written evidence.....	79
Chown Dewhurst LLP - Written Evidence.....	87
City of London Corporation - Written evidence.....	89
Confederation of British Industry (CBI) - Written evidence.....	91
Confederation of British Industry (CBI) – Supplementary evidence.....	99
Confederation of British Industry (CBI) – Oral evidence (QQ 1 – 28).....	103
Frank Cranmer - Written evidence.....	119
Arlene McCarthy MEP, Committee on Economic and Monetary Affairs - Written evidence	121
European Commission Directorate - General Taxation and Customs Union	127
Institute of Economic Affairs (IEA) – Written evidence	129
Sylvie Goulard MEP – European Parliament - Written evidence	136

International Swaps and Derivatives Association (ISDA) - Written evidence	141
Investment Management Association (IMA) - Written evidence.....	151
Lloyds - Written evidence.....	168
Mayor of London - Written evidence	174
NAPF – Written Evidence	176
New City Initiative - Written evidence.....	177
Oxford University Centre for Business Taxation - Written evidence	180
Peter Sinclair - Written evidence.....	187
Stamp Out Poverty - Written evidence.....	194
Trades Union Congress (TUC) - Written evidence.....	202
Trades Union Congress (TUC) – Oral Evidence.....	206
Unite the Union - Written evidence	207
Dr. Bart Van Vooren - Written evidence.....	209
Wellcome Trust - Written evidence.....	228

The Alternate Investment Management Association Limited (AIMA) – Written evidence

PART I

General questions on financial sector taxation

Q1 *Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?*

1.1. We see little merit in a FTT as proposed by the Commission and believe that as a method of achieving the Commission's stated objectives, it is seriously flawed. Further, the FTT could have serious and damaging impacts for both the EU financial services sector and the EU economy as a whole, with a particularly disproportionate impact on the UK's financial services sector and economy, given the manner in which the proposed FTT is framed. In particular, we do not consider that our hedge fund members should be so adversely impacted by the FTT when they were not responsible for the financial crisis, are not systemically important and have not received any direct form of taxpayer or government support.

1.2. The current VAT exemption for most financial and insurance services does not, in fact, lead to a tax advantage for the financial sector as VAT on costs and overheads incurred by finance and insurance businesses is currently not recoverable to the extent that it relates to their supply of exempt financial or insurance services and therefore represents a cost to the financial services sector. Accordingly, these sectors often bear a higher taxation burden in respect of VAT than other sectors. In addition, it is worth noting that the current exemptions for most financial and insurance services were driven by matters of political expediency and in particular a desire not to introduce a VAT under which end consumers would be required to pay VAT on their mortgage borrowings and insurance premia.

Q2 *What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?*

2.1 We would argue that no industry-specific taxation on the financial sector is appropriate as the industry already pays significant amounts of corporate tax and, ultimately, income and capital gains tax (on amounts representing profits and gains in the hands of the ultimate investors and other stakeholders such as employees). In addition, salaries paid to employees of financial sector businesses are subject to national insurance contributions (or equivalent social security contributions outside the UK). We also consider that a financial activities tax (FAT), like the proposed FTT, would be very difficult to implement in practice and might create competitive distortions between financial services imported to and exported from the EU.

2.2 It could also be argued that the FTT is not, in fact, a tax on the financial sector as the incidence of the tax is likely to fall on the ultimate pension holders and individual savers/investors.

3 Q3 *What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?*

3.1 History suggests that FTTs (or similar securities transaction tax, or “STT”) have been less than successful, with many examples of the tax being abolished within a relatively short time of its introduction. In the last three or four decades, several countries have introduced FTTs similar to that proposed by the Commission and the impairment and loss caused by these taxes have often been permanent and broadly include:

- Sharp drops in trading volumes;
- Permanent trade migration; and
- Hindrance to price discovery.

3.2 We set out below a summary of several examples from recent history.

Sweden:

3.3 In 1984, the Swedish government introduced a tax on the purchase or sale of an equity security (1% total tax, i.e. ‘round trip’). This was doubled to 2% in 1986. As a result, 60% of the trading volume of the 11 most actively traded Swedish share classes moved to London and 30% of all Swedish equity trading moved offshore. By 1990, 50% of all Swedish equity trading had moved elsewhere.¹ As trading volumes fell, so did revenues from capital gains taxes, to the extent that the lost revenue almost entirely offset the revenues from the transfer tax. A further example is that trading volumes dropped significantly in Sweden in 1989 due to the introduction of a 0.002% to 0.003% STT on bonds. It is estimated² that, during the first week of the tax, the volume of bond trading fell by 85% and the volume of futures trading fell by 98%. The options trading market all but disappeared. The FTT introduced in Sweden in the mid-1980s caused profound trade migration to non-taxed/lower taxed jurisdictions, especially the UK³. This example is extremely important as the tax rates introduced then are quite similar to the rates proposed now.

The United Kingdom:

3.4 In 1974, the UK introduced a stamp duty (in its modern form) of 2% levied upon registration of securities (not on transactions per se). This was reduced to 1% in 1984 and 0.5% in 1986. The market responded to the introduction of the tax by switching from equity trading to trading in equity derivatives with similar returns and trading in American Depositary Receipts. It is estimated⁴ that the UK stamp duty reduced equity trading volumes by as much as 50%.⁵ It is also estimated that the abolition of the 0.50% UK stamp duty would increase prices by 7.20% and reduce the cost of capital by 0.66%–0.80%.⁶ A potentially unintended consequence of the introduction of stamp duty in the

¹ Umlauf, S., 1993, “Transaction Taxes and the Behavior of the Swedish Stock Market,” *Journal of Financial Economics*, Vol. 33, pp. 227–40

² “Financial Transactions Taxes: The International Experience and Lessons from Canada” (Marion G Wrobel, June 1996).

³ *Supra* at 1.

⁴ Financial Sector Taxation: The IMF’s Report to the G-20 and Background Material (September 2010)

⁵ *Supra* at 2.

⁶ Oxera, 2007, “Stamp Duty: Its Impact and the benefits of its Abolition” (report prepared for Association of British Insurers, City of London Corporation, Investment Management Association and London Stock Exchange (London).

UK is the rise of the contract for differences (“CFD”) market; in 2011, it is estimated that €1.3 trillion of UK turnover is related to CFDs, accounting for approx 30% of total equity turnover or half the executable market.⁷

- 3.5 It is worth also noting that specific exemptions exist under the UK stamp duty/stamp duty reserve tax rules; in particular, there is an intermediaries’ exemption, to deal with a number of the issues presented by a FTT, but no such exemptions are proposed by the Commission (except for limited exemptions for, for example, central counterparties and for transactions with central banks). As set out below in response to question 6, this could lead to potentially severe ‘cascade’ effects.

Switzerland:

- 3.6 Switzerland also has experimented with a 0.15% stamp duty, which caused the mutual fund business to migrate to Luxembourg and the Eurobond and equity businesses to London. Subsequently, Switzerland abolished its stamp duty, to stem the migration.

Germany:

- 3.7 Germany’s experience with its own version of a FTT had similar results. A 1993 study⁸ confirmed that 30% of trading in German government bonds, 50% of trading in other Deutsche Mark-denominated bonds and 80-90% of trading in floating rate Deutsche Mark-denominated bonds migrated to London as a result of the introduction of a FTT. Eventually, the FTT had to be abolished.

The United States:

- 3.8 However, arguably the most dramatic development as a result of the introduction of a STT was the formation of the euro-dollar market. US government attempts to control capital exports and place other regulations on the banking system lead to the market bypassing US government control and the euro-dollar market being established in London as a result. It is estimated that this market grew from US \$20 billion in 1964 to over US \$3 trillion in gross size by 1988.⁹

China and Japan:

- 3.9 A study¹⁰ found that Japanese stocks experienced symptoms of inefficient price discovery in 1989 as a decision to reduce a Japanese STT was made public. Similar results were found with respect to Chinese equities.¹¹

Brazil

⁷ Breaking Down The UK Equity Market: Executable Liquidity, Dark Trading, High Frequency And Swaps” (Tabb Group, UK, January 2011).

⁸ “A Securities Transaction Tax: Beyond the Rhetoric”(Kupiec, White and Duffee, 1993

⁹ Supra at 2.

¹⁰ Liu, S., 2007, “Securities Transaction Tax and Market Efficiency: Evidence from the Japanese Experience,” *Journal of Financial Services Research*, Vol. 32, pp. 161–76.

¹¹ Baltagi, B, D. Li, and Q Li, 2006, “Transaction Tax and Stock Market Behavior: Evidence from an Emerging Market,” *Empirical Economics* 31: pp. 393–408.

- 3.10 The recent introduction of a Brazilian FTT also provides support for the idea that FTTs result in trade migration to low-tax jurisdictions. In October 2009, Brazil introduced a FTT of 2% on all foreign portfolio investments. As a result, foreign investors reallocated capital to Brazilian ADRs in New York. Recognizing the migration of trade from Brazil to New York as a result of the tax, a 1.5% tax on Brazilian ADRs was introduced.¹²

In summary, these examples demonstrate that there are many instances of a form of FTT being implemented in various jurisdictions and in many cases the tax was eventually abolished, due to its adverse impact on the markets and the wider economy and the poor levels of revenue actually raised.

PART II

Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

Q4 What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?

- 4.1 We agree with many of the Commission's objectives as articulated in its proposal as, at a high level, they appear to encourage a more stable and fair market. However, we argue strongly that a FTT is not a tool which can be used, or which would be effective, to achieve most (if any) of those objectives.

5 Q5 Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

- 5.1 We would argue that based on the cascade effect explained below in response to question 6, the currently proposed FTT is not the most desirable design. As currently proposed the FTT will, effectively, tax one transaction several times and potentially discourage good risk management procedures.

Q6 On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?

- 6.1 Given our overall policy position noted in response under 4 and 5 above, we do not propose to comment on transactions on which the FTT should be levied nor on what the rate of the FTT should be. However, we do wish to highlight that the differing rate of tax levied on shares and bonds, compared with that on derivatives, could encourage market participants to trade more using over the counter derivatives, which appears to be contrary to one of the Commission's objectives, i.e. to encourage participants, instead, to trade more on exchanges.

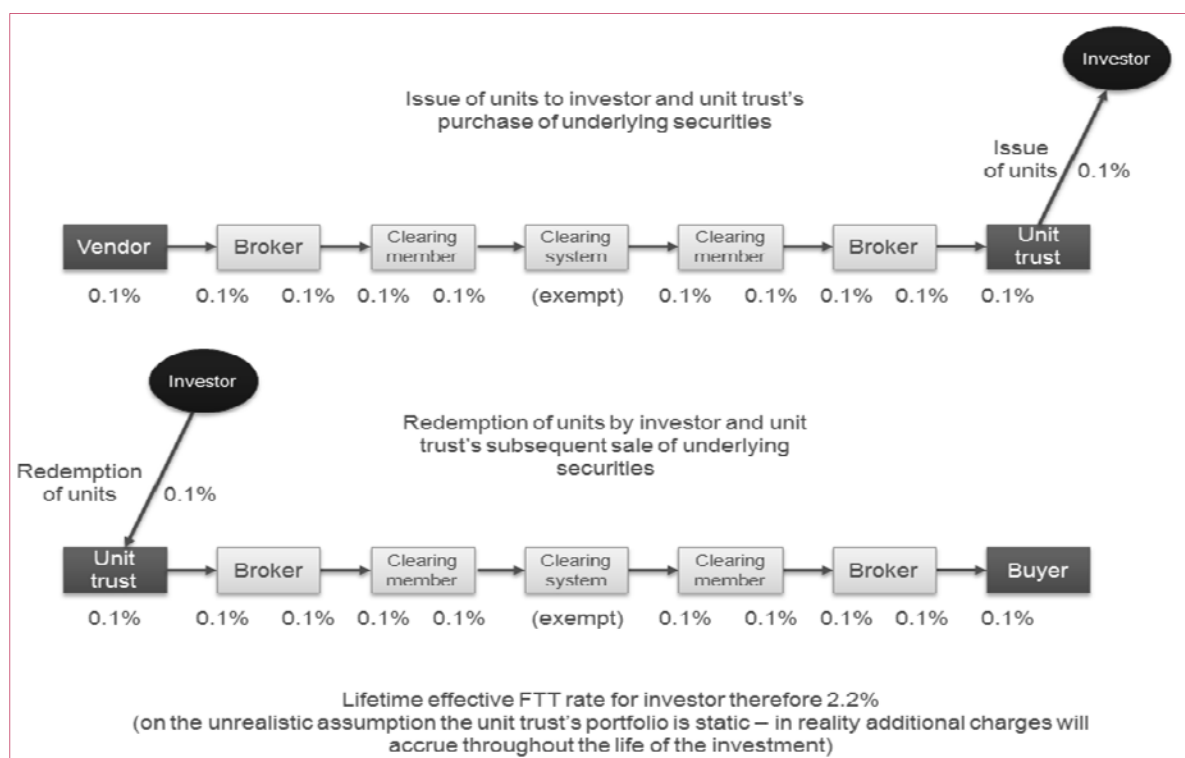
- 6.2 In addition, we would argue that the usage of notional amounts as the basis for a financial transaction tax, as currently proposed, is ambiguous. It would be unfair to use equal tax rates on notional amounts of different types of product class. The proposal makes a distinction only between derivatives and non-derivatives. We believe that it is more important to distinguish tax rates based on product characteristics and market conditions. As an example, the notional amount underlying interest rates futures with a

¹² Culp, C.L 2010 "Financial Transaction Taxes: Benefits and Cost"

short maturity is often a tenfold of the notional amount underlying equity index futures. As such, the tax burden for trading interest rates products with a short maturity normally comprise a relatively high taxable amount. It would exponentially and excessively increase the tax burden of transacting financial instruments in a particular product class, in comparison with others. We question whether notional amount is an appropriate basis upon which to charge FTT on derivatives, given these considerations and the potentially vastly differing payoff profiles of derivatives, compared with their notional amount.

- 6.3 Further, as proposed, uncertainty is created as to derivative transactions where collateral is moved or the underlying is transferred and whether this results in a further layer of FTT. If the tax were to discourage frequent exchange of collateral based on changes in market conditions, this would introduce significant new risks to financial stability.
- 6.4 We are also concerned that, as currently proposed, the FTT would have a severe cascade effect, so that although the rate on a particular transaction appears low, the overall rate to effect a complete transaction could be dramatically increased. The following illustration demonstrates such potentially onerous cascade effect on a relatively simple transaction by a unit trust (or pension fund, or similar) acquiring a security (and assuming that there is no change in market practice as to how such trade is undertaken). It might be that market participants would seek to shorten the 'chain' to reduce the cascade effect and, therefore, the cost of the FTT but this could lead to a reduction in transparency and regulatory oversight as market participants seek to exclude intermediaries.
- 6.5 It should be noted that there is also an opportunity cost, as the unit trust or pension fund will no longer lend out securities as the income earned, net of the FTT costs, is likely to make it uneconomic. This represents a potentially valuable stream of income foregone by these entities.

Issues of units to investor and unit trust's purchase of underlying securities



Note: Increased transaction costs due to the financial transactions tax (FTT) could:

1. Discourage sound investment management practices (like diversification and hedging).
2. Security holder would forego income from lending securities.
- 3.

Q7 *Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?*

7.1 It could be argued that the greatest risk of an EU-wide FTT is the possibility of transaction (and real, physical) migration away from Europe (especially from London to New York, Singapore or Hong Kong), as experienced by other jurisdictions which have implemented a FTT (or similar). The proposed tax would be levied on the basis of residence, i.e. whenever at least one party (who may not be a financial institution) to the financial transaction is located within the EU. Accordingly, a firm located outside the EU (for example, in the US) that trades an EU equity, bond or derivative would be exempt from the tax where it is trading with a non-EU counterparty even though a firm located within the EU would not only be taxed on trading EU equities, bonds and derivatives but also on international equities, bonds and derivatives, even where trading with a non-EU counterparty (and in these circumstances, the non-EU counterparty may also have a resulting FTT liability). Besides the enormous difficulty which the Commission would face in convincing international trading intermediaries to bear additional administrative costs associated with collecting and remitting the tax back to Europe (together with the difficulty of enforcing the same), such a tax must be inequitable and will strongly encourage institutions to relocate outside the EU.

7.2 The proposed FTT will also encourage market participants who are not based within the EU but who would otherwise engage in transactions with EU based counterparties

to seek counterparties based outside the EU and avoid the FTT. The FTT would apply to financial transactions in which an EU financial institution acts for the account of another person. Therefore, it would not only affect every principal in a transaction but would also cause a competitive disadvantage for a service providers based in the EU who acts as agent in a transaction. This would discourage investors based outside the EU from using EU asset managers to make transactions on non-EU exchanges in the name of that non-EU investor.

7.3 We are also concerned about the potential unintended consequences of the concept of joint and several liability, which could apply to all parties (not financial institutions alone) to a relevant financial transaction and which could therefore expose such parties to unacceptable credit risk which is not within their contemplation or intention.

8 *Q8 How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?*

8.1 The Commission's Impact Assessment concludes that revenues raised by the FTT would be between €16bn and €434bn. This is an extremely broad range and is based upon many assumptions. We would certainly hope that, for a proposal with such significant implications, the analyses and estimates as to potential impact would be calculated with considerable precision. The Impact Assessment itself estimates that at a tax rate of 0.1% and depending on the underlying assumptions used, the potential impact of the tax on the EU GDP would be a reduction in future GDP growth of between 1.76% (€216bn) and 0.53% (€65.05bn). That being the case, we question whether the loss in EU GDP would exceed the tax raised.

8.2 In our view, the proposed FTT could reduce overall revenues through unfavourable changes in the specifics of market arrangements affecting trading frequency and/or market spreads.

8.3 First, tax revenues collected from the financial sector depend substantially on the specifics of market arrangements affecting trading frequency. Since greater trading volumes (and trading values) render greater tax revenues, all other things being equal, a trading environment that encourages continuous trading would produce greater tax revenues than one that promotes periodic "calls" with reduced trading volume. A World Bank Policy Research Working Paper published in 2009¹³ reported that a FTT can substantially lower overall tax revenues precisely because it could lead to market arrangements shifting from continuous trading to a periodic "call".

8.4 Second, that World Bank paper concluded its study of FTTs by reporting that such a tax would be a "disappointment" because, even if the tax base were large, it would be concentrated in a small number of countries, reflecting the dominance of multiple technical transactions among wholesale financial market participants as they manage the risks of acting as market makers in foreign exchange and securities trading. That paper reported that even a small FTT would lead to market-makers changing their method of handling risk in a variety of ways that would sharply reduce the volume and total value of transactions. To the extent that those alternative risk management procedures left

¹³ World Bank Policy Research Working Paper #5230 (2009).

the market makers with higher risk, spreads in these markets would increase and liquidity would decline, undermining the FTT's ability to raise revenue sufficiently to compensate for other lost taxes. As with the Swedish experience, the ability of the FTT to raise revenue is also likely to be substantially reduced as a result of relocation of trading.

- 8.5 We find it surprising that the Commission claims that the tax would benefit EU taxpayers' given the Impact Assessment which, among its conclusions, admits that the burden of such a FTT would be passed on to consumers, not to banks or other financial institutions; it states that "banks are able to shift at least 90% of their corporate income tax burden [on to their customers], depending also on the competitive pressure they face."
- 8.6 It should also be noted that the cost of the proposed FTT would not only be borne by EU taxpayers; the burden of the tax would be much greater than regulators intend. Tim Worstall of Forbes¹⁴ has drawn attention to the cascade effect of transactions taxes (as originally explained by Sir James Mirrlees, Nobel Laureate). Using the example of pasta purchased and consumed in the UK but the various components of which are assembled in different parts of Europe, Mr. Forbes argues that, before a final product (in this case, pasta) reaches the hands of a European consumer, prices of its various raw materials would be hedged on financial markets by corporations in different countries in Europe in order to protect themselves from price fluctuations. In fact, the raw material (for example, wheat) - and the final product - would be subject to payment of the proposed FTT several times over through the financial hedging transactions undertaken by the corporations across Europe concerned. As a result, the cost of hedging, the cost of capital and therefore the price of the finished product would increase. Moreover, as the cost of hedging increases, trading volumes of financial instruments on 'soft' commodities would decline as firms face greater disincentives to use the financial markets to protect themselves from price fluctuations. Decreased trading volumes would cause widening in price spreads, further increasing the cost of hedging and exacerbating the impact on the cost of capital and the price of finished products (the pasta, in this example).
- 8.7 In summary, the FTT is likely to affect EU taxpayers most, by reducing savings and retirement income. It is also predicted that unintended investment incentives that undermine sound asset management practices, such as diversification, proper hedging and efficient execution, could arise as a consequence of the proposed FTT.
- 8.8 There is also a risk that the FTT would reduce investment in the real economy and discourage corporate governance and long-term engagement if investment managers invested less in equities and more in derivatives as a result of the bias in the FTT rates in favour of derivatives.
- 8.9 Further, we believe there is no justification for disadvantaging parties that trade more actively than others by means of market making or active trading strategies. For instance, a FTT would affect the returns of "safer" fixed income portfolios because these funds invest in shorter-duration bonds, involving a greater number of transactions and therefore incurring greater costs due to the higher turnover. Similarly, money

¹⁴ Forbes article (dated 9/22/2011) titled "Corporations Do Not Pay Taxes: They Can't, They're Not People".

market funds would suffer because they invest in high-quality bonds with short-durations. Specifically, it would eliminate large portions (if not all) of the profit margins of pension funds seeking market neutral returns through long-short strategies. Clearly, funds emphasising sound investment management principles that seek to reduce risk through diversification or hedging (for example, pension funds) will be exposed to greater risk as these measures result in heavy burdens on profit margins, exacerbating the pensions shortfall currently faced by many individuals. Moreover, active traders are important for the well functioning of a market in terms of providing market liquidity, price discovery, tightening in price spreads and ultimately decreasing price volatility.

Impact and effectiveness

Q9 *Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?*

9.1 It can be argued that, in practice, an increase in financial transaction costs would lead to an increase in market volatility. In fact most empirical evidence examining the relationship between volatility and transaction costs focuses on short-term price volatility and reports no effect of transaction costs on volatility, although in some cases there does seem to be a positive effect noted. For example, Roll (1989)¹⁵ finds no consistent relationship between volatility and transaction costs and Baltagi et al (2006)¹⁶ confirm that. However, among those that do find a positive effect are Jones and Seguin (1997)¹⁷, Hau (2006)¹⁸ and Green and others (2000)¹⁹. Most notably, the IMF reports (September 2010) that, while the net effect of an STT on volatility depends on market microstructure and the composition of trading, it could well cause an increase in price volatility.²⁰

Q10 *What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?*

10.1 The IMF report (September 2010) suggests that an FTT may suppress activity by informed traders and arbitrageurs, thereby pushing prices away from fundamental values.²¹ Other studies suggest that reduced trading volume and market liquidity increase the price impact of trades. In assessing the impact of transaction costs on the formation of asset bubbles, the IMF report also found that “though transaction costs may play a role in determining market cycles, they are clearly not a decisive factor.” That report adds that a low-rate FTT may slow the upswing of an asset cycle (during

¹⁵ Roll, R., 1989, “Price Volatility, International Market Links and Their Implication for Regulatory Policies,” *Journal of Financial Services Research*, Vol. 3(2-3), Vol. 211-246.

¹⁶ *Supra* at 9.

¹⁷ Jones, C., and P. Seguin, 1997, “Transactions Costs and Price Volatility: Evidence from Commission Deregulation,” *American Economic Review*, Vol. 87(4), pp. 728–37.

¹⁸ Hau, H, 2006, “The Role of Transaction Costs for Financial Volatility: Evidence from the Paris Bourse,” *Journal of the European Economic Association*, Vol. 4(4): pp. 862-90.

¹⁹ Green, C., P. Maggioni, and V. Murinde, 2000, “Regulatory Lessons for Emerging Stock Markets from a Century of Evidence on Transactions Costs and Share Price Volatility in the London Stock Exchange,” *Journal of Banking and Finance*, Vol. 24, pp. 577-601.

²⁰ “Financial Sector Taxation: The IMF's Report to the G-20 and Background Material”, Chapter 8, pg. 160. September 2010.

²¹ On the other hand, the IMF (September 2011) also notes that an STT may also reduce “noise trading” (trading based on spurious information such as past price movements) and therefore serve to stabilize markets (De Long, and others, 1990; Froot, and others 1992).

the formation of an asset bubble) due to reduced transaction volume although, on the other hand, it may even reduce the pace of price correction.

10.2 Orderly developed markets operate through participants working on different timescales from market-makers and other instant liquidity providers. This ranges from short-term through to medium and long-term traders, all of whom act to keep spread narrow and price discovery efficient. Only a healthy balance of market participants with differing trading objectives can smoothly and efficiently transfer risk facilitating best execution and proper risk management whilst keeping volatility and transaction costs down.

11 Q11 *How easily could the FTT tax be circumvented by market operators?*

11.1 It must be borne in mind that, given the potentially significant costs of the FTT to market operators, they may look to circumvent the FTT. Relocation of transactions, if not operations, to non-EU jurisdictions, particularly by large multi-national market operators, could become common and would be relatively simple to achieve, especially for derivatives which need no geographical nexus to be executed.

Impact of the FTT in the UK

Q12 *What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?*

12.1 Such an FTT, if implemented, is likely to have disproportionate significance for the UK. An EU-wide FTT would take precedence over the UK stamp duty and while it is yet to be legislated, it has been suggested by the Commission that the revenue raised by the FTT would be channelled towards supporting the EU budget, ahead of providing any support to Member States. It is estimated²² that the FTT would mean that transactions with a UK source would contribute between 71% and 80% of the tax. However, despite raising a significant portion of the tax revenue, the UK would receive little of the benefit. It should also be noted that, for example, London branches of German banks would be liable for FTT in Germany under the residence principle proposed, so that the direct contribution to the tax by the City of London may be difficult to quantify.

12.2 The success of the City in establishing itself as a centre for foreign exchange transactions stems, at least in part, from its regulation and taxes. The 2010 survey of currency trading conducted by the Bank for International Settlements shows that foreign exchange turnover in the UK reached more than \$1.9 trillion on a daily basis, accounting for approximately 37% of the global total. Further, the London Stock Exchange currently has the fourth largest domestic equity market capitalisation in the world, after exchanges in the USA and Japan, but remains larger than those in other European countries and in Hong Kong and Shanghai²³. London is also the most active centre in the world when it comes to trading in Eurobonds. New Eurobonds and medium-term notes issued in London during 2010 were equivalent to £416.6bn.

²² Schulmeister, S., M. Schratzenstaller, and O. Picek, 2008, "A General FTT: Motives, Revenues, Feasibility and Effects," Oesterreichisches Institut fuer Wirtschaftsforschung working paper, Vienna.

²³ World Federation of Exchanges, June 2010

12.3 In addition, the UK has the largest financial derivatives market, with an average daily turnover in interest rate derivatives of just over \$1.4 trillion, equivalent to approximately 46% of the total²⁴.

12.4 Further, the UK has the largest asset management business in Europe, accounting for just under a third of the entire market, calculated on a net asset basis. As many as 50,000 people are employed in the UK's fund management business (more than 30,000 in the hedge fund industry), accounting for 0.7% of UK GDP in 2010²⁵. Clearly, a FTT holds severe implications for London.

12.5 As noted above under question 8, the impact of the FTT will be much wider than for the financial services sector alone, with reduced returns for private investors and pension savers and higher costs of goods being among the most significant potential impacts.

13 Q13 *How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?*

13.1 As noted above, we consider that the cost burden associated with the FTT would lead to substantial migration outside the EU as for many in the industry it would be the only option, if they wish to continue to operate. The experience of the UK's stamp duty is not directly comparable as it applies to the purchase of, for example, UK shares, regardless of where the buyer or seller is located. This contrasts with the proposed FTT, which incentivises market participants to relocate outside the EU to avoid the tax. The initial relocation of transactions outside the EU would be closely followed by a relocation of people undertaking the trading activity which would be closely followed by people (and businesses) providing support services to the trading.

Q14 *Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?*

14.1 Depending on how the bank levy is calculated in a particular jurisdiction, there is a significant risk that the FTT, whilst not necessarily duplicating the bank levy, would be a significant additional burden to an affected institution, which would likely pass on the cost, particularly of the FTT, to its clients (the investors).

Implementation

Q15 *Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?*

²⁴ Bank for International Settlements, April 2010

²⁵ The City UK Fund Management Research Report (2011): <http://www.thecityuk.com/assets/Uploads/Fund-Management-2011.pdf>

15.1 In our view a FTT could not plausibly be introduced at an EU level as the risk of relocation and dislocation of markets is too great. Further, we also question whether a FTT introduced at a global level would be effective, given the potential (negative) impact on growth and significant impact on individual investors and savers.

15.2 The introduction of the FTT by certain Eurozone countries alone would be less damaging on the UK economy than an EU wide implementation; however, the UK financial services industry would nevertheless still be affected. UK banks would often still have Eurozone counterparties and operations in Eurozone countries. Similarly, banks based in the Eurozone countries might have operations in the UK which could be subject to the tax, especially having regard to the proposed definition of residence.

7 November 2011

The Association of Private Client Investment Managers and Stockbrokers (APCIMS) – Written evidence

1. APCIMS would like to flag with the Committee the impact that a Financial Transaction Tax (FTT) would have on ordinary individual investors.
2. Whilst the European Commission's objective appears to be for the financial sector to contribute more fairly to the costs of the economic crisis and perhaps in the future for any other significant financial "issues", any tax imposed on financial institutions will, where possible, be passed on to end-investors. For APCIMS-type firms who operate in an agency capacity, all such tax will likely be passed on to consumers.
3. Whilst we are not in a position to be able to judge what impact the FTT could have on investor attitudes, we do know that for the first time in the UK individual investors would have to pay tax when they sell as well as when they buy securities. In 2010, over 20.7 million trades were executed on behalf of retail clients, the vast majority of those in low-risk, non-complex products. Why should those investors contribute to the "failings" of institutions in other parts of the financial sector over which those individual investors have had no influence or control? Why should they have to contribute to a European fund when the vast majority of their trades are executed in UK domestic equities? We believe that just by posing such questions, it brings into question the whole principle behind such a tax.
4. As the Commission's "Frequently Asked Questions" make clear, 10 Member States already have a form of financial transaction tax in place. APCIMS believes that it is for individual countries to judge how their individuals and companies should be taxed, mindful of the need to ensure growth and investment and also mindful of their competitive position with other countries. Whilst APCIMS does not support the imposition of Stamp Duty and SDRT in the UK, a FTT will presumably require the UK to lose that revenue and somehow regain it in other ways.
5. Is it realistic to believe from Page 3 of the Commission's proposal ("The financing of the EU Budget") that the tax raised and to be potentially used as a new own resource in the EU Budget will result in a reduction in existing national contributions? The EU Budget has failed to have its accounts signed off by the European Court of Auditors on a large number of occasions and it is questionable whether investors would invest in a FTSE 100 company in a similar financial position.
6. The FTT may seek to target financial institutions but in many cases it will catch individual investors who played no part in the original financial crisis. APCIMS believes that the best way to ensure that financial institutions "pay their fare share" and do not cause future financial instability is to make sure that they are appropriately and properly regulated and adequately capitalised.

7 November 2011

Association for Financial Markets in Europe (AFME) – Written evidence

- I. The Association for Financial Markets in Europe (AFME) welcomes the opportunity to provide evidence to the House of Lords European Union Economic and Financial Affairs and International Trade Sub Committee. AFME represents a broad array of European and global participants in the wholesale financial markets and advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society. Our members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association).

Q1 (i) Is there a case for the introduction of a tax on financial transactions?

AI (i) - Summary

- I.1 In the light of the financial crisis, policymakers are, rightly, looking for ways to tackle systemic risk in the global financial system in order to achieve financial stability. We believe that proportionate regulation, designed carefully to address the specific problem identified, not new taxes that apply indiscriminately, is the right policy solution.
- I.2 The European Commission's proposed financial transaction tax does not help to deliver this strengthened financial system and would act as a tax on growth. It is based on flawed assumptions about the financial markets and their functioning and would have an adverse impact on almost every business and household in Europe.

The Negative Impact on Growth

- I.3 As the European Commission's impact assessment demonstrates²⁶, taxes on financial transactions would have a significant negative impact on growth in Europe.
- I.4 A tax on financial transactions would raise the cost of doing business for all sectors of the European economy, by increasing the cost of capital and discouraging investment²⁷.
- I.5 It would also risk creating wider inefficiencies in the economy²⁸. A tax on financial transactions – and particularly one that cascades throughout the economy, being payable on each transaction - would discourage transactions undertaken with financial sector firms, and weaken the ability of banks and others to perform their intermediation function - the critical role that the financial sector plays in the

²⁶ European Commission Impact Assessment Vol I page 51

²⁷ European Commission Impact Assessment Vol I 6 page 40, estimates a "sizeable long-run negative impact...on the real economy via firms' financing channel"

²⁸ European Commission Impact Assessment Vol I 1 page 4

economy, helping to ensure that capital and investment flows to where it is needed and can be used most productively to deliver growth and jobs.

- I.6 The Commission's own analysis demonstrates that these consequences could lead to a decrease in EU GDP in the long run of 1.76%²⁹. Moreover, initial analysis of the Commission's Impact Assessment indicates that the Commission's model may have failed to capture all of the potential negative impacts on growth, and that the effects could therefore be greater than their Impact Assessment suggests – we are exploring this matter further and may therefore need to write further to the Sub-Committee in the light of this additional work.
- I.7 At a time when the risk of recession in Europe is increasing³⁰, the focus of EU policy should be on measures that enhance growth and jobs and not on measures that both discourage investment and fail to take account of the new regulatory requirements that are in train.

The Negative Impact on Citizens

- I.8 Although the ostensible focus of the Commission proposal is financial transactions carried out by financial institutions, individual citizens and SMEs would not be shielded from its effects. In addition to the negative consequences for jobs and growth that the tax would bring, the tax would also have implications for the cost of the financial services products on which European citizens rely.
- I.9 The Commission's Explanatory Memorandum argues that citizens will be unaffected as "*most day-to-day financial activities relevant for citizens*"³¹ would be outside the scope of FTT. While it may be true that individual citizens would not pay the tax directly when they sign a contract for car insurance or take out a mortgage or invest in their pension fund, they would nevertheless be affected, as those retail transactions often rely on financial transactions elsewhere in the chain that *would* incur the tax³².
- I.10 The pension funds, on which many Europeans rely for their retirement income, would pay the FTT when they are investing individuals' contributions or using derivatives to hedge against risks, thus reducing returns; the providers of credit to households and to SMEs would pay the tax when accessing the wholesale financial markets to secure funding, thereby increasing the cost of borrowing.
- I.11 And the impact of an FTT on returns would have to be added to the consequences of other planned regulatory changes – though it is not apparent that this has been understood. Pension funds, for example, are already concerned about the negative impact on the performance of their investments that will result from pending changes to capital requirements and new rules on derivatives clearing.

²⁹ This is the 'baseline' scenario for the FTT; the best case scenario if the FTT's final design avoids the biggest negative impacts is still a loss of GDP of 0.53%

³⁰ European Commission Interim Economic Forecast, September 2011

³¹ Explanatory Memorandum accompanying European Commission proposal Page 8

³² "*Taxes on the financial sector could have a progressive effect if they fall disproportionately on high-income individuals, but middle and lower-income earners would also be affected*" – Vol 14 of European Commission Impact Assessment

- I.12 Given the potential for the FTT and the range of regulatory initiatives now being discussed at EU level to have significant cumulative impacts we believe that it is essential that a comprehensive Impact Assessment is produced, to inform policymakers' decisions.

Q1 (ii) Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

- I.13 The exemption from VAT for most financial and insurance services does not benefit the suppliers of those services. Financial services firms are obliged to pay substantial amounts of VAT on the inputs that they purchase from their suppliers, but unlike firms in other sectors they are unable to reclaim the tax that they have paid.
- I.14 Research has been undertaken by the Commission, and by the University of Warwick, with PwC, as to the effect of the VAT exemption for most financial and insurance services.
- I.15 Volume 6 of the Commission's impact assessment states that "the data suggest that the VAT exemption leads to an advantage in the range 0.11% to 0.17% of GDP....It should be noted that all these estimates are very rough approximations and should be interpreted with caution given the strong assumptions made when calculating the irrecoverable VAT."
- I.16 A press release from PwC states that "New research by Professor Ben Lockwood of the University of Warwick undertaken with PwC has revealed that the VAT exemption which applies to European banks does not lead to a tax advantage for the banking sector. The report³³ concludes that if bank services were subject to VAT (in place of the current exemption system) this would not lead to any significant increase in EU VAT revenues."
- I.17 We consider that the logical next step would be to try to reconcile these two sets of findings – and to assess the methodologies and assumptions used – before concluding on the effect of the VAT exemption.

Q2 What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

- 2.1 An additional financial sector tax appears to assume that the sector is in some way undertaxed at present. However, the assertion that the financial services sector is not paying its fair share and that this justifies an FTT is not supported by the evidence.
- 2.2 As the Commission's own Impact Assessment demonstrates³⁴ the sector is assessed for corporate and personal income tax in exactly the same way as other parts of the economy.

³³ University of Warwick with PwC: "How the VAT exemptions impact the banking sector"; October 2011

³⁴ European Commission Impact Assessment Vol 4 page 27: "We found no evidence that banks have a significantly lower or higher corporate income tax burden than companies active in other sectors. As a general rule, the applicable standard corporate tax

- 2.3 However, it differs from other sectors in that it is not required to charge VAT on its services and, therefore, is unable to reclaim the substantial amounts of VAT that it pays on purchasing goods and services from other sectors of the economy – this contribution, as well as the contribution that the financial sector plays in creating employment in the real economy in the locations from which it operates, is often overlooked. See also comments at A2 (ii) above.
- 2.4 Following the IMF report to G-20 in June 2010, several Member States have introduced levies on certain financial institutions. Such levies are intended to collect a fair and substantial contribution for the risks posed by the financial sector to the rest of the economy (albeit that the new regulatory measures that are being introduced in the light of Basel and FSB work will substantially reduce these risks). The contribution of the sector to government revenues is already demonstrably substantial in most Member States. In assessing any proposal for additional taxes, we would urge governments to take full account of the overall tax contribution from the sector. It should also be noted that financial institutions already make substantial contributions to deposit guarantee schemes and investor compensation schemes to ensure that eligible depositors and eligible investors are covered up to a maximum limit in the event that a deposit-taking institution or investment firm is unable to make payment. While these contributions do not generally constitute taxes as such, they should be recognised as significant financial contributions which mitigate the risks posed by the sector to the wider economy.

Q3 What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

- 3.1 We believe that the empirical evidence shows that where new transaction taxes are introduced, there is a clear and significant risk of relocation (and hence the desired revenues are not in fact raised). In the case of Sweden, transaction taxes caused migration of trading to London, with the effect that the taxes did not raise the expected revenues, and the taxes were subsequently abolished. The report “Financial transaction taxes: the international experience and the lessons for Canada” (prepared for the government of Canada) considers this case in some detail. It states that “with the 1986 announcement that the equity tax would double, 60% of the trading volume of the 11 most actively traded Swedish share classes, accounting for one half of all Swedish equity trading, moved to London. Foreign investors reacted to the tax by moving their trading offshore, while domestic investors reacted by reducing the number of their equity trades. Even though the tax on fixed-income securities was much lower than that on equities, the impact on market trading was much more dramatic. During the first week of the tax, the volume of bond trading fell by 85%. Once the taxes were eliminated, trading volumes returned.”
- 3.2 There are other cases in which a transaction tax still exists. This is the case with the UK’s stamp duty, but it is important to recognise that this includes special arrangements for financial markets. The UK government has always recognised that it

rate (including any municipal rates), computation of the tax base, deductible items or tax reliefs and so forth are generally the same for banks as for companies active in other sectors”.

is beneficial to companies in the wider economy that intermediaries should offer to buy and sell their securities. Intermediaries are therefore exempted where they provide this service. The UK government has also progressively reduced the rate of the tax, with a view to eventually abolishing it. It might be thought that reducing the rate of the tax, and eventually abolishing it, might lead to lower revenues for the government. The report “Stamp duty: its impact and the benefits of its abolition” (Oxera; May 2007) considered this matter. In summary, the findings were that the likely effects of abolishing the tax would be as follows: reduction in the cost of capital for listed companies in the wider economy, an increase in GDP, and higher revenues from other taxes, so that, overall, the government would raise more revenues by abolishing the tax.

Q4 What is your assessment of the Commission’s objectives as contained in its proposal for an FTT? Are they fair and appropriate?

- 4.1 The Commission’s objectives as contained in the proposal are as follows:
- to ensure that the financial sector contributes to covering the costs of the crisis
 - to ensure that the financial sector is taxed in a fair way vis-a-vis other sectors for the future
 - to disincentivise excessively risky activities by financial institutions
 - to complement regulatory measures aimed at avoiding future crises
 - to generate additional revenue for general budgets or specific policy purposes
 - to prevent distortions through measures taken unilaterally by Member States.
- 4.2 We believe that these are broadly appropriate objectives for public policy to pursue. However, we question whether the introduction of a new Financial Transaction Tax is necessary for their achievement or is the most appropriate mechanism to deliver them.
- 4.3 For example, there is no evidence that the financial sector is not taxed in a “fair” way compared to other sectors, given that it contributes to government revenues through a range of existing taxes, some of which are specific to the sector. The evidence indicates that the financial sector already pays at least as much tax as any other sector (for the same level of profits).
- 4.4 Moreover, there are no strong grounds to justify a new EU-wide transaction tax as being necessary now to prevent distortions – where Member States have introduced new taxes following the crisis they have not been in the form of transaction taxes but in the form of bank levies. We do not consider that the existence of long-standing securities transaction taxes in some Member States justifies a new EU-wide transaction tax. And given that an FTT applies to *all* financial transactions, it will not only raise the cost of those transactions that are held to be “risky” but also disincentivise the use of financial transactions that are very clearly undertaken in

order to *improve* the management of those risks that firms (financial and non-financial) face as a normal consequence of their business.

Q5 Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

- 5.1 Our understanding is that the economic effects of transaction taxes (whether applied to a narrow base or a broad base) are generally to raise the cost of capital for companies, to reduce security prices (and hence the value of savings such as pensions), to reduce investment and, in consequence, to reduce GDP. Financial transaction taxes also encourage relocation of business where this can be achieved – thus reducing the expected yield. See also comments at A3 above.
- 5.2 We believe that the Commission proposal would suffer from all of these serious disadvantages.

Q6 On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?

- 6.1 We do not believe that an FTT should be levied on financial transactions, for the reasons given in our response to question 5.

Q7 Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?

- 7.1 We have two concerns about the residence principle
- that it would lead to significant relocation; transactions carried out by two non-EU entities would not be subject to the tax.
 - that the definition of “establishment in the EU” – which appears to cover any undertaking conducting business with an EU client wherever that undertaking may be – may constitute extra-territorial legislation; and the EU has argued in other contexts against such legislation being imposed from outside the EU.

Q8 How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

- 8.1 The FTT may raise revenues, but there are serious doubts about whether they are sustainable, and whether those revenues are sufficient to justify the significant costs to the economy. Moreover, given that the Commission proposal for an EU-wide FTT would require the removal of existing, national measures such as UK Stamp Duty the overall revenue effects for individual Member States would have to be considered carefully.

- 8.2 The true incidence of securities transaction taxes arguably fall on the investor/consumer, and the same would be true of the FTT.
- 8.3 Any revenues from an FTT should be used for such purposes as the relevant Member State determines.

Q9 Would the Commission’s proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

- 9.1 The FTT risks aggravating the very problem of volatility that it is intended to address.
- 9.2 The Commission’s Impact Assessment states that “Several studies show that a FTT could even aggravate volatility (because of a reduction in the number of transactions), creating more room for speculators.”
- 9.3 It would also discourage sound risk management, by making it more expensive to carry out those hedging transactions that are a normal part of most businesses’ operations.

Q 10 What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?

- 10.1 Securities transaction taxes generally reduce market liquidity. We believe that this would also be the case for an FTT.
- 10.2 An FTT would have little effect on speculation in sovereign debt markets relative to proposed regulatory reforms. While some primary market transactions are exempted, the impact of the FTT to secondary market transactions will impact Governments’ finance raising.

Q11 How easily could the FTT tax be circumvented by market operators

- 11.1 Transactions between two non-EU entities would not be subject to the EU FTT.

Q 12 What impact would the FTT have on the UK’s financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

- 12.1 The FTT would be damaging for Europe as a whole and in particular for Europe’s financial centres.
- 12.2 The FTT would be damaging for the UK economy more broadly, for the reasons given at 5 above.
- 12.3 If a significant proportion of any transaction tax accrued in London, it would ultimately be borne by savers and investors in the underlying investments. Many such savers and investors would likely be British citizens.

- 12.4 There is a wider question in each Member State as to the implications for their taxpayers as a body, given the Commission's proposal that tax revenues would be remitted to the Commission and that other contributions from Member States to the EU budget would be correspondingly reduced.

Q 13 How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

- 13.1 We consider that there is a high likelihood of relocation outside the EU or migration towards less regulated parts of the financial sector.
- 13.2 The UK experience indicates that operating a securities transaction tax in what is essentially a closed economy can be achieved – and that the relevant stock exchange can still be successful – but at a cost to savers, investors and the wider economy, and with implications for the investment choices available to investors.

Q 14 Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

- 14.1 The tax base for an FTT would not be the same as the tax base for a bank levy. An FTT would therefore not *duplicate* the bank levy, though it would be an additional tax.

Q15 Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

- 15.1 We consider for the reasons given above that an FTT would not be effective at any level, whether global, EU or eurozone.
- 15.2 The costs of any FTT will be borne by users of financial products, so without agreement on a global tax, and to the extent that even with relocation of business some taxpayers continue to have their transactions subject to the tax, such taxpayers would be disadvantaged compared to taxpayers undertaking transactions free of an FTT and there would be a negative impact on GDP; the shift of financial sector business out of jurisdictions imposing an FTT to countries not doing so will also reduce GDP.

9 November 2011

Association of British Insurers (ABI) – Written evidence

Introduction

1. The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.
2. The ABI's role is to:
 - a. Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
 - b. Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
 - c. Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
 - d. Promote the benefits of insurance to the government, regulators, policy makers and the public.
3. The ABI is grateful for the opportunity to provide evidence to the Committee's inquiry into the EU Commission's proposal for a Financial Transaction Tax (FTT).
4. The ABI is strongly opposed to the proposed introduction of a FTT. We believe that such a tax will impose considerable costs not only on the financial services industry but on the wider economy across the EU as a whole and is likely to have a particularly significant impact in the UK.
5. Our responses to the detailed questions posed by the Committee are set out in the attached annex. At the end of the annex is a copy of a public letter to the Chancellor sent jointly by the ABI and other leading financial services trade associations regarding the financial transaction tax.

ANNEX - Questions for Consultation

PART I General questions on financial sector taxation

1. Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

Research undertaken in the Commission's impact assessment found that there were no significant differences in the tax treatment of the financial sector compared to other sectors, with the exception of VAT, and that transaction taxes "are not really effective to compensate for the VAT exemption".

It should be noted that the analysis of taxation of the financial services sector used in the Commission's impact assessment considered only banks, and did not look at taxation of the insurance sector³⁵. This means that 'findings' on the level of taxation in the sector do not take into account Insurance Premium Tax, which is often presented as a substitute for VAT on insurance contracts. In the UK, Insurance Premium Tax receipts for 2009/10 amounted to £2.3bn.

In any case, the VAT exemption does not result in the insurance sector being under-taxed – rather, the effect is that insurers bear the cost of this tax as they are unable to reclaim the input tax. In the year to March 2011 ABI member firms suffered irrecoverable VAT of £880 million.

2. *What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?*

In our response to the EU VAT Green paper the ABI argued that taxation of the financial sector could be rationalised by abolition of the Insurance Premium Tax, and the concurrent extension of VAT to financial services. We continue to believe this to be the most appropriate resolution of VAT issue and it would also help in the Government's ongoing project to simplify the tax system.

We expect that it would have a neutral effect on the pricing of insurance premiums – which currently factor in the irrecoverable costs borne by the industry of VAT on the goods and services that it consumes, along with the cost imposed by the UK's existing Insurance Premium Tax. Replacing IPT with VAT would also reduce administration costs both for the industry and for the Government.

We believe that, as indicated by the Commission's research, there is no other significant difference in tax treatment of the financial sector. The notion that the financial sector as a whole should be punitively taxed to recompense for the impact of the financial crisis is flawed, since not all parts of the sector contributed to the crisis. In particular, insurance acts as an absorber rather than a magnifier of shocks in the financial system – they are not reliant on wholesale markets for liquidity, and policyholders are not generally able to withdraw funds at short notice without significant financial penalties. It has been widely accepted that traditional insurance business does not create systemic risk, and did not lead to the demise of any company during the financial crisis (in the case of AIG it was risky capital markets activity by a non-insurance subsidiary that led to its bailout – all the traditional insurance activity of AIG was fully solvent and profitable).

Regardless of views on the comparative level of taxation of the financial sector there are significant detriments to all the suggested additional taxes. In particular, it is very difficult to see how a currency transaction tax could be compatible with EU law, as the Commission have explicitly acknowledged. Both a standalone securities transaction tax and a standalone derivatives tax would create severe market distortions as investments would shift wholesale towards whichever product was left untaxed.

³⁵ FTT Impact Assessment Annex 3, §1.1.4, European Commission, 28th September 2011

In April this year, the ABI detailed a number of concerns with the various methods of “FAT” (Financial Activities Tax) that the Commission proposed in their original consultation on taxation of the financial sector. These concerns still stand, in particular:

- difficulties in connecting the “addition method” FAT with the existing VAT system;
- challenges in defining the “normal” or “high” level of remuneration above which a “rent taxing” FAT would apply (such definitions would be entirely subjective);
- for the “risk-taxing” FAT, the impossibility of pinpointing when an acceptable level of risk becomes an unacceptable (and hence taxable) level of risk – especially when acceptable levels of risk in many areas will depend not only upon the activity but the specific economic and political circumstances;
- the significant risk that a FAT imposed at EU level would increase costs for businesses domiciled in the EU and could lead to some businesses moving some of their operations to non-EU jurisdictions; and
- the additional costs for the insurance sector would inevitably lead to price increases for consumers. This would be counter-productive for governments as increased costs could lead individuals to invest less in products such as risk protection or old age provision resulting in additional costs falling on the state.

3. *What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?*

It is evident from the Swedish experience that transaction taxes prompt a migration of business to jurisdictions which do not have such a tax. The Commission’s impact assessment acknowledges this but suggests that implementing the tax on an EU-wide basis will result in little or no relocation of business.

In reality, as acknowledged elsewhere in the impact assessment, the financial services business is highly mobile and with such costs it is very highly likely that there would be large-scale leakage of business to non-EU jurisdictions. The Commission muddy the waters by accepting this scenario in some aspects of their assessment, but ignoring it in others. For example, a reduction or relocation of derivatives transactions by 70-90% and securities transactions by 10% is assumed when calculating the revenue potential of the tax. However in the assessment of impact on GDP, only the securities element is taken into account, and it is assumed that no relocation takes place.

The UK, and the City of London in particular, compete with a number of other financial centres as a base for financial transactions. Most of the major competitors are outside the EU, and while the proposed tax would give no incentive for relocation within Europe, it is certain that a large amount of business would be lost to centres such as New York, Singapore, Dubai or Zurich.

It is important to note that the original rationale for any such tax developed by economic theorists (e.g. Keynes and Tobin) has always been predicated on worldwide implementation. There is no realistic prospect of global adoption of a financial transaction tax, as many of the largest non-European jurisdictions (including the USA, Canada, China, Australia and Singapore) have clearly stated that they will not introduce such a tax and thus the proposal is fatally undermined.

PART II Specific questions on the Commission’s proposal for an FTT

Rationale for an FTT and scope

4. *What is your assessment of the Commission’s objectives as contained in its proposal for an FTT? Are they fair and appropriate?*

At various points in the proposal, the Commission puts forward five distinguishable objectives for the FTT:

- to prevent distortion of the internal market through unco-ordinated taxation of the financial sector;
- to ensure that the financial sector makes a “fair and substantial contribution” to the cost of the crisis;
- to remedy ‘under-taxation’ of the financial sector;
- to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets (i.e. to tackle market failures and and/or systemic risk); and
- to create a new revenue stream that will gradually displace national contributions to the EU budget.

The ABI fully supports the objective of bringing about greater co-ordination of taxation of financial services in the EU, and has for some time argued that the current patchwork application of Insurance Premium Taxes across the continent is inefficient and burdensome to both industry and governments. A FTT, however, is not an appropriate solution to this problem – as the Commission’s own impact assessment notes, “Transaction taxes ... are not really effective to compensate for the VAT exemption”.

In any case, we contest the view that the financial sector as a whole is under-taxed. While VAT is not levied on certain financial products, this does not mean that the financial sector does not pay VAT. On the contrary, unlike businesses selling products which are subject to VAT, the finance sector is unable to reclaim the VAT they pay on goods and services that they purchase. As noted in our response to Q1, in the year to March 2011 ABI member firms suffered irrecoverable VAT of £880 million.

The Commission’s own research on this subject produces results which are in their own words “very rough approximations and should be interpreted with caution”³⁶. More recent research by PricewaterhouseCoopers and Warwick University concludes that “It is safe to draw the overall conclusion that the case is not made that the VAT exemptions for financial services lead to a lower taxation level ... the effects can be positive or negative, depending on the year, but are generally very small, and consistent with the position that the financial sector is neither overtaxed, nor undertaxed with respect to VAT.”³⁷

In the case of the insurance sector specifically, we maintain that the additional burden of Insurance Premium Tax (which is often also presented as a “substitute” for VAT) means that the balance is tipped very much towards overtaxed.

³⁶ FTT Impact Assessment (p.14), European Commission, 28th September 2011

³⁷ How the EU VAT exemptions impact the Banking Sector, PwC, 18th October 2011

It is also important to note, as observed in our reply to Q1, that the Commission’s analysis of taxation of the financial sector looked only at banks – thereby conveniently ignoring Insurance Premium Tax, and predicating its arguments on the false notion that all elements of the financial sector are taxed in equal manner and proportion.

The objective of eliciting a fair and substantial contribution to the cost of the financial crisis, while understandable, is not best achieved through an unfocussed initiative such as the proposed FTT, which would encompass sectors which did not contribute to the crisis, and were not responsible for the costs incurred by governments in resolving the crisis.

As the Commission’s own impact assessment points out “a large part of the burden would fall on direct and indirect owners of traded financial instruments”³⁸. The Commission also acknowledge that when the IMF considered financial transaction taxes, their conclusion was that they had a “cumulative and cascading effect which may fall largely on final consumers rather than financial institutions”³⁹. As a means of reallocating the cost of the crisis, an FTT would therefore be inefficient and poorly targeted.

As a means to create ‘appropriate disincentives’ for undesirable transactions, the FTT is woefully inadequate. It does not make any distinction between types of transaction beyond a simple division into “derivative transactions” and “other transactions”. On a very basic view, a low-level FTT will by definition be more of a disincentive to low-margin, low-risk transactions than to high-margin, high-risk transactions. There is a strong risk that an FTT would in fact incentivise more complex and less transparent transactions, or encourage companies to effect the transactions through subsidiaries in jurisdictions that do not apply a FTT. In their analysis of financial transaction taxes, the IMF concluded that “... a FTT does not focus on the core sources of instability”⁴⁰ and that the corrective attributes of a FTT have significant disadvantages.

Furthermore it is immediately apparent that the last two final two objectives conflict with each other - to the extent that an FTT is successful in reducing certain types of transaction it will be less successful in raising revenue. The idea that an FTT could generate a revenue stream that would replace national contributions to the EU budget is undermined by the finding of the impact assessment that “short run elasticities [of financial transactions] are lower than long run elasticities ... the [revenue] estimates do not cover this dynamic effect which reduces the tax base over time.”⁴¹

5. *Does the Commission proposal for an FTT reflect the most desirable design for an FTT?*

The ABI does not believe that a transaction tax is practical under any of the designs considered by the Commission. Some of the transaction tax designs considered, such as applying the tax to currency transactions, would contravene European law protecting the free movement of capital.

Questions 6 and 7: We have no comments on these questions.

³⁸ FTT Impact Assessment (p.53), European Commission, 28th September 2011

³⁹ FTT Impact Assessment (p.11), European Commission, 28th September 2011

⁴⁰ Financial Sector Taxation: The IMF's Report to the G-20 (p.17), IMF, September 2010

⁴¹ FTT Impact Assessment Annex 11, p.15-16, European Commission, 28th September 2011

8. How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

With respect to **revenues**, it should be noted that the Commission's estimates of the potential revenue raised are based on a "best of all possible worlds" scenario, which selects the most optimistic base assumptions and ignores many salient factors. For example:

- It assumes the most optimistic scenario of potential decrease in derivative trading (70% decrease rather than 90% decrease)
- It does not take into account the impact on revenues from other taxes

The latter is particularly relevant for the UK, since the Commission's proposal requires Member States not to 'introduce or maintain' any other transaction taxes – meaning that Stamp Duty and Stamp Duty Reserve Tax would have to be abolished, at a cost to the Exchequer of £4bn.

Other questionable aspects of the revenue calculations include that the estimated figure of 85% of all financial transactions as being undertaken by financial institutions is based on data from foreign exchange markets and OTC interest rate markets only - despite spot currency transactions not even being included in the tax, and OTC interest rate and foreign exchange derivatives representing only a third of the total predicted revenues).

The Commission's impact assessment also makes no estimate of the FTT revenue that would accrue to each Member State. Studies cited in the impact assessment estimate 62% of FTT revenues would be collected on transactions undertaken in the UK – but under the Commission's proposals, the tax revenue would be accrued to the country in which the party to the transaction is established. Thus a significant proportion of the revenues from transactions undertaken in the UK would not be received by the UK.

Furthermore the impacts of relocation, of the reduction in GDP and of the reduction in transactional activity would be likely reduce revenues from corporation tax, income tax and national insurance. One of the main factors in Sweden's decision to abolish their own FTT in 1991 was that net tax revenue decreased for exactly this reason.

An analysis of the Commission's proposal by Clifford Chance notes that it is "perhaps the first tax in history which is being proposed in the knowledge it will reduce tax revenues".⁴²

On **the reliability of a FTT as a revenue stream**, the Commission's impact assessment notes that "the short run elasticities are lower than the long-run elasticities. The [revenue] estimates do not cover this dynamic effect which reduces the tax base over time."⁴³ The FTT would therefore not provide a reliable revenue stream.

With regard to **the incidence of the tax**, the Commission's impact assessment indicates that "A large part of the burden would fall on direct and indirect owners of traded financial instruments."⁴⁴ This will include pension-holders, savers, and insurance policy-holders. It will

⁴² The Financial Transaction Tax – 14 questions and answers, Clifford Chance client briefing, September 2011

⁴³ FTT Impact Assessment Annex I I p.15, European Commission, 28th September 2011

⁴⁴ FTT Impact Assessment p.53, European Commission, 28th September 2011

also impact the cost of ‘fixing’ the price of a wide range of products, such as mortgages, utility bills, advance travel fares (see joint trade association letter to the Chancellor, which follows our answers to these questions).

Given the strong possibility that the FTT will result in lower rather than higher tax revenues for Member States, the ABI does not feel it is appropriate to comment on how any supposed revenue should be spent. The question for the UK Government should rather be how the net revenue loss would be covered.

Impact and effectiveness

Questions 9 and 10: We have no comments on these questions.

11. How easily could the FTT tax be circumvented by market operators?

The Commission’s impact assessment notes that the FTT could be circumvented by moving trading activities to subsidiaries or other related entities in a third non-taxing country and repatriating profits via dividends (which would be exempt either under the non-taxing country's domestic law or under its double taxation agreements), or via transfer pricing arrangements.⁴⁵

It is also unclear how a tax on the notional amount of a derivatives contract could be constructed to prevent avoidance through altering the specification of the notional amount.

Impact of the FTT in the UK

12. What impact would the FTT have on the UK’s financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

Given the estimate that 62% of transaction tax revenues would be gathered from transactions undertaken in the UK, the impact on the UK financial services sector is likely to be significant. The Commission estimate that 70-90% of derivative trading will either cease or relocate.

The incidence of the tax under the current design would not necessarily fall on British citizens for transactions undertaken in London – this would depend on the ultimate beneficiary of the transaction. However all savers, investors or policyholders whose investments or policies depend on transactions between European financial institutions would feel the ultimate burden of the tax.

The estimated GDP impact of the tax, which for a 20 basis point tax would be 3.5% (only considering securities transactions, and assuming no relocation) would be unlikely to be evenly concentrated across the EU, but would be greatly magnified in Member States with significant financial centres. However, because of the structure of the tax, those Member States would not necessarily collect the revenues of the tax.

⁴⁵ FTT Impact Assessment Annex 7 p.7, European Commission, 28th September 2011

As noted earlier the Commission's impact assessment indicates that a large part of the burden of the tax will fall on direct and indirect owners of traded financial instruments, including individual savers, pensioners and investors.

13. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

It is certain that a FTT would result in relocation of parts of the financial services industry to non-EU jurisdictions. In addition, it would put UK and European financial services industries at a significant competitive disadvantage when dealing with non-EU financial institutions.

The UK's stamp duty has significant design differences to the Commission's proposed financial transaction tax, including a comprehensive system of reliefs. The ABI has also called for the abolition of stamp duty and SDRT on shares, which brings significant detriment to consumers through reduced returns on occupational pensions and stakeholder pensions. Abolishing stamp duty would also provide a boost to GDP and increase revenue from other taxes (capital gains tax, corporation tax and income tax).

Question 14: we have no comments on this question.

Implementation

15. Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

Many of the undesirable aspects of the FTT proposal would apply equally at whatever level it were to be introduced. There would still be a negative impact on end consumers of financial products, and on incentives to save and invest. There would still also be the mismatch between the focus of the economic impact, which would be concentrated in financial centres, and the destination of the revenues – which would be assigned to the jurisdiction of the transacting party rather than the jurisdiction where the transaction is undertaken.

A FTT in Euro area countries alone would nevertheless have a serious impact on the UK and on UK financial services (including insurers) since the UK's main trading partners are in the Euro area and hence a substantial proportion of business would still be affected.

24 October 2011

The Association of Corporate Treasurers (ACT) - Written evidence

1. The ACT qualifies, supports and represents professionals working in treasury, risk and corporate finance. Our 4,200 members and 2,400 students work widely in companies of all sizes through industry, commerce and professional service firms. Further information is provided on our website www.treasurers.org.
2. Our members working in non financial services companies are typically responsible for their company's dealings with the financial markets. A proportion of our members work in financial services firms but in making this submission we comment from the point of view of those working in non financial companies⁴⁶. References to the real economy are equally intended to refer to those business sectors not engaged in providing financial services.

General

3. This document is on the record and may be freely quoted or reproduced with acknowledgement.

Summary

4. The ACT does not support the proposal from the European Commission to impose a Financial Transaction Tax (FTT). If the objective is to subject banks to additional taxation in order to raise revenue we would advocate that this be carried out through taxation of profits or of added value (to include employee remuneration).
5. In an industry where there are significant barriers to entry for new competitors the imposition of an extra cost onto all participants will inevitably lead to it being passed through to end customers. Although the headline tax rates look low there is a very significant multiplier effect as each end customer transaction with a financial institution will often be the culmination of or the start of a long chain of dependent transactions. Equally one financial "need" in the end customer may generate transactions that are repeated or "rolled over" repeatedly or adjusted over time giving multiple taxable occasions.
6. The proposals for a FTT seem to presume that financial transactions in shares, bonds and derivatives are speculative and are therefore in some way risky and bad and must be penalised. The Commission fails to recognise that these sorts of transactions and the related markets assist in the provision of capital and risk reduction for companies and as such are essential for the operation of the economy. Furthermore, investment in shares and bonds with risks managed using derivatives is fundamental to operation of pre-funded pension schemes, etc. and to much of other savings by individuals.
7. For any commercial activity or investment a company needs to measure its return against the risk and the benchmark of cost of capital. Any addition to cost of capital will inevitably lead to reduced activity taken across the economy as a whole.
8. By way of example the impact of the 50 b.p. stamp duty on UK share transactions has been estimated as material were it to be abolished: "There could be a reduction in

⁴⁶ The ACT seeks to represent non-financial-sector corporates as explained in our Policy & Technical manifesto <http://www.treasurers.org/technical/manifesto>

the nominal post-tax cost of equity of 7% - 8.5% (or 0.66–0.80 percentage points), and in the nominal post-tax cost of capital of 5.4% - 6.5% (or 0.50–0.60 percentage points). (Report for the local government body for London and two investment organisations, *Stamp duty: its impact and the benefits of its abolition*, 2007, http://secure-uk.imrworldwide.com/cgi-bin/b?cg=downloadsedo&ci=cityoflondon&tu=http://217.154.230.218/NR/rdonlyres/27537B8B-E089-4A71-A41F-F7E7CA7FBE46/0/BC_RS_stampduty_FR.pdf.)

9. We believe that this is the most important side effect of any FTT. An increase in cost of capital inevitably means that economic activity is reduced as less profitable business activity ceases to be viable.

Response to specific questions

PART I General questions on financial sector taxation

1. *Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?*

No. The idea that the VAT exemption leads to a tax advantage for banks illustrates a widespread but incorrect belief. It does not. Banks suffer an additional cost because they cannot recover much of the VAT that they pay on their expenditures such as telecommunications and electricity.

If financial services were standard rated, banks would become "fully taxable persons" and be able to recover all of their VAT input tax. In turn they would charge VAT to their customers. Customers engaged in business would recover this input VAT and it would make no difference to them or to the prices they charge their own customers. Customers who were private individuals would have to bear the VAT as an additional cost, adjusting their expenditure elsewhere. Accordingly the real beneficiaries of the VAT exemption of financial services are private individuals and other non-business consumers of financial services.

2. *What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?*

If the objective is simply revenue raising targeted on the financial sector, the fairest approach and perhaps simplest would be through adjusting the tax rate in the existing regimes for taxation of profits (or of added value if it were desired to catch employee remuneration also). If somehow the tax politically needs to appear to be taxing excessive trading or "speculation" then a Financial Activities Tax would be a suitable format since depending on exact definitions this tends to tax adjusted profits in some form or another. Taxing profits after adding back remuneration might have a populist element by effectively not providing a tax deduction for remuneration. Increasing taxation on any particular sector or activity will

change the amount of that activity undertaken as society adjusts to the economic signals that are generated. Higher order effects may be material.

3. *What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?*

Others are better placed to answer this question.

PART II Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

4. *What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?*

The Commission states that it seeks i) to avoid fragmentation in the internal market; ii) to ensure financial institutions make a fair contribution; and iii) to create appropriate disincentives for transactions that do not enhance the efficiency of markets. These seem to be reasonable objectives but we do not believe that the FTT will achieve them.

Fragmentation can only be avoided if all countries in the EU impose the FTT.

Point ii) will not be achieved since undoubtedly the cost will be passed on to the end customer and not borne by the financial institutions. In a business where there are a comparatively limited number of players and high barriers to entry if every participant is hit with the same cost increase, the FTT, then it is clear that they will pass on that cost to the customers. If demand is price elastic, volume will be reduced.

Point iii) may well be achieved but only at the expense of also hitting perfectly reasonable financial transactions done by companies operating in the real economy

5. *Does the Commission proposal for an FTT reflect the most desirable design for an FTT?*
6. *On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?*

If there is to be a FTT then levying it on a wide range of instruments may seem fair and help avoid distortions and avoidance. Alternatively, it may just spread the damage to a wider area. We welcome the idea that issue of shares and bonds in the primary markets are to be exempt. However this provides only marginal relief for companies in the real economy. First, their cost of capital is affected by the rates demanded by the market through secondary trading and these will in turn be affected by the imposition of a FTT. Secondly, companies have to issue bonds where and in the form they can, using derivative transactions to switch to the currency and interest rate type they need and this can give rise to many and continuing additional transactions.

7. *Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?*

The residence principle may be a consequence of seeking to capture any transactions where at least one leg is in the EU. Of course the obvious next question is the extent to which transactions will migrate outside the EU. For larger international groups there will be the potential to divert group funding (perhaps excluding equity) or group hedging to more favourable regimes to the detriment of European financial markets and with internal inefficiencies for the company.

8. *How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?*

As mentioned in Q4 the true incidence of the FTT will fall onto end customers. SME's may have limited volumes of transactions and suffer limited impact, very large companies may well be able to move some of their financial transactions out of the EU thus perhaps leaving the mid-sized companies disproportionately affected

Impact and effectiveness

9. *Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?*

A FTT will add a cost to those engaged in high volume or high frequency trading and presumably damp down levels of activity if trading profitability is affected. However, there is no feature of the FTT that is risk related so it will not directly reduce risk taking. It will disproportionately impact complicated financial structures or schemes that are made up of a chain of transactions but that is not to say that complicated is the same as risky or even undesirable.

10. *What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?*

Others are better placed to answer this question.

11. *How easily could the FTT tax be circumvented by market operators?*

Others are better placed to answer this question.

Impact of the FTT in the UK

12. *What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?*

As more fully explained in the answer to Q13 below any FTT will inevitably adversely impact the cost of capital for businesses with a direct negative consequence for activity in the real economy.

The tax is proposed to be levied on both ends of a transaction, with joint liability, and on the entire chain of intermediaries that might be involved in generating one end transaction. The

multiplier effect as deals work through the market could quickly create a significant burden on the end user of financial transactions, increasing the real end tax rate by many multiples of the headline tax rate.

There is also a multiplier effect at the user end too. Consider an example. A company hedging an expected receipt of a foreign currency in 12 months time would do a deal to sell that currency 12 months forward. As that date gets closer the treasurer learns that the receipt may be delayed so they close off the original deal and reinstate it for a date one month later. This may be repeated several times and perhaps the amount adjusted too. The one hedging need generates multiple taxable events.

As another example a company with surplus cash may want to keep that cash readily available to meet business cash flows or contingencies so might place deposits for a week at a time. That would generate a tax rate 52 times higher as compared to a single one year deposit

13. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

The continuance of London as a major trading centre for shares is despite the imposition of stamp duty. The implication being that there are other advantages to the UK that more than compensate, e.g. availability of a stable legal system notably in the arena of insolvencies, a reliable judicial system, a favourable time zone etc.. Also within the chain of market making transactions stamp duty exempts all but the final transfer.

However the impact of the 50 b.p. stamp duty on UK share transactions has been estimated as material were it to be abolished: "There could be a reduction in the nominal post-tax cost of equity of 7–8.5% (or 0.66–0.80 percentage points), and in the nominal post-tax cost of capital of 5.4–6.5% (or 0.50–0.60 percentage points). (Report for the local government body for London and two investment organisations, *Stamp duty: its impact and the benefits of its abolition*, 2007, http://secure-uk.imrworldwide.com/cgi-bin/b?cg=downloads&ci=cityoflondon&tu=http://217.154.230.218/NR/rdonlyres/27537B8B-E089-4A71-A41F-F7E7CA7FBE46/0/BC_RS_stampduty_FR.pdf.)

And, while UK stamp duty exempts intermediary transactions, the proposed FTT would only exempt the central counter party (CCP) in a UK share sale and purchase transaction. So, a sale from a selling pension fund to the seller's broker, then on to the broker's clearing member of the CCP then on to the CCP, from the CCP to the buyer's broker's clearing member and onto buyer's broker and thence to the buying pension fund would add up to 10 times the proposed 0.1%, far higher than UK stamp duty. This multiplier effect would not occur in a jurisdiction where intermediaries act purely as agents.

A similar added cost effect occurs in the UK where collateral associated with many transactions is posted in the form of financial instruments by transfer of title, and so subject to FTT, and is avoided in jurisdictions where collateral is posted by way of security taken but not perfected.

We believe that the tax as added to cost to the ordinary financing and operation of commercial and industrial firms is the most important side effect of any FTT. An increase in cost of capital inevitably means that economic activity is reduced as less profitable business activity ceases to be viable in a jurisdiction levying a FTT.

14. Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

No comment

Implementation

15. Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

Financial transactions are more readily mobile as compared to physical transactions so without a widespread introduction there is bound to be scope for some transactions to migrate. Were a FTT is to be introduced it would be most effective if introduced globally. It would be damagingly distorting if introduced locally or regionally and this would add to the inherent negative effect of the tax on the real economy.

4 November 2011

AVIVA PLC - Written evidence

Aviva plc is the world's 6th largest insurance group. In 2010, it carried on general and/or life insurance business in 22 countries, generating pre-tax IFRS profits of £2,440m, representing a return on shareholders' equity of 14.8%. The Group employed approximately 45,000 people at 31st December 2010, of whom 20,762 were employed in the UK. Aviva had 19 million customers in the UK in 2010 (source: Aviva plc Annual Report & Accounts).

PART I – GENERAL QUESTIONS ON FINANCIAL SECTOR TAXATION

Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

1. Any new tax will either result in an increase in price of the taxed services or reduced profits for the producer, or a mix of the two. Reduced demand or supply of the products may also result.
2. If excessive profits were being generated, a Government guarantee provided, or the products were perceived to be 'bad', that could be an objective basis for introducing a new tax. In our view, it is wrong to tax all financial products and transactions in the same way. Insurance in the UK is either compulsory (as for motor vehicles) or beneficial for the customer and the Government, since houses and businesses are protected from risk and investments and pensions provided to retail customers. Profits from insurance are not excessive, but are consistent (in money terms) with other sectors, such as manufacturing and pharmaceuticals (source: ABI General Insurance Losses Report 2009). UK insurance companies were not supported by Government 'bail outs' during the financial crisis. It follows that there is no case for taxing the insurance sector's use of financial transactions as part of the everyday management of investments.
3. If insurance services were not exempt from VAT in 2010, then an additional (approximately) £2,545m of UK output tax in respect of services provided by Aviva would have been payable. However:
 - a) the increase in VAT would affect customers, not the financial sector; VAT on taxable supplies is borne by customers - were VAT to become payable on insurance services it would need to be passed on in higher product prices, as was done with the 2010 Insurance Premium Tax (IPT) rate increase;
 - b) it should be noted that there is a cost to Aviva of irrecoverable input VAT under current rules which gave a contribution to the Government of £138m in 2010;
 - c) additionally, Aviva's payments of IPT on insurance services to the Government totalled £280m in 2010.

(Note: - values re-calculated to allow for 20% VAT rate)

**What would be the most appropriate form for a taxation of the financial sector?
Would an FAT be preferable? Would variations of FTT be preferable?**

4. The financial 'bail outs' of UK banks were compensated for by the UK Bank Levy from which insurers are (correctly) exempted. Such taxes also encourage safe capitalisation of banks.
5. Hedge funds and similar traders in securities, which may generate volatility in markets, are mostly based in tax havens, so any tax designed to reduce market volatility or to recompense governments for its future consequences would need to be on a world wide basis to catch all substantial targets.
6. Other forms of financial tax such as Financial Activities Tax, currency transaction taxes etc. would have similar disadvantages to FTT if introduced only in Europe.

What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

7. The Swedish tax was charged on equity shares and options at rates which increased over the period from 0.5% to 2%. (Tax rates on fixed income securities were lower.) The effects were (broadly):
 - Equity share prices fell, as the market effectively sought to net out the incorporated capitalised value of future FTT payments against future capital gains;
 - Companies' cost of capital rose, with the impact being more noticeable for those with less liquid shares i.e. smaller companies;
 - Although bonds don't generally see the same volume of trading (with the FTT therefore having a lower impact), Sweden's Bond Markets were impaired with bond trading falling by around 85%, futures trading by around 98% and the options trading market effectively disappeared;
 - Government borrowing costs increased, even though the tax rates were relatively low, and similar to the FTT;
 - Mobile financial activities migrated from Sweden to non-taxed or lower-taxed jurisdictions (e.g. initially 60% of the trading volume of the 11 most actively traded Swedish share classes, accounting for one-half of all Swedish equity trading, moved to London);
 - Tax yields from the remaining Swedish activities were a fraction of those projected, both as a result of reduced activity in Sweden, migration to other markets and others action taken to net out the cost of the FTT (see the first bullet point). Even when the tax was doubled, in 1986, the revenue only increased by around 22%.
8. We think that the Swedish experience demonstrates that:
 - Mobile business will migrate to locations where no FTT is charged;

- Non mobile investment activity will fall in volume where subject to the FTT;
- Investments affected by the FTT will fall in value;
- The cost of capital will increase both for companies and governments;
- Revenue projections from an FTT will fail to materialise.

PART II – SPECIFIC QUESTIONS ON THE COMMISSION’S PROPOSAL FOR FTT

What is your assessment of the Commission’s objectives as contained in its proposal for an FTT. Are they fair and appropriate?

9. The Commission’s proposal ‘aims at addressing particularly risky behaviour’ and suggests that ‘private households and SMEs not actively investing in financial markets would hardly be affected by this proposal’. Aviva’s use of investments and derivatives is exclusively to generate investment returns to support insurance services for customers. The acquisition and holding of shares and bonds to generate such a return is not ‘particularly risky behaviour’ nor is the use of derivatives to ‘hedge out’ the risks of holding equities. It seems perverse to label insurance or savings as an activity to be discouraged when the Government recognise the positive contribution insurance and savings make to society by providing tax incentives to encourage them.
10. The cost of an FTT would be passed on to our 19 million customers who would be affected by the proposal. The proposal seems to us to be neither fair nor appropriate to meet the stated objectives.

Does the commission proposal for an FTT reflect the most desirable design for an FTT? On which transactions should the FTT be levied? What should be the rate for FTT?

11. We think any FTT would be damaging, no matter how it were designed.

Is it appropriate for the FTT to be applied on the basis of the Residence principle? How likely is the Residence principle to work in practice?

12. ‘Residence’ in a country is a standard basis for being subject to taxation there, and applies (broadly) to UK Corporation Tax and similar foreign taxes. In many countries the tax base is extended to include foreign ‘controlled’ companies, as in the case of the UK’s ‘CFC’ rules; such rules can be very complex, and are by no means universal. CFC rules may be required to make an FTT effective - that would add complexity. The British Government has taken 4 years to rewrite the UK CFC rules, and it has proved to be a difficult and controversial process.

How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of FTT fall? Should the revenue be used to finance the deficits of Member States?

13. The FTT will be difficult to calibrate and there is a high risk that the FTT will fail to raise significant revenues at the levels anticipated (Please see our response to Question 3).
14. Amongst other things, Aviva has found it difficult to estimate the cost of the Commission's FTT proposal, even on a stable no change in activities basis, because it is based on the 'notional value' of derivatives (as well as the market value of shares and bonds). So, if Aviva purchased a 'put' option for £100 entitling it to sell 10m shares of A. N. Other Ltd for £1 each at some point in the future (to hedge the risk of holding them) the FTT would be 0.01% of £10m (the nominal amount) not 0.01% of £100 (the cost). We do not collect data for the nominal amount of derivatives trades since it does not affect our assets or income. A high level estimate at the cost of the proposed FTT to Aviva's UK customers would be around £220m per year.
15. The Commission's estimated yield of €57 billion appears to be consistent with estimates for turnover in financial assets made by the Bank for International Settlements in 2007. However, the reliability of the income stream would depend on taxpayers' responses. Although it is likely that large established businesses, like insurers and large banks, would be less able to avoid the tax and the consequential costs associated with it, including the increases in cost of capital that would ensue, more mobile tax payers such as securities dealers and hedge funds could simply move their operations to a tax haven. (Please see our response to Question 3).
16. As noted above, much of the cost would, ultimately, fall on consumers rather than high net worth investors in hedge funds or financial institutions.
17. Given the issues set out above and in our response to Question 3, including the increase in the Government cost of borrowing, it is conceivable that an FTT could generate a net fiscal loss, a point that has been acknowledged in work undertaken by IMF staff earlier this year in the analysis of the issues and evidence around FTTs.
18. We would also note that the impact assessment accompanying the EU proposal recognises that it may lead to a significant relocation and 'disappearance' of activities and substantial hikes in the cost of capital, resulting in a reduction of long-run economic growth in the EU by an estimated 1.8%. The burden of that will be borne by those Member States more reliant on the capital markets, such as the UK. There is clearly a case for FTT revenues to be used to off-set the impacts on and losses in revenue that Member States are likely to face. Alternatively, it might provide a mechanism for cross-subsidising the funding of deficits in distressed Member States.

Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

19. The proposal may curb speculation carried on by EU resident banks, but will clearly not affect the activities of non EU banks nor those of hedge funds. The UK Bank Levy by contrast encourages banks to hold safer capital and so reduces the risk to the Government of bailing out our banks by more direct means.
20. The real issue and inappropriateness in the EU proposal is that as well as curbing speculation it will also 'curb' long term investment, saving and insurance.

21. In addition, it could discourage the hedging of risk by financial institutions, which could discourage equity investment and/or increase volatility.

What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?

22. We have no specific comment.

How easily could the FTT be circumvented by market operators?

23. The FTT would apply to all transactions where one party is resident in the EU. Suppliers of derivatives and bonds can be based anywhere in the world, but their transactions would still be subject to FTT if the customer (a bank, insurer, collective investment fund or pension scheme) was resident in the EU. Some customers would find it easy to avoid FTT – for instance risks affecting a whole group of companies could be hedged via an offshore group company. Some customers – for instance large insurers with thousands of employees acquiring investments on behalf of policyholders, would find it difficult to either hold the investments subject to FTT offshore or to move their operations offshore. If firms undertook FTT avoidance measures the tax take would be reduced, and the resulting offshoring of activity could undermine transparency, and therefore crisis resolution measures.

What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

24. Aviva is a retail financial services provider - around 75% of its services are provided to UK citizens and around 50% of its own shares are held by UK shareholders. Necessarily the cost of any FTT borne by Aviva would substantially fall on UK citizens.

25. In addition to the increased costs of insurance products which would result from the proposed FTT, certain of Aviva's current set of investment products could become unsustainable because their investors' investment returns would be substantially eroded by the tax. We think that certain of our collective investment funds (UCITS) and hedge funds could fall into the unsustainable category. Those funds currently hold some £10bn of investments, and generate significant revenues and employment in London. The residence and operation of those, and similar funds managed by the UK fund management industry, would probably have to migrate offshore in response to an FTT. That alone would result in substantial damage to the City of London.

26. More broadly the British Government's stated policy is to have the most competitive tax regime in the G20. Imposing a tax of perhaps £20bn, (which is equivalent to 55% of the whole 2010/11 yield from Corporation Tax) on the financial sector will push the UK further down the order of competitiveness within the G20, and will clearly discourage insurance companies, banks and collective investment schemes from locating in the UK rather than, say, Switzerland.

How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with Stamp Duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

27. An FTT would discourage inward investment and would be a factor in considering relocation by financial services companies (along with intrusive regulation, personal tax for managers and corporate tax). Stamp Duty (by comparison) is only charged on UK equities (not bonds) and applies to all investors, not only those resident in the UK. Stamp Duty has clearly not prevented investment in UK equities from taking place, but it is one of the costs which investors take into account in comparing investment returns. Since the expected return on capital is the principal driver in capital allocation, increasing the cost attached to UK operations is going to discourage investment here.

Will the FTT duplicate existing taxes in countries which have already implemented a bank levy such as the UK?

28. The European Commission proposals suggest that an FTT would balance the VAT exemption for financial services. In fact, there are a number of tax costs borne by financial service companies which are not borne by businesses generally, in particular:

- a) The Bank Levy calibrated to raise £2.5bn per year in the UK;
- b) Irrecoverable input VAT – which may rise significantly as a result of the modernisation of the financial services exemption being considered by the European Council;
- c) Insurance Premium Taxes; charged at 6% on general insurance premiums in the UK. In 2010/11 the yield was £2.3bn;
- d) Stamp duties on shares; these are very substantially borne by insurers, pension funds, and collective investment schemes. In 2010/11 the yield was £3bn.

29. In our view some or all of these taxes would need to be repealed if an FTT were introduced.

Could such an FTT be plausibly introduced at an EU level or would an FTT only be effective if introduced globally? Should an FTT be introduced an EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by Euro area countries alone?

30. Clearly a global FTT, if effected, would have the substantial advantage of taxing hedge funds resident in tax havens, which are a major source of volatility in markets. It would also remove the risk of business relocation to tax havens. (In practice, achieving a truly global FTT could be difficult, but near global effect could be achieved if all major economies in Europe, North America and Asia introduced a residence based FTT supported by Controlled Foreign Company rules; that would be a major undertaking, but would be at least theoretically possible.)

31. An FTT at EU level or Eurozone area level would, equally clearly, be less effective than a global FTT, and encourage relocation. Furthermore, an FTT which applied to collective investment schemes, pensions funds and insurers, whatever its geographic scope, would tax consumers, not the financial operators, so would be dysfunctional.
32. In our view an FTT should not be introduced except on a global basis and then with careful exemptions for retail investment providers and insurers in order to protect consumers.

7 November 2011

BlackRock - Written evidence

We are grateful for the opportunity to comment on the House of Lord's call for evidence on the introduction of a Financial Transaction Tax (FTT) in the European Union. BlackRock recommends that Europe's law makers closely consider the very real impact of an FTT on Europe's pensioners, savers and households, on sound investment management principles and on the European economy. We commend the House of Lords for doing so.

Our detailed responses to the questions in the call for evidence follow but we would highlight that BlackRock, as a fiduciary to our clients, seeks to maximise their risk adjusted investment returns. We believe that an FTT will hit our client's investment performance hard, reducing savings and retirement income at the very time when Europe's pensioners, savers and households are struggling to recover from the financial crisis and are being asked to take greater responsibility for their own financial futures.

An FTT will create unintended investment incentives and undermine sound asset management principles such as diversification, proper hedging and efficient execution. Perversely, as a result of an FTT, active portfolios will be forced to take higher levels of risk and/or invest to a greater extent in derivatives in order to deliver the same level of return to clients. It will also reduce market liquidity and increase volatility, further hurting investment performance for pensioners and savers.

BlackRock does not believe one of the key rationale given for the introduction of an FTT, namely that the financial services sector in Europe is under-taxed. The VAT exemption for financial services does not lead to a tax advantage for financial services but instead protects investors and households. In contrast, all of the different FTT models considered (currency FTT, securities FTT and derivatives FTT) will primarily impact detrimentally the end investor rather than banks, thought to be the main target of such a tax.

Any benefits of an FTT in terms of revenues generated will be outweighed by the costs. Revenues will be significantly less than projected as an FTT will reduce liquidity and the volume of trades, shrinking the tax base. In contrast, in addition to significantly reducing investment income and creating unintended investment incentives, an FTT will reduce investment in the real economy and discourage corporate governance as investment managers invest less in equities and more in derivatives. It will dramatically reduce the size of the European financial services industry and have a disproportionate effect on London as European-related activities will decline in volume and non-European activities will cease to touch the European Union. New markets may arise outside the European Union which allow non-European persons access to "European assets" without incurring an FTT, by wrapping the asset so that subsequent transfers of the wrapper no longer attract an FTT.

In conclusion, BlackRock does not believe that an FTT should be applied to savings and investment income as it will directly reduce the savings and retirement income of Europe's citizens.

We appreciate the opportunity to address and comment on some of the issues raised by an FTT. We are prepared to assist the House of Lords in any way we can, and welcome continued dialogue on these important issues. Please contact either of the undersigned if you have comments or questions regarding BlackRock's views.

BlackRock is one of the world's preeminent asset management firms and a premier provider of global investment management, risk management and advisory services to institutional and retail clients around the world. As of 30 September 2011, BlackRock's assets under management totalled £2.85 trillion across equity, fixed income, cash management, alternative investment and multi-asset and advisory strategies including the industry-leading iShares® exchange traded funds. Through BlackRock Solutions®, the firm offers risk management, strategic advisory and enterprise investment system services to a broad base of clients with portfolios totalling more than £8.51 trillion.

Our client base includes corporate, public, multi-employer pension plans, insurance companies, third-party and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals. BlackRock represents the interests of its clients by acting as a fiduciary and it is from this perspective that we engage on all matters of public policy. BlackRock supports regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analyses, preserves consumer choice.

BlackRock is a member of European Fund and Asset Management Association ("EFAMA") and a number of national industry associations reflecting our pan-European activities and reach.

PART I General questions on financial sector taxation

I. Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

No case for the introduction of an FTT

I.1 - BlackRock, an independent asset manager, believes that an FTT would severely impact European investors. We believe no case for the introduction of an FTT exists for the following reasons:

- An FTT will reduce significantly the income of European savers and pensioners as it will hit hard the investment performance of pension and investment funds and directly tax their subscriptions and redemptions into such vehicles. An FTT is unable to distinguish between pensioners and high frequency traders or to make a distinction between 'undesirable' and 'desirable' short-term trading.
- In addition, end-investors will suffer an indirect cost through wider financial products' bid-ask spreads (the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it).
- An FTT will increase volatility and lower market liquidity due to a lower number of market participants, further hurting performance for pensioners and savers.
- An FTT will also lead to unintended investment incentives and undermine sound investment management principles such as diversification, proper hedging and

efficient execution. Perversely, as a result of an FTT, active portfolios will be forced to take higher levels of risk or invest to a greater extent in derivatives to achieve the same level of return for clients.

- An FTT will reduce investment in the real economy and discourage corporate governance if investment managers invest less in equities and more in derivatives (as a result of the bias in an FTT rates in favour of derivatives).
- Finally, an FTT will make European assets less attractive to investors, especially non-European investors, at a time when the region needs to attract inward investment.

The VAT exemption for financial services does not lead to a tax advantage for the financial sector

I.2- According to the European Commission's impact assessment "the VAT exemption leads to a tax advantage for the financial sector in the range of 0.15% of GDP. It results in a preferential treatment of the financial sector compared with other sectors of the economy as well as in distortions of prices."

I.3- BlackRock believes that this statement is wrong. VAT is meant to be a tax on the Business-to-Consumer ("BtoC") transactions and not on the Business-to-Business ("BtoB") transactions. The VAT exemption for the financial services protects investors and households from banks recovering the VAT they incur on their costs. Thus, the VAT exemption on financial services is not a fiscal advantage for the banking system.

I.4- Under the current European VAT system, the exemption of financial services means that financial services providers are not able to recover VAT from their customers. Were VAT to apply to banking services in the European Union, banks would be able to recover their input VAT, as would business customers within "BtoB" transactions. VAT revenues would therefore only increase by the amount of VAT raised on "BtoC" transactions.

I.5- This is explained in a report entitled "How the VAT exemptions impact the banking sector" issued in October 2011 by the Warwick University along with Price Waterhouse Coopers. This report demonstrates that the VAT exemption for financial services does not lead to a tax advantage for the banking sector. The report concludes that tax revenues might even fall if financial services are VAT taxable. According to the report's analyses, Member States' overall VAT revenues from 2000-2007 would have fallen if a VAT had been imposed on financial services.

I.6- We believe that the effect on final VAT revenues is uncertain as it will depend on the proportion of "BtoB" and "BtoC" financial transactions carried out by banks⁴⁷.

2. What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

⁴⁷ Final VAT revenues could range from -100% to +100% of the current VAT revenue raised. If only "BtoB" transactions are carried out, the VAT revenue is reduced to 0 (-100%) and where transactions are only made "BtoC", all the cost is passed on to financial customers and the VAT revenue doubles (+100%).

2.1- BlackRock would like to make the following comments about the potential forms an FTT might take.

Currency transaction tax

2.2- The currency transaction tax is a particular form of an FTT. Restricting an FTT to currency transactions would reduce the impact of an FTT on investment returns but would still be detrimental to investors, particularly those outside the major currency zones. For instance, UK investors would be more deeply affected than investors based in the Eurozone countries.

2.3- A currency transaction tax would curb the liquidity of the Foreign Exchange (FX) market at a time when volatile currency movements and high raw material prices make it essential to be able to hedge quickly currency risk. FX forward and swap transactions allow currency risks related to investments and commercial activities made outside the domestic market to be hedged. Thus, imposing a tax on FX forward and swap transactions would increase hedging costs and limit the hedging ability of investors (against variations of FX rates).

Securities transaction tax

2.4- A tax on securities transactions will have a negative impact on savings and pensions as the tax applies to all securities (bonds and shares) transactions, including those on behalf of pension and investment funds. The tax would apply across the spectrum of investment vehicles (from cash ISAs, NEST funds and UCITS, to separate accounts) and investors (from office workers, teachers, steel and railway workers, nurses, and firemen, to high worth investors and executives). It would be hard to explain to pensioners and savers why their retirement and savings income will be further taxed in response to the crisis.

2.5- BlackRock has analysed the impact of the European Commission's proposal by applying an FTT tax rates to the actual transactions made during 2010 in a selection of mainstream funds typically used for long term investing. This analysis does not take account of an FTT's impact on investment performance due to its application to FX transactions, to client subscriptions and redemptions, nor of the cascading effect of an FTT. This therefore underestimates the final impact of an FTT on end investors. The table below demonstrates the annual investment performance hit of an FTT on sample portfolios.

Impact on Representative Fixed Income and Equity Portfolios

Fund Type	Active Return Expectation* (bps)	Annual Cost of an FTT in Basis Points (bps)		
		Total (bps)	Cash Securities (10bps)	Derivatives (1bp)
Fixed Income Euro ETF	0	8	8	-
Fixed Income Euro Index	0	6	6	-
Fixed Income Euro Active	50	25	21	4
Equity UK Index	0	1	1	0
Equity UK Active	100	6	6	0
Equity Global Active	150	33	33	0
Equity European Active	300	257	252	5

*Expected return above benchmark, gross of fees

Source: BlackRock Risk and Quantitative Analysis (RQA)

From these analyses, we have drawn the following conclusions:

2.6- Short term impact: An FTT will, for example, absorb for a fixed income active portfolio half the active return per annum (0.25% of 0.5%). This is especially damaging in the current low yield environment.

2.7- Long term impact: a prudent 40 year old investing €10,000 in this fund would pay nearly €1,000 of this original amount to an FTT by the time he/she were nearing retirement 20 years later. Were the same 40 year old to invest €10,000 in a global equity fund, an FTT would have eaten over €2,300 in expected returns by the time he/she reaches 60. More significantly, the same individual would lose nearly €15,000 investing in a more dynamically managed European equity fund over this timeframe. This is 50% more than what he/she originally invested.

2.8- Finally, it should be noted that an FTT represents a double taxation for savers and pensioners as savings are made out of taxed incomes and pensions will be taxed at the prevailing income tax rates when the pension is paid out. An FTT will end up being a tax on the management of investments.

Financial tax on derivatives

2.9- As explained in the currency transaction tax section above, a tax on hedging transactions would be detrimental to the hedging ability of investors. Derivatives provide savers and pensioners with the ability to properly hedge the variation of their portfolios'

value. As shown above, imposing a tax on derivative transactions would damage portfolio performance, and the efficiency of portfolio's risk management.

3. What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

3.1- The experience of other countries which have adopted similar financial sector taxation schemes has shown that the introduction of an FTT leads to reduced liquidity in financial markets. With fewer trades the tax base shrinks and revenues from the tax decrease. This occurred in Sweden when it introduced a 0.5% tax on the purchase or sale of shares in 1984. This rate doubled in 1986, and, in 1989, a new tax rate was introduced for fixed-income securities, but at a considerably lower rate of 0.002% for securities with a maturity of 90 days or less and 0.003% on bonds with a maturity of five years or more. This new tax was expected to raise around 1,500 million Swedish kroner per annum, but ultimately yielded less than 80 million kroner per annum, with an average close to 50 million kroner per annum. It's important to note that the Swedish exchange relocated much of its financial transactions to London, and that Sweden abandoned an FTT in 1991.

3.2- Other countries have introduced taxes on financial transactions and incomes, but few of them have raised significant revenues. Among these are: stamp duty on trades of shares of locally registered firms in the U.K., bank debit tax in Argentina, the banking and insurance transactions tax in Turkey, and transactions taxes in Brazil. None of them have a scope as wide as an FTT proposed by the European Commission. Their impact on the real economy is therefore less damaging than that of the new proposal.

PART II Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

4. What your assessment of the Commission's objectives is as contained in its proposal for an FTT? Are they fair and appropriate?

4.1- The objectives set by the Commission in its proposal for an FTT are to force the financial sector to contribute to the financial crisis' cost and to reduce market speculation, volatility and systemic risk. The Commission also states that the European Union needs to find a new revenue stream and that the taxation of the financial sector represents one of the "candidates for own resources to gradually displace national contributions".

4.2- José Manuel Barroso has stated that an FTT 'is a question of fairness', that 'it is time for the financial sector to make a contribution to society'. An FTT should 'limit undesirable market behaviour' and 'will not have an undue impact on households'.

4.3- BlackRock has a number of concerns regarding the Commission's objectives:

- An FTT represents a direct tax on European savers and pensioners. In contrast, banks, widely recognised as those causing the crisis, will largely be able to pass on the costs they occur to the end investors.
- The introduction of a new tax for financial services should not be to raise revenues but should be limited to systemically risky activities to ensure that investors in banks,

and their funding sources, bear and price the true risk. An FTT delivers the wrong message to banks if the revenue an FTT creates is used to provide a bail-out for future crises.

- The financial crisis was due to excessive leverage and lack of prudence by many players and was not strongly correlated with the frequency of transactions.
- The proposal states that an FTT will 'limit undesirable behaviour'. BlackRock fears instead that it will penalise sound investment management principles and create perverse unintended investment incentives. An FTT will for example hit disproportionately "safer" fixed income portfolios investing in shorter-duration bonds and therefore subject to a greater number of transactions. It will hit pension funds seeking market neutral returns through long-short strategies and will have a significant impact on portfolios seeking diversification by investing across different geographic regions (and hence exposed to different currencies) and/or different asset classes. Finally, because an FTT will be applied to all transactions regardless of purpose, it will penalise hedging transactions and other forms of efficient portfolio management. Reducing diversification and hedging will expose pensioners and savers to greater investment risk especially in volatile market conditions.

4.4- Rather than targeting the real causes of the latest financial crisis, an FTT will adversely impact savers' investment performance, reducing savings and retirement income throughout Europe as it would apply to all financial transactions including those on behalf of pension and investment funds. BlackRock believes that none of these outcomes are 'fair' for European pensioners, savers and households and are particularly inappropriate at a time when they are struggling to recover from the financial crisis and are being asked to take greater responsibility for their own financial futures.

5. Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

5.1- BlackRock believes that whatever its design, an FTT is neither fair nor appropriate, and as the IMF stated in their report to the G20 last year, "is not focused on core sources of financial instability. An FTT would not target any of the key attributes – institution size, interconnectedness, and substitutability – that give rise to systemic risk; adjusting the tax rate to reflect such considerations would be possible in principle, but highly complex in practice"⁴⁸.

5.2- An FTT is not a solution for the reduction of speculation, volatility and systemic risk. In addition to the views that we have already expressed, we believe that an FTT only peripherally addresses behavioural issues as the relationship between the frequency of transaction and risk is tenuous. An FTT cannot determine the purpose of a transaction and so will perversely tax even those transactions devised to reduce risk.

5.3- Our analysis proves that an FTT will significantly reduce investment performance. Investment managers of active portfolios seeking to achieve the same returns post enactment of an FTT will have to take greater risk, and/or apply more leverage and/or make

⁴⁸ IMF paper on FTT directed to the G20 summit (September 2010) : <http://www.imf.org/external/np/seminars/eng/2010/paris/pdf/090110.pdf>

greater use of derivatives. Clients unhappy with investment managers taking greater risk in an attempt to achieve the same investment return post an FTT (or conversely, increasing costs by continuing to use derivatives in order to manage risk) may decide to move from actively managed to passively managed ('index') funds. Our analysis of an FTT's impact on investment performance demonstrates that clients investing in fixed income passive portfolios, for example, will be locking into a consistent underperformance against indices, exacerbating the pensions shortfall currently faced by many individuals.

5.4- In addition, an FTT will make securities lending unattractive, an activity which helps long term investors earn additional income to help offset fund expenses. FTT would cost 10 bps when the stock is lent and then another 10 bps when the stock was returned, making it extremely costly to lend securities.

5.5- More importantly, the design of an FTT is not appropriate given its cumulative and cascading effect. The final costs of an FTT, mainly borne by end-investors (both business and individual), as we have already explained, will be very heavy. The real cost on end-investors will actually be much higher than the headline tax rates (0.1% for securities transactions and 0.01% for derivatives transactions). This cost could even be ten times higher. To quote a report made by Clifford Chance on an FTT in October 2011 "The reason is the chain of trading and clearing that lies behind most securities transactions. A purchase of securities on the London Stock Exchange, for example, ordinarily involves the sale and purchase by a number of parties, including brokers, clearing members and the central counterparty to the clearing system. Each sale will be subject to an FTT (with only the central counterparty exempt)."⁴⁹

5.6- Finally, from an operational perspective, compliance with the proposed FTT will be burdensome and costly. For example, the draft Directive proposed that financial institutions would have three days from the date of the transaction to pay an FTT. This would be impossible for OTC derivatives which can take up to a month to confirm the transaction.

6. On which transactions should an FTT be levied? Is it appropriate for an FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of an FTT?

6.1- As explained in our above responses, we do not believe that an FTT is appropriate for any transaction.

7. Is it appropriate for an FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?

7.1- Please refer to our response to questions 11, 12, and 13.

8. How significant is the potential for an FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of an

⁴⁹ Clifford Chance report on FTT (October 2011):
http://www.cliffordchance.com/publicationviews/publications/2011/10/financial_transactionupdate.html

FTT fall? Should the revenues arising from an FTT be used to finance the deficits of Member States?

An FTT cannot be a reliable source of revenue

8.1- Based on the Commission's impact assessment, "the revenue estimates for an FTT at a tax rate of e.g. 0.01% are between €16.4 (with an elasticity of -2 and high volume decrease) and €43.4 billion (with an elasticity of 0 and low volume decrease) (0.13% to 0.35% of GDP) when all sources are accounted for and the value of the asset underlying the transaction was taken as the taxable amount. If the rate is increased to 0.1%, total estimated revenues are between €73.3 (with an elasticity of -2 and high volume decrease) and €433.9 billion (with an elasticity of 0 and low volume decrease) (0.60% to 3.54% GDP)".

8.2- However, as explained in our responses to questions 3 and 4 above, the potential for an FTT to raise significant revenue is likely to be disappointing. Indeed, the introduction of an FTT will lead to a drop in liquidity. With fewer trades, the tax base will shrink and revenues from the tax will likely be significantly less than predicted. In the Commission's impact assessment, the modelled revenues are very sensitive to the tax elasticity of the derivatives and securities markets. Nevertheless, this model uses the same elasticity for bonds and for equities when the bond tax elasticity may actually be higher (from Sweden's experience). Thus, an FTT cannot be a reliable source of revenue given that it is hard to determine the tax elasticity of the securities markets and even more difficult to measure how adversely market liquidity will react to an FTT.

The true incidence of an FTT will fall on end-investors and on the global economy

8.3- As already explained, an FTT costs will fall on end-investors. This actually means that an FTT revenues that the proposal is talking about ultimately are part of end-investors' savings and pensions.

8.4- An FTT will also have perverse effects on the global economy. Even if an FTT brings the abovementioned expected revenue, it is not right to say that the benefits of an FTT will outweigh the cost. More specifically, an FTT will reduce investment in the real economy, increase capital costs, and discourage corporate governance and long term engagement, as investment activity moves towards the use of derivatives in order to reduce net FTT cost. The European Commission estimates that the cost will be around 1.76% of the European Union's GDP for the securities transaction tax and 0.17% for the tax on derivatives transactions. Nevertheless, the figures of the impact assessment are based on a tax on purchases only and therefore underestimate the harm done to the real economy (2x1.76% of GDP). Also, these figures only take into account the increased costs of capital without modelling the cost of any decline or relocation of the financial sector outside the European Union. BlackRock has already seen a decline in Euro investments from institutional investors over the last few years largely due to uncertainty of market conditions. This trend will likely only be further exaggerated with the introduction of an FTT which, surely, must make European Union assets less attractive than non-European assets that are not similarly subject to an FTT.

Impact and effectiveness

9. Would the Commission’s proposal for an FTT be effective in addressing short-term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

10. What would be the impact of an FTT on market liquidity? What effect would an FTT have on speculation in sovereign debt markets?

9-10.1- Contrary to the intentions of policy makers, an FTT will reduce liquidity and increase volatility in the marketplace. To compensate for the cost of an FTT levied on both their financial transactions with their clients and on all the intermediary transactions made to hedge their risks, market makers will adjust spread levels (the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it). In addition, were collateral and margin call transactions to fall into an FTT’s scope, the impact would be even more adverse for liquidity. This would further increase spread levels and lead in turn to a greater liquidity shortfall and increased volatility in the marketplace (fewer market participants due to the increased tax cost means that the market prices will be much more sensitive to any financial transaction leading to higher volatility).

9-10.2- An FTT will curb some short-term trading but, as explained in our response to question 4, not all short-term trading is high frequency trading. In seeking to address HFT, an FTT will do great damage to the viability of higher velocity strategies from low risk-return strategies such as ultra-short duration sovereign and corporate debt fixed income funds through to higher risk-return alternative strategies. FTT is too blunt an instrument to control HFT. BlackRock would recommend an alternative approach – for further details see our Equity Market Structure *ViewPoint*⁵⁰.

9-10.3- An FTT will also lead to reduced liquidity in the sovereign debt market. A decrease in liquidity will make it harder for sovereigns to locate funding sources, increase yields and exacerbate deficits.

11. How easily could an FTT tax be circumvented by market operators?

11.1- The tax would apply to both sides of any transaction involving a “financial institution” (very widely defined) and a person based in the European Union. Thus, in principle, a non-European financial institution transacting with an individual would be chargeable. It is unclear how the liability would be collected or enforceable, but it is likely that a system can be developed in a manner to enforce compliance. Accordingly, transactions where the “end-user” is in the European Union will likely not avoid an FTT, but the volume of such transactions will decline dramatically. Financial activity that European financial institutions perform for non-European customers will of course cease to be routed through the European Union.

11.2- Accordingly, the size of European financial service firms will likely decline substantially, since:

⁵⁰ BlackRock’s *ViewPoint – Equity Market Trading in Europe* (June 2011) – is available on BlackRock’s Public Policy Website : <http://www2.blackrock.com/global/home/PublicPolicy/ViewPoints/index.htm>

- European-related activities will decline in volume; and
- Non-European activities will cease to touch the European Union.

11.3- We believe some markets may arise outside the European Union to allow non-European persons access to “European assets” without incurring an FTT, by wrapping the asset so that subsequent transfers of the wrapper no longer attract an FTT (except where the buyer or seller is a European person, which would be unusual since no non-European seller or buyer would wish to expose themselves to an FTT). The act of wrapping the asset would likely incur a “toll charge” FTT, but the aim would be that subsequent transfers would not be liable. .

11.4- The end result could be a restricted financial services European market, small in volume and isolated from the world markets for everything except very essential global transactions where an FTT cost would have been accepted by the parties as worthwhile.

Impact of an FTT in the UK

12. What impact would an FTT have on the UK’s financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

12.1- The introduction of an FTT will have a detrimental impact on London as one of the major international financial centres for the reasons outlined above. An FTT will also hit the UK economy more broadly as an FTT will reduce investment in the real economy if it causes investment managers to invest less in equities and more in derivatives. The EC’s impact assessment figures speak for themselves. The GDP of the European Union will decline by 1.76%. Nevertheless, as explained above, the figures of the impact assessment are based on a tax on purchases only and therefore underestimate the harm done to the real economy (2x1.76% of GDP). Also, the impact on the UK GDP is likely to be higher given that UK investors invest more in cash securities and derivatives than many other European countries. Likewise, as the UK is outside the Eurozone, an FTT on FX forwards/ swaps are likely to impact the UK more than any other Eurozone countries.

12.2- According to a report released in October 2011 by Clifford Chance on the practical and policy implications of an FTT, the impact assessment does not address that stamp duty and similar taxes will be abolished (Article 12 of the Commission’s draft reserves exclusively for itself taxes on financial transactions). According to Clifford Chance, stamp duty represents £2-4 billion annually for the UK budget. Also, in the case that an FTT is deductible, UK corporate tax cost (equal to 26% of FTT) would be deductible in the UK. Finally, Clifford Chance states that the cost of potential declines and relocations of the financial industry would make a loss of about £60 billion a year (current tax revenues from the financial sector).

13. How would you assess the likelihood that an FTT would cause financial services to relocate outside the European, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

13.1- If an FTT is not implemented at a global level, financial services in the European Union will be at a strong competitive disadvantage. The Commission's belief that a European FTT could lead to a global FTT seems unlikely at this stage. While a proposal for an FTT may be introduced in the US Congress, the proposal is unlikely to be passed due to significant political opposition to such a proposal. There is a credible counter-argument that the rest of the world would just simply seek to benefit from increased activity, rather than level the playing field. We therefore believe that it is highly likely that financial institutions will invest considerable energies in exploring different avenues to limit their and/or their end clients' exposure to an FTT. For instance, the European Commission's own assessment indicated that 70%-90% of derivatives transactions would move outside the European Union.

13.2- Stamp duty is different from an FTT for the following reasons. Stamp duty only applies to UK shares and therefore applies regardless of the location of trading. Consequently, funds are not incentivised to move offshore. More importantly, stamp duty exempts the intermediary transactions so does not have cascading effect as an FTT does.

13.3- Nevertheless, it should be noted that the introduction of stamp duty in the UK did result in a shift from cash equity investment to investing in equity derivatives which are not subject to the stamp duty. It also causes a performance drag, especially for lower velocity, derivatives-adverse investors.

13.4- We note that as swap volume and spread betting increases as a proportion of turnover, the link between investors and shareholders registers becomes broken and confused. Contracts for Difference (CFD) investors obtain the economic rights, but not the legal privileges that come from direct ownership of shares themselves, nor do such investors have a say in corporate governance, a factor that is becoming of increasing importance. Further, in seeking to minimise stamp duty, investors are paying for leverage they do not need as a year's leverage is cheaper than a one-time stamp duty.

13.5- In reality, stamp duty:

- Inflates bank's balance sheets
- Levers the system
- Hides the true ownership of companies, diminishing share holder engagement.
- Obliges investors to favour derivatives over shares.
- Gives banks revenues based on the market makers exemption

13.6- Were an FTT to similarly exempt market makers, this would point an FTT away from the very institutions that the European Union is actually seeking to target and thus fail the European Union's own test of making those responsible pay.

14. Will an FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

14.1- Implementing both an FTT and a bank levy will result in a 'double taxation' of assets. Banks will pay a tax on their balance sheet, including assets bought via financial transactions, which will have already been subject to an FTT.

Implementation

15. Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

15.1- International cooperation is essential, particularly in the context of cross-border financial institutions. Any European Union unilateral actions risk being undermined by tax and regulatory arbitrage. BlackRock believes that even a 'small' FTT enforced at the European or Eurozone level could lead to European financial centres losing market share. If financial transactions are considerably more costly in Europe/ the Eurozone than in other regions, these financial transactions will cease or move overseas to those regions not subject to an FTT. Implementing an FTT at the Eurozone level would have implications for UK investment managers. There would be inconsistencies in asset management practices; for example, complications for a UK resident fund manager managing a Eurozone resident fund.

15.2- Nevertheless, even if globally applied, an FTT would still be very detrimental to end-users including pensioners and savers for the reasons that we have already given.

15.3- In conclusion, BlackRock recommends in the strongest terms that Europe's policy makers closely consider the real impact of an FTT on Europe's pensioners, savers and households, on sound investment management principles, and on the European economy. An FTT should not be applied to savings and investment vehicles as this will directly reduce the savings and retirement income of Europe's citizens.

7 November 2011

British Bankers Association (BBA) - Written evidence

1. The British Bankers' Association (BBA) is the leading trade association for the UK banking and financial services sector. We represent over 200 banking members, which are headquartered in 50 countries and have operations in 180 countries worldwide. These member banks collectively provide the full range of banking and financial services and make up the world's largest international banking centre.
2. The BBA welcomes the opportunity to contribute to The House of Lords European Union Committee's draft call for evidence on a Financial Transaction Tax (FTT) and its implications for the UK.
3. In this submission, the BBA sets out its concerns and issues in relation to the European Commission's proposal for an FTT. In brief, we remain steadfastly opposed to the introduction of this tax, for the reasons that it will: negatively impact on growth and employment in the EU; run counter to measures currently being pursued to promote financial stability; generate additional costs for households and businesses; create strong incentives for markets to move to jurisdictions outside the EU and for institutional redomicile; and ultimately fail in its own objective to raise additional revenue. The BBA considers that it is essential that the interplay of fiscal policy with regulation, supervision and macro-economic policy is fully understood when contemplating additional financial sector taxation. The BBA has grave doubts about the European Commission's appreciation of the interaction of its FTT proposal with other priorities of the EU, such as financial stability, economic growth and employment.

Executive Summary

4. By the European Commission's own admission, the FTT will have a negative impact on GDP and employment. Economic growth requires viable businesses to have access to secure and sustainable funding. The FTT undermines the efforts of the banks to facilitate growth.
5. The financial services sector is not undertaxed; the European Commission's Impact Assessment concluded that "Broadly speaking, the study does not find any significant differences in the tax treatment of the financial sector compared to other sectors..." The financial services VAT exemption does not constitute a tax advantage; rather it generates a cost to the sector. Exemption means that VAT is not charged on outputs (supplies to customers). This means that net VAT payments by banks to HMRC (VAT charged on outputs less VAT paid on inputs) are small relative to the size of the sector. However, exemption also means that banks cannot recover all the VAT incurred on inputs (goods and services that they purchase). This irrecoverable VAT represents a significant addition to the banks' cost base, and the banks contribute a significant amount of tax revenue through this irrecoverable VAT.
6. The Commission's proposal fails to comprehend the complex interactions between the financial transactions it proposes to tax and the real economy. An FTT would generate considerable costs for households and businesses. For instance, the 'cascade effect' of the proposed FTT would impact ordinary savings and pensions through the direct

taxation both on the funds themselves and on the sale and purchase of units/shares in investment funds. Households may suffer the transmission of costs on transport and energy prices, as companies manage pricing risk by utilising derivatives. The tax on forward transactions and derivatives, commonly used by multinational businesses to hedge movements in exchange rates, would result either in a reduction in the number of hedged transactions for some businesses that attempt to keep costs down, with an attendant increase in the holding of more risky positions, or otherwise increased passed-on costs for consumers.

7. The UK's Stamp Duty Reserve Tax (SDRT) is not a useful comparative tool for contemplating the probable effects of an FTT on the EU market. Stamp duty is levied on market participants, but not financial intermediaries, regardless of where the buyer and seller are located at a rate of 0.5% of the value of purchases of UK listed companies. The FTT has a broader scope⁵¹ and is levied on all intermediaries except the central counterparty, resulting in a "cascade effect", making the effective rate of the FTT much higher than the headline rate of 0.1%. Stamp duty applies to UK shares regardless of where the buyer and seller are located, so there is no incentive for the financial sector to move elsewhere. The proposed FTT, however, applies where a party is located in the EU, positively incentivizing redomicile to avoid the residency principle.
8. The BBA does not believe that the European Commission has produced a robust rationale for an FTT.
9. The revenue estimates for an FTT are grossly overstated and any increase in tax revenue will be offset by a reduction in other forms of taxation, which would be exacerbated by the reduction in economic growth.
10. The proposed FTT would negatively impact on measures currently being pursued to promote financial stability, such as on market liquidity.
11. An EU FTT would create strong incentives for markets to move to jurisdictions outside the EU and for institutional redomicile. This would disproportionately affect the UK, not only because of the concentration of European financial services business within London; but also because the UK is outside of the Eurozone and so more foreign exchange trades are conducted as part of normal hedging activity. London's pre-eminence as an international financial centre could not continue in the wake of an EU FTT.

General Comments

12. The conclusions of the 23 October 2011 European Council called for the Council and Commission to "ensure that all actions at the European Union level fully support economic growth and job creation"⁵², but by the European Commission's own admission, the FTT will have a negative impact on GDP, with an attendant risk for employment.

⁵¹ FTT applies to financial transactions, which includes the purchase and sale of a financial instrument (which includes shares, bonds and other securities, options, futures, derivatives, units in unit trusts and other funds/collective investment schemes), repos and stock lending, the conclusion or modification of derivatives, and in the case of group transactions only, "the transfer of the right to dispose of a financial instrument as owner and any equivalent operation implying the transfer of the risk".

⁵² <http://www.consilium.europa.eu/uedocs/NewsWord/en/ec/125496.doc>

13. A strong and growing business sector is crucial to economic recovery, to job creation and to the UK's future prosperity. This requires viable businesses to have access to secure and sustainable funding, to set up and to expand. Banks have been doing their part. The UK's six largest banks (Barclays, HSBC, Lloyds, RBS, Santander and Standard Chartered) decided to examine how they could help the economy return to sustainable growth by supporting businesses. The Business Finance Taskforce was created to ensure money is lent prudently and fairly to support the economic recovery without initiating another credit surge. However, in the meanwhile, banks have seen a steep increase in the cost of wholesale funding, upon which much of their lending depends. The FTT undermines the efforts of the banks to facilitate a return to growth by taking more money out of the financial system.
14. It is essential that the interplay of fiscal policy with regulation, supervision and macro-economic policy is fully understood when contemplating additional financial sector taxation. The BBA has grave doubts about the European Commission's appreciation of the interaction of its FTT proposal with other priorities of the EU, such as financial stability, economic growth and employment.

PART I General questions on financial sector taxation

I. i) Is there a case for the introduction of a tax on financial transactions?

15. The political and theoretical appeal of a tax on all financial transactions is understood by the banking industry. EU citizens have to pay value-added tax on most of the goods and services that they buy, so, ostensibly, there is an appeal in taxing purchases of stocks, bonds, and derivatives. However, there is a fundamental misconception that such a tax would only hit wealthy individuals and financial service companies, and raise significant revenue in addition.
16. In actuality, the market response to the FTT will increase various costs within the financial system and impede the efficient operation of markets which are crucial not only for direct market participants, but for the vast array of end users who benefit from an efficient financial system. An FTT would result, for example, in increased costs of intermediation and reduced pensions for the public as the cost of managing risk and investing increases for the financial sector. This 'cascade effect' would impact ordinary savings and pensions more generally through the direct tax both on the funds themselves and on the sale and purchase of units/shares in investment funds - tax will be payable for the first time when a private investor sells, not only on purchase (although the tax on purchases currently only applies to certain securities, for example UK shares).
17. Supporters of an FTT believe that it is possible to limit the impact of any tax, but such a belief fails to comprehend the extremely deleterious effect of the tax, or the complex interactions between financial markets and the real-economy. For example, the Commission estimates that between 70%-90% of derivatives trading will leave the EU. Derivatives are a valuable risk management tool; vital to exporting and importing businesses and those with an exposure to commodity prices, and also underpin activities as diverse as the provision of fixed rate mortgages and consumers locking in their gas and electricity prices.

18. Proper consideration must be given to the impact of an EU or Eurozone FTT on the UK's competitiveness and London's position as the world's largest international banking centre.
19. The UK Government is on record as saying it would not accept an FTT unless it were implemented globally. We would go further and question the desirability of a globally imposed FTT. Even a global FTT would, however, reduce financial activity, and reduce liquidity in financial markets, to the detriment of all economies and consumers, with a disproportionate effect on financial centres such as the UK. It needs also to be borne in mind that a global FTT would also be a complex cross-border arrangement and that mechanisms would need to be put in place for revenue sharing and dispute resolution.

ii) Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

20. In its August 2011 publication, "Pay As You Earn and Corporation Tax receipts from the banking sector", Her Majesty's Revenue & Customs (HMRC) addressed the issue of the VAT exemption for financial services and its consequences for tax receipts, stating:

*"Some goods and services are exempt from VAT. This includes most financial services supplied by banks. Exemption means that VAT is not charged on outputs (supplies to customers). This means that net VAT payments by banks to HMRC (VAT charged on outputs less VAT paid on inputs) are small relative to the size of the sector. However, exemption also means that banks cannot recover all the VAT incurred on inputs (goods and services that they purchase). This irrecoverable VAT represents a significant addition to the banks' cost base, and the banks contribute a significant amount of tax revenue through this irrecoverable VAT"*⁵³

21. The VAT exemption for financial services, therefore, yields a benefit to end consumers, in that they do not bear a VAT cost on their purchase of financial services (mortgages, credit cards etc). This actually results in a 'sticking VAT cost' for the financial sector. A September 2011 survey of 17 of the largest BBA members shows that these banks are contributing to UK finances some £3bn of irrecoverable VAT. Across the entire banking sector operating in the UK (the BBA has some 230 banking members) the figure would be substantially higher.
22. New research⁵⁴ by Professor Ben Lockwood of the University of Warwick, undertaken with PwC, has revealed that the VAT exemption does not lead to a tax advantage for the banking sector. The report concludes that if bank services were subject to VAT (in place of the current exemption system) this would not lead to any significant increase in VAT revenues, as it is unlikely that the VAT raised from consumers would be significantly higher than the tax governments would lose from banks recovering VAT on their costs. The report estimates that the sector pays €33bn per annum of irrecoverable VAT in the EU.

⁵³ 'Pay As You Earn and Corporation Tax receipts from the banking sector', HMRC, Aug 2011, <http://www.hmrc.gov.uk/stats/banking/intro.pdf>

⁵⁴ 'How the EU VAT exemptions impact the Banking Sector, Study to assess whether banks enjoy a tax advantage as a result of the EU VAT exemption system', PwC & University of Warwick, 18 October 2011, http://www.pwc.com/en_GX/gx/financial-services/pdf/2011-10-18_VAT_Study_final_report.pdf.

23. It is, however, important to note that the main reason for the VAT exemption for financial and insurance services is the political and socio-economic policy objective with regard to retail consumers accessing financial and investment products.

2. i) What would be the most appropriate form for a taxation of the financial sector?

24. The BBA's members accept their responsibility to make a fair and substantial contribution to public finances. Banks have also historically (over the full economic cycle) contributed considerable amounts to overall tax revenues from all sources (i.e. corporate income tax on profits, taxes on remuneration of employees, VAT and other transactional taxes). Banks are still contributing significantly to the UK Exchequer, for instance between 2009-10 and 2010-11 Pay As You Earn and Corporation Tax receipts from the sector rose by 21 per cent to £21.0 billion⁵⁵. Banks operating in the UK have already additionally contributed to fiscal consolidation in the UK through the Bank Payroll Tax (£3.5 billion gross of bank payroll tax receipts were paid in August 2010⁵⁶), and now through the permanent annual Bank Levy (estimated to raise £2.5 billion for the year to 31 December 2011⁵⁷).

25. When contemplating additional taxation, it should also be considered that the some EU banks have indicated that they will voluntarily accept a significant write down on their holding of Greek sovereign debt⁵⁸, thereby contributing significantly and additionally to the reduction of government debt in the EU.

26. It is also important to remember the manifold ways in which banks contribute to the economic, social and legal fabric of our society. Not simply through the provision of financial services, but also the collection of tax on deposit interest and in assisting with the global fight against crime and terrorism through the tracking and reporting of suspicious transactions and measures to combat fraud and money laundering. Banks are also significant employers in the EU, and generate employment amongst the ancillary and support services geared towards the financial sector.

27. BBA members are significantly impacted by a range of regulatory reform measures, set internationally, to support the future stability and resilience of the financial system. The current economic and market uncertainty in the European Union (EU) reinforces the importance of ensuring that the current roadmap for international reform is prioritised

⁵⁵ 'Pay As You Earn and Corporation Tax receipts from the banking sector', HMRC, August 2011, <http://www.hmrc.gov.uk/stats/banking/intro.pdf>

⁵⁶ 'Pay As You Earn and Corporation Tax receipts from the banking sector', HMRC, August 2011, <http://www.hmrc.gov.uk/stats/banking/intro.pdf>

⁵⁷ 'Pay As You Earn and Corporation Tax receipts from the banking sector', HMRC, August 2011, <http://www.hmrc.gov.uk/stats/banking/intro.pdf>

⁵⁸ October 27, 2011 — The following statement was issued by Mr. Charles Dallara, Managing Director of the Institute of International Finance: "We welcome the announcement by the leaders of the Euro Area of a comprehensive package of measures to stabilize Europe, to strengthen the European banking system and to support Greece's reform effort. On behalf of the private investor community, the IIF agrees to work with Greece, Euro Area authorities and the IMF to develop a concrete voluntary agreement on the firm basis of a nominal discount of 50% on notional Greek debt held by private investors with the support of a 30 billion Euro official PSI package. This should set the basis for the decline of the Greek debt to GDP ratio with an objective of reaching 120% by 2020. The specific terms and conditions of the voluntary PSI will be agreed by all relevant parties in the coming period and implemented with immediacy and force. The structure of the new Greek claims will need to be based on terms and conditions that ensure an NPV loss for investors fully consistent with a voluntary agreement. "<http://www.iif.com/>

and that any additional fiscal measures are carefully considered and sequenced within the context of that roadmap.

28. McKinsey & Company, in its report 'Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation', concludes that "Basel III will have significant impact on the European banking sector. As the rules are written today and based on Q2 2010 balance sheets, by 2019 the industry will need about €1.1 trillion of additional Tier I capital, €1.3 trillion of short-term liquidity, and about €2.3 trillion of long-term funding, absent any mitigating actions... Closing these gaps will have a substantial impact on profitability. All other things being equal, Basel III would reduce return on equity (ROE) for the average bank by about 4 percentage points in Europe"⁵⁹.
29. Other regulatory measures should also be taken account of. The current estimate of a UK prefund required under the Deposit Guarantee Scheme Directive, to be established by 2020, is £12bn, whilst the current estimate for the UK prefund for the Investor Compensation Scheme Directive is £4.5bn. The five year implementation costs of the UK Retail Distribution Review will amount to an estimated £1.7bn. The combined costs of the changes required to give effect to the pending Amending Directive to the European Savings Tax Directive and the US Foreign Account Tax Compliance Act will also run to hundreds of millions of euros.
30. The European Commission's Impact Assessment concluded that "Broadly speaking, the study does not find any significant differences in the tax treatment of the financial sector compared to other sectors, with the main exception of VAT..." It further finds "The taxation of financial instruments does not seem to lead to specific tax advantages in most countries reviewed".
31. Additional taxation not only runs counter to measures required to strengthen banks, but ultimately will be counterproductive, worsening the position of EU citizens by generating additional and unhelpful costs for all consumers of financial services and taking more funds out of the financial system, making it harder for banks to support employment, economic growth and recovery through increased lending.

ii) Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

32. The question implies that additional forms of tax are necessary; however, the BBA does not accept that banks should be subjected to new taxes at present.
33. Banks operating in the UK are already subject to a Bank Levy on liabilities (excluding tier I capital, and insured deposits); the design of which was based on the International Monetary Fund's proposal in its June 2010 Report to the G20, which also set out a number of "significant drawbacks" of an FTT⁶⁰. In introducing the levy, the Government stated that the Levy was designed to encourage less risky funding and complements the wider agenda to improve regulatory standards and enhance financial stability. The Levy is

⁵⁹http://www.mckinsey.com/client-service/Financial_Services/Knowledge_Highlights/~media/Reports/Financial_Services/Basel%20III%20and%20European%20banking%20FINAL.ashx

⁶⁰ <http://www.imf.org/external/np/g20/pdf/062710b.pdf>

expected to raise in excess of £2.5bn annually. The Financial Secretary to the Treasury has noted that “Even allowing for the larger size of the UK banking sector, the UK levy is larger than that of France or Germany... the French levy is expected to raise between €500 million to €1 billion a year, much less than the £2.5 billion we shall raise in the UK, a difference that cannot simply be explained away by the different sizes of our banking sectors. Moreover, unlike the UK, the French levy is deductible from their corporation tax liability”⁶¹. The German Bank Levy is set to raise up to €1.3 billion per annum.

34. The BBA considers that a Financial Activities Tax (FAT) would impede growth in loss absorbent capital and so constrain lending. The BBA does not understand the contemplation of a tax that runs counter to regulatory efforts to boost the strength of the financial system via increased capital and liquidity. Additionally, it will result in increased costs to consumers because, while it cannot be passed on directly like FTT, it will be factored into higher pricing models.
35. On the question of other variations of an FTT, there is no basis under which the BBA could consider FTT a desirable form of taxation. FTT would raise the cost of capital with a direct adverse consequence for investment and economic activity and employment in general. We consider that this would be undesirable at any time but most particularly at present.
36. It should be apparent that adding FTT on foreign exchange transactions would have a direct detrimental effect on any international trade between countries with different currencies. While the EC’s proposal may exempt “spot” foreign exchange transactions, it would tax forward transactions and derivatives, which are very commonly used by multinational businesses to protect against movements in exchange rates. The tax would result either in a reduction in the number of hedged transactions for some businesses that attempt to keep costs down, with an attendant increase in the holding of more risky positions, or otherwise increased passed-on costs for consumers.
37. Increasing the costs of buying and selling shares and bonds harms savers, whether they be individuals holding investments directly or “institutional” investment vehicles, including pension funds, holding investments for the ultimate benefit of individuals. Charging the tax on issue of investment fund units adds a further layer of tax cost for savers and discourages the use of collective investment vehicles, a perverse outcome that jars with the widespread policy thrust encouraging saving through such means.
38. Any FAT would have to displace national levies – in order to avoid double-taxation - and be pursued globally to minimise business relocation risks and maintain a level playing field. In the absence of a global agreement (and competitive level-playing field), GDP growth, the health of the UK financial services sector and availability and pricing of a broad range of financial products will be negatively impacted.
39. Additional taxation, of whatever form, comes at a price. Banks cannot build their capital, lend more and pay more tax all at the same time. Policy makers should be aware that the imposition of such taxation would be to the detriment of economic growth and financial stability.

⁶¹ HC Deb 5 July 2011 c1419, c1418

3. What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

40. Sweden introduced a 50-basis-point tax on the purchase or sale of an equity security in 1984. A purchase and sale transaction resulted in a 100-basis-point tax. The tax applied to all trades in Sweden using local brokerage services and to stock options. It did not apply to gifts or bequests. In July 1986 the rate was doubled. The next year, a tax at 50% of the normal rate was applied to trades between dealers. In January 1989, a tax on fixed-income securities was introduced.
41. Studies suggest that revenue raised from the tax did not meet expectations: the tax on fixed income securities was expected to raise 1,500m SKr per annum, but in practice never exceeded 80m SKr in any single year. Analysis also demonstrates that as taxable trading volumes fell, so too did revenues from capital gains taxes, almost entirely offsetting revenues from the equity transactions tax.
42. Furthermore, following the 1986 announcement that the equity tax would double, there is evidence that 60% of the trading volume of the 11 most actively traded Swedish share classes, accounting for one-half of all Swedish equity trading, moved to London. Some 30% of all Swedish equity trading moved offshore; by 1990, more than 50% of all Swedish trading had moved to London. The volume of bond trading declined 85%.
43. Anders Borg, Sweden's finance minister, has commented publicly that "We abandoned [the tax] because it was a very, very bad functioning tax."⁶² He issued a warning that the EU FTT proposal would essentially be "taxing growth away from Europe, and that is not a very good idea". The BBA believes that Sweden's experience should serve as a salutary lesson for those seeking to introduce an FTT on an EU or Eurozone basis in the near future.
44. The UK's Stamp Duty and Stamp Duty Reserve Tax (SDRT) are not useful comparative tools for contemplating the probable effects of an FTT on the EU market. First, intermediaries are exempt from stamp duty / SDRT. Secondly, SDRT applies to purchases of UK shares regardless of where the buyer and seller are located. There is no incentive for the financial sector or customers to move elsewhere. The proposed FTT, however, applies where a party is located in the EU, positively incentivizing redomicile to avoid the residency principle⁶³. SDRT is collectible on the bulk of UK equity purchases by non-exempt persons because UK equities are most commonly settled in CREST, where SDRT is deducted automatically, though following recent legal developments we expect to see increased investment in UK companies through non-stampable depository receipts. Applying this approach to all EU securities traded on all exchanges worldwide would be highly challenging as an administrative matter, and highly improbable in relation to derivatives.
45. It is worth noting that the European trend has recently been towards abolishing taxes on financial transactions, for instance, Germany abolished its stock transaction tax in 1991 and France in 2009.

⁶² <http://www.bbc.co.uk/news/business-15123470>

⁶³ The European Commission's IA assumes volume decreases from relocation and disappearance of 70% and 90% of derivatives transactions

PART II Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

4. What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?

46. The European Commission outlines the objectives of its proposal as:

- To avoid fragmentation in the internal market for financial services, bearing in mind the increasing number of uncoordinated national tax measures being put in place: This seems to be a political objective of the Commission as Member States have expressly reserved the right to manage their own fiscal response to the financial crisis, with some but not all introducing bank levies. The BBA considers that a blend of national measures, with robust double tax relief, is a reasonable price to pay to maintain competitive tax systems and fiscal sovereignty. National measures that threaten the free movement of goods, services, persons or capital within the single market can already be challenged under the EU Treaty. The BBA has not seen any evidence that the levies introduced in a number of member states have caused any fragmentation in the European market for financial services. Moreover, the measures that Member States have introduced have not been transaction taxes, and so the introduction of an EU-wide FTT would do nothing to address any concerns the Commission might have about the impacts of a proliferation of national measures.
- To ensure that financial institutions pay a fair contribution to covering the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view: There has been no evidence adduced that the financial sector is under-taxed compared to other sectors of the economy; in fact, the Commission's Impact Assessment acknowledges that "Broadly speaking, the study does not find any significant differences in the tax treatment of the financial sector compared to other sectors...". Furthermore, a number of Member States have already introduced some form of additional taxation on the financial sector, such as the UK's Bank Levy.
- If the objective were for financial institutions to pay a larger contribution, the FTT would be flawed in delivering that objective as it additionally falls on the non-financial services sectors and households. The very wide definition of financial institution in the draft directive brings in investment funds, pension funds, insurance companies and even many non-financial corporate groups simply by virtue of their treasury operations.
- To create appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complimenting regulatory measures aimed at avoiding future market crises: The Commission has made much of the proposition that FTT would deter or even eliminate so-called "high frequency trading" in equities. It is debatable if this activity detracts from the efficiency of markets or indeed caused or contributed to the financial crisis. The causes of the financial crisis were complex and manifold. Borrowing among consumers, companies, investors and governments, which resulted in excessive debt accumulation and systemic risks appears to the BBA to be of more significant impact than the supposed transactional risks that the Commission has identified. What should be self-evident is that it is not possible to manage the

inherent risks associated with sophisticated and interconnected global economies through regional taxation.

Even if there were a public policy objective to curb high frequency equity trading (or indeed other particular financial market activities), our view remains that fiscal policy is too imprecise a lever to successfully or predictably drive a particular behavioural response. The FTT would penalize all investors. It would be more appropriate to employ governance and supervisory tools, rather than fiscal ones. Furthermore, we consider it highly likely that the imposition of this tax would have undesirable consequences for the efficiency of financial markets. With the inevitable decrease in liquidity, volatility of market prices would increase, leading to a decrease in stability and more extreme reactions to external shocks.

- To create essentially a new revenue stream for the Member States and the EU budget... The revenue arising from the FTT in the EU can be wholly or partly used as own resource for the EU Budget...: The BBA notes that HM Treasury has previously indicated that it is not in favour of any new taxes to fund the EU budget .

5. Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

47. The BBA does not consider there to be a desirable design for an EU-wide FTT. All forms of FTT reduce liquidity and result in increase transactional costs for investors and consumers.
48. Some specific examples of the problems generated by the Commission's proposal, are:
 - In imposing FTT on collateral payments, the EU would be creating a counter-incentive to the mitigation of counterparty credit risk.
 - In imposing FTT on repurchase agreements, also known as a repo - which are secured lending - but not on deposits and other unsecured lending, the EU would create a tax bias toward unsecured lending.
 - In imposing an FTT which has a cascading effect, the EU would undermine the secondary market for financial investments in Europe, thereby creating a greater requirement for direct bank financing of the economy at a time when other measures (notably Capital Requirements Directive IV) would require the opposite.
 - In imposing an FTT on intra group transactions, the EU would be discouraging centralization of risk and in turn sound risk management.
 - The FTT proposal would encourage a move away from low-margin / high-volume activities (primarily the liquidity provider role) in favor of higher margin activities, which by nature are more complex. This would have the combined effect of reducing liquidity for financial instruments, and incentivising banks to concentrate on complex assets, which appears to be contrary to current regulatory intent.

6. On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?

49. The BBA does not consider an FTT on any transactions to be appropriate. Furthermore, it considers the lack of exemption for intermediary activities to have damaging consequences for market liquidity and efficiency.

50. The proposed headline minimum rates of 0.1% and 0.01% are misleading. The “cascade effect” makes the effective rate of the FTT on securities much higher than the headline rate of 0.1% - perhaps ten times higher. The reason is the chain of trading and clearing that lies behind most securities transactions. A purchase of securities on a stock exchange, for example, ordinarily involves the sale and purchase by a number of parties, including brokers, clearing members and the central counterparty to the clearing system. Each sale will be subject to the FTT (with only the central counterparty exempt). By way of an example, if an investment or pension fund (or insurer) bought an equity or bond, it would presumably buy it from a financial institution. That institution would in general itself acquire the security from another institution (and there could easily be a longer chain). For each equity and bond purchase (or sale) by the end investor, there are therefore at least two transactions and four charges to tax i.e. 0.4% in FTT payable.

7. Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?

51. The proposal as drafted would mean that tax would need to be paid at both ends of a transaction. If one counterparty is based outside of the EU, the EU counterparty could be charged twice – which would appear to be both unfair and destabilising for EU-based institutions. The residence principle is anyway a misnomer because the place where a financial institution is deemed to be established, for the purposes of FTT, is determined by reference to a series of factors many of which are quite unrelated to where the institution is “resident” either as that term is commonly understood or in its technical sense of residence for tax purposes. Since parties to transactions will need to ascertain the place of deemed establishment of their counterparties to each transaction we foresee significant difficulties in the practical application of this so-called residence principle.

52. The FTT is to be levied when at least one party to a taxable financial transaction is based within the EU. Institutions based outside the EU but trading the same product, would not incur the tax, which creates strong incentives both for markets to move to financial institutions outside the EU, and for institutional redomicile, rather than curbing activity. This would further impact the Commission’s expected target yield of €57bn.

53. It is unclear how the tax would be collected in practice. However, the “residence” principles ensures that this will be a costly tax to introduce and to collect, since there will be multiple charging points. This is further complicated by the introduction of joint and several liability for the FTT on the part of the EU counterparties.

8. How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

54. The European Commission estimates revenue gains at €16bn to €57bn (although this excludes reductions in stamp duty which FTT would replace) of which 62% would be generated in the UK.

55. The Commission analysis also does not take into account reductions in receipts from other taxes. Stamp taxes on shares in the UK are - at present - forecast to raise £3.3bn in 2011-12, rising to £4.5bn in 2014-15. Inevitable reductions in corporation and personal tax receipts should also be factored into a rigorous cost-benefit analysis. To give but one illustration, consider the impact of such a tax on a defined benefit company pension scheme. The increased tax payable by the scheme will increase the amounts that the sponsoring company needs to contribute to the scheme, reducing the profits on which the company is taxed and which it could invest or distribute as (taxable) dividends to shareholders. The implications for defined contribution schemes would be similar save that it would be the scheme members who would have to increase their contributions or face lower pensions. The knock-on effects on both tax receipts and economic activity can quickly be appreciated.
56. The European Commission has detailed in its own Impact Assessment that there would be a depression of EU GDP in the long run of between -0.5% and -1.76% depending on the success of 'mitigating factors'. The factors are described in the Impact Assessment as being "at the expense of scientific rigour" and carrying "large caveats and uncertainties". The Impact Assessment also suggests the likely impact would range from -1.8% to -5.3% in the short term. The Commission's figures do not model the economic cost of decline/relocation of the financial sector.
57. The Swedish experience would suggest that in practice the revenue yield, after taking into account the relocation and depressing effect on economic activity, would be significantly lower than projected by the European Commission. The BBA anticipates that impact of such a decline in economic output would outweigh any gain from an FTT, with an overall negative effect on revenue.
58. The BBA considers it extraordinary and counterintuitive that the European Commission should countenance introducing a tax which it acknowledges would significantly reduce the GDP of the EU. Further, the BBA suggests that banks must instead be allowed to continue to do their job of supporting economic growth, at this fragile time in the macro-economy.
59. The BBA considers the use of the amounts raised by FTT to be a question for governments and not banks.

Impact and effectiveness

9. Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

60. In the sense that the FTT is certainly likely to have a severe adverse impact on all financial activity in the EU, it is true to say that it would reduce financial activity across the board. However, it should be noted that the FTT would cause parallel markets to develop outside the EU (not all EU shares or EU sovereign debts are held by holders based in the EU, for example), in which case financial activity, including both short term trading and speculation, could take place outside the scope of the FTT and potentially further from the EU regulatory and supervisory oversight. The FTT could even have the

impact of deterring effective risk management by making it more expensive to take steps such as hedging, collateralisation by way of debt securities or OTC clearing.

61. If it is desired to reduce short term trading or potentially speculative activity for policy reasons, the BBA considers that the appropriate response should be targeted regulatory measures. Furthermore, we consider that the reduction in liquidity is likely to *increase* volatility, not reduce it.

10. What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?

62. The FTT is likely to have a significant adverse impact on market liquidity. The general increase in transaction costs, the lack of any relief for financial intermediaries and market makers, and the charge on stock lending activity are all characteristics which indicate a significant reduction of liquidity.
63. Regulatory measures are already in train in relation to the practices of short selling and trading in credit default swaps (CDS). The rules will impose more transparency, increase the powers of the European Securities and Markets Authority (ESMA) and virtually ban certain CDS trades, thereby making speculation on a country's default more difficult. The BBA also notes that the European Stability Mechanism may also have the effect of acting as a brake on CDS trading. In our assessment, movements in the prices of government bonds are driven primarily by macroeconomic and fiscal fundamentals and market sentiment regarding such factors, not by speculative transactions seeking to profit from short term price movements.

11. How easily could the FTT tax be circumvented by market operators?

64. Whilst there is a risk that a number of counterparties will simply not transact, and so simply run more business risk (because it is unhedged), the greater risk is that, all else being equal, markets will naturally flow to where costs are lower (and indeed the loss is anticipated in the Commission's Impact Analysis). The American experience in relation to the introduction of Regulation Q, which resulted in a shift in demand away from US markets towards the European capital markets and provided strong impetus for the growth of a Eurobond market in London, serves as a practical illustration of what can happen and that such shifts cannot subsequently be easily reversed.
65. The majority of transactions where a non-EU counterparty transacts with a financial institution are expected to take place outside the EU, if the FTT is introduced. A considerably wider range of transactions will also take place outside the EU, because the FTT disadvantages EU financial institutions to the advantage of non-EU financial institutions. Whilst both an EU financial institution and a non-EU financial institution will suffer a charge to the FTT on a transaction with an EU counterparty, the EU financial institution will also suffer the FTT in respect of those transactions it subsequently undertakes to offset the risk it has taken on through the original transaction. The non-EU financial institution can undertake its hedging transactions without incurring the FTT and therefore can always be more competitive on the pricing of the original transaction with its EU counterparty.

Impact of the FTT in the UK

12. What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

66. An FTT would disproportionately affect the UK. This is not only because of the concentration of European financial services business within London; but also because the UK is outside of the Eurozone and so more foreign exchange trades are conducted as part of normal hedging activity. Even more significantly, London's pre-eminence as an international financial centre leads to the execution here of a great deal of international transactions involving persons outside the EU. It is precisely this type of business which is most likely to migrate beyond the reach of an EU FTT – it would simply make no sense for non-EU persons to pay a tax that they would not face when dealing with non-EU financial institutions. Accordingly, as explained above, ultimately if any EU FTT were imposed, London and, hence, the UK economy would suffer quite disproportionately.
67. The most notable impact of the FTT would be on the end user consumers of financial services through e.g. increased mortgage costs and reduced pensions, impact on ordinary savings and pension more generally through the direct tax both on the funds themselves but also on the sale and purchase of units/shares in investment funds; increased costs for importers and exporters, due to the additional costs of managing foreign exchange risk through derivatives. There would be hidden costs for British citizens, such as through the transmission of costs on transport and energy prices, as companies manage pricing risk by entering into derivatives.
68. An EU FTT would undermine the ability of the UK Government to determine the appropriate fiscal regime for the UK. In November 2010, the Government recognized in the document 'Corporate Tax Reform: delivering a more competitive system'⁶⁴, that "too many businesses have left the UK amid concerns over tax competitiveness. It's time to reverse this trend. Our tax system was once viewed as an asset. And it needs to be an asset again." An EU FTT will not enhance the tax competitiveness of the UK. Furthermore, should the EU FTT be adopted, the unanimity requirement would make it very difficult to amend or adapt, denying the UK Government the ability to alter the scope of the measure or the tax rate without securing the agreement of every other Member State, even if experience were to show that it was having a significant detrimental impact on the UK. The flexibility that the UK Government has currently to determine the most appropriate tax regime for the industry in this country is of significant benefit and the BBA believes that it would be ill-advised to lose this freedom of action.

13. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

⁶⁴ http://www.hm-treasury.gov.uk/d/corporate_tax_reform_complete_document.pdf

69. The BBA believes that there is a strong likelihood that the introduction of an FTT on an EU-only basis would lead to the substantial migration of transaction business away from Europe.
70. The UK's current stamp duty arrangements are not levied on a cumulative basis and should not, in our view, be seen as a relevant comparator with an FTT that would deliver a cumulative impact upon end users (e.g. pension funds). Please also see the answer at Question 3.

14. Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

71. The draft directive expressly precludes member states from maintaining or introducing taxes on financial transactions other than FTT or VAT. However the UK bank levy is a tax on equity and liabilities rather than transactions so it would appear there is the possibility of UK banks suffering both FTT and bank levy. The French and German bank levies are also based on year end balances rather than transactions.

Implementation

15. Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

72. If an FTT were implemented at EU level it is inevitable that there would be significant migration of activity to non-EU jurisdictions. We are doubtful whether imposing an FTT within a subset of EU member states would be compatible with the EU treaty (and its "fundamental freedoms" designed to maintain a "single" market). If it were nonetheless imposed e.g. amongst euro currency countries then it is possible that a certain amount of business would migrate to the UK from Eurozone countries. However, we note that the EC's proposal purports to have an extraterritorial impact because it deems financial institutions outside the EU to be established in the EU and hence subject to the tax whenever they are dealing with persons in the EU. Replicating that construct for the Eurozone would mean that financial institutions in the UK would still be subject to FTT on any dealings with persons within the Eurozone.

11 November 2011

The British Land Company - Written evidence

Thank you for the opportunity to comment on the FTT proposals which may affect the financial community.

We presume that there is no intention to catch “non financial business” within the FTT proposals initiated by the European Commission. Currently, the scope of FTT is defined using Alternative Fund Managers Directive (AIFMD) which could result in “non financial business” (such as bricks and mortar property companies like The British Land Company PLC) being within the scope of these proposals. Therefore, the scope needs to be carefully considered for FTT or Financial Activities Tax (FAT), should this be considered, applying the same AIFMD definitions.

Briefly, we set out reasons below why we consider FTT is not appropriate to our circumstances:

1) We are not part of banking/financial community

British Land operates in the real economy where our business is to own, manage and deliver tangible assets ie properties to meet the needs of our customers. By way of background, British Land is one of the largest Real Estate Investment Trusts (REIT) in Europe with a net worth in excess of £5bn. Our core business is developing and managing property including offices, retail premises, and housing for the benefit of businesses and citizens. As stated, we operate in the real economy as opposed to the financial economy.

As a REIT, British Land is exempt from corporate taxation on profits from rental income and capital gains on the sale of investment properties (but must meet a distribution requirement in return – see further below). The Government established the REIT regime in the UK in 2007 to allow investors to buy into real estate, especially commercial, without having to physically own particular properties. This also removed the double taxation where companies were taxed on rental income profits with shareholders also being taxed on dividend returns. British Land paid a one-off corporation tax charge of £295 million in 2007 to convert to REIT status.

REITs must distribute at least 90% of the profits of their property rental business in the form of property income dividends (PIDs) to shareholders who are then subject to tax. The aim of this is to make the tax implications of investing in REITs equivalent to that of investing directly in property. REITs are also required to meet certain conditions, such as a gearing ratio and a requirement that a minimum proportion of total profits and assets is held as property investments. They remain liable to corporation tax on non-property rental business including property management fees or profits on the sale of trading properties.

2) Subject to VAT

British Land is a net payer of VAT to the UK Government. This is achieved through the group “opting to tax” for VAT on its commercial properties. Therefore, VAT is recoverable on costs (inputs) and VAT is payable on rent receivable (outputs).

The British Land Company - Written evidence

The British Property Federation has expanded in greater detail on the above matters but I thought it useful to draw your attention to the apparent anomaly applying the proposed AIFMD definitions.

7 November 2011

British Property Federation (BPF) - Written evidence

1. The British Property Federation is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses, comprising commercial property developers and owners, financial institutions, corporate and private landlords and those professions that support the industry, including law firms, surveyors and consultants.

2. We welcome the opportunity to give evidence to the House of Lords EU Economic and Financial Affairs and International Trade Sub-Committee in relation to the European Commission's proposal for a Financial Transaction Tax ("FTT"). The focus of this response is on one narrow issue, namely, the way in which the Commission's proposal implicates real estate businesses as an alleged part of the financial sector. We comment briefly in more general terms, but focus on that issue because it is of great importance to the property sector, even though it is a small part of the overall proposal.

General comments

3. Any attempt to raise revenue from financial transactions or from the financial sector needs to be very carefully designed, because of the serious risk of unintended consequences (which are inadequately considered in the Commission's voluminous impact assessment). Generally, the Commission's proposals have too many disparate objectives with no clear prioritisation as between them and rather dubious evidence bases to support them (for example, as regards the alleged under-taxation of the financial sector). The end result is proposals that are a poor match for the declared policy objectives and very likely to have all kinds of unanticipated and undesirable consequences. The most obvious risks of unintended consequences to which the FTT proposal gives rise would seem to be:

- the cost of the FTT being passed on to ordinary businesses and individuals
- a reduction in liquidity in credit markets, with reduced access to credit for ordinary businesses and individuals
- a reduction in the liquidity and efficiency of investment markets, with reduced returns to investors
- large scale relocation of transactions or businesses, particularly affecting London, as the leading European financial centre, and other steps being taken by affected businesses to avoid or mitigate the incidence of the tax
- overall, reductions in growth, employment and even revenues, at a time when we need precisely the opposite.

4. Having regard to these risks and to the broader vulnerability of the European banking system, the already strained credit environment and the regulatory and the political pressures threatening to make things more difficult still, we strongly oppose the FTT as proposed. However, we believe that others will be better placed than we are to elaborate on these issues, so this response concentrates on the direct implications of the Commission's proposals for the real estate industry.

Financial sector taxation and real estate

5. As a trade association for the commercial property industry, we would have expected to have no more than a modest, indirect interest in the FTT proposal. Property businesses generally need access to debt finance and use derivatives (most commonly interest rate swaps) to hedge against market risks. It is common for real estate assets to be held through special purpose vehicles, and some firms provide (real estate) investment management services to investors – but overall, the real estate industry is a customer of the financial sector, not a part of it.

6. For that reason, we were alarmed by the Commission's financial sector taxation proposals in late 2010 and early 2011 which contemplated a financial activities tax ("**FAT**") levied on "*the whole financial sector*" including, in particular, "*investment funds*". The rationale for the FAT (whatever one may think of it) was constructed by reference to the banking sector and other organisations involved in the provision of credit – we can see no justification for applying the tax to investment funds, which have a fundamentally different role in the economy. We were particularly concerned by the proposal that investment funds be captured by reference to, among other things, the Alternative Investment Fund Managers Directive ("**AIFMD**"), which applies not only to hedge funds (its original and primary target), but also to private equity and real estate firms.

7. By contrast, the Commission's consultation in early 2011 explicitly stated that FTT "*would tax transactions based on their transaction value, regardless of the nature of the parties involved. [...] Therefore, its impact is not limited to the financial sector per se*" [emphasis added]. However, the FTT legislative proposal contemplates a specific taxpayer base of "financial institutions", and defines that term in a way that is problematic both because of what it includes and because of its vagueness. As a result, having originally paid little attention to the FTT proposal from a specifically real estate perspective, we are now concerned that its design is bad for real estate and sets a very worrying precedent should the FAT idea be revived in the future.

The "Financial Institutions" definition

8. Property is a complex and diverse sector. Viewed one way, it is firmly part of the real economy, building, maintaining and improving the built environment, creating jobs in the construction industry, property management and advisory professions and providing the premises that businesses and individuals need. Viewed another way, property is an important asset class that delivers a reasonably strong prospect of capital preservation and regular income, offering valuable risk diversification benefits to investors. Unfortunately, in recent Internal Market and Tax initiatives, the Commission seems intent on seeing property solely as an investment asset class, and property businesses as fundamentally financial institutions providing investment management.

9. This problem of perception largely originates in the AIFMD, a Directive which was not properly consulted on, evolved under intense political pressures, and key elements of which have yet to be even discussed properly, let alone resolved, long after its text was settled.

10. The AIFMD seeks to regulate the managers of alternative investment funds, so its key scope definitions concentrate on identifying funds and fund managers. However, other EU legislative proposals – notably a Regulation on OTC derivatives and the financial sector proposals, although there are sure to be more – use AIFMD definitions to bring funds and

their managers into broad concepts of the financial sector. This approach is deeply flawed, and throws up two discrete problems for real estate.

11. First, it is widely accepted that investment funds which invest directly in physical real estate fall within the scope of the AIFMD, and that the managers of such funds are accordingly regulated by it. That does not mean, however, that such funds or their managers are “financial” businesses when it comes to the use they make of derivatives, or for the purposes of tax proposals aimed principally at the banking sector and other providers of credit. Our objections to their being so treated have not been countered with any real arguments, but they have nevertheless fallen on deaf ears in Brussels.

12. Secondly, there is continuing uncertainty over the status of other types of property business, particularly ordinary property companies, whether listed or private. One of our members, which is a corporate property group which also carries out fund management activities for external investors, summarised the difference between the two parts of the business as follows:

- The proprietary business is very capital intensive and income is created from the economic return of the direct ownership of real estate. This is where real estate is directly owned and enhanced/developed for the benefit of the property business.
- The fund management business is not capital intensive and income derives from the fees received for providing a service to investors. It is a customer/investor focused activity, which has real estate as the asset class.

13. We are not suggesting that corporate form *per se* is a reliable and consistent indicator that an entity is not a fund or fund manager – indeed, we have not been able to identify any single, simple way of testing the status of any particular entity for the purposes of the AIFMD which will give the right result in all cases without being vulnerable to arbitrage. However, we strongly believe that most corporate groups which carry on proprietary businesses of developing, refurbishing letting and managing buildings using their own resources for the benefit of their shareholders are not fund managers. To date, it has not been possible to establish a clear consensus on how the boundary of the AIFMD should be drawn where the real estate industry is concerned. We are hopeful that a clear and sensible outcome can be achieved over the coming months, but success is far from certain.

14. Taking those two problems together, we have a situation where the Commission naturally reaches for the AIFMD definitions when seeking to impose new regulation and, now, taxation to which it wishes to subject hedge funds. As a result, bricks and mortar investors and developers which may or may not be fund managers but are certainly not financial organisations in any relevant sense, get caught in the crossfire. We believe this to be accidental in policy terms – but policymakers are terrified of making specific provision for real estate businesses lest they open up arbitrage opportunities that hedge funds might exploit.

15. One detailed example of uncertain and arbitrary outcomes resulting from the link to the AIFMD in the FTT proposal concerns the treatment of capital raisings on primary markets. The legislative proposal is clear that the issue of shares or bonds by a company on a primary market should not be subject to the FTT (recital (7)). However, as explained above, it is possible that (some or all) property companies will be treated as alternative investment funds within the scope of the AIFMD – and the legislative proposal states that

issues of shares or units by AIF should be subject to the FTT (recital (4)). No-one at the Commission appears to have considered what the 'right' treatment is, in policy terms, of capital markets issues by REITs or other listed property companies or by private property companies.

16. It is worth mentioning that, even if non-fund management real estate businesses are recognised as falling outside the scope of the AIFMD, they may – in common with who knows what other ordinary businesses – be deemed to be financial institutions by virtue of the very broad and very vague last limb (para (j)) of the proposed definition. While FTT Level 2 work might be expected to clarify matters in due course, it is deeply unhelpful that the taxpayer base of this proposed tax should be so very uncertain at this stage.

Conclusion

17. In summary, the FTT proposal seems flawed in a number of fundamental ways, but it also exemplifies a serious problem faced by the UK and European real estate industry as a result of the European Commission's indiscriminating use of AIFMD definitions in completely different contexts to which they are not well suited.

18. As an industry, we would be even more concerned to see the FAT revived, if it were imposed on "financial institutions" defined as they are in the FTT proposal. Depending on where the AIFMD ends up, that could give rise to the absurd position that UK and other European REITs, a strong global brand for property investment vehicles which are subject to a special tax regime under which tax is generally paid on distribution to investors and not at the corporate level – are nevertheless subjected to corporate taxation through a FAT.

19. Even aside from the more general concerns around these financial sector taxation proposals, we hope that the UK government will make sure that the problems accidentally created for the real estate development and investment industry by the AIFMD are not allowed to infect tax policymaking as well.

7 November 2011

The Charity Tax Group - Written evidence

1. The Charity Tax Group (CTG) has over 400 members of all sizes representing all types of charitable activity. It was set up in 1982 to make representations to Government on charity taxation and it has since become the leading voice for the sector on this issue. CTG has persuaded successive Governments to introduce a range of tax reliefs and has also campaigned successfully to protect existing concessions, saving charities a considerable amount of money in the process.
2. The proposal for a financial transaction tax (FTT) – the so-called “Tobin Tax” or “Robin Hood Tax” – appears to be gathering momentum: supporters include the Archbishop of Canterbury and Bill Gates. Oxfam, for example, is proposing an FTT of 0.05% and estimate that it could raise up to £300bn.
3. We make no comment on the advisability or otherwise of an FTT or, indeed, of a Financial Activities Tax (FAT); nor do we deal specifically with the Commission’s proposals. The purpose of this submission is to point out that a blanket imposition of either an FTT or an FAT across the board will impact adversely on the activities both of charities with investment portfolios in general and of grant-making charities in particular.
4. The Wellcome Trust, for example, has a £14 billion investment portfolio which is managed by an investment team with the aim of generating a 6 per cent real return over the long term. The income from the portfolio provides the resources that the Trust uses to fund its charitable purposes: improving human and animal health by supporting biomedical research and research in the medical humanities, public engagement and education in health matters and the application of research to improve health. The imposition of an FTT or an FAT without some kind of compensatory mechanism will reduce that income.
5. Common Investment Funds (CIFs) will be similarly affected. CIFs (established under Schemes made by the Charity Commission under section 22 of the Charities Act 1960 or section 24 of the Charities Act 1993) provide simple investment vehicles for charities. Because they are deemed in law to be charities themselves they are registered as such and have the same tax status as other charities. In effect, their purpose is to enable smaller charities to diversify their investments in a way that reduces risk, is tax – and cost – efficient and is administratively simple.
6. Inevitably, the imposition of an FTT or an FAT will take away resources from charities of all kinds and from CIFs. The result will be that they will have fewer resources to devote to their charitable purposes – and however worthy the cause to which the proceeds of the tax might be devoted, we cannot see any logic in supporting worthy causes such as overseas development at the expense of the charity sector generally. Nor, given that successive governments have resisted the hypothecation of tax revenues to any particular purpose, could there ever be a firm guarantee that the funds so diverted would be put to any specific, predetermined purpose.

The Charity Tax Group - Written evidence

7. In short: if either an FTT or an FAT is to be introduced, a mechanism should be found to relieve charities of the burden that that will inevitably impose. We do not believe that an FAT or an FTT would simply be absorbed by the financial institutions, since they do not have an existence independent of their investors. If there is a rise in costs it will inevitably be passed on to the final consumer.

7 November 2011

John Chapman- Written evidence

Summary

1 Discussion of a tax on finance must take into account the fundamental changes in financial markets over the past 25 years – with markets now dominated by hedge funds operating closely with investment banks, shorting a major market activity, and derivatives trading of many \$ trillion.

2 While steps have been taken to patch up the financial system, the opportunity for real reform following the 2008 crisis has not been taken. Instead we now have a “crazy capitalism”. Some 30% of market activity is betting against companies or countries, with companies then reluctant to take the risks of investment necessary for growth out of the economic gloom.

3 Exclusive hedge funds use their multiple and unfair trading advantages to out-perform the market, with hedge fund gains being matched by lower returns on traditional funds. Huge rewards for hedge fund managers pollute finance and other sectors.

4 The institutions and practices mainly responsible for the 2008 crisis, investment banks, hedge funds and derivatives, still dominate financial markets, and are still largely unchecked.

5 Eurozone governments are regularly humiliated by financiers betting against their bonds or banks or the euro, even though national deficits have been swollen by the financier-induced crisis.

6 A Financial Transactions Tax (FTT) at the levels of 0.1% for shares and 0.01% for derivatives would do little to address the problems of today’s bizarre capitalism. The main impact might be on high frequency traders. An FTT could, however, raise substantial revenue, though it would appear difficult to devise criteria to use that revenue to reduce national deficits.

7 With three quarters of trading reportedly down to hedge funds and high frequency traders the FTT revenue collected in the UK could depend on the extent fund managers and traders reside in the UK.

8 A “Negative” Speculation Tax, set at 1% for shares and 0.1% for derivatives (or higher), and levied on all negative or downward bets through shorting, futures, options, contracts for difference, swaps, etc , could achieve real financial reform – acting as a deterrent to shorting, phasing out hedge funds and their exploitation of traditional funds and their indefensible rewards, diminishing the institutions responsible for crises, and enabling governments and official institutions, and not hedge fund gamblers, to decide at what pace deficits should be reduced.

9 With London responsible for some 70% of hedge fund assets managed in Europe, a Speculation Tax would bring significant costs, these arising from the “error” of allowing the City to become a bridgehead into Europe for today’s crazy capitalism. But the UK would have a strong case for using revenue gained by a Speculation Tax to reduce such costs.

10 A Speculation Tax would lead to a reorientation of financial markets away from betting against companies and towards a focus on companies boosting the R&D, capital expenditure and employment projects necessary for growth out of the economic downturn.

PART I General questions on financial sector taxation

Background – the scarcely believable changes in financial markets

11 Before discussing the merits of different taxes, it is important to recognise the fundamental changes in financial markets - changes that are little known and even less understood. The lack of any discussion of these changes and their implications is a substantial weakness of the Commission's background papers to its proposal for a Financial Transactions Tax (FTT).

12 Today's financial markets are dramatically different from those of 25 years ago. **US hedge funds**, allowed by Reagan to be unregulated for millionaires and certain institutions, now dominate. Betting long or short through multiple strategies, and operating hand in hand with prime brokers of Wall Street **investment banks**, managers of the \$1.5 trillion of hedge funds accounted for 30-60% of activity in the main sections of New York and London stock exchanges in 2007 – about the same as the \$60 trillion of long investors managing pension, insurance and mutual funds put together (1). In effect, “the market” is now led by the hedge fund gamblers.

13 **Shorting**, the borrowing of shares to sell and to bet against companies, was at trivial levels in the mid 1990s, but then took off with the rise in hedge funds, to now account for some 25/30% of equity trading (2), and even as much as 30/40% of trading overall (3). Little known and murky securities lending is now a major industry serving the short-sellers.

14 The value of world financial transactions, which was 25 times world GDP in 1995, rose to 70 times that value by 2007 (European Parliament 2010). The growth of transactions has been concentrated in **derivatives** (literally products derived from basic products, like an option to sell a share at a price next year) (4). Between 2002 and 2007 the gross nominal value of credit default swaps alone rose from \$2 trillion to \$60 trillion (5). The past decade has also witnessed explosive growth in algorithm or computer driven trading, much of which is high frequency trading.

Background – A weak response to the 2008 crisis

15 In a recent article “A good crisis gone to waste”, the Financial Times columnist John Kay lamented that the opportunity to reform the financial system presented by the 2008 crisis had been missed. “Not only are investment banks back in business as usual, they have successfully transferred most of the consequences of their own failure to governments and the rest of the economy” (6)

16 There have been some reforms. The EU Alternative Investment Fund Managers Directive and the US Dodd Frank Act has introduced timid regulation of hedge funds. The US Volcker rule is aimed at preventing banks from owning or investing in hedge funds, or engaging in proprietary trading. The UK Vickers report goes some way in the same direction. Trading in derivatives, calamitously deregulated under the Commodities Futures Modernization Act

2000, is to become more transparent. The EU is to ban naked credit default swaps. Basle III tightens bank capital and risk-taking. But, as Kay suggests, little has really changed. The message “Let the show go on” has so far won the day, however crazy the show may be.

Background - A crazy capitalism

17 Debating “What can governments do facing the markets?” in Le Monde, the writer Maria Nowak commented that “What we have now is not a market economy but a crazy capitalism, beneficial only to a few” (7). It is indeed crazy to:-

- Allow betting on the downfall of companies or countries to become a major activity of financial markets, a development that is basically immoral. Also it is inhibiting to company expansion. Companies must not fear that one false move will lead to a shorting attack.
- Ignore the multiple (and unfair) trading advantages of hedge funds. Not only can they indulge in shorting, they face few constraints in employing derivatives and leverage, in taking betting positions, and in using tax havens. As indicated earlier this year (8), in gross terms hedge funds outperformed the market by some 14% a year over the last 12 years. With the market being a zero sum game, such gains must have been matched by lower returns for traditional funds.
- Allow hedge fund managers to make billions from their gambles. In a speech earlier this year FSA Chairman Lord Turner referred to the resented “excess wages” or bankers’ bonuses, and pointed out that hedge funds have the highest remuneration of all (9) .
- Allow democratically elected governments to be regularly humiliated by financiers, particularly as government deficits have been swollen by the financier-induced crisis. Financial Times headlines like “US hedge funds short Italian bonds” (10), and “European banks face short sellers fire” (11), give the flavour.
- Allow the institutions responsible for the 2008 crisis still to dominate financial markets. In its report the US Financial Crisis Inquiry Commission was scathing about derivatives promoted by Wall Street investment banks, and described how exiting hedge funds had become a torrent which caused financial markets to seize up (12).

My response is in two parts, dealing first with a Financial Transactions Tax (FTT), and then with a Speculation Tax (ST).

PART I of the inquiry – General questions on financial sector taxation

Case for a tax on financial transactions, and its appropriate form.

18 With financial services being exempt from VAT, there is a case for a tax to align with other sectors. There is also a case that the financial sector should “pay for” the financial crisis. But a general tax would be crude in that some institutions were more culpable than others. The Commission’s working papers suggest that an FTT would be more appropriate than options like a Financial Activities Tax. An FTT would impact particularly on High Frequency Trading, a practice which increases systemic risks, and can be used unfairly.

19 Aside from an FTT, there is a powerful case for a Speculation Tax to remove the features of today's crazy capitalism, as discussed from para 31.

Part II – Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

20 In its paper "Executive Summary of the Impact Assessment" of an FTT, the Commission set out problems (costs of crisis, tax advantages of financial sector, market failures and systemic risks), and objectives to tackle such problems (13).

21 The Commission's "problems" do not correspond with the problems of today's "crazy capitalism", i.e. excessive shorting, exploitation of traditional funds by hedge funds, offensive rewards of hedge fund managers and bankers, humiliation of governments by financiers, and continuing domination of markets by the institutions responsible for the worst crisis and recession of our lifetime. So it is difficult to discuss the objectives set out by the Commission as they do not address the real problems.

22 There is some attraction in a tax to recoup the costs of the crisis, and to pay for future crises, but it is difficult to judge how any revenues might be deployed "equitably" to cover such costs. For example, the Committee asks whether the revenue should be used to finance the deficits of Member States.

23 Table I (attached) shows the deficits and public debt of several West European countries. In all countries deficits as percentage of GDP increased significantly between 2007 and 2010, with the largest increases in Ireland, Spain and the UK. The largest deficits in 2010 were in Ireland, Greece, the UK and Portugal. Does this make the UK a prime candidate for support from an FTT revenue pool?

24 Prima facie, the Commission's proposals on design, coverage and residence principle appear sensible. It is not clear, however, how trade between non EU residents on EU exchanges would be covered. The appropriate rate of tax is difficult to judge, and 0.1% on shares and bonds and 0.01% on derivatives (why a 10-fold difference?) appear like figures plucked out of the air.

Impact and effectiveness

25 The impact of an FTT would depend crucially on its level. At the rates proposed it seems likely that an FTT would only be a minor irritant, except for high frequency traders. It would probably have little effect on "liquidity, volatility and harmful speculation" – issues raised by the Committee.

26 Relating to the problems brought by "crazy capitalism", an FTT at the rates proposed would be lobbied against, but ultimately shrugged aside by the hedge funds and their investment bank "partners"

Impact of an FTT on the UK

27 The ten City trade associations, representing insurers, financial markets in Europe, hedge funds, private client investment managers and stockbrokers, bankers, futures and options operators, investment managers, swaps and derivatives operators, security lending, and energy and wholesale brokers, have written a collective letter to the Chancellor advocating a robust opposition to an FTT (14).

28 Their letter was surprising in that it raised broader economic concerns, possible increases in costs, and derivatives trading leaving the EU, rather than presenting a convincing assessment of what the tax might mean for the UK and for the City in particular.

29 The associations also chose not to mention UK stamp duty on equity trades, which at 0.5% is higher than the 0.1% proposed for an FTT. If an FTT led to harmonisation of rates, conceivably UK residents buying UK equities could face lower costs.

30 According to the Investment Management Association, “a good three quarters of stock market turnover is down to hedge funds and high frequency traders, not traditional investment managers” (15). So the impact of an FTT on the UK could depend largely on how many hedge funds and high frequency traders were resident in the UK.

Return to Part 2, focusing on a Speculation Tax

Rationale for a “negative” Speculation Tax

31 A Speculation Tax is needed to eliminate crazy capitalism – to discourage shorting and its damage to company growth, to phase out hedge funds and their parasitic exploitation of traditional funds, to do away with hedge fund rewards as the probable root cause of excess wages in the finance sector, to remove the instigators of world financial crises from their dominant positions, and to relieve governments of the costs of shorting attacks.

32 A Speculation Tax might be set initially at 1% on shares and bonds, and at 0.1% on derivatives, and then raised as necessary to reduce shorting to its trivial levels of 25 years ago, and to phase out hedge funds, as discussed last year (16). Its primary purpose would be to reform financial markets, not to gather revenue.

33 **Such a tax would be focused on “negative speculation”**, typically on betting that a company’s share price would fall, and on other means of shorting -through futures, options, contracts for difference, credit default swaps, etc, including shorting as part of hedging operations. A “positive” speculation tax might be used in special circumstances, eg against bubbles. But the overall aim of a Speculation Tax would be to discourage negative bets, and thereby to point markets towards encouraging investment and growth.

33 **Discouraging shorting.** Shorting by hedge funds has reached immoral levels. With some 30% of trading in equities made up of bets against companies, the effect on company risk-taking and growth must be strongly negative, as companies seek to avoid set-backs that attract the attention of short sellers. “It is particularly damaging when vulnerable companies are targeted by naked short sellers, who then destroy any remaining market confidence, and drive companies to the brink” (17). (Note – in reality attacks do not need to be through

naked short selling, as shares to short are generally available through the murky and little known securities lending industry).

34 Phasing out hedge funds. The unfair trading advantages of exclusive hedge funds (ability to short, freedom with derivatives, leverage and tax havens, etc) result in dramatic out-performances. Over the past 12 years net returns of hedge funds overall, as indicated by the Hennessee Composite Index, (which has lower returns than others, and so, it is hoped is less bias-prone) have averaged 9% a year, compared with S&P returns of 2% a year. In gross terms outperformance is even more striking. With manager fees of 2% a year and 20% of profits, 9% net becomes 14% gross. Adding 2% for securities lending and broker fees, overall gross performance amounts to 16% a year (18).

35 In gross terms hedge funds have outperformed the market by some 14% a year over the past 12 years. (In the eight years when markets rose outperformance averaged 8% a year, and in the years when markets fell it averaged 22% a year – indicating the huge advantages of being able to short). With the market being a zero sum game, the bill for such out-performance is shouldered by traditional funds through their returns being lower. In effect the hedge fund gamblers are simply parasites living off traditional funds.

36 Removing excess wages. In 2009 the top 10 hedge fund chiefs received from \$825m to \$4billion (19). Such rewards pollute the financial sector, with banks forced into absurd bonuses to retain key staff. Other sectors then play catch up, with the USA and UK being amongst the world's most unequal countries. In the USA incomes of the top fifth of people are 8.5 times those of the bottom fifth. In the UK the ratio is 7.2, France 5.6, Germany 5.2, Sweden 3.8, and Japan 3.4. Most social ills rise with inequality (20).

37 Removing culpable institutions from their dominant positions. The 2008 crisis, and its' devastating economic effects, was largely caused by investment banks selling highly rated but in reality toxic derivative mortgage products, Collateralised Debt Obligations (CDOs). Panicking leveraged hedge funds then applied the coup de grace by overwhelming the markets in their rush to the exits. The immediate cost of the crisis was swollen by hedge funds using other derivatives, Credit Default Swaps, to bet against the CDOs (most shamefully in collusion with investment banks selling the toxic products), with the bail-out bill for AIG alone rising to \$180 billion (21). Yet investment banks, hedge funds and derivatives still dominate financial markets, still unchecked.

38 Allowing governments, and not hedge funds, to decide on the pace of tackling deficits. Hedge funds, whose owners and managers are largely American, are now focusing their artillery attacks on bonds of Eurozone countries and on the euro, in effect deepening the Eurozone crisis with gambles which academics suggest are not justified by the actual fiscal deficits (22). It is also argued authoritatively that "it is actually the US dollar, rather than the euro, that looks the more vulnerable of the two currencies" (23). That hedge funds are less eager to attack their mother country, or even their UK cousin with its large deficit, suggests a political side of their operations.

39 The reforms resulting from a Speculation Tax would bring about **a reorientation of financial markets** with activities focused on investing in companies offering the best prospects for growth and returns – with betting on companies to fail becoming a distant memory. Such a new focus would appear essential if companies are to lead countries out of the economic downturn.

40 The proposed design features, coverage of transactions, and residence principle for an FTT might of trades not caught by the residence principle. It would clearly be undesirable if non-resident hedge funds were allowed to bring their negative impacts to EU markets.

Impact and effectiveness

41 The problems of short term volatility, harmful speculation and excessive risk-taking should disappear with a Speculation Tax. Opponents would put forward the usual academic arguments for short selling – more liquidity, lower bid/offer spreads, better price discovery, tackling of bubbles, etc. But academics suggest there is excessive liquidity in markets (24). Other academics point to price manipulations and predator trading strategies.

42 As for hedge funds pricking bubbles, the opposite appears to be the case. Some academics (25) found that hedge funds exploited the 2000/2003 dotcom bubble, cashing in extensive holdings before the crash. They were aware of the bubble, and decided the best strategy was to ride the wave, rather than correct prices. Another academic (25) concluded that “The dotcom bubble to a large extent was driven by hedge fund speculation”.

43 Such academic disputes may be insignificant compared to the harmful effects of shorting on companies, the exploitation of traditional funds by hedge funds, and the other negative features of the crazy capitalism brought by hedge funds and their investment bank operational partners.

Impact of a Speculation Tax on the UK

44 TheCityUK’s latest paper on hedge funds indicates that London is the largest hedge fund centre in Europe. While the bulk of hedge funds are managed in the USA, some 22% are in Europe, with hedge funds located in London managing about 70% of European based hedge fund assets (27).

45 Arguably the City made a huge error in allowing US hedge funds to establish a European bridgehead in London, with crazy capitalism impacting negatively on companies and traditional funds in the UK and elsewhere in Europe. There may then be dislocation costs for the UK as hedge funds are phased out, but the UK would have a strong case for revenue from a Speculation Tax being used to meet such costs.

46 The long term interests of the UK lie in backing a Speculation Tax to phase out shorting and hedge funds, and in joining German Finance Minister Schauble in leading the reorientation of financial markets towards investment in R&D, capital expenditure, employment and growth.

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Table 1 - Budget deficits and National Debt of West European Countries

	Budget deficit		National Debt	
	% GDP	% GDP	% GDP	% GDP
	2007	2010	2007	2010
Austria	-0.9	-4.4	60.2	71.8
Belgium	-0.3	-4.1	84.1	96.2
France	-2.7	-7.1	64.2	82.3
Germany	0.2	-4.3	65.2	83.2
Greece	-6.5	-10.6	107.4	144.7
Ireland	0.1	-31.3	24.9	94.9
Italy	-1.6	-4.6	103.1	118.4
Netherlands	0.2	-5.1	45.3	63.9
Portugal	-3.1	-9.6	68.3	93.3
Spain	1.9	-9.3	36.2	61.0
Sweden	3.6	0.2	40.2	39.7
UK	-2.7	-10.3	44.4	79.9

Source: eurostat release, 21 October 2011

7 November 2011

Chown Dewhurst LLP⁶⁵ - Written Evidence

The Tobin Tax has never had any serious support amongst economists, and although the FTT now being proposed by the European Union has substantial and understandable populist support, it would be very damaging generally, and specifically to the UK economy as a whole. This would not fall mainly on the financial sector. Although a supporter of UK EU membership, I am very concerned with the risk to us arising from the strong political desire in the EU to get legislation through, in defiance of the basic principles of 'States Rights' which should underlie even a full Federal Union.

The measure is obviously a 'tax' which should be governed by the Article 113 unanimity rule, but it is very clear that the proponents are employing a large team of lawyers in the hope of finding a loophole through which they can force the measure. We really need to deploy the best of our own legal and diplomatic talents to protect ourselves. One possible loophole is the "enhanced co-operation procedure", and the measure may only be imposed on those agreeing to it - probably the eurozone. We will not know until we see the detailed provisions what the impact of these would be on the UK but we have to prepare for the worst.

What are the costs and benefits of the proposal? The two objectives: are to change the behaviour of the financial markets, and to raise revenue (specifically "fonds propre"). Will it, and should it, succeed in either?

Financial markets perform a valuable service in the efficient intermediation of finance, and the analysis and spreading of risk. Taxes on transactions notoriously reduce the liquidity, and add to the cost of intermediation. Yes, there have been very serious abuses by banks but these arose, not from the nature of markets, but from conflicts of interest, mis-selling, the principal-agent problem and excessive risk-taking by those who personally benefit from the upside but leave the downside with others – in the last analysis the taxpayer. As a stern critic of such practices I have the last couple of years written two articles and three book reviews on this theme for "Central Banking" - and read and talked about it a great deal more. This is a real problem which needs to be addressed, but there is nothing to suggest that the FTT will make a significant contribution.

It is claimed that €57 billion per annum will be raised by the tax, but have they taken sufficient account of the reactions of how potential payers will adjust their actions in consequence? If this tax is raised, the EU's own impact assessment states that the negative impact on the GDP level in the long run is expected to be limited (!) to around 0.5%. All taxes cost the taxpayer more than the net benefit to public expenditure, partly because of administrative and compliance costs, but also because they do distort (mostly, but not always, adversely) economic activity. particularly in the case of an ill-conceived tax. The EU figures suggest that this will be a very bad trade-off for the EU economy as a whole. The only real beneficiaries will be the Brussels bureaucracy. I have mentioned conflicts of interest - is this confined to the banks?

Who will bear the tax? Not necessarily those paying it. The issue of 'tax incidence' can be complex, but it is obvious (e.g.) that VAT is paid by the supplier and borne by the consumer,

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while stamp duty is paid by the stockbroker but borne by the purchaser. This raises a very interesting point. Where tax is imposed (with the Cascade Effect) on non-financial organisations (using the markets for their real purpose) the tax will be passed on and will be an additional cost to manufacturing and service organisations and, to a lesser extent, to pension funds. FTT will to this extent raise revenue for Brussels (but see below) with probably moderate damage. However, the very much larger volume of speculative transactions, proprietary trading and high-speed trading will simply move away, and the tax will contribute to neither objective.

If the €57 billion is raised in the EU, nearly half (up to £20 billion) could come from the UK, equal to nearly 40% of the total raised in taxes from UK financial institutions. If this were actually to be achieved, at whose expense would this be? The answer is interesting.

The costs borne by bona fide, resident taxpayers will reduce their own profits, and the tax take from such profits. It will also reduce the price of the shares, many of which are held by pension funds who will also bear directly the costs imposed on financial services rendered to them.

Even if the tax was borne by the banks, as proponents appear to hope, this would reduce the tax they pay (and pensioners would suffer to the extent to which pension funds own banking shares). Where it fell on banks largely government owned or supported the general cost would fall on the taxpayer. International banks may decide to move outside the United Kingdom altogether, as some have been considering. So far, they have been influenced by favourable changes in UK corporate taxation, but FTT may become a decisive factor, causing even more loss of tax revenue than just that involved with the FTT.

A substantial part of the tax paid to Brussels would therefore be at the cost of the British taxpayer, simply transferring revenue from the UK budget subject to Parliamentary scrutiny (and a National Audit Office which is allowed to be effective) to Brussels where there are no such safeguards. Another part of the damage would fall on pension funds, which means most of us. This is surely not a good trade-off, from whatever point of view we look at it.

25 November 2011

City of London Corporation - Written evidence

Submitted by the Office of the City Remembrancer

Introduction

1. The City Corporation welcomes the opportunity to contribute to the Committee's scrutiny of the rationale behind the introduction of a financial transaction tax. The City is a strong advocate of a fiscal structure for UK-based financial services (regardless of the nationality of ownership) that will enhance the stability of the financial system, restore public confidence and safeguard the competitiveness of the sector. A healthy and thriving financial services sector provides funding and other support for business growth (including smaller businesses), creates employment, generates export earnings and produces tax revenue (via Corporation Tax, VAT, Income Tax and Stamp Duty). This UK-based activity therefore needs to remain competitive if Britain is to continue both to attract international business and to prosper in global markets.
2. The Corporation's work on financial regulation and tax matters is informed by the International Regulatory Strategy Group (comprising senior representatives from a variety of industry sectors including investment banking, asset management, insurance, legal and accountancy services, exchanges and market infrastructure). Its role includes identifying strategic level issues where a cross-sectoral position can add value to the expression of views from particular sectors.
3. The City Corporation is responding to the Committee's questions within the context of a Financial Transaction Tax being implemented at an EU-level, as outlined in the EU Commission's proposals.

Consideration of the Committee's questions

1. Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

In the City Corporation's view the case has not been adequately made for such a tax. No arguments have been put forward which show unequivocally that it would strengthen the stability of the European financial system, or boost the development of emerging economies, or of itself provide a revenue reserve against future bail-outs of banks and other financial institutions. The European Commission has also published an impact assessment into the effects of its own proposals for such a tax. The impact assessment actually demonstrated that more money could be lost by firms relocating outside of the EU than would be raised by the tax.

2. Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

Raising the cost of financial transactions through the imposition of an FTT might serve to deter market participants from entering into transactions, one consequence of which might be to dampen volatility, but the argument for this is not conclusive. There is no precise definition of "harmful speculation" and "excessive risk taking" against which the likely impact of an FTT can be judged.

3. What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

Given the concentration of EU and international financial services activity in the London markets, in areas including bond and equity issuance and trading, foreign exchange, asset management, insurance and reinsurance, the impact of such a tax imposed at a pan-EU level on the UK would be unfavourable and disproportionate. The EU's impact assessment also estimated that 62% of the revenues generated by an EU-wide transaction tax would come from the UK. If as a result transactions were increasingly booked in other non-EU centres, there would be a gradual loss of critical mass in London, international businesses would choose to carry out activity (including possibly non-transactional activity) elsewhere, and there would be a negative impact on direct and indirect tax revenue and on employment in financial and related business services.

4. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

The City Corporation believes there is a real risk that the introduction of an FTT, to which business conducted in the UK is subject but which was not applied globally, would be a considerable factor in driving essentially mobile transactions to other centres. Such transactions could include trading in non-EU or Euro and Sterling denominated equities and bonds, foreign exchange transactions in non-EU currencies and insurance or reinsurance contracts.

Stamp Duty on the purchase of listed equities has been a feature of the UK's fiscal system for many years. Those participating in the UK equity market have been able to plan for it. The Duty is applied to a specific type of transaction at a specific point in the transaction process. While it is suggested that there are significant economic arguments for abolishing the Duty or reducing the rate at which it is applied, it cannot be compared with an FTT in its impact on the overall cost of financial services transactions. It would also be important to note that if an FTT were to be applied, the need to avoid further increases in the cost of capital impacts on the equity market, would imply a reduction in the rate of Stamp Duty and consequently a possible loss of direct revenue to the UK Exchequer.

5. Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

A FTT would certainly be an additional fiscal burden, falling not only on banks but on other financial institutions, which are of course already subject to the same taxes as other areas of the economy – Corporation tax, business rates and others. The additional risk is that the costs of an FTT would be passed, in whole or part, directly to consumers, whether in the retail or wholesale area. Not only would this be an additional cost burden in recessionary times, but might deter consumers from undertaking financial transactions which are economically or socially desirable, including insurance and retirement saving.

15 November 2011

Confederation of British Industry (CBI) - Written evidence

- *The CBI is the UK's leading business organisation, speaking for some 240,000 businesses that together employ around a third of the private sector workforce.*
- *Our contribution to the EU Economic and Financial Affairs and International Trade Sub-Committee, focuses on the impact of the proposed Financial Transactions Tax ("FTT") on business and the economy.*
- *The CBI's membership encompasses companies of all sizes and sectors, including firms in the financial sector, so we are uniquely well placed to do this.*

Executive Summary

The CBI represents a broad cross section of UK businesses from across the financial and non-financial sectors. We strongly oppose any attempts to introduce a financial services tax at the EU level for a number of fundamental reasons:

- The priority for legislators must be economic growth, now and for the foreseeable future – but this tax will be substantial and hit business and investment.
- The tax would be hugely damaging for the broader business sector, not just the European financial sector.
- Estimates of revenue raised by the tax in the European Commission's Proposal are less than its expected economic cost, and the assumptions on which they are based are flawed.
- The FTT will not support the financial reform programme in any meaningful way.
- Arguments that the financial sector is under-taxed are not convincing; and tax increases would in any case simply get passed through to customers.
- The principle of subsidiarity applies - any financial services taxes should be for individual member states to decide.

We do not believe that a tax that hurts businesses and individuals, reduces economic growth and damages an important industry whilst bringing little guarantee of significant new revenue should be introduced.

PART I – General questions on financial sector taxation

I. Is there a case for the introduction of a tax on financial transactions?

We do not believe that a tax that hurts businesses and individuals, reduces economic growth and damages an important industry whilst bringing little guarantee of significant new revenue should be introduced.

Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

We do not believe that the current exemption from VAT gives the financial services sector an advantage which needs correcting...

Financial services firms are unable to recover the VAT they pay when producing a service. Indeed, financial services firms have higher VAT costs than companies in other sectors. From a UK perspective, irrecoverable VAT comprises a quarter of all tax paid by the sector and the UK financial services industry's overall share of tax paid compares well to the sector's proportion of GDP⁶⁶.

The VAT exemption benefits consumers who would be hit by any attempt to remove it. The financial services providers themselves, however, are unable to recover the VAT they pay when producing a service.

Financial services firms also pay contributions to deposit guarantee schemes and investor compensation schemes.

In particular, unlike VAT, there is no mechanism within the FTT proposal for FTT paid earlier in a series of principle transactions to be credited on later transactions. This, together with the application of FTT to collateral postings, will cause the FTT to be multiplied many times for some common transactions.

2. What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

Governments should not single out specific sectors for tax treatment...

The CBI does not believe that governments should single out specific sectors for tax treatment. We believe that there are certain principles of taxation that all taxes should meet regardless of the sector on which they are being imposed:

- simplicity and clarity
- certainty and stability
- flexibility
- neutrality⁶⁷.

The FTT clearly fails a number of these tests. In an international context, we could also add to these the principle of subsidiarity, which comes under threat from an FTT.

3. What lessons can be learnt from the experience of other countries (such as the transactions levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

Examples from abroad show how quickly and permanently certain financial services would exit the UK...

In summary, the imposition of an FTT in Sweden led to:

⁶⁶ PricewaterhouseCoopers estimates UK financial services contributed 11.2% of government tax receipts in 2010 compared to its 10% share of GDP. **Source:** The CityUK

⁶⁷ Neutrality relates to the principle that the tax system should not distort business decisions – both in terms of whether a transaction is undertaken and how it is structured. It would appear the FTT has the exact opposite aim in mind: its purpose is to distort business decisions.

- 60% of the trading volume of the 11 most actively traded Swedish shares, and more than 50% of all Swedish equity trading, moving to London
- The volume of bond trades falling by 85%, futures trades by 98%, and the money market transactions fell by 20%.

The experience of Sweden is the example most used to highlight the impact of an FTT. It demonstrates that an FTT has the impact of forcing transactions to relocate away from the affected jurisdiction.

The Commission has adopted this example *as their base case* demonstrating that they expect – and want – the outcome of the Swedish Tax to be repeated in Europe. Their impact assessment is based on two scenarios which assume a transaction flight of 70% and 90% respectively, “based on the Swedish experience”⁶⁸. As the majority of these transactions occur in London, the UK would be affected disproportionately.

PART 2 – Specific questions on the Commission’s proposal for an FTT

4. What is your assessment of the Commission’s objectives as contained in its proposal for an FTT? Are they fair and appropriate?

The Commission’s objectives are neither the right ones or likely to be met...

The European Commission cited three objectives of the FTT. We comment on each in turn:

- to ensure that financial institutions make a fair contribution to covering the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view*

There are a number of flaws with this statement, but most concerning is the implication that this tax could be used for financial services to repay the costs to society of the financial sector.

The financial crisis had a number of causes, and among them were failures of risk management in a number of banks and investment firms.

However, the impact of the FTT will be felt for the most part by end-users, not large financial firms. This includes individuals saving for their retirement and businesses trying to raise funds or sensibly manage their risk. This penalty would be felt by businesses in the form of increased costs of financial products.

“While an FTT would have the greatest impact on low-margin, short-term trading, it would also increase the cost of capital for all firms issuing taxed securities, since investors would require higher returns to compensate them for reduced liquidity. This increase would be greater for issuers of more frequently traded securities, such as large corporations, since expected costs of trading activity would be capitalized into security prices. Some studies find that these effects are quite large, and hence could have a significant adverse impact on long-term economic growth.”

IMF, “A Fair and Substantial Contribution by the Financial Sector”, June 2010

The FTT’s impact would not be restricted to firms which pose the greatest risk to financial stability as these are not necessarily the firms that undertake the most market transactions.

⁶⁸ European Commission, FTT Impact Assessment Summary, p.10

The tax is likely to fall most heavily on consumers saving for their future, those parts of the industry which were less involved in the financial crisis, for example insurance firms, and those whose failure did not pose systemic risk.

“An STT⁶⁹ disproportionately burdens sectors and activities that issue or trade securities more heavily. These sectors include the financial sector itself, which is the single largest commercial consumer of financial services, as well as pension funds, public corporations, firms engaged in international commerce, and public entities (assuming that the tax was imposed on government bonds). The cascading effect of a transactions tax would impose multiple layers of tax on some transactions, so that even an apparently low-rate STT might result in a high tax burden on some activities.”

IMF Working Paper – Taxing Financial Transactions: Issues and Evidence March 2011

- ii. *to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures aimed at avoiding future crises.*

The FTT is supposedly aimed at reducing the number of “risky” practices, but in reality it does not discriminate. All transactions would be hit, from risk management products to long term pension investments.

Neither the European Commission’s Proposal nor its Impact Assessment suggests any scenarios where the tax would be a more effective means of reducing regulatory or systemic risks than regulation. As a matter of principle, undesirable market behaviour should be dealt with through regulation. There is a range of reforms underway with this objective.

“[FTTs are] not focused on core sources of financial instability. An FTT would not target any of the key attributes—institution size, interconnectedness, and substitutability—that give rise to systemic risk; adjusting the tax rate to reflect such considerations would be possible in principle, but highly complex in practice.”

“If the aim is to discourage particular short-term transactions, regulation or targeted taxes are more effective [than an FTT]”

IMF, “A Fair and Substantial Contribution by the Financial Sector”, June 2010

For individual firms, the increased costs that the tax will lead to is likely to discourage the use of financial products, including derivatives. Far from being transactions which “do not enhance the efficiency of financial markets”, the use of derivatives to sensibly manage risk is essential for a the majority of types of business. They allow firms to manage their risks and focus on their businesses, allowing them to invest over the longer term, export to customers outside the UK and manage the price of their raw materials.

⁶⁹ Securities transactions tax (STT) is defined in the IMF Working Paper as “a tax on trades in all or certain types of securities (equity, debt and their derivative)”. “It may include original issuance (similar to a capital levy), or be restricted to secondary market trades. Though a STT may be levied as a flat fee per trade, it is more commonly an ad valorem tax based on the market value of the securities”.

In respect of the market as a whole the FTT may damage stability as it is likely to increase volatility. The Commission's own impact assessment itself says that "the economic literature concludes that the effects of the FTT on volatility is largely inconclusive"⁷⁰ and in the Impact assessment states that there is likely to be 'a positive relationship between transaction costs and volatility'. We believe that the FTT would increase volatility, rather than reduce it, particularly if markets relocate from Europe as less liquid markets can be more volatile.

- iii. *to avoid fragmentation in the internal market for financial services, bearing in mind the increasing number of uncoordinated national tax measures being put in place*

We have not seen any evidence that suggests that different taxes on financial services firms and transactions across Europe has caused fragmentation of the internal market or any clear suggestion of what the mechanism of this supposed fragmentation is. The Proposal and Impact Assessment do not explain how this fragmentation manifests or what solution the proposal provides. It is not clear how the FTT will have any effect on other "uncoordinated national tax measures".

- 5. Does the Commission proposal for an FTT reflect the most desirable design for an FTT?**
- 6. On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?**
- 7. Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?**

We do not believe that a tax that hurts businesses and individuals, reduces economic growth and damages an important industry whilst bringing little guarantee of significant new revenue should be introduced. So we have chosen not to answer questions on the specifics of how the tax should be implemented, as covered in questions 5-7.

- 8. How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream?**

Estimates of revenue raised by the tax and the assumptions on which they are based are flawed...
The Proposal document sets out an estimate that €57 billion would be raised through the tax each year.

However, the Commission's Impact Assessment, which is intended to support the Proposal, has a far wider range, estimating that somewhere between €16.4bn and €434bn would be raised. This will depend on a number of factors, including levels of relocation. It 'stresses' that these assumptions are '*subject to uncertainties and caveats*' and emphasises that '*uncertainty about revenue potential is large*'.

There is therefore no guarantee that the tax will result in significant revenues despite the significant economic cost.

⁷⁰ European Commission, FTT Impact Assessment Summary, p.10

Where would the true incidence of the FTT fall?

The impact of the FTT will be felt ultimately by end-users, not large financial firms. It is likely that in most circumstances the final tax burden will rest with investors and customers of financial services firms. This might arise in the form of higher prices for financial services or products, it might hit consumers' savings, and it might reduce firms' ability to raise funds from banks or the market.

“In a small, open economy, the after-tax return on capital is determined on the world market. In response to imposition of the Securities Transactions Tax (STT), capital would flow out until its after-tax return was restored to the world market level. In the long run, capital owners would therefore not bear the burden of the STT; it would fall on workers, who as a result of the smaller capital stock would be less productive and receive lower wages.”

“As the increase in transactions costs reduced financial transactions and investment, financial firms' dealing, trading, and underwriting profits would contract. Since the tax on surviving transactions would apply to all financial firms, they would likely be able to pass its cost on to their customers.”

IMF Working Paper – Taxing Financial Transactions: Issues and Evidence March 2011

Moreover, since all transactions between intermediaries when acting as principal would be subject to the FTT, the rate of 0.1% (or 0.01%) would be multiplied and the cost increased further.

Other than the direct financial impact, an FTT would act as a disincentive to save and invest, obtain proper insurance and use other financial risk management products.

In the wider economy, the Commission's impact assessment recognises that the FTT would damage business, suggesting that the tax will increase the cost of capital for business and would reduce levels of investment. It would also stifle economic recovery, hitting employment and savers. It warns that the tax could have 'far reaching potential impact on the financing of investment projects'.

This impact is very worrying, but this is compounded by the fact that that the size of the impact has not been determined with any degree of confidence. The cost assessment set out in the Commission's proposal does not fully reflect the work undertaken in the accompanying impact assessment. It is very likely that a more rigorous assessment would produce an outcome much higher than the figures quoted.

The Proposal document suggests that the likely impact will be 0.53% of GDP, but this is based on a number of questionable assumptions, including only factoring in the tax on securities and ignoring the tax on derivatives.

Indeed the 0.53% final estimate is itself derived from an earlier 1.76% estimate, artificially reduced in order to take into account certain "mitigating factors". The impact assessment itself states that these adjustments are 'not necessarily well taken into account' and that the approach used is 'at the cost of scientific rigour and with large caveats and uncertainties'. This points to a certain degree of uncertainty around the true impact of the tax.

The cost, therefore, is unlikely to be the 0.53% that is quoted, and may be much higher than even the 1.76% and will increase over time according to the impact assessment.

The Commission concedes, for example, that it has been unable to factor in the impact of a reduction in GDP caused by the new tax and points out that the deterioration of the tax base ‘could go well beyond revenue shortfall’ and could include ‘misallocation of financial funds’ and then ‘products might disappear’.

Should the revenues arising from the FTT be used to finance the deficits of Member States?

Much of the recent public debate has been concerned with the potential revenue raised by the FTT. However, the flaws in the tax are so significant, both in principle and practically, that any such discussion is inappropriate. We do not believe that a tax that hurts businesses and individuals, reduces economic growth and damages an important industry whilst bringing little guarantee of significant new revenue should be introduced.

However, we note that the Commission proposes that any funds raised from the tax be used to fund the EU budget. The Proposal states that “this proposal will be complemented by separate own resource proposals setting out how the Commission proposes that the FTT will service as a source for the EU budget”.

For the business community, a critical point is to maintain discipline and avoid any additional upward pressure on overall taxation. On that ground, the CBI firmly rejects any EU taxation, including the financial transaction tax proposal.

9. Would the Commission’s proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

We believe that the introduction of an FTT could decrease market liquidity, leading to an increase rather than decrease in market volatility, as we have laid out in our response to question 4.

10. What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?

The FTT would hinder market liquidity and add costs to businesses...

Given that it is estimated that the imposition of an FTT would see a reduction in transactions of between 70-90% (please see our response to question 3), the effect on market liquidity would be very significant.

Liquidity in markets is important because it reduces costs, as participants do not need to pay a premium for liquidity, and it assists price discovery.

Firms would not be able to have access to the same availability of products as previously, and those which were available would undoubtedly be more expensive.

The reduction in liquidity would also affect sovereign debt markets, although some countries’ debt would be affected more than others. It is not clear how or why this would affect ‘speculators’ more than other market participants, or how that term should be defined.

11. How easily could the FTT be circumvented by market operators?

Whether circumvented or not, the FTT will make using financial services more expensive for businesses...

The Commission itself recognises that derivatives transactions will move abroad.

Even if certain schemes could be developed to avoid the tax, we believe the consequence would be to make financial services more expensive for the end user, whether they are a business looking to sensibly manage risk or an individual with their savings in a low-risk pension fund.

12. What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

We believe the introduction of an FTT would have a damaging impact on the UK and City of London, as we set out in more detail in our response to questions 3 and 4.

13. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector?

We believe there is a significant risk of financial services activity relocating outside of the EU. The lessons of Sweden (described in more detail in response to question 3) provide a good guide to this threat.

14. Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

We do not think the FTT is an appropriate tax to introduce, irrespective of other national taxes/levies currently in operation.

15. Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

The FTT, even at global level, is a tax whose cost falls on business rather than banks...

The imposition of an FTT would be ineffective if not done at a global level, but in any case there is much evidence to suggest that the idea of the tax in itself is a poor one. Indeed the IMF has concluded that “[the FTT’s] real burden may fall largely on final consumers rather than, as often seems to be supposed, earnings in the financial sector”⁷¹.

8 November 2011

⁷¹ IMF, A Fair and Substantial Contribution by the Financial Sector (Interim Report for the G-20), April 2010

Confederation of British Industry (CBI) – Supplementary evidence

Given the technical nature of much of the debate surrounding the FTT, we are grateful for the opportunity to expand briefly on points made in our oral evidence session.

Cost to Business

The cost of the FTT will fall directly on businesses and savers...

Advocates of the FTT have claimed that Robin Hood Taxes are designed to specifically target the excessive profits, bonuses, and risky behavior in the financial sector, whilst protecting the investments of ordinary people and businesses. However, we do not believe that they achieve this; in fact they increase costs for businesses and pension funds, and the case as to whether they reduce risky behavior or support financial stability is unproven.

Cost to Businesses

Consultation with our members suggests that they expect the cost of the FTT to business would be significant. For example, a large car manufacturer has estimated an increase in costs as a direct consequence of an FTT of approximately €10m on its hedging portfolio alone. This is a significant sum which will be paid by a manufacturing company, not by a bank.

In addition, there is also the indirect cost to business to consider. The FTT is likely to result in certain transactions becoming uneconomical. The Commission, for example, believes that 80-90% of derivatives transactions that are currently undertaken in Europe will either not happen or will happen outside of Europe if the FTT comes into being. This will close some of these markets in Europe entirely. If this happens, businesses' investment decisions - which rest on the ability of the firm to hedge its risk appropriately – may be altered, and in some cases a tipping point may occur where this investment is not made. Thus an FTT has the potential to limit investment in the real economy indirectly, as well as imposing a direct cost on businesses for those transactions they do decide to undertake.

Cost to Savers

Pension funds use many of the products taxed under the FTT to invest on behalf of savers.

Many pension funds constantly rebalance their hedges as market conditions change – to reduce the risk their portfolios face and secure a more predictable return for savers. Whereas some advocates of the FTT claim that those “turning over” their portfolio like this are simply conducting very short-term speculative trading, the reality is that pension funds investing in long term options for everyday savers often use this technique to minimise the risk their clients face.

The FTT would increase the cost for pension funds attempting to sensibly manage risk in this way resulting in lower returns for savers.

Cascading effect

The extent of the cost to business and savers of the FTT is often underappreciated. The cascading effect of the tax – the fact it is paid at every stage of the transaction by both parties, with multiple stages for each transaction – greatly increases the *effective* level of the tax above the proposed 0.1% for equities and 0.01% for derivatives. This is explained further in the box below.

Did you know?

A 0.1% tax on equity transactions gives rise to a much higher rate on the *overall* transaction. The tax would in fact be levied at a number of points within the overall transaction, with each point incurring the tax at the 0.1% rate. **Therefore the cumulative cost of the FTT, as a result of various stages of trading and settling transactions, is higher.**

This example of an equities transaction produces an illustration of the cumulative impact of the tax:

- **Seller => Seller's broker** [0.1% tax incurred on both parties]
- **Seller's broker => Clearing member** [0.1% tax incurred on both parties]
- **Clearing member => central counterparty** [0.1% tax incurred on the clearing member only, since the central counterparty is exempt under the proposed FTT]
- **Central counterparty => clearing member** [0.1% tax incurred on the clearing member only, since the central counterparty is exempt under the proposed FTT]
- **Clearing member => buyer's broker** [0.1% tax incurred on both parties]
- **Buyer's broker => buyer** [0.1% tax incurred on both parties]

TOTAL TAX DUE ON EACH OVERALL TRANSACTION:

$$10 \times 0.1\% = 1\%$$

How much will the FTT cost the economy overall?

The Proposal document suggests that the likely impact will be 0.53% of GDP, but this is based on a number of highly questionable and in some cases clearly inaccurate assumptions, which include only factoring in the tax on securities and ignoring the tax on derivatives.

Even the estimate 0.53% fall is derived from the original Impact Assessment estimate of 1.76%, but artificially reduced to take into account a number of 'mitigating factors' that have been applied. The impact assessment itself states that these adjustments are 'not necessarily well taken into account' and that the approach used is 'at the cost of scientific rigour and with large caveats and uncertainties'.

The cost, therefore, is unlikely to be the 0.53% that is quoted, and may be much higher than even the 1.76% and will increase over time according to the impact assessment.

Appropriateness of the Tax

The FTT does not deliver on the stated objective of increasing financial stability...

Evidence around the FTT's ability to reduce volatility is inconclusive

The issue of volatility has been raised, both by the Committee in its questioning and more widely by advocates of an FTT. However, the Commission's own Impact Assessment notes that "the economic literature concludes that the effects of the FTT on volatility is largely inconclusive and depends on market structure". Furthermore, the IMF concludes that "it is now generally recognized that this is not always true in either theory (thinning of markets,

for instance, can increase volatility) or practice (the empirical evidence suggesting that transactions taxes either do not affect price volatility or increase it)".⁷²

Some have raised concerns that the increased frequency of equities trading poses a risk to financial stability. This, they argue, could be addressed through an FTT. This would reduce some of the incentives for financial institutions to trade frequently. However, there are a number of potential approaches to markets regulation that could address any risks that were identified without the negative side effects of a FTT, and which will not have the knock-on impacts on business and savers.

Thus, citing the FTT's ability to reduce volatility in markets or support financial stability as a firm reason for its introduction is wide of the mark.

FTT doesn't contribute to wider financial sector reform

The FTT will not add to the significant programme of financial reform currently underway (both at a domestic, European, and international level). The priorities for business are to see an increase in stability and ensuring continued credit flows to the real economy. It is not clear how the FTT meets either of these objectives.

Revenue from an FTT

The size of revenue predicted for the FTT are unknown, and they are unlikely to be used for that which many of its advocates want...

Uses of proposed revenue

Advocates of the FTT have spent its revenue many times over. Their desired uses for the revenue include:

- Climate change (TUC, Robin Hood Tax)
- Climate change in developing nations
- International Aid (Bill Gates report to G20, Robin Hood Tax)
- Global Poverty (TUC)
- Health (Stamp Out Poverty, Robin Hood Tax)
- Education (Stamp Out Poverty)
- Reversing fiscal consolidation in member states ("anti-cuts" use) (TUC, Robin Hood Tax)
- Reducing member states' deficits

In reality, however, the Commission's proposal already sets out where the revenue will go: it will be used to finance the EU Budget. [Para 1.2 in Proposal]

Lost revenues from stamp duty

The current proposal requires that transactions which fall under the purview of the FTT *could not be taxed under stamp duty as well.*

Thus the £4bn revenue currently accruing from stamp duty would be severely reduced – indeed it is not unreasonable to suggest that there is no guarantee that the revenue accruing from the FTT that is distributed to the UK from the EU Budget (£57bn divided in some proportion to be determined among 27 member states) would be any larger than

⁷² IMF, *A fair and substantial contribution by the financial sector: interim report for the G-20* (April 2010)

that which used to be brought in via stamp duty.

There is also the issue of national control of finances to consider. Effectively replacing stamp duty with the proposed FTT would shift the power to raise money from the financial sector (albeit via revenue paid for through higher costs to businesses) from the UK government to the EU. This is a significant transfer of power away from the UK government.

12 December 2011

Confederation of British Industry (CBI) – Oral evidence (QQ 1 – 28)

Evidence Session No. 1

Heard in Public.

Questions 1 - 28

TUESDAY 22 NOVEMBER 2011

Witnesses: Richard Woolhouse, Owen Tudor and Duncan Weldon

Members present

Lord Harrison (Chairman)
Lord Hamilton of Epsom
Baroness Hooper
Lord Jordan
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford
Lord Moser
Lord Woolmer of Leeds

Q1 The Chairman: Good morning to our witnesses. This is the first witness session we are taking on the financial transaction tax. Welcome to the public who have joined us, as I know it is an important issue. Can I ask members of the Committee to declare any interests that they might have at the first time of speaking, as it is our first witness session? I remind colleagues and the witnesses that this will be webcast and secondly that there will be a transcript made of the evidence given today. We will return that to you and ask you to correct it if there are any errors in the transcription. I would also ask you to think when you leave the room whether there are any elements that you feel that you did not make to the Committee that you would like to apprise us of—please feel free to write a supplementary answer; the Committee will be very grateful. Let me begin the questioning. Can I ask the three of you how you would assess the case for the introduction of a tax on financial transactions. Could we start with Mr Woolhouse?

Richard Woolhouse: Thank you. We strongly oppose the idea of introducing a tax on financial transactions. At this current juncture the priority for legislators must be the promotion of economic growth and we think that this tax will be extremely damaging, not only for the financial sector itself, but for the broader economy: for investment and job creation. The other point to make is that this may be one of the only taxes proposed that will fail to raise any revenue. If you look at the Commission's own impact assessment, the estimates of revenues raised are extremely uncertain; they are predicated upon assumptions about migration of activity to other jurisdictions, which means that they are very difficult to assess. At the same time, the economic costs of introducing this also look to be quite significant (with a very broad range), and the methodology that has been used to assess both the costs and revenues is quite unconvincing. We also think that a proposed financial transaction tax would not support the financial reform programme that is under way in any meaningful way. We think it is far too blunt an instrument and it is not likely to address the issues around systemic risk and other problems that have come out of the crisis. In summary, we do not think that a tax, which hurts businesses and individuals—the users of financial services—reduces economic growth and jobs, and damages an important industry while bringing little guarantee of significant revenue, should be introduced, particularly at this time.

The Chairman: Mr Woolhouse, I neglected to ask you to state your position in the CBI, so perhaps you would be kind enough to do so.

Richard Woolhouse: I am the Head of Tax and Fiscal Policy at the CBI.

Q2 The Chairman: Perhaps I can ask Mr Tudor to begin. Again, would you state your position in the TUC?

Owen Tudor: I am Owen Tudor. I am the Head of the European Union and International Relations Department of the TUC and I am joined by Duncan Weldon, who is a Senior Policy Officer in our Economic and Social Affairs Department. My Lord Chairman, you may not be surprised to know, and it is obviously unfortunate, that we disagree with the CBI on this issue. We think the case for a financial transaction tax is very strong. We believe it would generate much needed revenue for global public goods, in particular tackling climate change and helping to meet the costs of any deal agreed under the UNFCCC process, helping to achieve the millennium development goals and combating poverty and the need for damaging public service cuts in advanced economies. We also believe it would help rebalance the economy by first extending taxation to sectors of the economy not currently adequately taxed in the financial sector and transactions that, unlike most transactions that people engage in, are not currently taxed through a VAT process or something like that. It would also have a longer-term effect of reducing either damaging or unhelpful things like high-frequency trading and algorithmic trading and shift or release resources so that they are available for long-term manufacturing investment rather than what is, in effect, gambling. I entirely accept the point that that is a long-term effect and would not deal with existing levels of unemployment, for which we think other tools would be necessary. This is an obvious concern for legislators: in one of the unfortunately slightly shrinking number of democracies currently in Europe, this would be a popular tax that would reflect popular feelings that the financial sector is currently under-taxed and does not contribute to society in the way that it ought to.

Q3 The Chairman: Mr Weldon, would you like to make a first response?

Duncan Weldon: I would just like to emphasise one brief point in Owen's response there, which is this second-round effect. If a financial transaction tax makes certain activities less profitable and if we are looking at, say, the banking sector, the banking sector will presumably, seeing certain activities being less profitable, reallocate parts of its balance sheet away from those activities to other activities. One thing it could lead to is more lending to UK businesses, for example. I think it is important to bear in mind this second-round effect rather than just looking at the first-round effect. If an FTT stops certain transactions, we should then ask ourselves how players in the financial market will respond to that—what will they do instead?

The Chairman: Mr Woolhouse, Lord Hamilton was excited by something that you said and would like to come in.

Q4 Lord Hamilton of Epsom: I do not know how excited I was, but I would like to ask Mr Woolhouse this. The Government's position is of course that if this tax is going to be introduced, it should be on a global basis. Does that have anything to recommend it at all?

Richard Woolhouse: I think it is very unlikely that it will be introduced on a global basis.

Lord Hamilton of Epsom: I asked as a matter of principle; is it better that it is a global tax than a European one?

Richard Woolhouse: Clearly, if it were introduced on a global basis the ability of activities to avoid the tax by moving to other jurisdictions would be reduced. It would still, however, be a tax falling not on financial services' profits *per se* but on the users of financial services and therefore it would still have a damaging impact on investment, job creation and economic activity.

Q5 Lord Kerr of Kinlochard: I should declare an interest as a director of an investment trust. I am very grateful for the excellent written evidence that we received from the CBI and the TUC, and I would like to ask a question of Mr Tudor. A popular tax, you say: what impact do you think it would have on financial services and on the City? It seems to me it is a tax specifically designed to affect wholesale financial transactions and, since the great bulk of such transactions in the EU occur in London, it would have more effect on London than on any other EU capital. What do you think that effect would be? In your written evidence you seem to imply that you accept it would shut down bits of the London market or reduce them in size, because you say you believe there are better uses for the capital involved and the comparatively few employees engaged in such trading could find something better to do. Is that your view and who do you think actually pays for this in the long run? Surely it would have some impact on UK consumers. There must be some feed-through. It would not surely just be wicked financiers who you would wish to see put out of work.

Owen Tudor: Thank you, Lord Kerr. There are a number of questions that you are asking, so do pull me up if I miss some of them; apologies in advance. I think a key issue is who pays the tax. Our understanding from looking at the way this works is that we expect there will be some contribution to the overall revenue raised from the financial institutions themselves in terms of reduced bonuses, reduced expenditure on wages and so on. So some of the money will come from the actual financial institutions themselves—less profits in some of the cases.

Lord Kerr of Kinlochard: You could presumably achieve that benefit by taxing bonuses rather than trying to close down a market.

Owen Tudor: You could, indeed, but you would not produce the other revenue effects. We did say in our evidence, for instance, that we are not necessarily against things like the financial activities tax. Obviously, as the IMF described it, the financial activities tax was designed to tax excessive profits, excessive bonuses and so on. We do not think that you would pull in as much from that overall as you would from a financial transaction tax, because obviously a large amount of the financial transaction tax revenue would be generated from the customers of some of the high-frequency trading and the processes that would be most taxed under this proposal.

When I say customers, there was a report produced by the Institute of Development Studies in Sussex earlier this year that laid this out clearly, in saying that many of the costs, but not all, would be passed on to customers. It is important to remember that that does not mean all customers in all classes of business; it refers to the customers of the transactions that are being undertaken, so it means the high-net-worth individuals who are putting their money in the processes that are used to buy and sell in this way. Obviously, a large amount of the tax will be raised from those high-net-worth individuals who are putting their money into that sort of trading.

Now, you also ask about the impact on the City. As I say, there would be an impact in terms of reducing the amount of income that some of the people involved in the selling would get and the bonuses and so on. You would also, we assume, in some classes of transaction, get a fairly significant reduction in the actual activity undertaken. Now, some of that is done by computers, so it is not actually individual people who are doing a lot of that buying and selling. A relatively small number of the overall number of people engaged in financial services are actually involved themselves in operating those systems and whose jobs are likely to be considerably reduced in that area. That is the group that we referred to—the highly paid mathematicians and analysts and so on—who we suspect would be able to find other occupations worthy of their endeavours. As Duncan said, some of that will be simply that their jobs will be shifted into other areas of financial sector activity, such as finding productive businesses to invest in and so on.

Q6 Lord Kerr of Kinlochard: Have you thought about a point that struck me in some very interesting evidence from an economics professor at Birmingham who says that since as much as 40% of the wholesale financial transactions in London concern two financial firms, one headquartered or resident in another EU country, a substantial slice of the FTT proceeds, perhaps 18% or so, would have to be transferred from the UK Exchequer to other EU Governments? Now, that would distinguish this form of tax from, say, a tax on bank profits or a tax on bank bonuses. The financial transaction tax would, irrespective of the eventual end use of the moneys, involve the UK transferring revenue from the UK fiscal authorities to the German or the French. Do you agree with that?

Owen Tudor: I think that could be the effect of the proposal as currently drafted but one of the things that this Committee could certainly point out is that the legislation is draft legislation and we would say there is an awful lot of work to be done on the detail of how that actually works. There is a lot to play for in terms of the actual design of how the Commission's proposal is eventually realised. I think there are cases in which it would be appropriate for such money to be transferred because I think it depends where you think it is appropriate for that revenue to end up and what you think you are actually taxing in terms of whether this is an activity in the UK, the revenue from which would be appropriately kept in the UK, or whether it is merely that the UK is being used as a venue for something. When we pay VAT on other transactions we pay it at the point of sale. That does not necessarily

indicate where that good was generated or where that good is eventually used, but you pick one place to apply the tax, which is the place at which you make the purchase.

Q7 The Chairman: Mr Weldon, could you help us with the design question that Lord Kerr's question raised with Mr Tudor? How could it be so designed as to ensure that it has a beneficial effect, as it were?

Duncan Weldon: I will start off by saying I have not seen this report from this professor at Birmingham you mentioned; I will have a look. As Owen said, the way the tax is currently designed, that could be happening and I would agree with Owen that there are circumstances in which that might be quite right and proper. I can envisage, say, two German banks, Deutsche Bank and Commerzbank, trading German equities with each other and they may happen to be in Canary Wharf and Lombard Street respectively, but I can perfectly see the case why those tax revenues under this system should go to Germany. In the same way, presumably if HSBC and Barclays were trading with each other in Frankfurt and trading UK instruments, I can see the case for that coming back to Britain. Obviously, the complicating factor is that London has such a large financial sector compared to Frankfurt or Paris or anywhere else that would be covered, but more generally I would agree with what Owen said. I think that it was up to 18% you mentioned in this study. Maybe it should not be that high, and again this is draft legislation at the moment from the Commission, and this is something that certainly should be looked at, but I can see the moral case if nothing else as to why some of these revenues should be transferred abroad.

Q8 The Chairman: Mr Woolhouse, would you like to respond to Lord Kerr's question?

Richard Woolhouse: Yes. There are a couple of points I would like to pick up. I think obviously the fact that three-quarters of interest rate derivatives activity takes place in London, that a lot of commodity and energy derivatives activity takes place in London and that the Commission estimates that between 70% and 90% of this activity will cease means clearly there will be a disproportionate effect on London and employment opportunities in London's financial markets. The other point that is worth noting is that there is a sort of tacit assumption here that all of this activity is non-economic. The reason why a lot of these markets exist is for real businesses to be able to hedge their activities. If I am a manufacturing company selling into an export market, I have exchange rate risks; I can use derivatives instruments to hedge out that risk. If I have got uncertain interest costs, if I am in a commodity market, if I am an energy supplier, it means I can get long-term certainty by hedging and using derivatives instruments to secure effectively a lower risk-adjusted return. Now, not only would this tax have a devastating impact on the economics of those markets but it would have a significant impact on the real economy. There would be much lower liquidity in those markets, the costs of hedging would be much higher and there would be many activities that companies would have otherwise undertaken that will not be undertaken because of their inability to hedge their risks. There is an assumption that runs throughout the Commission's impact assessment that, in effect, getting rid of all of this derivative activity is somehow a good thing. It is absolutely wrong. There is a significant economic benefit associated with the business users of these instruments.

Q9 Baroness Maddock: I wonder how you assess the likelihood that a financial transaction tax would cause financial services to relocate or do you think that perhaps it might contribute to the migration of certain financial transactions into the less regulated part of the financial sector? To Mr Tudor, particularly: in your evidence you state that you believe

the risk of relocation is overstated, and I wonder what evidence you base your judgement on, particularly in the light of the Swedish experience in the 80s and 90s.

Owen Tudor: The Swedish example is an extremely useful one, illustrative precisely of the fact that this depends on design. Very roughly what the Swedish Government did was it implemented a tax on any transaction that took place on the Swedish exchanges and as a result transactions took place on the Danish exchanges instead, which, possibly, you would have thought was a fairly obvious risk that they could have guarded against and they did not. As the IMF pointed out in their research on this, if you compare that, for instance, with the way that the British stamp duty on shares works, that says “We do not mind which exchange you trade it on but if you want to buy those shares you have to pay that tax,” so any share for a company that is listed in the UK you have to pay that tax. That has proved to be a very difficult tax to avoid by moving. So part of the question is about how you design the tax. Design can deal with a lot of the problems that exist.

I think there are other arguments. As you know, Chair, we are part of the Robin Hood Tax campaign and they have a paper on precisely this issue of relocation, which I will submit subsequently to this, which does cover a number of areas such as, first, what it is that drives decisions about where to locate and where to have financial activities. For instance, the City of London has done a study that indicates that actually the main determinants of that are around certainty about tax, but not so much the level. What anybody wants if they are going to get involved in financial transactions is to know in advance what is going to be the tax environment that you are operating in. So that is a key issue.

There are also issues around whether you have access to the right staff and the right trading environment. One of the advantages obviously for the City of London is merely scale: there are more people there to do business with so it makes sense to be there. In terms of larger financial institutions, there is the “too big to fail” issue as well, which is that many of the larger financial institutions would only be able to migrate to another jurisdiction that was able to cope with what would happen if they went bust, as we have experienced over the last few years. You need to be based in a jurisdiction that can bail you out if something goes badly wrong, as unfortunately it looks as if it does tend to in these markets. That also controls where you can go and suggests that some of the offshore trading environments are not actually as advantageous for companies as it may seem. But we have a paper.

Richard Woolhouse: There is an assumption that there is some sort of demonstration effect from introducing this at the EU level, which will coerce everybody to come along. I do not see any evidence of that at all and, from what we understand, the chances of this being implemented globally are zero. In terms of how easy it is to move activity to other locations, it is not very difficult at all for global operations to conduct business in New York or Singapore or somewhere else.

The other point I would like to make that I think we should be aware of is the cascading effect of this tax, as this applies to every transaction in a linked set of transactions. If you look, for example, at a pension fund purchasing an equity—it purchased that from a broker who purchased it from a clearer—all the way along the chain both sides are effectively incurring the tax. The total cost across the chain could be 10 times the original tax. If that occurs, why would a pension fund carry on doing business in Europe when it could do it in another jurisdiction at a much lower cost? I find it remarkable that the only justification for this is some sort of global demonstration effect.

Duncan Weldon: Just to add to what Owen said, it is worth bearing in mind the experience that last year the current Government unilaterally implemented the bank levy on the UK

banking system, which was of course implemented just in London, not globally and not at a European level. In the run-up to that being implemented, there were of course some complaints and some speculation about what this would do to London's banking centre. Whether HSBC or Standard Chartered would relocate to Hong Kong came up several times and it is worth bearing in mind we have unilaterally implemented tax on banks in London and they are all still here.

Richard Woolhouse: Yes, but the scale of the bank levy relative to what we are talking about—as if you can painlessly raise £200 billion by a financial transaction tax with no impact on the economy or the financial services sector—was much smaller and was targeted at a different objective. There were also bank levies introduced in France and Germany at the same time.

Q10 Baroness Maddock: Can I just ask Mr Woolhouse: so you do not think that businesses would take any account of the bailout issue that Mr Tudor raised? Mr Tudor said that one of the considerations that people might have is this “too big to fail” business and being able to be bailed out. In England we have seen that there is the ability to bail out institutions but in other places that may not be the case and therefore it might be attractive for them to stay here because of that. I just wondered what your view was on that?

Richard Woolhouse: We had an implicit bailout in the US, which was many times bigger, potentially, than what we had here. We have not yet seen the extent of the implicit bailout in the euro area. We are waiting for that to hit still. I do not think that is a good argument for why activity would locate in a certain area or not. Activity is already too interlinked and global; it can move around more easily than that.

Q11 Lord Moser: Mr Woolhouse, you referred when you were replying to Lord Hamilton to the global tax. It is obviously very important for us to be very clear on the issue of whether, if this was at EU level only, that is plausible. Is that feasible, or can such a tax as the FTT only work really properly if it is global?

Richard Woolhouse: I think we have covered that a couple of times now. I think that the design of the tax is fatally flawed if it is only introduced in one area because it is very easy to get around. If it were introduced globally it would still be very damaging to business, so there is a more nuanced point about if it were introduced in the euro area what the implications of that would be.

Q12 The Chairman: Would you like to comment on that as well?

Richard Woolhouse: The way that this residence principle has been designed means that it would be likely to pick up a lot of activity of French and German banks transacting in London and this residence principle has a very broad net that is quite untested and potentially risky in terms of the implications for extra-territorial control of revenues. In effect, fiscal authorities in France and Germany would be levying money off activities taking place in London—the point you referred to very well—and that could be a very significant amount, which will have enormous political implications if this is being done from within the euro area. I also think it is a bad thing to happen in the euro area anyway because I think it would be damaging to growth in what is still our biggest trading partner.

Lord Moser: It is bad either way.

Richard Woolhouse: Indeed.

Owen Tudor: We would undoubtedly prefer a global financial transaction tax. That would be the best of all possible worlds, mostly because it would produce the most revenue for the global public goods that we want to fund and, if we think it would have a beneficial effect on long-term investment strategies in the UK or in the EU, we would obviously hold the same view globally. I welcome at least the CBI's consistency on the issue. A number of the actors in this, for instance the British Government, seem to have a fundamentally inconsistent view, which is that it would be a good thing at global level but it would be a bad thing at any other level than that. I think, frankly, politics is being played and they do not believe it is any more likely to happen at global level than the CBI does, but they are willing to buy a bit of credibility and a bit of goodwill by saying that they want it to happen globally when they do not think it is going to happen. It would be inconsistent to hold that view and it would also direct you down the channel which I think the Government ought to adopt, which is to try to persuade those countries that are currently not in favour of a financial transaction tax to be in favour of one, rather than, as we know happens in the G20 and in the European Union meetings, of constantly trying to block the tax.

This also goes back to the question about relocation. There are lots of financial transaction taxes around the world. The IMF study pointed out 16 different financial transaction taxes in the G20 countries alone. While no one has the same tax as anybody else at the moment, it would be folly for financial institutions to assume that they could ever rely on going to a place that would be completely free of one form of taxation or another, regardless of whether it is exactly the same one. I am generally in favour of consistency in tax regimes because (a) it makes arbitrage a bit more difficult and (b) it actually brings a bit more certainty to global financial arrangements, but it is quite clear from the work that the IMF have done and in another way Bill Gates—I mean, I would not say Bill Gates and the IMF are interchangeable in their assessments of feasibility of tax measures, but from both spectrums from which they come at this they say it is quite feasible to implement these taxes at national level, at regional level, such as the EU, or at global level, and I hold with their assessment of that.

Q13 Lord Moser: One thing that is pretty clear from what you have said already is you would favour going ahead or the EU going ahead even if global is ruled out. The other thing that your later remarks lead to, and I think it was in your evidence, is that you referred to a number of countries that have done it unilaterally. Did you have any particular countries in mind and could you tell us whether it has always been a tremendous success or have there been some stunning failures?

Owen Tudor: For the record we certainly would prefer it to go ahead at an EU level even if we could not reach global agreement and, indeed, we would prefer it to go ahead at eurozone level if we could not reach EU agreement, and so on. In terms of the examples, I think you have had evidence from Stamp Out Poverty on the issue, listing the number of different places that have got taxes of one sort or another, and, with the notable exception of Sweden that we have already addressed, our main conclusion drawn from those taxes is that the sky has not fallen in and that they have been found to be generally useful ways of raising some revenue. There are always issues in terms of tax policy about what is a better way of raising revenue than something else and I would not want to argue that the financial transaction tax was the standout best way of raising revenue in all circumstances. I can think of lots of other taxes that are very good ways of raising revenue as well. We think the financial transaction tax adds to the tax armoury of exchequers in terms of producing appropriate amounts of money from economic activity.

Q14 The Chairman: Mr Weldon, could you respond to some of Lord Moser’s supplementary points about whether there have been any disasters with a tax that was restricted to one country?

Duncan Weldon: Again I would just echo what Owen was saying. The Stamp Out Poverty evidence you should have received has a very good table summarising different forms of financial transaction tax around the globe in different countries and assessing how they have worked and the standout example of a failure is Sweden, which I think, for reasons we have been into, was a very badly designed tax.

Q15 Lord Kerr of Kinlochard: The example that comes to my mind the most is the creation of the London eurobond market, which owed a huge amount to a change in US tax law that had an absolutely instantaneous effect.

I would like to ask about volatility. I am confused. The Commission are upfront and honest: they say that they think GDP would be reduced by a minimum of 0.5% up to 1.8% by the tax but they think the offsetting advantage of reducing speculation, wicked derivative trading and these evil algorithms would mean that it made sense. They imply that they think, although you cannot prove it from the economic literature, that volatility would be reduced and that is a good thing. The evidence from the TUC sits on the fence a little bit, saying it is difficult to predict, but basically you guys do not like algorithmic trading and you do not like derivatives. You think probably it would reduce volatility and probably that would be a good thing. The CBI evidence is that it would reduce volatility and liquidity and that would be a bad thing. Is volatility good or bad, please?

Duncan Weldon: A very interesting question, Lord Kerr.

The Chairman: Do you want to respond to that first of all?

Richard Woolhouse: Sure. I will quote from the Commission’s impact assessment: “The economic literature concludes that the effects of the FTT on volatility is largely inconclusive.” I think that using what is an extremely blunt instrument to try to address specific issues of micro-market behaviour is wrong. If you want to address specific issues, use regulatory tools to address those issues rather than using a hugely blunt instrument, which will, as I say, on the Commission’s own estimates, knock out 70% to 90% of all of this activity, which will have serious knock-on effects to the real economy. It is not costless.

Q16 The Chairman: Before I bring back Mr Weldon, Mr Woolhouse, did you want to respond to any of Lord Moser’s points about whether it should be applied in the euro area, the EU 27 or globally?

Richard Woolhouse: I would just make the points that I think we have made before, that there seems to be an implication that, “Well, if we cannot get it globally, let’s get it wherever we can and we will build on it.” That is just a disastrous prescription for effectively destroying a lot of activity that occurs now in London, whether that were to take place at a euro level or an EU level. I just reiterate what I said before, that even if this was implemented on a euro area basis only it would have a very damaging impact on London

Duncan Weldon: I think earlier Mr Woolhouse said he detected an assumption from the TUC and other proponents of a financial transaction tax that we assumed several of these activities had no economic impact on the real economy. Now, if we have allowed ourselves to be portrayed like that, that is really not where we are coming from. Absolutely and utterly, there is a legitimate need for things like interest rate swaps and forward exchange

rate contracts; these are very useful for real corporations in the real economy. What concerns us is that the volume of these contracts far outweighs their use in the real economy. We know that global foreign exchange trading is a huge multiple of actual international trade and currency transactions for people that need to do this, so we worry about some things like high frequency trading and we worry about some derivative contracts. We are not against all forms of derivatives. Going back to the economic literature and the very start of this, really, when a financial transaction tax was first proposed by James Tobin, the Tobin tax, the whole point of it was that Tobin was worried that the volume of financial flows had become disconnected from the real economy. This was creating excessive volatility, financial crises and exchange rate crises. Going back 40 years to when this tax was first proposed, it was trying to address a problem that has since become worse. This tax was not originally proposed as a revenue raiser. It was proposed in the mid 1970s to deal with excessive volatility by a Nobel Prize-winning economist.

Q17 Lord Jordan: I would like to address my questions to the TUC and I speak as one of probably millions who believe that the market and the City's excesses need to be curbed. A financial transaction tax, if it could work, could make a positive contribution to that. You have said FTTs could be designed in such a way as to avoid circumvention. I am just reminding you that you are dealing with people here who could and perhaps should have been awarded Nobel Prizes for their ingenuity in circumventing almost anything with their design of financial instruments. Now, are you going to get these people to calmly come along and allow you to take the billions that you think this would raise? When I think of the complexity of this, VAT and carousels come to mind, where even barrow boys were circumventing that particular tax.

Owen Tudor: Lord Jordan has been trying to get answers out of the TUC for many years. He has obviously refined the art now. I accept the point you make about the fact that you can never be absolutely certain that you will ever design a tax perfectly enough so that people will not be able to avoid it, although obviously there are large numbers of people who do not spend their time trying to avoid tax. I think one of the benefits of a tax on financial transactions, and one of the reasons why it can be designed in such a way to be extremely difficult to avoid, is that it reflects in many ways the way in which financial markets and financial transactions are currently structured in terms of the way that they flow through electronic exchange systems. They need to be registered in some way so that you can make sure they are enforceable. Those sorts of things actually make financial transactions relatively simple to tax—for instance, our colleagues in southern Europe find even things like swimming pools are in some ways more difficult to tax. Financial transactions go through exchanges that make it much easier to track them and tax them and so on.

It is quite likely to be the case, obviously, that many of those people who are currently engaged in running high-frequency algorithmic trading operations will indeed, as the Commission's impact assessment demonstrates, move on to doing something else, and one of the things that we think they will hopefully move on to do is something more, as Lord Turner would have put it, socially useful than what they are doing at the moment and that you will therefore be able to get a double benefit of (a) the tax revenue from that and (b) the fact that it is useful in the first place, such as investing in industry, which I know is a subject dear to your heart.

So I think it is possible to design it in a way that will minimise the risk of that sort of migration although I remain to be astounded by yet another shift in the way that the financial sector operates. I think the answer to that one simply is there are two options: you either give up the ghost and accept that there are some masters of the universe who you will never

be able to tax adequately or you keep trying to find ways to make sure they can be taxed adequately, including the political argument that simply says, “What you are doing at the moment is unsustainable on a social and political level, let alone on an economic level”. There are increasing voices in the financial community recognising that something does have to be done about addressing the inflated economic circumstances that we have at the moment.

Q18 Lord Jordan: In the hope that we can in fact get a financial transaction tax to work, how would you assess the potential of such a tax to raise significant revenues and how reliable would that revenue stream be?

Owen Tudor: Obviously, as I have said, we would prefer it to be done at a global level because that has the potential to raise the most amounts of money, but we think that it could raise considerable amounts. It is a bit difficult to predict at this stage how much that would be because we do not know precisely what the impact would be on market behaviour. We have tried to be as conservative as possible in our estimates of what we think it would raise, which we think would be about \$400 billion a year if done globally. We think that domestically it would add to the existing, say, £3 billion revenues from stamp duty—we think it would add another £20 billion to UK tax raising and these are estimates done on the basis of assuming quite significant reductions in trading volumes of derivatives.

In terms of predictability, as I said, I think there is an issue in terms of how much difference would be made to trading volumes when you first introduce it, but once it has been introduced we think it would be, roughly speaking, as predictable and as reliable as other forms of taxation. Economic activity, income tax, VAT—all these things respond to movements in the economy generally, so they are none of them guaranteed earners for Government, but we think that once you have implemented it, once you have taken into account the change on trading behaviour, you would find it a more reliable form of income.

Q19 The Chairman: How do you respond to the circumvention question raised by Lord Jordan, and the second question about the amount of money that might be got in by such a tax?

Richard Woolhouse: The two are obviously very closely related. Economists’ principle of taxation is that it is easier to tax things that are less mobile. The point about a lot of the transactions that we are talking about is that they are incredibly mobile. They can be done at the touch of a button anywhere in the world. We have not got a closely argued or costed case for how much diversion would take place; I just refer you to the Commission’s own impact assessment. They assume 10% of securities transactions will cease to occur and 70% to 90% of all derivatives transactions will not take place. So it seems to me that in fact these are extremely mobile activities that can take place very easily, especially within global financial institutions, in other markets.

Q20 Lord Marlesford: I would like, if I may, to ask Mr Woolhouse what the essential difference is between one of these financial transaction taxes and, say, stamp duty on shares, because that seems to work quite well.

Richard Woolhouse: The main difference is that stamp duty is not borne by intermediaries. The cascade effect of a financial transaction tax is that it is incurred by those people all the way along the chain from the vendor through the broker and through the clearing house—both sides—whereas a stamp duty is only paid by the end purchaser and is paid irrespective of where the transaction takes place.

Lord Marlesford: Right, so it is a better, in your view—

Richard Woolhouse: I did not say that. It is a very different beast in terms of where its incidence occurs.

Q21 Lord Marlesford: I have only got a couple of points for Mr Tudor, if I may. First of all, you talk quite a lot as though the product of an FTT would be hypothecated in some way and I was rather interested in your priorities for the use of it in your evidence: climate change, poverty at home and abroad and public sector deficits. Are those three really the main concerns, with climate change the highest among your members?

Owen Tudor: No. I may even have been doing it alphabetically. I am not certain. We define it in different ways at different times. Global public goods is the main argument that we think it should be used for, but among those, certainly, the Robin Hood Tax campaign, which we have been part of since its inception and which we helped found, has always said we would like 50% of that raised spent on domestic programmes, which would include cutting the public sector deficit without making cuts in services in the UK or alternative anti-poverty programmes, 25% going to meet international climate change obligations and 25% global poverty concerns. The TUC is not particularly in favour of hypothecation, however, partly because we simply do not think it will happen like that. Money will be collected by exchequers and will be subject to political decisions about how it should then be dispensed. We think that the argument is that it should be spent on these things.

We are conscious, I have to say, that the European Commission may not be entirely in agreement with us about exactly what should be done with the money that is spent. In fact, I am not entirely certain the European Commission is in tune with anybody about how the money should be spent, including the national governments who would actually decide how the money would be spent, so there are issues, which I am sure you will be looking at, as to what happens to the revenue once it is raised, and that does need to be addressed.

Could I just pick up one of the points about reductions in trading volumes that was raised earlier? I do not think one should assume that the reductions in trading volumes that are anticipated are as a result of that trading going elsewhere. The main reduction I think that you would find in terms of derivative trading would be because certain parts of derivative trading would become less remunerative as a result of the application of the tax and therefore people would spend the money they are currently spending on derivative trading on something else where the relative incentive and the relative remuneration would change. That is important, not least for us, because of the impact of the FTT on the activity of pension funds, for instance, where at the moment pension funds invest small, certainly not substantial, but potentially significant amounts in high-frequency trading vehicles. They do it not directly but in vehicles that do that, and our view is that that would become less remunerative and therefore the pension funds would need to switch into other investments more in line with the sort of investments that currently take up 90% to 95% of their activities, which is more long-term investment in financial products.

One of the reasons why the economic effects of the financial transaction tax are overstated in terms of GDP is that actually it almost assumes that if you are not making that money out of the high-frequency trading then that money is the money that is lost, without taking into account that actually you would shift it and do something else with it, which I accept might produce less of a return, but not that much less of a return. These are often quite marginal amounts, which is why we are suggesting a percentage at such a low level for a tax. In terms of the cascade effect, I think one of the critical issues is it is not so much the cascade effect but the frequency with which things are being moved around the system. Some of that is in

cascading, because you are paying someone to do something; you pay someone else to do something else, and some of it is just the more general high-frequency trading where people are just buying and selling large volumes of shares or currency or whatever on an hourly basis.

Q22 Lord Moser: In answering Lord Jordan, who has just left us, on the return on such a tax, you said it is very difficult to estimate, quite obviously, but I asked you earlier about the many countries that you quoted in favour of the tax. Do you not have lots of evidence of how in their tax system this particular tax operated and how well?

The Chairman: Perhaps Mr Weldon can help us with that. I think you tackled that earlier.

Duncan Weldon: Yes, I do not have on me revenue-raised figures for those countries, although we can supply that.

Q23 Lord Kerr of Kinlochard: I am just still thinking about this volatility point. The most recent answer from Mr Tudor fascinates me and reminds me of the minutes of the Board of Admiralty before the First World War when they first considered the submarine and decided that since we were the capital ship navy, we were not in favour of submarines. You want to ban derivatives really, don't you? You do not like derivatives. You do not like high-frequency trading: you think it is dangerous; you do not think it has a smoothing effect. You do not care if derivative trading is driven offshore because you think that it is bad for us to have high-frequency trading of derivatives going on in London. Is that a gross exaggeration?

Owen Tudor: I am certainly opposed to high-frequency trading; I do not think that is helpful, no. We are certainly not opposed to derivatives, as Duncan pointed out earlier. There are some derivatives that we think are quite useful in terms of allowing people to hedge and so on. What we are not sure is valuable is the same things that Adair Turner says he thinks are not valuable, which are vast amounts of money simply going around and around in a spiral that is not being used productively. That is my concern and I think it can have negative effects in terms of destabilising decision-making. I do not think high-frequency trading, for instance, actually assists in the realisation of the efficient markets hypothesis because I think it actually confuses people as to the value of products rather than revealing it more.

Q24 The Chairman: Mr Woolhouse, would you care to reply to that?

Richard Woolhouse: The focus continues to come back to high-frequency trading and algorithmic trading. We do not have any good evidence of how big that activity is. I will just point out that if I am a pension fund or a corporate treasurer or an energy company and I have got a book of activity in terms of, say, foreign exchange exposures or interest rate liabilities, because the underlying markets move around I have to change the hedges on that book on a daily basis quite often if I want to remain fully hedged. So there is a lot of activity that goes on around genuine commercial risk management that is high frequency. There is this assumption that all derivatives activity is basically undertaken by proprietary trading desks who are returning returns to themselves. That is not true at all; there is a significant economic function associated with a lot of these markets and I really think we need to make sure that that is established because this would undermine the economic basis of a lot of that activity.

Lord Marlesford: I want to go back in a sense to a question that Lord Kerr asked early on. Several times, Mr Tudor, in your evidence you have explained why we need such a tax, and as well as the economic point you have talked about the popularity and Lord Adair's point

about social use and all that. I do still wonder why you favour this very complicated tax rather than straight income tax. Bear in mind that the Treasury has estimated that this year there are going to be 14,000 people with a taxable income of over £1 million and 42,000 people with a taxable income of over £500,000. These 56,000 would I suppose include all those in the City who you feel would be popular targets for the Tobin 'Robin Hood' tax. Why do you not just propose a more progressive income tax, for whom at the moment the top rate is 50% which starts at incomes over £150,000?

Q25

Owen Tudor: Shall I start and then when I get something wrong, Duncan will explain why I have got it wrong. Certainly I do not think the TUC would want to go on record as being against a more progressive income tax system, but I think that there are probably three things to say about the relationship in policy terms between financial transaction taxes and income taxes. First, the motivation for introducing the financial transaction tax and the effect of it is not merely that it produces revenue from a particular group of people who are currently particularly well off and have benefited. It also has an effect on how capital is used, on the way financial markets are operating and things like that, which income tax would not have. I am not entirely certain it is true that financial transaction taxes are a more complex form of tax than income tax, actually. Financial transaction taxes are in some cases considerably easier to implement and collect than income taxes. My income tax is relatively simple because it is simply deducted at source by my employer, in the same way as much of the financial transaction tax would be deducted at source as transactions are taken, and I would draw your attention yet again to those Greek swimming pools as evidence that even things you can see on Google Earth can prove difficult to tax.

Lord Marlesford: I am talking about income tax, not capital tax.

Owen Tudor: No, absolutely, but I am just saying income tax is not necessarily a simple tax to collect compared with financial transaction taxes. Obviously, for individual wage earners it is relatively simple, but when you are talking about some of the ways in which people are remunerated in the City, it is not quite as simple as all that. That is one of the reasons, for instance, why people like Warren Buffett have pointed out that he ends up paying less tax on what is actually income than his secretaries do. The other point is that income tax has an effect on the entire structure of income. A progressive income tax obviously is less likely to do this than an overall income tax but—and this is perhaps more a political point than an economic point—income tax is considered less popular than a financial transaction tax would be because people on very low incomes are worried that it will have an impact on them in a way in that it would not with a financial transaction tax, where they are more clear that the impact is on someone else.

Q26 Lord Woolmer of Leeds: Let me turn back to the question of, in the words of the Commission's document, one of its three objectives: "Limiting undesirable market behaviour and thereby stabilising markets." If you ask the general public, as it were, in Europe and the world, they would say undesirable behaviour is to do with the reasons behind the financial collapse in 2008, the financial turmoil and the eurozone problems. At the levels proposed by the Commission, do you think that if the tax had been in place from 2007 onwards it would have played any part at all in reducing the likelihood of the financial problems that started in the United States housing market and so on and in the eurozone at the present time? In other words, with the public's expectation that this would have an effect on the big

instabilities in markets, do you think that, at these levels, this tax if implemented would have any effect on those two lots of events?

Richard Woolhouse: We could spend a lot of time talking about the causes of the financial crisis. This is probably not the place to do that. Clearly, the proposed financial transaction tax, as I said before, is a very blunt instrument with which to address the issue, be it either the issue of stability of the system or, as stated in the Commission's assessment, making a fair contribution—the people that caused this have to pay. That is one element. Our view is that the stability of the system should be addressed by regulatory measures, be they higher capital, which is being implemented globally, having proper resolution funds so that systemically important institutions do not need—

Lord Woolmer of Leeds: Can I interrupt you? I just asked whether you thought that, at these levels, it would have had an effect.

Richard Woolhouse: The answer is no and there are a lot of other tools that should be used to address those issues.

Duncan Weldon: It certainly would have had some impact. What I cannot promise is that the existence of an FTT in the last decade would have stopped the current eurozone crisis or what happened in the US subprime mortgage market. What I can say is that, if we look at 1998 and the near failure of Long-Term Capital Management, which does not get as much attention nowadays but was very nearly a catastrophic failure that had to be stopped by the Federal Reserve Bank of New York, LTCM's trading methods almost certainly would have been stopped by a financial transaction tax: pure high-frequency trading, a strategy described as "picking up nickels in front of a steamroller" by the Federal Reserve, after it nearly blew up. So I think there are certain financial crises that have happened in the last 15 or 16 years on which this could have had a very large impact. As for the current one we are going through, no, I do not think an FTT would have prevented it, although it might have lessened the impact; it might have made it less likely.

Lord Woolmer of Leeds: So in terms of the expectation in Europe and perhaps in the European Parliament that bringing this in would have a significant effect and contribute towards stabilising the eurozone, and stabilising financial markets, would that be over-optimistic?

Owen Tudor: I think people in the Commission, in the Parliament and in various Governments around Europe have a number of different reasons why they are in favour of a financial transaction tax. There is certainly not a monolithic explanation for how it would benefit and I would not, if I was the Commission, want to rely on that as the reason for having a financial transaction tax.

Q27 Baroness Hooper: You have talked about some of the possible or estimated impacts of the proposed FTT. What about a possible impact on market liquidity? What effect would it have on speculation in the sovereign debt markets, do you consider?

Richard Woolhouse: We have talked a lot about the impact on market liquidity and market by market you can look at the underlying assumptions in the impact assessment. As I say, 70% to 90% of derivatives will cease to occur. I have not seen anything specific about speculation on sovereign debt markets so I would not want to comment particularly on that, but I think what we talked about earlier in terms of the cascading effect of this tax is that it would have significant implications for liquidity in a number of areas and that would in and of itself have a knock-on effect in terms of the ability for people to hedge themselves.

Duncan Weldon: There clearly would be an impact on market liquidity across several markets but that is sort of the point of the financial transaction tax—as well as raising revenue, to stop certain types of trading. So yes, there would be an impact on liquidity. Now, again, going back to a point that has been made several times, I absolutely and utterly recognise that many types of derivatives contract are very useful for real-world companies, whether that is hedging commodity exposure or foreign exchange or interest rates, but the point stands that real-world transactions by non-financial companies are absolutely dwarfed by trading between proprietary trading desks of banks and between hedge funds. Going back specifically to sovereign debt, again, I have not seen anything specific. I imagine the impact on actual cash sovereign bond markets would not be particularly large, as there is very little high-volume trading there. Perhaps on credit default swap contracts linked to these bonds there may be more of an impact, but I could not say with any certainty.

Q28 The Chairman: I will ask the last question if I may. What is your response to the proposition from the Commission about using the residence principle in applying the FTT? Mr Woolhouse, do you think that might be successful?

Richard Woolhouse: This is an attempt to circumvent the weakness of implementing it just in the Europe area and clearly it is an untried and untested approach, which, as I said earlier, potentially has essential extra-territorial tax implications. I could see there being significant political implications were there to be a significant flow of tax revenue from London, if this was implemented in the euro area, to euro area fiscal authorities. I think that could have a major political implication.

Owen Tudor: I am not sure if you have seen the UNITAID report that sets out a possible alternative to using the residence qualification, but we will certainly submit details of that if you want. It is effectively an extension of the current UK laws on stamp duty to derivatives, which is something that we ought to consider and the Commission ought to consider alongside residence. I think the residence suggestion is an imaginative solution to extra-territoriality, but I am not sure it is necessarily the right one. I would be happy to be convinced by the Commission that they were right but I think that they need to consider alternatives as well.

The Chairman: Mr Tudor, Mr Woolhouse and Mr Weldon, we have trespassed on your time way beyond that which we originally agreed. We are most grateful to you for that. We have ranged widely from Greek swimming baths to the window tax. I think the House of Lords would be a loser by any such window tax. We are most grateful to you for providing us with this first witness discussion. We did not manage to tackle questions on where the incidence of an FTT would fall and we did not manage to cover questions about the appropriate rate. Could I ask you to respond to those in writing but also to look at the transcripts that we will send to you to correct those? Also, if there are additional thoughts that you have that you think would be useful to the Committee in making up its mind, we would be very grateful to you if you could communicate those. What I do want to convey to you is the thanks of the Committee for a most stimulating hour and a quarter. We will think very hard about what we have heard. In the meantime, in concluding the Committee today, I am most grateful for your appearance here before us. Thank you very much indeed.

Frank Cranmer - Written evidence

1. The proposal for a financial transaction tax (FTT) appears to be gathering momentum. Oxfam, for example, is proposing an FTT of 0.05% and estimates that it could raise up to £300bn.
2. The idea, which is superficially very appealing, appears to be predicated on four assumptions:
 - that taxing financial transactions at a very low rate will be unnoticeable by consumers;
 - that every government will sign up to it;
 - that it will not change market behaviour to any degree that is likely to be deleterious to the UK economy; and
 - the proceeds will be used to finance overseas development.
3. I wish to focus on the general principle of an FTT and I beg to differ from the general enthusiasm for the tax, for several reasons.
4. The first is that in order to have any chance of working without a distorting effect on behaviour an FTT would have to be a universal tax: unilateral action would provide a perverse incentive for financial institutions to relocate to countries that did not impose FTT. Since the evidence suggests that universal implementation is extremely unlikely to happen, the United Kingdom should not be a party to pioneering its introduction.
5. Crucially, it would be totally unrealistic for the UK to impose such a tax unless the US agreed to do the same: otherwise, business would simply be moved from the City to Wall Street. When Sweden decided unilaterally to introduce an FTT in 1984 a significant amount of its financial business moved to London. A study by the Adam Smith Institute found that 60 per cent of trading volume of the 11 most actively-traded Swedish shares migrated to London during the period in which Sweden had the tax in place. The Swedes repealed their FTT after five years of operation.
6. The conclusion to be drawn from this is that in no circumstances should an FTT be introduced at EU level unless it is introduced at a global level. In the absence of parity across the Atlantic an FTT regime in Europe would have the potential to do serious damage to the UK financial services sector – and financial services loom far larger in the UK economy than in the economies of the other major members of the EU.
7. The second is that an FTT, however low it is set, will produce a shift of real resources from consumers to government.
8. The cliché that ‘there are no free lunches’ is a cliché *precisely because it is true*. Proponents of the measure are wrong in the assumption that an FTT would be painless because individual taxpayers would not pay FTT personally: ultimately,

the cost of the tax would be bound to fall on consumers in one way or another. Whether or not it is appropriate for HM Treasury to increase the overall tax-take on purely economic grounds is a complex political question on which I am not competent to take a view; however, the decision on tax-take ought to be made on an assessment of the needs of the UK economy as a whole – not merely in reaction to a particular piece of campaigning.

9. Thirdly, the imposition of an FTT will impact adversely on the operations of pension funds. The Government is anxious for people to make better private provision for retirement and anything that tends to reduce the size of individual pension-pots runs counter to that objective.
10. Fourthly, it will have an adverse impact on the activities of grant-giving charities in particular and (because almost all have investments to generate income) on charities in general. Major grant-giving charities such as the Wellcome Trust and the Esmée Fairbairn Foundation rely particularly heavily on the income from their investments in order to fund their grants and, inevitably, the imposition of an FTT will reduce their available resources.
11. The final reason for opposing the proposal is that there cannot be any guarantee of the ends to which the proceeds of an FTT would be devoted. Successive governments of all political persuasions have resisted the hypothecation of tax revenues to any particular purpose; on the assumption that this policy is unlikely to change any time soon, it is perfectly possible that the proceeds of an FTT could end helping to fund public services generally – which is not what the proponents of the FTT have in mind.
12. The present Government deserves considerable credit for ring-fencing the overseas development budget. Supporting overseas development is right both on moral and on geopolitical grounds. That said, however, the amount of resources that the UK devotes to overseas development should be a conscious decision arrived at in the context of overall economic policy rather than being tied to an automatic process such as an FTT.
13. In short, the proposal for an FTT is deeply flawed. Apart from more general objections, I can see no logic whatsoever in supporting a particular cause such as overseas development, however worthy it may be, at the expense of UK charities and pension-funds generally.⁷³ Should an FTT be implemented, however, at the very least a mechanism must be found to relieve charities and pension funds of the burdens that it will inevitably impose.

7 November 2011

⁷³ My own pension is from the House of Commons Pension Fund, so I have no personal financial interest in this matter.

Arlene McCarthy MEP, Committee on Economic and Monetary Affairs - Written evidence

Introductory remarks

In the wake of the financial crisis the debate about taxation of the financial sector has become a key question of policy and politics, and the subject of both public campaigns and policymaker debates, at national, EU and global level. The debate focuses on three main factors:

- we need more resources, both at a global level to help meet development and climate change mitigation commitments, and at national level to enable budget consolidation while minimising the effect on growth and the pain of regressive spending cuts. All forms of taxation therefore need to be considered, particularly those with progressive incidence and limited impact on growth;
- the debate has highlighted the under taxation of the financial sector, given the general exemption from Value Added Tax across the EU,
- the financial sector was at the heart of the crisis and in the EU has received a total of 4.6 Trillion Euros of pledged support from governments to date. In the UK alone the Office of National Statistics calculates the effects of financial sector intervention as 1.4 Trillion Pounds, or 24 Thousand Pounds for every man, woman and child in the country. Many of the interventions reflect an ongoing effective subsidy to the financial sector. The costs of the financial crisis go far deeper and wider than this direct impact, including job losses, reduced tax revenues, and business failures.

There are a range of taxation options for the financial sector, each with different effects and which are not mutually exclusive. The Financial Transaction Tax (FTT) is one such tax. It has a highly progressive tax incidence; it could deliver stability benefits through its dampening effect on purely speculative, socially unproductive transactions such as high frequency trading and has significant revenue raising potential. It is analogous to VAT and by focussing on speculative activity it has a minimal impact on the real economy. The FTT has captured public support, as evidenced by the Robin Hood Tax campaign, and is the most promising candidate for progress at the EU level. Successful implementation at the EU level could lead the way to introduction of a global FTT. FTTs have a track record which can be learnt from, with the UK already implementing one form, the Stamp Duty on share transactions. It is also important to note that the EU has already adopted taxation legislation, such as on VAT and energy taxation, which provides a framework design and minimum rate for the tax concerned, thereby preventing arbitrage within the internal market, while being levied and collected by the Member States and allowing the Member State to apply a higher rate. The Commission proposal concerning the FTT is therefore in line with existing practice on tax matters in other fields.

It is, however, vital to get the design and technical details of the tax right. This makes close UK engagement in the EU legislative process on the FTT essential, particularly as an FTT introduced by some EU Members, even without UK participation, is likely to have significant effects on the City of London, as the major European financial centre. The UK faces a

practical choice; to closely engage with this proposal and argue for a well designed tax that could raise much needed funds, support financial stability and the real economy and would have strong public support, or to step back from the debate, veto UK participation from the outset, and ignore the public will while risking a damaging outcome for both our financial sector and our real economy. The most effective means to influence this process is to positively engage in the discussions and influence the FTT's design in the UK's interests, reaching a final decision on whether to agree to the legislation on the basis of the final outcome of these policy discussions.

Response to questions

PART I General questions on financial sector taxation

1. *Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?*

There is both a fairness and an economic efficiency case for the introduction of an FTT as, compared to other economic sectors, the financial sector is under-taxed and earning super-normal profits from their privileged position in the economy and the provision of taxpayer subsidy. There is a clear tax advantage for the financial sector by being largely exempt from VAT which the European Commission calculate as being worth 18 Billion Euros per year. As the introductory remarks to this submission make clear, this current under-taxation is just one of the compelling reasons for supporting an FTT.

2. *What would be the most appropriate form for a taxation of the financial sector? **Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector?** Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?*

Options for taxing the financial sector include bonus taxes, levies, a Financial Activities Tax which was examined by the IMF as a tax on the distribution of dividends and bonuses by banks, and financial transaction taxes, which themselves come in different forms. The UK implements a limited transaction tax on share purchases, while the original proposal for a global transaction tax made by Professor Tobin was for a currency transaction tax. As generally proposed in the current debate an FTT would be a broader form of the UK Stamp Duty, which could be extended from shares to encompass bonds, currencies and derivatives contracts.

Alternative options for taxing the sector are not mutually exclusive and an FAT and an FTT are two different taxes with different objectives which should each be considered on their own merits. It should be noted that an FAT, as analysed by the IMF, would be levied on banks, risking arbitrage with the shadow banking system. It would also impact on income from all banking activity, including "real economy" retail banking operations which would not be encompassed by an FTT. An FTT would fall on all institutions engaged in VAT exempt financial trading activities and on those activities which can contribute to financial instability. By taxing trading and being levied proportionately more on those who trade instruments frequently rather than holding them as long term investments, an FTT will impact mainly on those activities Lord Turner, the Chairman of the Financial Services Authority, has classified as "socially useless". In doing so, it may also inhibit the potentially disrupting and destabilizing

activities in financial markets such as high frequency trading, which was responsible for the "flash crash" in US markets in May 2010.

3. *What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?*

One advantage of an FTT is that it is possible to learn from both positive and negative examples. The Swedish experience shows why it is important to get the design of the tax right. By levying it on the location of the broker, Sweden's tax was easily avoided by trading elsewhere. The commission proposal explicitly takes this lesson on board by suggesting that the EU FTT be levied on the basis of the location of the party to the transaction. The UK Stamp Duty, in place in its current form with a Stamp Duty Reserve Tax since 1986, adopts a third design option, whereby it is levied on any transaction involving shares in a UK company, shares in a foreign company with a share register in the UK, or options to buy, rights arising from or interests in such shares. The UK's tax has coincided with London becoming a pre-eminent financial centre. In total ten EU Member States currently operate some form of an FTT.

PART II Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

4. *What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?*

The Commission's objectives are stated as:

- avoidance of fragmentation in the internal market
- ensuring a fair contribution from the financial sector, and
- enhancing financial stability by disincentivising certain activities

These are appropriate aims for this proposal, which contribute to the regulatory agenda in financial services while also facilitating EU Member States in raising much needed additional revenue.

5. *Does the Commission proposal for an FTT reflect the most desirable design for an FTT?*

As mentioned in response to question 3, the design of an FTT is critical, particularly with relation to the place of taxation. Minimising avoidance should be the key criterion in this respect. The Commission have proposed one of three available models, which can be summarised as follows:

- the place of the transaction, the Swedish model
- the place of the parties to the transaction, the Commission proposal
- the place of registration of the instrument, the UK Stamp Duty model

Such options could also be combined. Rather than take a rejectionist stance, the UK should undertake an analysis of the different options to ensure the optimal design.

6. *On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?*

The tax rate should be set to maximise revenue. It is therefore important that the rate is not set so high that it encourages a level of avoidance which undermines the tax take. The Commission proposal includes certain exemptions it believes necessary for legal compliance reasons, such as spot currency transactions, and to minimise real economy effects such as exclusion of first issuance of equities. The details of this scope should be considered hand in hand with analysis of the design of the tax (see above) to ensure it is effective.

7. *Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?*

The Commission has selected the residence principle, which would be simple to apply and avoids the pitfalls of the Swedish model of the FTT. As set out above (question 5) further analysis needs to be undertaken to ensure the optimal design, including consideration of the UK stamp duty model.

8. *How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?*

Estimated revenues from an FTT vary widely depending on the detailed design options chosen. The European Commission estimate of 57 Billion Euros for its broad form of the tax is consistent with the range cited by the academic literature. At a time of growing financing needs for international development and climate change mitigation, alongside the need for budget consolidation, all viable sources of additional revenue should be considered. As such transactions represent global business flows, it is reasonable for governments to dedicate a share to meeting our international obligations. For the share dedicated to domestic priorities, each country should be free to choose the appropriate mix of faster deficit reduction or increased spending, but on current patterns the additional revenues could be well spent in the UK on boosting government investment.

Impact and effectiveness

9. *Would the Commission's proposal for an FTT be effective in addressing short term volatility **and curbing harmful speculation**? Would it reduce excessive risk taking?*

Volatility has been a key concern since the US "flash crash" of May 2010, when high frequency trading on the basis of computer algorithms malfunctioned, bringing trading to a halt. At the proposed rate an FTT would have negligible effect on those investing for the long term. For example, a pension provider will purchase securities to provide for commitments to pay a retiree's pension over 20 years. In this context a one-off 0.1% tax is a minimal cost. In contrast, a high frequency trader, who buys and sells in fractions of seconds, will be disincentivised by such a levy. This could discourage destabilising, socially useless market activity while avoiding impact on genuine investment.

10. What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?

A reduction of certain types of socially useless trading is a specific objective of the proposal. While liquidity is crucial to well functioning financial markets, there is no evidence that activities such as high frequency trading provide genuine liquidity. Such trading only takes place on the basis of the margin between buyers and sellers in different markets, therefore while it increases the number of transactions that take place it does not facilitate any extra trading between sellers and end purchasers. This lack of genuine liquidity provision was demonstrated in the US "flash crash".

11. How easily could the FTT tax be circumvented by market operators?

The ability of market participants to avoid the FTT would depend on the design adopted; as set out in response to question 5, the key criterion for the design should be to minimise circumvention.

Impact of the FTT in the UK

12. What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? *If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?*

AND

13. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

Subject to achieving an optimal design, there is no reason to assume financial services will relocate outside the EU to avoid an FTT, or that an FTT will harm the long term health of the economy. This view is consistent with the UK experience of stamp duty. The tax's effect on economic growth must be compared to the alternative negative effects of raising other taxes, such as VAT, or of cutting spending, and considered alongside the positive effects on growth of increased investment. By relieving the pressure for tax rises on households and real economy firms and/or by funding additional investment, an FTT could be used to boost growth. UK citizens will be a major beneficiary of a well designed FTT, given the size of the UK's financial services sector.

14. Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

As made clear in response to question 2, there are numerous options for taxing the financial sector which achieve different objectives and are not mutually exclusive. The UK's levy is designed as a disincentive for banks using wholesale funding as a major component of funding the liabilities on their balance sheet. This is a different economic objective than those of the FTT and the two measures are fully compatible. While providing a framework for

transaction taxes the Commission proposal would leave Member States free to introduce or maintain levies, bonus taxes or an FAT.

Implementation

15. *Could such an FTT be plausibly introduced at an EU level, or **would an FTT only be effective if introduced globally?** Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?*

A global FTT would be the most effective model for a financial transaction tax should be the UK's and EU's ultimate ambition. It warrants a major diplomatic effort, and international leadership which the UK government has failed to provide.

It is unlikely early progress will be made towards a global FTT. In this scenario, an EU wide tax, with a low rate and an appropriate design to counter avoidance, would be a powerful demonstration of the potential of an FTT, and could advance the cause of global agreement, just as the UK Stamp Duty shows countries can have successful transaction taxes without broader agreement.

It is important to note that under the EU Treaties a group of willing Member States, such as the Eurozone 17, could proceed in enhanced cooperation without the participation of all 27 Member States. This would be both a missed opportunity and a risk to the UK's national interest, as we would have lost any influence over the design of the FTT but could still be affected by its operation. It is therefore imperative that the UK government actively participates in discussions with a view to taking part in an FTT if a design can be agreed that will uphold the UK's economic interests.

7 November 2011

European Commission Directorate - General Taxation and Customs Union

Part I: General questions on financial sector taxation

Question 1:

- 1) There is a case for the introduction of a tax on financial transactions for two reasons:
- The financial sector has hugely benefitted from massive rescue operations undertaken by the tax payers in Europe in the context of the financial crisis which also triggered an economic and aggravated a sovereign debt crisis. Now asking the financial sector to contribute to the financing of these rescue operations is simply applying a key principle of effective policy making, i.e. that those who benefit from a policy should also be those that should pay for it, unless there is a political consensus that others should pay.
 - The financial sector is exempt from paying VAT for most of its operations. Thus, levying a tax on financial transactions could partly offset this preferential treatment.

Question 2:

2) The most appropriate form for a taxation of the financial sector would be the levying of a financial transaction tax (FTT), so as to collect a significant financial contribution from this sector to finance the rescue operations undertaken in its support. Also abolishing the VAT exemptions for financial services would generate a level playing field with other sectors. Bank levies or taxes also contribute to the cost of past and future financial crises. As far as future crises are concerned, bank levies support a credible resolution framework of financial institutions. The design of a tax/levy can help to create the right incentives for banks to carry out their business in ways which reduce their contribution to systemic risk and the impact of their failure.

3) A Financial Activities Tax (FAT) would not be a preferable means as it would provide incentives to reduce the employment intensity of financial services and as it would privilege highly automated investment banking activities as compared to traditional but more labour-intensive retail banking activities.

Question 3:

4) The lesson to be learned from the Swedish experience is that a tax on financial transactions would have to be as broad as possible in geographical scope and with a tax base in respect of products, markets and institutions covered. This is why the Commission has proposed to cover all financial instruments (securities as well as derivatives and structured products), all financial markets (organised and over-the-counter) and all financial market actors.

Part II: Specific questions on the Commission's proposal for an FTT

Question 9:

5) The revenue raising potential for the FTT is significant. Other revenue raising options would be an increase in corporate income taxes, VAT, energy taxes or social security contributions. The true incidence of a tax falling on the financial sector is much more likely for an FTT than for the other options. After all, the bulk of financial transactions are between financial institutions. However, economic literature and economic models seem to

indicate that the financial sector will try to pass this tax on to the borrowers, thus increasing the cost of capital, but not to the lenders, such as pension funds.

Question 11:

6) The FTT could only be circumvented by market operators in circumstances where they decided to abandon serving the European market altogether, and thus foregoing the profits which could be earned here. However, the European market, with its GDP of more than €12 trillion, is much too big a market to be abandoned. This suggests that the incentives to circumvent the tax are rather limited. This argument holds more weight as the tax rates are very small.

Question 12:

7) The impact of the FTT on the UK's financial services sector and the City of London, as well as the UK economy more broadly would be rather limited, as traders would simply have to adjust their business models. Market segments expected to be affected most will be the automated high-frequency trading (HFT) and highly-leveraged transactions, which are typically not very labour intensive. Also, the consolidation of market volumes presently characterised and distorted by the virtual liquidity provided by such HFT is not expected to reduce the efficiency of the markets. On the contrary, as less rents would be skimmed off by these HFT and deviated into the pockets of the traders the market should become more efficient from the perspective of the non-insiders.

8) As the City of London is often the booking centre for financial transactions only (similar to e.g. the port of Rotterdam for the imports of goods to continental Europe) and as the tax would have to be paid by the parties to the transaction (like the customs duties who would have to be paid by the importer), the burden would not necessarily fall on British citizens (like the payment of customs duties collected in the port of Rotterdam does not fall on Dutch citizens).

Question 13:

9) See the answer to Q 11. Also, the UK experience with its stamp duty indeed shows that levying an FTT (the UK rates are 0.5% while the EU rates proposed are 0.2% for a round trip) is not inconsistent with maintaining a successful stock exchange. However, it also shows that limiting a tax to only one category of products (shares) while leaving similar substitutes untaxed provides incentives to circumvent the tax by abandoning the trading in the underlying asset (shares) and going for derivatives, such as contracts for difference. No justification for the preferential tax treatment of such derivatives has ever been provided.

Question 14:

10) See also the answer to Q2. The bank levy is a different instrument that serves different purposes and the Commission will publish before the end of the year a legislative proposal on the cross-border crisis management in the banking sector, setting out its views on a sustainable way to provide private financing for addressing future problems in the financial sector in the form of resolution funds. Additionally, there is a second feature of the harmonisation of the FTT as this tax has been proposed also as a basis for a new own resource to the EU budget.

16 November 2011

Institute of Economic Affairs (IEA) – Written evidence

This paper is a short introduction to the ever-burgeoning literature on the proposed financial transactions tax (FTT). It does not attempt to be either all-inclusive or definitive. Rather, the aim is to provide answers to the common questions asked about the FTT.

A financial transactions tax is, as the name suggests, a tax on each and every financial transaction. Such taxes have been proposed by economists of the stature of J. M. Keynes and James Tobin in past decades and interest has been revived recently by the Robin Hood Tax campaign and a variety of official bodies such as the European Commission.

Keynes thought that excessive speculation could be damaging, although that did not stop him being one of the most aggressive commodities speculators of his day. Tobin was worried about exchange rates in the context the tail end of the Bretton Woods system in the late 1960s and early 1970s. Fixed exchange rates (which could only be changed by agreement and *in extremis*) were giving way first to various ‘dirty’ floats and then to the more free market approaches of recent decades. Specifically he proposed his Tobin Tax on currency transactions in order to reduce the liquidity of currency markets. His point was that governments ought to be able to determine the exchange rates and speculation made this more difficult so speculation should be discouraged through taxation.

This particular reason for an FTT rather goes away if it has already been decided to have freely floating exchange rates. Once this has been done there is no reason to limit speculation, a policy which would result in movements coming in discrete and large steps. It is preferable to have deep and liquid markets so that changes are incremental and smooth.

The Robin Hood Tax campaign seems to think that hundreds of billions of dollars can be extracted from the financial markets without anyone really noticing very much: a rather naïve if cute idea. The European Commission is continuing its decades-long campaign to have its ‘own resources’. Under its proposal, FTT revenue would be sent to the Commission, which would thus become less dependent on national governments for its budget. This is neither unusual nor reprehensible in a bureaucracy. It is the nature of the beast that it would like to have its own money to spend without being beholden. We should be aware of this background though when evaluating justifications for an EU FTT.

Despite these motivations it is still possible that an FTT is desirable and that the incidence will fall on the desired targets; even that it might reform the financial markets so that current economic woes will be less likely to occur in the future.

The rest of this paper asks and then, as far as the literature already does so, answers the following questions about an FTT.

- Is it feasible?
- How much revenue will be raised?
- What will be the incidence?
- How will it change financial markets?
- Will it make another financial crash less likely?
- Could it be extended to currencies?

Is a financial transactions tax feasible?

A financial transactions tax is certainly feasible. It is possible to tax just about anything from head of population through transactions to windows. That the last UK attempt to have a poll tax led to riots and the results of the taxation of windows can be seen in the blanks on nearly every Georgian house in the country does not mean that feasible is to be equated with desirable and so it is with an FTT.

An FTT can be imposed with varying effects depending upon how many other governments do so at the same time. A purely EU FTT would see much trading leaving the EU, as happened to Sweden when it unilaterally imposed such a tax in the 1980s and 90s. A global tax would not have the problem of trading moving but would still have all of the other associated problems.

The feasibility or not of the FTT is something of a red herring: the UK government does say that it would only consider one if it were universal but this is much less important than the longer list of things which are wrong with an FTT in principle, however widely it may be levied.

How much revenue will be raised by an FTT?

No net revenue will be raised by the specific proposals that have been put forward. This will sound strange to those who can see that there will indeed be revenue coming from the tax, but that is because while there will indeed be revenue from the tax itself there will also be falls in revenue from other taxes. The net effect of this is that there will be less revenue in total as a result of an FTT.

But of course, do not just take our word for it. That of the European Commission should be sufficient:⁷⁴

‘With a tax rate of 0.1% the model shows drops in GDP (-1.76%) in the long-run. It should be noted that these strong results are related to the fact that the tax is cumulative and cascading which leads to rather strong economic reactions in the model.’ (Vol. I (*Summary*), p. 50)

Revenue estimates are as follows:

‘[A] stylised transaction tax on securities (STT), where it is assumed that all investment in the economy are financed with the help of securities (shares and bonds) at 0.1% is simulated to cause output losses (i.e. deviation of GDP from its long-run baseline level) of up to 1.76% in the long run, while yielding annual revenues of less than 0.1% of GDP’ (Vol. I (*Summary*), p. 33)

A reasonable estimate of the marginal rate of taxation for EU countries is 40-50% of any increase in GDP. That is, that from all of the various taxes levied, 40-50% of any increase in GDP ends up as tax revenues to the respective governments. Thus if we have a fall of 1.76%

⁷⁴http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/impact_assessment.zip

in GDP we have a fall in tax revenues of 0.7-0.9% of GDP. The proposed FTT is a tax which collects 0.1% of GDP while other tax collections fall by 0.7-0.9% of GDP. It is very difficult indeed to describe this as an increase in tax revenue.

There are, however, bureaucratic reasons why the European Commission might still suggest such a tax move. The revenues from the FTT would be designated as the EU's 'own resources', that is, money which comes to the centre to be spent as of right; not, as with the current system, money begrudgingly handed over by national governments. The EU bureaucracy therefore has a strong interest in promoting such a change. What's in it for the rest of society is harder to spot.

This result is not unexpected. When the Institute for Fiscal Studies looked at the impacts of the UK's own FTT, Stamp Duty upon shares⁷⁵, they found much the same result - from the same cause too. Such a transactions tax upon securities lowers securities prices. This then makes the issuance of new securities more expensive for those wishing to raise capital. More expensive capital leads, inexorably, to less of it being used and thus less growth in the economy.

Please note that this is not some strange application of the Laffer Curve argument. It is not to say that lowering all taxes, or any tax, leads to such extra growth that revenues increase. Rather, it is derived from Diamond and Mirrlees (1971)⁷⁶ that transactions taxes multiply then cascade through the economy. They are therefore best avoided if another method of achieving the same end is available. Indeed, they point out that taxation of intermediate inputs is to be avoided if possible - better by far to tax final consumption or some other final result of the economy. This very point is acknowledged in the way VAT is structured. Rather than a series of sales taxes which accumulate as one company sells to another along the production chain, there is a value added tax which amounts to one single rate at the point of final consumption.

That this point is recognised in a major part of our taxation system suggests that it might be wise to recognise it with regard to the FTT.

What will be the incidence of an FTT?

Incidence refers to who really bears the economic burden of a tax, not who hands over the cheque for that tax. More formally, the legal incidence is not always the same as the economic incidence. The most obvious example of this is with employers' national insurance contributions. It is the company which hands over the cheque but almost all economists are united in saying that much (and possibly all) of the economic burden is carried by the worker in the form of lower wages. Quite how much depends upon the elasticity of the supply and demand of labour and quite how much is still an area where economists argue - but some to all being 'really' paid by the worker is the general conclusion. The worker might believe, however, it is really the company paying, which is arguably what makes such payroll taxes so appealing to unscrupulous politicians.

⁷⁵ <http://www.ifs.org.uk/wps/wp0411.pdf>

⁷⁶ Diamond, P. A. and J. A. Mirrlees (1971) 'Optimal Taxation and Public Production II: Tax Rules', *American Economic Review*, 61, 3, 261-78.

Another way of putting the same point is that a tax, all taxes and any tax, means less money in the wallet of some live human being. The study of incidence is the study of whose wallet gets picked.

The first and great lesson of tax incidence is that taxes on companies are not paid by companies. They are not, despite legal personality, live human beings and therefore cannot carry the ultimate burden of any tax. We see this when we discuss the incidence of corporation tax. Companies do not pay this, cannot. It is some combination of shareholders in lower returns, workers in lower wages and/or customers in higher prices who do. The general result in an open economy like the UK's is that workers carry the majority of the UK's Corporation Tax in the form of lower wages. Similar results are found for other countries, shareholders bearing more where the economy is either larger or more closed, workers more where the economy is smaller and/or more open.

The statement is not that companies and or shareholders conspire to make the workers pay what government has righteously decided should be paid by companies. There is no attempt to 'pass on' the tax. Rather, there is a world return to capital and a corporation tax reduces, in that taxing jurisdiction, the rate to below that. Capital will therefore flow out (or fail to flow in) until the scarcity of capital pulls the after tax return up to the world return. This clearly means less capital being applied to the labour available in that jurisdiction which imposes the corporation tax. Less capital being applied to labour is, other things being equal, going to lead to less productive labour for it is capital added to labour which increases productivity. As average wages in a country are determined by average productivity in that country that lesser amount of capital is going to lead to lower average wages.

It is not that the employees of the company being taxed get paid less: it is that less capital being employed *in toto* leads to lower wages for all in the country.

The importance of this effect is still argued over. Various reports from various people with different assumptions about capital openness and so on lead to estimates of 30-70% of corporation tax really being paid by the workers, the rest by the shareholders. One study, Atkinson and Stiglitz (1980)⁷⁷, points to the at least theoretical possibility that the incidence on the workers' wages can be over 100%. That is, that the employees lose in wages more than the revenue raised by the tax.

So what will be the incidence of an FTT? The one place we know the tax cannot fall is on the banks. For the banks are corporations and corporations cannot bear the burden of a tax; it has to be some human being. We have some combination of the workers, the shareholders and the customers to consider.

The simplest method of tracking this incidence is to look at, as in the IFS report, the incidence of Stamp Duty and then to add what we have been told by the European Commission.

From the IFS report we see that the incidence of stamp duty is dual: some part of it falls upon capital, making raising capital more expensive. This, in turn, just as with the corporation tax, will affect the workers' wages: more expensive capital leads to less of it being employed and thus lower average wages. Note that this does not mean that it is

⁷⁷ Atkinson, A. B. and J. E. Stiglitz (1980) *Lectures on Public Economics*, New York: McGraw-Hill.

bankers earning less: it is the workers who earn less as a result of less capital being employed. The second part is the incidence upon the users of the financial markets: a fairly obvious result of a transactions tax. The IFS found that pensions achieved lower returns, partly as a result of lower share values as a result of the tax and partly as a result of paying the tax itself when changing which shares were owned in the pension fund. So part of the incidence of the FTT will be upon all users of any financial instrument, for all financial instruments are to be taxed.

Finally, from the European Commission numbers, we can see that the Atkinson and Stiglitz result is likely to be true. The loss in GDP as a result of the tax is larger than the revenues raised from the tax. Thus, quite clearly and obviously, the total incidence, the total lost from all pockets, is higher than revenues and thus the incidence of the tax is over 100%.

So we can say that the incidence of the FTT will be upon workers in the form of lower wages, upon consumers of financial products in higher prices and that the incidence, the loss of income resulting from the tax, will be over 100%. The loss will be greater than the revenues raised.

There really are good reasons why Diamond and Mirrlees say that we should not tax intermediate inputs if we can achieve the same aim in some other manner.

How will an FTT change financial markets?

An FTT would certainly make financial markets smaller. To many proponents of the tax this is a good enough reason to desire it. However, smaller financial markets seem an odd thing to desire. It is necessary to have a better argument than a distaste for Mammon before changing the world so much. The argument usually given in a lot of the pro-FTT literature is that speculation increases volatility. This is nonsense as is well known, so among the more intelligent proponents there is the argument that ‘excessive’ speculation increases volatility, while ‘not-excessive’ speculation reduces it. This is indeed possible and a number of theories have been put forward as to how ‘noise traders’ and the like increase rather than reduce volatility.

Of the various papers that have been written the one with the best overview of this part of the argument is the one from the Institute of Development Studies.⁷⁸ It looks at the various theoretical papers which have outlined how this might be true. The second section, which examines empirical studies, is of particular interest to us. It is concluded that:

‘The balance of evidence would seem to suggest that there is a positive relationship between transaction costs and volatility, although the size of this effect varies across different studies. Whether a Tobin Tax would affect volatility in the same way as underlying market transaction costs is not clear.’

This suggests that a transaction tax would *increase*, not decrease volatility.

Since an FTT would decrease the size of the financial markets, prices would jump around rather more than they do at present - completely the opposite of what certain supporters of the FTT conclude in their theoretical musings. It is a reasonable intellectual exercise to

⁷⁸ ‘Tobin Tax: A review of the evidence’, Economics Department Working Paper Series, Institute of Development Studies.

theorise but it is necessary at times to calibrate such theories to the real world. The FTT would increase volatility.

Will an FTT make another financial crash less likely?

A smaller financial market might reduce the probability of there being a repeat of the events of 2007/8. However, it is worth noting that an FTT would have had no effect whatsoever on the financial crash that actually happened in 2007/8, nor on the current problems of the eurozone.

The markets that do the sort of high volume, low margin trades that would be affected by an FTT are the foreign exchange (FX), futures, options and stock markets (with special reference to high frequency trading of the often demonised computer algorithm type). None of these markets failed in any manner in the recent or current troubles. Indeed, it is possible to find entirely respectable economists (Robert Shiller for example) arguing that it was the lack of options and futures markets in housing that failed to prick the US housing bubble before it blew.

What we did have was a housing bubble and collapse with the consequent falling over of large parts of the banking system. But none of that has anything to do with high volume or low margin trading activities. Mortgage Backed Securities (MBS), Collateralised Debt Obligations (CDO), Credit Default Swaps (CDS) and the leverage of the banks themselves were what did cause the problems in 2007/8 and none of them would have been affected in the slightest by the imposition of an FTT. They just weren't traded all that often. MBS and CDO securities, like most bonds, were traded once, at date of issue and parked in an investment account. However much they may have been misvalued, having them being traded less as a result of a tax on them wasn't really possible, let alone helpful. The current woes are about sovereign debt which does, at least normally, have a liquid market. But even then the addition of a tax is not going to change the frequency of trading all that much as bonds just aren't traded all that much - nowhere near as much as FX, stocks, options and futures are.

So the FTT doesn't even work as a way of avoiding the recent financial crash: for it taxes the things that did not cause problems and would not make much difference to those things which did.

Could the FTT be extended to currencies?

The FTT could not be extended to currencies in the European Union. The EU's preliminary report⁷⁹ stated:

'At least for a levy on currency transactions some legal aspects have to be considered. In relation to the original proposal by Tobin for a currency transactions tax legal obstacles were put forward by the ECB on its compatibility with the **free movement of capital and payments between Member States and between Member States and third countries** [emphasis in original] under Article 63 of

⁷⁹http://ec.europa.eu/economy_finance/articles/international/documents/innovative_financing_global_level_sec2010_409en.pdf

the Treaty on the Functioning of the European Union (TFEU) (ex Article 56 of the Treaty Establishing the European Community (TEC)). Since the mechanism of a currency transactions levy is supposed to be based on taxing the net position of foreign exchange transactions, it could represent a restriction of the free movement of capital and payments (Article 63 TFEU). Besides the effect on the netting operation itself, it indirectly restricts underlying transactions, including those between Member States and with third countries, by rendering them more costly. It is unlikely that, for this restriction, a justification sufficient for the purposes of the Treaty could be found. Even if e.g. raising funds to benefit stability funding were to be considered as an overriding requirement of general interest, that requirement could not explain why transactions involving countries with different currencies would be treated less favourably than those involving only one currency. Furthermore, the tax is considered to be disproportionate as funds could alternatively be raised by other means of budget attribution without affecting a basic freedom of the Treaty and, in any event, because the scope of the tax would be unrelated to the risks to be covered by the tax revenue raised. Even a very low tax rate would constitute an infringement, and it would not be possible to establish a threshold of insignificance.’

An FTT on FX in the EU would be illegal and it is doubtful that anyone wants to go through the process of revising the basic treaty to change this. It is worth noting that the EU's later and most recent proposal for an FTT specifically excludes the possibility of an FTT on spot FX trades. However, in the details of the longer version⁸⁰ at various points the revenue from such an FX tax does appear. It appears that it was only late in the analysis that the illegality was remembered and thus not all of the supporting work has been changed to agree with the top of the report.

Conclusion

As well as the EU, several papers on FTTs have been written by other more or less reputable organisations including the IMF.⁸¹ There have also been studies from organisations such as the TUC and the Robin Hood Campaign, but we have restricted ourselves to details from those bodies with at least a working knowledge of economics and financial markets.

The end result of this survey of papers about the proposed financial transactions tax is clear. It is not possible to impose an FTT on foreign exchange transactions in the EU. An FTT will not reduce volatility, it will increase it. An FTT would not have prevented either the Great Financial Crash or current sovereign debt problems. It would shrink those parts of the financial markets which did not in any manner contribute to these problems.

An FTT is feasible but then so are many things that are not desirable. The FTT would not increase revenue collected. Indeed it would reduce total revenue by shrinking the overall economy. Finally, those who would carry the economic burden of the FTT would not be the banks but workers and consumers in general, and their burden would be more than 100% of the revenue raised by the FTT.

2 November 2011

⁸⁰http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/impact_assessment.zip

⁸¹ For example: <http://www.imf.org/external/pubs/ft/wp/2011/wp1154.pdf>;
<http://www.imf.org/external/np/g20/pdf/062710b.pdf>

Sylvie Goulard MEP – European Parliament - Written evidence

1. Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

Most of the financial and insurance services are exempted from VAT (see article 135(1) of the VAT directive). Given the role of these services in the economic and financial crisis, given the current need for additional resources by governments and international institutions, given the speed of some transactions which are disconnected from economic rationality and the ever diminishing role of financing the real economy, given the support received by financial institutions from the public budgets, there is a genuine legitimacy in asking these services to take a fair share of their responsibilities.

This new revenue source could generate significant amounts of tax revenue for public budgets. One option could be that this FTT would become an own resource for the EU budget. Such an option would lead to a significant decrease in the national contribution (and therefore help Member States in their consolidation efforts).

2. What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

There is first a political decision to make: whether or not to tax an entire sector that until now has escaped taxation and caused huge problems to the real economy.

The technical choices come afterwards. The impact assessment (in 19 volumes amounting to more than 1000 pages) accompanying the European Commission's proposal of September 29 2011 clearly shows that the issue has been studied in depth.

3. What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

The idea is obviously to take weaknesses or bad experiences into account. For example, the Swedish experience has notably shown that a tax levied on any transaction (irrespective of being domestic or made by foreign customers) that was carried by a Swedish broker could easily be avoided by choosing foreign brokers for the transfer.

One has also to keep in mind that if the primary aim of financial markets (as it should be) is to finance the real economy then the soundness of the underlying assets traded in the EU should anchor the transactions in the EU: if the legal framework is adequate, it is fundamentally the quality of the assets that guide the investments.

4. What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?

The proposal adopted by the college of Commissioners is a good basis for discussion. Now it is going to be discussed democratically in the EP and the Council

5. Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

The mechanism chosen by the Commission is based on the country experiences (see volume 9 of the impact assessment of the Commission) and on the objectives it intends to reach. Building on these, it seems to be the appropriate tool. But of course, the EP and the Council will examine it and if necessary, improve it.

6. On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?

As stated by the Commission in its proposal "the scope of the tax is wide, because it aims at covering transactions relating to all types of financial instruments as they are often close substitutes for each other" and covers all kind of trading venues. Given the intended objectives, such as the stability of the financial markets (of course not only addressed by this piece of legislation), it is logical to cover all the transactions.

There is a political as well as legal debate on the opportunity to include the spot currency exchange transactions.

Another debate focuses on the stakeholders that should be paying the FTT: should private households or non-financial institutions such as SMEs be included? The democratic debate will provide answers concerning the scope.

7. Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?

This option of residence principle seems to be adequate to cover all transactions having a link with the EU. The non-EU resident institutions trading with the EU could also be appropriately included in the scope.

8. How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

See the Commission's impact assessment, volume 12, and part of my answer to question 1 above.

The resulting product of the FTT can be used either to finance Member States' budgets or to finance the EU budget or even to contribute to development. Many options are available, and a combination of all can also be envisaged.

9. Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

A tax on a transaction gives some concreteness to speculation: the stakeholders will have to truly assess the need of each transaction given that they will be taxed on it.

This piece of legislation, in consistency with others such as the short selling legislation or the MiFiD, will complement through the taxation dimension the regulatory and supervisory framework created by the other pieces of legislation.

10. What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?

The answer to this question is dependent on the assumption regarding liquidity: is there a shortage of liquidity or is there over-liquidity on the markets? One can however assume, having undertaken some economic reading, that the FTT may slightly decrease the liquidity. It is in practice the interaction with other regulatory requirements which will impact the liquidity. Luckily tools exist to manage liquidity.

11. How easily could the FTT tax be circumvented by market operators?

One can say that market operators will always find a way to circumvent the tax. This is why the legislation must lay down the basic objectives and principles and leave enough flexibility for the implementation by the European Commission or any other body entrusted by the legislation.

Of course, this step is foreseen as a contribution to a global change in this field. Sooner or later, the other financial centres in the world will follow, not least because in some countries, national budgets are seeking more innovative methods of financing.

At the beginning of the 20th century, many people opposed the introduction of a tax on private revenues. Afterwards, it was widely implemented. The same for the VAT, invented in France, adopted worldwide.

12. What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

On the website of the City of London, it is stated that "there are 241 foreign banks with branches or subsidiaries in the UK, more than in any other country. The assets of foreign-owned banks in the UK are almost as large as those of the local UK-owned banks." It is also stated that "According to a survey by the Association of Foreign Banks published in Spring 2011, the wholesale operations of foreign banks in the UK currently employ around 124,000 people, 40,000 of whom have a foreign passport."

The City of London is indeed an effective place for financial services but the non-UK origin of quite a meaningful part of the financial transactions is also quite clear.

13. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

If well and fairly conceived, the FTT would not cause any relocation. As stated previously, the benefits of having well regulated, predictable and efficient financial markets within the EU (allowing the underlying assets to prove their value) would offset the cost triggered by any FTT.

The figures for the FTT proposed by the Commission are fairly modest.

14. Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

The purpose and the scope of a bank levy differs from that of the FTT. The bank levy often only focuses on credit institutions, quite a few activities such as the ABX index contract would not be covered.

The bank levies are either used to finance national resolution schemes or to finance the general budget: this is narrower than the objectives foreseen by an FTT.

The bank levy can not be seen as an alternative to an FTT.

15. Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

The best option would of course be that it is implemented globally (if the term means that it would be applied by the G20 economies). However, the lead may be taken by the EU. It is not the first time that the EU would pave the way for others.

On the issue of knowing if the FTT should be implemented at EU level or at Euro area level, we may underline that some Euro area leaders said that it would be done inside the 17-block anyway. However given the economic inter-linkages between all the Member States but also the similarity of preoccupation of public opinions (see Standard Eurobarometer 75 - "Europeans' Perceptions on the State of the Economy" - in particular on the potential introduction of a FTT) it seems reasonable to try to find an EU-wide response.

Discussions regarding changing the way things are working within the financial sector appear to be quite lively in the UK. Indeed the Vickers commission has suggested major reforms in the banking sector. Despite the positions taken by the government, or by the financial industry lobbies, there seems to be growing public support for major reforms, and not only in the banking sector. The increasing public support for an FTT or similar mechanism seems to be quite clear. For example, on November 1, 2011 the Archbishop of Canterbury wrote in the Financial Times that "The Church of England and the Church Universal have a proper interest in the ethics of the financial world and in the question of whether our financial

practices serve those who need to be served – or have simply become idols that themselves demand uncritical service."

7 November 2011

International Swaps and Derivatives Association (ISDA) - Written evidence

Q 1. Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

We do not believe that the introduction of a tax on financial transactions along the lines proposed by the European Commission produces a fair basis for the taxation of the financial sector. In fact we believe that the proposal will produce distortions in the operation of the financial sector and additional costs for end-users of banking products including derivatives. The current system of VAT exemption for many transactions entered into by financial institutions results in irrecoverable VAT suffered on goods and services consumed by those institutions. This provides a significant contribution to tax revenues from the banking sector. It is the case that VAT is not accounted for as output tax by the financial institutions themselves and therefore consumers do not pay VAT on financial service fees. In other words, the VAT exemption benefits the users of financial services, rather than financial institutions.

The difficulties of devising a scheme for calculating an appropriate margin on which to impose VAT on financial products raise the question of whether the imposition of VAT on financial products would result in an overall increase in VAT revenues. Indeed, the Commission's own documentation from 2007 and 2008 discussing potential changes to the exemption suggested that such a change would reduce inefficiencies for the financial sector but broadly neutral for VAT revenues as a whole.

There is no evidence of under-taxation of financial institutions within the EU. These institutions make a major contribution to corporation tax revenues and their employees make a similarly significant contribution to payroll taxes on the same basis as corporations and employees in other sectors. In addition banks operating in the UK have recently made additional contributions to taxation revenues via the bank payroll tax and now the banking levy.

Q 2. What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

ISDA believes that an FTT on financial transactions and in particular on derivatives would be harmful to the financial and non-financial sectors alike. The derivatives industry provides important risk management tools helping to achieve growth in the economy. It serves a variety of large, medium and small corporations and entities, which use derivatives products to manage risk, including interest rate, currency, credit and counterparty risks. ISDA is concerned that the FTT will ultimately increase the costs of hedging those risks. We believe that managing such risks is essential for the long-term economic growth and recovery of European economies. In some cases, we believe that the tax could lead to risks being left unhedged.

The introduction of additional taxes (FTT or FAT) on the financial sector also risks reducing the capital base of financial institutions at a time when regulators are demanding higher capital buffers. Additional costs passed on to customers as a result of this taxation would act as a barrier to accessing the financial markets, as well as restricting liquidity (and therefore increasing volatility) in those markets.

We would also suggest that a well-designed taxation system applies across the economy, to all sectors and businesses. Targeting particular sectors is, by definition, going to be distortive and create difficult boundary issues and scope for avoidance.

Q 3. What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

The risk of relocation of cross border business outside the EU is acknowledged by the Commission (clearly based on Sweden's experience when it introduced a tax on equity and debt securities transactions in the late 1980's). However the Commission's estimation of the economic impact of this relocation on such a significant international financial centre as the City of London is understated. Derivative and currency transactions markets are integral to many other financial transactions which would also relocate to countries where the cost of doing business is lower.

Even in relation to EU business (which will be ring fenced within the FTT zone by the operation of a "reverse charge" on transactions) the Commission's paper does not take into account the cumulative cost of FTT as it cascades down the various stages of trading and settling transactions. One example of this is the exchange traded derivative markets where the execution and clearing arrangements create multiple layers of charge (even though the clearing houses are themselves exempt). Even when entering into a simple OTC derivative, a bank will generally seek to hedge itself through further transactions, and some of the parties it transacts with will in turn hedge themselves – resulting in another cascade of FTT charges. Similar effects will arise in the context of financial instruments. It is, therefore, inconceivable that these markets would continue to operate in the same way as they currently do. The end result is smaller, less liquid markets for financial institutions and end users continuing to trade within the EU.

The blow to the Swedish economy as a result of the introduction of a FTT was alarming and not merely imagined. Sweden's FTT was collected from 1984 to 1991 and resulted in between 90 and 99% of trades in bonds, equities and derivatives moving from Stockholm to London. This was an expensive lesson for Sweden and this experience should be sufficient to prevent Europe from making a similar mistake.

We are aware that the Commission and others have suggested that a lesson of UK stamp duty is that transaction taxes are not in fact incompatible with a successful financial services industry. This is not the place to repeat the well-rehearsed arguments about whether stamp duty in fact costs more in growth than it raises in tax. We would, however, stress that the point is entirely misplaced – stamp duty is different from the financial transaction tax in two very significant ways. First, stamp duty does not generally apply to financial intermediaries – it only applies to the end purchaser of securities and does not "cascade". Second, and crucially, UK stamp duty applies to purchases of UK equities regardless of where the buyer

and seller are located. There is no incentive for the parties to relocate – which is why UK stamp duty continues to contribute a meaningful amount to the UK Exchequer. The proposed EU FTT, however, applies where a party is located in the EU - so it positively incentivises relocation outside the EU.

We would also note that France had an 'impôt de bourse' tax which was abolished a few years ago. We are not in a position to articulate why the French administration abolished it, nor do we have data on how much it collected. However, we are aware of some difficult issues prior to it being abolished in relation to its scope in particular where it may have applied to foreign /non French transactions which had led to ways in which transactions with French investors in non French shares had to be executed to ensure that the tax did not arise.

Q 4. What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?

The Commission has stated three main objectives:

- a) "to avoid fragmentation in the internal market for financial services, bearing in mind the increasing number of uncoordinated national tax measures being put in place". However, given that (as far as we are aware) no member state has proposed an FTT, it is unclear how the proposed Directive will assist in this regard.

The principal measures that have been proposed are bank levies and, whilst these have presented double (and indeed multiple) taxation problems, the FTT Directive is of no relevance to them. It is therefore hard to avoid the conclusion that this objective is registered to assist compliance with Article 113, which provides for indirect tax measures to be adopted where "harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition."

We would agree with the Chancellor of the Exchequer when he said at the Council of Ministers on 9 November that the EU's energies would be better spent harmonizing bank levies.

- b) "to ensure that financial institutions make a fair contribution to covering the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view".

The difficulty with the first half of this is that the "financial institutions" subject to the FTT include many entities that bear no responsibility for the financial crisis and which received no taxpayer support. This includes pension funds, unit trusts, holding companies, and leasing companies, for example.

The difficulty with the second half is that no evidence is provided that there is an unequal playing field (save for some papers which erroneously suggest that the financial sector suffers an advantage from current VAT rules).

- c) "to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures aimed at avoiding future crisis"

It is not clear the disincentives created by the FTT are at all aligned with current regulatory measures. For example, the FTT discourages parties to derivatives depositing securities as collateral (as those deposits will in most cases be subject to FTT charges, 10bp on each transaction party when deposited and 10bp on each transaction party when returned, i.e. 40bp in total).

The FTT will also, as noted in our answer to question 3 above, disincentivise the use of exchange traded derivative markets.

There is of course another key objective, to raise direct funding for the EU – but this is a political question on which we make no comment other than to note that, even if the principle were politically acceptable, it would seem imprudent for the EU's budget to become dependent upon one sector of the economy.

Q 5. Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

It seems to us that financial transaction taxes in the forms usually proposed have two serious flaws. First, they cascade (as noted in our answer to question three above). Second, unless introduced globally, they will simply prompt relocation, as the Commission themselves acknowledge, particularly in the case of derivatives. This will have a greater impact on countries with large financial centres.

It should be recalled that these were not problematic issues for Tobin's original proposal for a financial transaction tax. The cascade effect was not a flaw but, rather, a key feature of the tax – Tobin's motive was not to raise revenue but to close down forex speculation – he did not propose to apply the tax on other financial instruments. The relocation issue was not a concern because Tobin envisaged a tax that was global in scale.

We would therefore conclude that the FTT is an undesirable tax, and that this is due to the fundamental nature of financial transaction taxes and not specific to this particular implementation.

As a result of all the above, the impact of an FTT will fall mostly on users of financial markets including ordinary consumers. The transaction tax would be passed on to end-users: savers, investors and businesses as the EU pointed out within their own analysis.

The Commission's proposal seeks to accommodate companies and consumers as if they could be sheltered from the direct effects of the tax - but this ignores the effects of tax incidence which the Commission has itself highlighted in the past. Pension funds across the EU would pay the tax when they buy or sell investments or use derivatives to hedge against inflation, interest rate volatility or credit, commodity or foreign currency risks. As a result the FTT will reduce the value of pensions.

Borrowing costs will increase as the providers of credit to household and small and medium-sized businesses will have to pass on the tax to end-users when using the financial markets to secure funding.

The Commission estimates that in the long run (20 years time) the FTT would reduce Europe's total output by between 0.5 and 1.8 per cent therefore reducing the total EU employment by more than 0.2 per cent, or about half a million jobs, because of the loss of certain markets, such as derivatives, in Europe. We think that these estimates are rather optimistic since in the long run the loss of particular activities will increase the financial blow to European employment in most sectors including manufacturing (as can be proved by the exodus of the car manufacturing industry to Eastern Europe and Asia where employment costs are smaller). The inability to secure funding and hedging at the right cost will not help the development of these industries and job creation in Europe but instead is likely to encourage such development elsewhere.

Moreover, the big gaps in the Commission's economic and financial modeling, which for example, does not take account of the financial services and the ancillary jobs that will leave Europe, suggest that these projections are likely to be significantly underestimated as was the case with the studies carried out before this tax was applied in Sweden.

Therefore, we believe, that the Commission's design is not the most desirable. The FTT would increase capital costs, reduce investment, reduce real wages and GDP. We know that anything that is elastic should be taxed at a zero rate. Financial transactions are the most elastic of all transactions. According to OECD text books, this is the most harmful tax that could be invented. There is a risk that the Commission has underestimated the impact on GDP and overestimated the revenues assumed from the FTT. We believe that this tax will impact the secondary market for government bonds. For some countries that will be an important development. Some observers have pointed out minimal changes in bond costs of 20 to 30 basis points can have significant effect. Even these changes, that we believe are grossly underestimated, will have a negative impact and will be borne by taxpayers.

Q 6. On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?

As we have mentioned above, we would oppose the introduction of the FTT on any class of financial product. We would, however, note in relation to the rate that the headline rates (0.1% generally, and 0.01% for derivatives) are somewhat misleading viewed in isolation. The question is what the effective rate is, and cascade effects need to be taken into account.

Q 7. Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?

It is unusual, if not unprecedented, for a party to be deemed resident in a territory for a tax purpose solely as a result of transacting with someone in that territory. The EU's trading partners may not welcome this kind of extra-territoriality.

We would also observe that inefficiencies may result from the fact that multiple parties can become subject to the same tax on one transaction, but each in a different jurisdiction and potentially at a different rate and with different local anti-avoidance rules. The FTT is therefore likely to be a complex and expensive tax to administer.

These factors, combined with the joint and several liability, mean that a financial institution would need to monitor FTT implementation and practice across all the EU jurisdictions where its counterparties reside.

Q 8. How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

We would make several points in this regard.

First, we would query the reliability of the revenue estimates in the impact assessment. The Commission's impact assessment estimates revenues of €25bn to €43bn (on the respective assumptions of a 90% or 70% reduction in derivatives). Other figures are discussed in the FTT documentation, but relate to implementations of the FTT that are not reflected in the final Directive (e.g. an FTT that covers spot forex trades). Therefore, these figures are highly speculative, based as they are on estimates of tax elasticities with very little precedent from real world taxes.

Moreover, for reasons that are not clear to us, the headline revenue estimates appear to have been calculated using a lower elasticity than recommended by the impact assessment (-1, opposed to -1.5 (see Vol. 12, p. 15 of the impact assessment)). Furthermore, revenues have been modeled by adopting the same elasticity for bonds as for equities, despite evidence (from Sweden's experience) that the actual elasticity of bonds may be an order of magnitude higher.

However, the most serious flaw in the Commission's impact assessment is that it assumes the effective rate of the FTT is 0.01% for derivatives and 0.1% for financial instruments. In even the simple case this is not correct - most derivative transactions and many financial instrument transactions are between two financial institution parties, and the effective rate will therefore usually be double the headline rate. Cascade effects (as described below) have the potential to multiply this considerably. If the elasticity is indeed greater than -1 then the higher effective rate will translate into lower revenues (i.e. as institutions and transactions decline and/or relocate).

Second, the revenue estimates need to be set against the fall in tax revenue that will result from the FTT. There are several reasons why such a fall would be expected:

- (a) FTT will replace stamp duty on securities, and therefore £2-4bn of UK tax revenues will be lost.
- (b) As a trading expense, the FTT would be tax deductible – accordingly there would be an immediate corporation tax loss of (broadly speaking) 26% of all the FTT paid by UK banks and non-UK banks with London branches. The very significant level of financial business carried on by London branches of EU banks makes this a particular issue for the UK - for example, a German bank's London branch entering into a derivative will pay FTT to Germany, but the 26% corporation tax deductibility of that FTT would be borne by the UK.
- (c) As noted below, the GDP and employment effects of the FTT will cause reduction in general corporate and personal tax revenues.

The Commission's impact assessment does not set out to model these reductions in tax revenue. It therefore remains an open question whether the FTT will, overall, be fiscally revenue negative.

Third, as the Commission have themselves acknowledged (Staff Working Document SEC (2010)1166), there is a lack of data relating to tax incidence and financial transaction taxes. However, as that paper also implicitly acknowledges, most of the incidence is likely to fall on end-users of financial services, either directly (by companies seeking to hedge interest rate exposure) or indirectly (by individuals whose pension funds bear FTT costs on their investments).

Q 9. Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

Additional taxation on the financial sector is likely to decrease the banks' liquidity and their ability to build up capital reserves. The sudden reduction in number of financial transactions is likely to decrease liquidity and make the markets more volatile. In the context of derivatives the FTT proposal makes no differentiation between speculative and hedging transactions. The cascade effect of the taxation favours OTC over exchange traded derivatives and runs directly contrary to the regulatory push towards central counterparty clearers to provide collateral and netting for a majority of standardized derivatives. The European Commission's assessment itself affirms that an FTT will inevitably aggravate volatility and reduce liquidity. There are multiple places in the Commission's impact assessment describing this important point. All three Central banks that responded to the public consultation are clearly against an FTT and also voiced concerns against any tax that would reduce market liquidity (SEC -2011- 1102 Volume 2 page 9). Prof. Seán Yoder (University of Maine) is quoted in the Commission's impact assessment with reference to liquidity too. He said that FTTs are seen as a way of taxation of an activity (and not of income or expenditure) and to correct negative externalities. He criticised the cascading effect of those taxes and their negative effect on liquidity (whose effects would be felt far beyond the financial sector) and also hinted towards the possibilities of circumvention by way of netting settlement agreements (SEC -2011- 1102 Volume 2 page 19).

Reducing liquidity is a way of creating room for speculation. This will affect the economic stability of European countries. Liquidity is a determinant of market quality and thin liquidity is conducive to high volatility as the recent financial crisis has shown. For example, the FTT will reduce arbitrage opportunities considerably, reducing the number of financial transactions and creating more opportunities for speculators rather than fewer opportunities.

Furthermore, the increased cost to business of hedging risks (interest rate, currency and credit risks in particular) will itself exacerbate volatility across the economy. For example, the capacity of end-users being able to fix low prices for their demand of basic commodities (i.e. electricity, fuel, basic materials) will be impaired as a result of the FTT, as it may make much hedging uneconomic in Europe.

We would also note that many of the funds and other entities who the Commission views as engaging in harmful speculation are also based outside the EU. These entities currently trade through exchanges in the EU (predominantly in London) because that is where the liquidity

is. If the FTT were introduced, we would expect pools of liquidity to rapidly move outside the EU; at which point these same entities would be able to continue their trading/speculation outside the ambit of the FTT. It is, ironically, precisely those whom the Commission wishes to target who will escape the effects of the FTT, whilst the so called "real economy" and consumers will have no such option. In our view, this result is not peculiar to the Commission's implementation of the FTT, but inevitably follows from any FTT that is not introduced globally.

Q 10. What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?

As noted above, we would expect arbitrators/speculators to continue to operate, but to do so outside the EU and therefore outside the scope of the FTT. Liquidity for EU market participants would likely decrease; liquidity for non-EU participants trading EU securities may not (for the reasons noted above).

Q 11. How easily could the FTT tax be circumvented by market operators?

There may be some shift to economically equivalent products, i.e. instead of (as is typical in the UK market) a lender advancing a floating rate loan to a borrower and the borrower then hedging its interest rate exposure, the lender could advance a fixed rate loan. The hedge would be within the FTT; the fixed rate loan would not. This would, however, be an inefficient result, reducing choice for borrowers.

The FTT proposal would also seem to favour indirect investment (e.g. via structured notes) rather than direct investments in funds. Therefore the trend would be towards products which may be less well regulated or carry more issuer credit risk.

However we would view the most significant change to be one prompted by simple price competition rather than circumvention, as non-EU financial institutions out-compete EU financial institutions which are subject to the FTT.

Q 12. What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

Considerable attention has been paid to the estimate in the Commission's impact assessment that the FTT will have a long term cost of 0.53% to 1.76% of EU GDP. It is, however, important to note that these figures only reflect the increased cost of capital for corporate. Due to limitations of the Commission's model, the figures do not reflect the increased cost of hedging for corporates. Even ignoring this limitation, the figures fail (for the reasons noted above) to reflect the multiple and cascading charges of the FTT, and are therefore out by (it is reasonable to assume) at least a factor of two, and probably more. More significantly still, the figures do not reflect any decline in the financial sector, even though this decline is anticipated elsewhere in the Commission's documentation to amount to 70-90% of the derivatives market alone. We therefore believe the GDP effect of the FTT will be considerably more pronounced than the Commission's headline estimates suggest; and it is to be expected that this cost will be disproportionately carried by the UK.

It is, therefore, not the level of taxation paid but the relocation of business outside the EU which is going to have the greatest impact on the economy. It will not just be the trading and settlement activities of the investment banks which will be affected but also the fund management industry, the clearing houses and exchanges and associated IT and advisory professionals who support EU based markets and products.

The FTT will impact the broader UK economy as most banking products (including loans which are not subject to FTT) depend on derivatives for pricing and hedging. Bank lending is likely to be curtailed or to become more expensive. Many banks have credit risk policies or capital constraints which require the credit risk on their loan book to be fully or largely hedged. The availability and cost of credit default swaps is critical to banks' ability to lend.

Corporate borrowers' ability to raise money on capital markets will be constrained if they are unable to swap the cash flows which are attractive to investors for ones which meet their funding needs. Therefore the FTT will increase the cost of borrowing.

Q 13. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

We can make the obvious point that derivatives can be transacted anywhere in the world, and that the cascading cost of the FTT will clearly place EU institutions at a competitive disadvantage when transacting, compared with non-EU institutions. The obvious outcome is for EU institutions to close their derivatives desks or move them outside the EU – not circumvention, but a natural consequence of the tax. To fail to do so would result in the business being lost to competitors based outside the EU for the reasons outlined above. UK stamp duty, for example, is noted by a number of the FTT's proponents as evidence that the FTT is viable. But, crucially, stamp duty does not share the two flaws mentioned above – it does not cascade (because intermediaries are generally exempt) and it does not prompt relocation (because it generally applies on the basis of the jurisdiction of the issuer of the securities in question, not the residence of the buyer/seller).

Q 14. Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

The purpose is duplicative, i.e. to recompense the Treasury for the cost of bank bail-outs, but of course the nature of the tax is quite different.

Q 15. Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

Relocation difficulties would of course be eliminated if the FTT were adopted worldwide. However, as the Chancellor of the Exchequer stated on 9 November, it seems clear from

the published views of the US, Canada, Australia, China, Singapore and others that this is not going to happen.

We would, however, differ from the Chancellor in that we see financial transaction taxes as fundamentally flawed even if they were adopted at a global level. Cascading charges are the inevitable result of seeking to apply taxes to transactions between financial intermediaries and are therefore inherent to both this and other FTT proposals. A global FTT will also adversely impact on pensions, in the same way that the EU FTT would. These effects plus the tax incidence issues discussed above mean that the FTT is simply a bad tax – inefficient in operation, opaque in who bears the cost and economically distortive and expensive.

11 November 2011

Investment Management Association (IMA) - Written evidence

Executive Summary

1. IMA⁸² is pleased to have the opportunity to submit a response to the call for evidence on a Financial Transactions Tax (FTT).
2. An FTT is a tax that would be borne by ordinary savers and investors and not the financial services industry. The proposals do not meet their key stated aim of ensuring that financial institutions make a fair contribution to covering the costs of the recent crisis. Any tax that meets this objective would need to be targeted more specifically at the financial institutions that contributed to the crisis, and not be an indiscriminate tax on savings, investment and pensions.
3. The UK is Europe's pre-eminent global financial centre and UK citizens will pay a disproportionately large share of the FTT (perhaps up to 60% of the overall estimated €57 billion).
4. The FTT will incentivise financial institutions to move financial transactions outside the safeguard of regulated UK and EU markets. This would permanently damage one of the UK's most successful and important industries.
5. When Sweden introduced an FTT in 1984, during the first week of the tax the volume of bond trading fell by 85%. The volume of futures trading fell by 98% and the options trading market disappeared.
6. The estimated tax-take of €57 billion assumes no relocation of financial activity outside the EU. The real tax-take is likely to be much lower. (Sweden initially expected to collect 1,500 million Swedish kronor per year but in the event the average was close to 50 million kronor per year.)
7. However, the estimated negative impact on GDP (estimated at 0.53%, or €65 billion across the EU) will be proportionately higher in the UK because of its position as a global financial centre.
8. The FTT will replace SDRT. SDRT amounts to £4.6 billion⁸³ of tax revenues per year to the Exchequer, which will be lost.
9. The VAT exemption for financial services actually means that financial services businesses are not able to recover input VAT. The VAT exemption does not imply that the financial services industry is under-taxed.

⁸² IMA represents the investment management industry operating in the UK. Our members include independent investment managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around £4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our members represent 99% of funds under management in UK authorised funds (i.e. unit trusts and open-ended investment companies).

⁸³ http://www.hm-treasury.gov.uk/d/foi_taxreformcom_06.pdf

10. As drafted, the FTT applies multiple times to every transaction along the investment chain – at a minimum to the purchase of units in a fund, the fund’s deal with the broker and the broker’s deal with the market maker, and again when the fund units are sold.

PART I General questions on financial sector taxation

1) Is there a case for the introduction of a tax on financial transactions?

11. IMA does not believe that a good case has been made for the introduction of an FTT. As we explain below, such a tax would be borne by ordinary savers and investors and not the financial services industry.
12. The Press Release accompanying the Commission’s Proposal⁸⁴ (the Proposal) states that the FTT could raise €57 billion per year and that “*citizens and businesses would not be taxed*”.⁸⁵ It justifies the tax on three grounds:
- First, that the financial sector played a role in the origins of the financial crisis;
 - Second, that Governments and European citizens at large have borne the costs of massive taxpayer-funded bailouts to support the financial sector; and
 - Third, that the sector is currently under-taxed by comparison to other sectors.
13. No-one of course can seriously argue with the proposition that some sectors within the financial services industry contributed to the financial crisis and in many cases required bailing out. But it does not follow from this that an FTT is the appropriate response. Moreover, neither of these justifications is applicable to the investment management sector.
14. It is interesting to note that the conclusions in the Press Release and the Proposal are not strongly supported by the detailed evidence contained in the Commission’s Impact Assessment⁸⁶ (the IA). In many cases, the evidence as set out in the IA is ambiguous and even directly contradictory to the Press Release and the Proposal. We cite many of these instances in this submission. We find it worrying that the Commission intends to press ahead with the Proposal on the basis of such weak, and frequently contradictory, supporting evidence. The implementation of a tax as radical as an FTT requires robust supporting evidence.
15. The IA recognises that an FTT would damage business, suggesting that it would increase the cost of capital for business and would reduce levels of investment.⁸⁷ It would also stifle economic recovery, hitting employment and savers. Moreover, it warns that the tax could have a “*far reaching potential impact on the financing of investment projects*”.⁸⁸ This analysis is very worrying, and is compounded by the fact that the size of the impact has not been determined with any degree of confidence. The cost assessment set

⁸⁴ Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC

⁸⁵ Commission Press Release Financial Transaction Tax: Making the financial sector pay its fair share (IP/11/1085)

⁸⁶ European Commission Staff Working Paper Impact Assessment Accompanying the document “Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC”

⁸⁷ The Commission states (at page 4 of the Proposal) that the exclusion for transactions on primary markets has been designed “...so as not to undermine the raising of capital by governments and companies...”. Yet the IA shows that there will be an impact on the cost of capital. Volume 16 of the IA, Effects on Macroeconomic Variables, acknowledges that “*The [FTT] may lead to a drop in share prices and thereby to an increase in firms’ costs of raising capital*” (at page 34).

⁸⁸ Impact Assessment Volume 1: Instruments for the Taxation of the Financial Sector

out in the IA underestimates the cost by half as it considers the tax effect on only one side of the transaction. In fact, the Proposal is for tax to apply to both the buyer and the seller. The fall in GDP could therefore be twice the estimated 0.53%. Elsewhere, the Proposal does not fully reflect the work undertaken in the IA. On the basis of the current evidence, and the analysis undertaken, it would be irresponsible to implement this tax.⁸⁹

16. The true incidence of the FTT would fall on ordinary EU savers and pensions⁹⁰ (in contradiction to the statement in the Press Release that “...citizens would not be taxed”). Moreover, if these taxes were imposed on funds it would be the (direct and indirect) investors in these funds who would bear the costs. The problem is compounded by the fact that the FTT will apply also to the creation and cancellation of units in collective investment vehicles. There will be extra tiers of the charge, directly paid by investors, the number of which will depend on the number of layers of retail intermediaries involved. Given that the investors own the funds, there is no-one else who could bear the FTT relating to the cost of acquisition and surrender of units. The vast majority of the FTT costs incurred earlier in the acquisition chain will be passed on to end-investors, either through an adjustment to the spread levels (the difference between the highest price a buyer is willing to pay and the lowest price a seller is willing to accept) or brokerage fees.⁹¹ This would include the broad mass of savers and those in occupational pension schemes, who as taxpayers have already contributed to the stabilisation of financial markets. Charities’ investments, too, would be taxed.
17. The FTT’s impact would not be restricted to firms that pose the greatest risk to financial stability as these are not necessarily the firms that undertake the most market transactions. The tax is likely to fall most heavily on consumers saving for their future, those parts of the industry whose failure did not pose systemic risk, and those parts of the industry that were less involved in the financial crisis, and arguably were strong forces for market stability, such as insurance firms and investment managers.
18. It would be unjust to impose an FTT on investment funds, since they had no part in the creation of the financial crisis. Also, and importantly, the end result would be to dilute the costs imposed on those responsible for the financial crisis and instead impose the charge on ordinary savers who, as taxpayers, citizens and consumers, are already bearing a disproportionate share of the cost. This would be a perverse outcome, and one could contrast the situation in respect of VAT, where one of the stated rationales for the granting of exemption for fund management services to special investment funds was to prevent a tax charge arising on retail investors; see the Abbey National Case C-169/04 and our comments below.

⁸⁹ The IA Volume I summarises at page 11 some of the conclusions from the IMF report “A fair and substantial contribution by the financial sector” (the IMF Report). The IMF concluded that the FTT does not appear well-suited for the purposes of the G20. The argument that a FTT would cause little distortions because it would be levied at a very low rate on a very broad base is not persuasive. By distorting business decisions, an FTT reduces total output because it cascades into all prices at each stage of the production. Despite these strong conclusions from the IMF there is no clear or systematic attempt in the Impact Assessment to rebut these conclusions.

⁹⁰ See the IMF report which comments at page 20 that: “[An FTT’s] real burden may fall largely on final consumers rather than, as often seems to be supposed, earning in the financial sector”.

⁹¹ At Vol 11 of the IA page 3, the Commission refers to the fact that empirical studies of the impact of an [FTT] “generally confirm...that they reduce asset prices.” The Oxera Report estimates that abolition of the UK’s SDRT regime would increase share prices by 7.2% and reduce the cost of capital by between 66 and 80 basis points.

19. In contrast to VAT, there would be a powerful cascading effect with the FTT because there is no mechanism within the FTT proposal for tax paid earlier in a series of principle transactions to be credited on later transactions. This, together with the application of FTT to collateral postings, would cause the FTT to be multiplied many times for some common transactions.
20. There are significant negative implications of transaction taxes, including damages to pensions and savings and to companies' competitiveness by increasing their cost of capital; an analysis of the effects of stamp duty in the UK has clearly quantified this.⁹² While a counter-argument can be made that transaction taxes can be calibrated in order to minimise the impact on ordinary savers, such a move would not be straightforward. It would have to involve either (potentially complex) exemptions or rates far lower than the 0.1% proposed in the draft Directive. Exemptions would however complicate the design of the FTT, which would conflict with arguments that it would be relatively simple to implement.
21. Indeed, the calibration of the FTT forces a focus onto what precisely it is intended to achieve. If the goal of the tax is to raise revenue rather than to reduce market volatility, then it is clear that this will become a tax on investing and thus on ordinary savers. In a European (indeed international) context where welfare outcomes are increasingly dependent upon long-term saving and investment (defined contribution pensions being the prime example), this would be profoundly counter-productive.

Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

22. The assertion that the current exemption from VAT for most financial transactions leads to a tax advantage for the financial sector is not supported by the evidence. It is a fundamental misunderstanding of the operation of the VAT exemption to assume that exemption *necessarily* results in under-taxation. VAT is a tax on the final consumer and therefore, if financial services were not exempt from VAT, it would be the final consumer that would be subject to the VAT and not the financial institution.
23. Furthermore, the VAT exemption means that much of the input VAT suffered by financial institutions (including investment managers) cannot be reclaimed and is therefore a cost to the industry, compared to the position of a trader whose supplies are fully subject to VAT and who can therefore reclaim all the VAT suffered on inputs. The VAT exemption thus results in additional VAT being levied on the industry. By subjecting financial services to VAT, the financial institution could actually be in a better position because they could recover the VAT suffered on supplies.
24. The IA admits that: "*The extent to which applying VAT to the financial sector would raise additional tax revenues and – consequently – the extent to which the exemption constitutes a tax advantage for the financial sector is an unsettled empirical question*".⁹³ Nevertheless, the

⁹² See the OXERA report, *Stamp duty: its impact and the benefits of its abolition* A report prepared for ABI, City of London Corporation, IMA and London Stock Exchange, May 2007 (the Oxera Report). See also the comments of Professor Kenneth Rogoff (October 3, 2011). "[The wrong tax for Europe](http://blogs.reuters.com/great-debate/2011/10/03/the-wrong-tax-for-europe/)". Reuters. <http://blogs.reuters.com/great-debate/2011/10/03/the-wrong-tax-for-europe/>

⁹³ Impact Assessment, Volume 6: Is the Financial Sector Undertaxed? page 2. At Volume 2 page 5 of the Impact Assessment it is noted that all replies to the public consultation by registered and non-registered financial organisations rejected the

IA goes on to estimate an advantage in the range of 0.11% and 0.17% of GDP⁹⁴. It should be noted however that the IA accepts that this data is not robust, since:

“...all these estimates are very rough approximations and should be interpreted with caution given the strong assumptions made when calculating the irrecoverable VAT. However, they indicate that the argument that the VAT exemption of financial services might be an advantage for the financial sector has some merits.”⁹⁵

This is transformed in the Press Release into an unqualified statement that

“...the sector is currently under-taxed...”

25. IMA suggests that the recognition in the IA of the fundamental weakness in the data being used to support the proposition that the sector is under-taxed should, at the very least, require further research and stress-testing to be undertaken before claims can be made that the financial services sector is under-taxed.⁹⁶ Moreover, the Commission is, of course, currently engaged in a thorough review of VAT on financial services and the final outcome of that review should not be pre-empted. Instead, the outcome should be awaited before any additional taxes are considered for the financial services industry or its customers.
26. Whether or not there is an argument in support of the view that the sector overall might be under-taxed (and IMA stresses that it is by no means convinced that this is the case), the situation in the context of funds is quite different. Funds and fund managers are not financial traders, and investments (which are not “on balance sheet”) are made on behalf of a range of clients. Investments sit within collective investment vehicle structures, mainly within highly-regulated funds.
27. Thus, the VAT exemption for investment and administration costs incurred by special investment funds was introduced as a matter of deliberate policy, to ensure that VAT did not become a tax on savings, because it was recognised that collective investment schemes are ideal vehicles for saving for small investors. This social reason for the VAT exemption in this context was specifically recognised in the *Abbey National* case (C-169/04) of 4 May 2006; see, in particular, the reference to the comments of the Advocate General at point 62.⁹⁷

argument for under-taxation of the financial sector but none of the arguments raised by respondents are explicitly addressed.

⁹⁴ Impact Assessment Volume 6, page 5.

⁹⁵ Impact Assessment Volume 6, page 5.

⁹⁶ A recent study by PwC confined to the banking sector rather than the entire financial services sector (How the EU VAT exemptions impact the Banking Sector, 18 October 2011) concludes that “*imposition of VAT on banking services might not lead to a material increase in VAT revenues. In fact, in four out of eight years ... over the period 2000-2007, the outcome shows a loss in Member States’ overall VAT revenues.*” In this calculation, they used the same data source as the European Commission did in their study. They thus draw quite different conclusions from the same data. PwC take issue with the Commissions conclusions on four key grounds, which are: (i) the assumption made by the Commission that banks absorb current irrecoverable input VAT and would keep the entire benefit the additional recoverable input VAT if they became fully taxable; (ii) the Commission does not assume any behavioural changes by consumers caused by the imposition of VAT; (iii) for the purposes of determining the amount of VAT incurred on inputs, the Commission assumes that banks have similar patterns to household; and (iv) the Commission applies an input recovery rate of 21%, a figure taken from an earlier PwC report which looked at the financial sector as a whole.

⁹⁷ See [http://curia.europa.eu/juris/p/cgi-](http://curia.europa.eu/juris/p/cgi-bin/gettext.pl?where=&lang=en&num=79939495C19040169&doc=T&ouvert=T&seance=ARRET)

[bin/gettext.pl?where=&lang=en&num=79939495C19040169&doc=T&ouvert=T&seance=ARRET](http://curia.europa.eu/juris/p/cgi-bin/gettext.pl?where=&lang=en&num=79939495C19040169&doc=T&ouvert=T&seance=ARRET)

28. This social argument is a recognition that any tax, which is in reality a tax on savers, should if possible be avoided since it discourages capital accumulation by the broad mass of the public, and is moreover economically distortive since it creates an incremental tax cost that would not arise where the investor held a portfolio of investments directly. The VAT exemption is therefore in place to ensure that *investors* do not suffer the tax. To conflate this exemption with the VAT exemption elsewhere within the financial services industry is to confuse two quite distinct forms of the exemption.

2) What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector?

29. It had been suggested by the Commission that it would be appropriate to introduce an FAT at EU level as opposed to globally, but the Proposal does not explain why there has been a change of view.

30. Whatever the arguments for and against an FAT, any tax introduced must be properly targeted. The term "the financial sector" is very broad and includes not only banks and so-called "shadow banks" but also insurance companies, investment managers, collective investment schemes and pension funds. Even if one accepts that there might be strong arguments for the introduction of an FAT on some parts of the financial services sector, it does not follow that an FAT should apply to *all* parts of the sector and certainly not to many of its customers.

31. In particular, IMA does not believe there is proper justification for the FAT to be applied to the investment management sector or to funds. The primary justifications for applying the FAT are to tax economic rents and/or inherently risky activity. These justifications do not apply to investment managers. Investment managers represent the "buy side" of the industry and as such contribute to market stability. Moreover, they undertake transactions exclusively on behalf of their clients, i.e. no transactions are "on balance sheet".

32. The investment management sector is highly competitive, and in this scenario it should be left to the markets, not the tax system, to determine appropriate prices and hence, indirectly, profitability. An investment manager's profitability derives predominantly from funds under management, which depend on consistently superior investment management, and the quality and duration of investor relationships. As already stated, such investment performance is transparent and subject to market discipline. Moreover, if these taxes were imposed on funds it would be the (direct and indirect) investors in these funds who would bear the costs. This would include the broad mass of savers and those in occupational pension schemes, who as taxpayers have already contributed to the stabilisation of financial markets.

33. Furthermore, the sole argument advanced for extending the proposed tax to investment managers, which is to create as wide a tax base as possible, runs completely counter to the policy goals. Accurate targeting of the parts of the financial services sector that contributed to the crisis (and to those alone) is essential if systemic risk is to be countered effectively and recompense obtained from those who are responsible. To do otherwise is to dilute responsibility, and thus create moral hazard.

34. We remain opposed to the introduction of an FAT. However, if one is introduced, the risk-taking form of the FAT would be the only plausible form, since its aim would be to deter undesirable behaviour, behaviour which is not a characteristic of the investment management industry.

Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

35. Close analysis of the foreign exchange market suggests that most foreign exchange transactions (spot and forward) have nothing to do with speculation, but are undertaken to hedge risk and to ensure liquidity.⁹⁸

3) What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

36. Sweden abandoned its transaction tax after it proved to be a disappointing revenue source with wide-ranging negative side effects. The taxes were initially supported by the general public because financial transactions were viewed as destabilising to the economy and as promoting excessive wage differentials, factors now cited as key reasons for the introduction of an FTT.
37. In January 1984, Sweden introduced a 0.5% tax on the purchase or sale of an equity (i.e. 1% overall) and the tax was doubled in July 1986. In January 1989, the tax base was extended when a considerably lower tax of 0.002% on fixed-income securities was introduced, where the security had a maturity of 90 days or less. For a security with a maturity of five years or more, the tax was 0.003%.
38. The revenues raised were disappointing; revenues from the tax on fixed-income securities were initially expected to amount to 1,500 million Swedish kronor per year but in the event the average was close to 50 million kronor per year.⁹⁹ In addition, as taxable trading volumes fell, so did revenues from capital gains taxes, which completely offset revenues from the equity transactions tax.¹⁰⁰
39. Although the tax on fixed-income securities was much lower than that on equities, the impact on market trading was much more dramatic. During the first week of the tax, the volume of bond trading fell by 85%. The volume of futures trading fell by 98% and the options trading market disappeared.
40. The main lesson that can be learnt from the Swedish experience is that it is difficult to estimate the overall tax yield of a transactions tax or the other behavioural consequences and their effect on overall economic performance. It is reported that

⁹⁸ Honahan & Yoder: Financial Transactions Tax: Panacea, Threat or Damp Squib? World Bank Development Research Group Paper March 2001, page 4 http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2010/03/02/000158349_20100302153508/Rendered/PDF/WPS5230.pdf; see also Mende and Menkhoff: "Tobin Tax Effects Seen from the Foreign Exchange Market's Microstructure." *International Finance* 6:2, 2003: pp. 227–247.

⁹⁹ Campbell, John Y. and Froot, Kenneth A. "International Experiences with Securities Transaction Taxes (December 1993)," NBER Working Paper No. W4587. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=338864

¹⁰⁰ Umlauf, S.R "Transaction Taxes and the Behaviour of the Swedish Stock Market" *Journal of financial Economics*, 2003, No 33 pp 227-40 (henceforth "Umlauf"). [doi:10.1016/0304-405X\(93\)90005-V](https://doi.org/10.1016/0304-405X(93)90005-V).

following the doubling of the transaction tax in Sweden in 1986 around 60% of the trading volume in 11 of the most actively traded stocks on the Stockholm exchange migrated to London¹⁰¹ and 30% of all Swedish equity trading moved offshore. By 1990, more than 50% of all Swedish trading had moved to London.¹⁰²

41. Even after the abolition of the transaction levy, the damage has proved permanent. This business has remained outside Sweden.
42. In structural terms, IMA views the proposed FTT as closer to the transaction levy than to the UK's Stamp Duty Regime. (For our comments on the UK's regime, please see our response to question 13.)

PART II Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

4) What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?

43. The Commissions stated objective's contained in its Proposal for an FTT are:
 - *“to avoid fragmentation in the internal market for financial services, bearing in mind the increasing number of uncoordinated national tax measures being put in place;*
 - *to ensure that financial institutions make a fair contribution to covering the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view;*
 - *to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures aimed at avoiding future crises.”*

It is manifestly the case that these aims should not apply to the investment management industry.¹⁰³

44. With regard to the first aim, we agree that different national measures for taxing financial services may create incentives for relocation either within or outside the EU, and thereby distort competition. However, we do not believe that introducing additional taxes on the financial sector would resolve that issue. The UK already has a financial transactions tax on UK equities and certain other financial instruments (broadly, certain bonds which in economic terms contain an embedded equity component) i.e. Stamp Duty or, in its dematerialised form, Stamp Duty Reserve Tax (SDRT). IMA (and others) have long argued for the abolition of SDRT which has distorting effects.

¹⁰¹ Umlauf. See also the analysis in Wrobel, Marion G: Financial Transaction Taxes: The International Experience and the Lessons for Canada. Paper, Government of Canada, June 1996. <http://dsp-psd.tpsgc.gc.ca/Collection-R/LoPBdP/BP/bp419-e.htm>

¹⁰² Umlauf.

¹⁰³ Impact Assessment Vol 2 (results of the Public Consultation), page 6 notes that fund and asset managers made this point and that similar arguments were raised by other sectors.

45. With regard to the second aim, since the FTT will become a tax on savers, it will fail to support the desired outcome. The investment management industry did not contribute to, nor receive public financial support during, the financial crisis. Consequently, there should be no specific targeting of the investment management sector. Investment funds and investment managers already work to *encourage* financial stability and market efficiency and do not therefore contribute to systemic market risk. Moreover, funds and investment managers do not contribute to “short-termism”. Most institutional investors seek performance over at least a three-year period and assess investment managers on that basis, not by reference to short-term apparent gains. The main requirement to have a top-selling fund is to demonstrate upper quartile performance over three to five years and the stability of the investment team.
46. With regard to ensuring a level playing field with other sectors from a taxation point of view, it has not, in our view, been conclusively demonstrated that all sections of the financial sector are under-taxed. In particular, we do not believe that investment funds or their managers are under-taxed. Fund managers pay the full range of taxes to which other bodies corporate are subject, as trading entities and as employers. Investment funds often do not pay tax, but it has long been accepted that this is justified. A common policy objective for the tax treatment of funds is that broad tax neutrality should be achieved as between investing directly in the underlying portfolio and investing through a collective investment vehicle. Any additional tax imposed on collective investment vehicles would represent a tax on savers, not on investment managers.
47. The IA states that the financial sector is under-taxed due to the VAT exemption on financial services. Please see our response to question 1.
48. With regard to the third aim, we do not believe that an FTT would deter speculative trading if the FTT targets all types of financial transactions since such an FTT could not discriminate against those that are inherently risky.¹⁰⁴
49. It is important to note that the proposed form of the FTT means that it would not be restricted to those firms that pose a high risk to financial stability as there is no obvious correlation between the frequency of trades undertaken and risk to financial stability. High levels of liquidity in certain markets are important not just to ensure general efficiency but also to facilitate risk management. If trading volumes were reduced to an extent that materially impacted liquidity, this would be detrimental to capital raisers and to investors. Moreover, the indiscriminate nature of the FTT would discourage financial institutions and ordinary businesses from entering into financial transactions for the purpose of reducing risk or increasing financial stability (such as currency hedging).
50. The Proposal and the IA do not explain why an FTT would be a more effective means of reducing regulatory or systemic risks than regulation. As the CBI has commented:

“the [IA] accepts that the FTT does not focus on the core sources of instability (such as size of institutions, interconnectivity, and substitutability, which give rise to systemic risk) whilst the Commission, for example, finds that there is likely to be ‘a positive relationship between

¹⁰⁴ A point made by Professor Seán Yoder at the Brussels Tax Forum 2011: Taxation of the Financial Sector

transaction costs and volatility’ – indicating that an FTT would make markets more volatile, not less.”¹⁰⁵

Moreover, this aim has no relevance to investment funds and their managers. As the “buy side”, investment funds and investment managers in fact encourage financial stability and market efficiency and therefore do not contribute to systemic risk.¹⁰⁶

51. Moreover we also note that enhanced regulation of speculative activity and high frequency trading is proposed as part of the MiFID/MiFIR review. This type of regulatory approach is likely to be much more effective at reducing excessive trading and speculative activity if this is an aim of the Commission.
52. In summary, we do not believe that an FTT is capable of meeting the objectives the Commission has set and it cannot therefore be an appropriate tax. 100% of the FTT charge related to the acquisition of an investment portfolio by a collective investment fund will be borne by that fund and thus (indirectly) by individual savers. Since the tax will apply also to the creation and cancellation of units in collective investment vehicles, the investors in funds will face a “double hit”. Even where the legal incidence of the tax is suffered by banks and other financial traders, i.e. at an earlier stage of the ownership chain, most of the cost of an FTT will be passed onto end-investors (individual savers and pension funds) by increased dealing spreads and brokerage fees. It is not fair or appropriate to ask ordinary investors – citizens and taxpayers who have already had to fund the financial crisis – to do so again. Yet this perverse outcome will arise under an FTT.

5) Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

53. Since *any* version of the FTT is fundamentally flawed (because in reality it will be a tax on savers), we find it hard to conceive of a version of the FTT that would be desirable.

6) On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission?

54. Since an FTT is not an appropriate tax and is fundamentally flawed in concept as well as in detail, we believe that there are no transactions on which it should be levied.
55. A narrower based FTT (excluding bonds and derivatives) might be less harmful than the broad-based tax suggested, but this would produce other problems such as distorting market behaviour to take into account tax arbitrage opportunities. A tax that would cause great damage unless avoidance measures are routinely implemented is a bad tax.

What should be the rate of the FTT?

56. There is no rate at which an FTT would make sense.

¹⁰⁵ CBI Position Paper Financial Transactions Tax, page 4.

¹⁰⁶ Victoria Perry of the International Monetary Fund identified, at the Brussels Tax Forum 2011, excessive leverage as the primary cause of the financial crisis.

7) Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission?

57. As IMA is completely opposed to the introduction of an FTT, it is not meaningful for us to take a position as to whether the residence principle is appropriate or not.
58. However, it is worth noting that the definition of “residence” for these purposes is very wide. In order that the FTT is not applied, the transaction must be carried out where both parties to the transaction are “establishments” located outside the EU. If only one of the parties to the transaction is established within the EU, then the counterparty to the transaction will be deemed to be established in the same Member State as the EU member. To ensure collectability, the EU member will carry liability for both legs of the transaction. The definition of “establishment” within Article 3 of the draft Directive is very wide, and is clearly intended to ensure that the FTT net is far-reaching. Where an entity is incorporated in an EU Member State, but is a party to a transaction through a non-EU branch, the onus will be on that entity to establish that there is no link between the economic substance of the transaction and the territory of any Member State.
59. If these rules were implemented as envisaged, it would suggest that no non-EU counterparty would wish to do business with a party with any meaningful EU presence, unless they were fully indemnified against FTT risk. This in itself might cause a material part of securities, bond and derivatives trading to migrate outside the EU.
60. A more tightly-drawn definition might therefore reduce the damage that an FTT could do to financial trading. Note, however, that the FTT will still remain a tax on EU savers.

How likely is the residence principle to work in practice?

61. It is premature to hazard a guess, in IMA’s view. Since the term is drawn very widely, there must be a risk that markets will take a very conservative view and assume that there is a risk of an FTT charge even where it is not self-evident that at least one of the parties is established in a Member State.

8) How significant is the potential for the FTT to raise significant revenues?

62. We do not believe that a tax that hurts businesses and individuals, especially savers and pensioners, reduces economic growth, creates unemployment and damages an important industry, while bringing little guarantee of significant new revenue should be introduced.
63. The IA recognises that the FTT would damage business, increase the cost of capital for business and reduce levels of investment. Also, it would stifle economic recovery, hitting employment and savers. Moreover, it warns that the tax could have “*far reaching potential impact on the financing of investment projects*”.¹⁰⁷
64. Even under the assumptions set out in the Proposal, the estimated annual revenue (€57 billion) is less than the estimated negative impact on GDP (0.53% of European GDP or €65 billion). The Proposal suggests that the likely impact will be 0.53% of GDP, but this

¹⁰⁷ Impact Assessment Volume I, page 33.

is based on a number of highly questionable, and in some cases clearly inaccurate, assumptions. The most important incorrect assumption is the use of an assumed overall cost of a transaction of 10 bips when the true incidence is a minimum 20 bips. This error is compounded by the fact that the data used includes only the impact of the tax on securities, and excludes the impact of the tax on derivatives. The suggested 0.53% reduction in GDP is derived from the original IA estimate of 1.76%, but adjusted to reflect a number of 'mitigating factors'. The IA admits that these adjustments are "not necessarily well taken into account"¹⁰⁸ and that the method used is "at the cost of scientific rigour and with large caveats and uncertainties".¹⁰⁹ Thus, the methodology by which the figure of 0.53% is arrived at is fundamentally flawed and it seems highly likely that the impact will be much higher than the quoted 1.76%.

65. The estimates in the IA for the annual revenue that the FTT would raise have a far wider range of somewhere between €16.4 billion and €434 billion. This would depend on a number of factors, including levels of relocation. The IA stresses that these assumptions are "subject to uncertainties and caveats"¹¹⁰ and emphasises that "the uncertainty about the real revenue potential is large".¹¹¹
66. The Commission concedes, for example, that it has been unable to factor in the impact of a reduction in GDP caused by the new tax and points out that the deterioration of the tax base "could go well beyond the revenue shortfall, such as, ... the misallocation of financial funds... and/or products might disappear".¹¹² The Swedish case, which resulted in a significant loss of capital gains tax, suggests this is a real concern. There is no guarantee that the tax will result in significant revenues despite the large economic cost. Moreover, since it is an integral part of the FTT proposal that Member States will have to abolish their national transaction taxes; the UK would lose about £4.8 million per annum in SDRT receipts. Given the pre-eminence of the UK as a financial centre, it is very likely that the economic costs will fall disproportionately on the UK.

How reliable would it be as a revenue stream?

67. IMA believes that the higher estimates for the tax, which assume material amounts to be collected from financial traders, will not be realised. However, because the FTT will become a tax on savers, who cannot easily relocate, the amounts collected might well be substantial. The FTT would therefore be reliable as a revenue stream.

Where would the true incidence of the FTT fall?

68. As stated above, it would fall on savers, investors and pensions. Very little of the cost would fall ultimately on financial institutions.
69. Moreover as the tax applies at each level of the transaction (see paragraphs 19 and 28 above), smaller investors in collective investment schemes will be disproportionately burdened as they would pay the FTT at the level of the fund, as well as on the fund's

¹⁰⁸ Impact Assessment Volume I, page 51.

¹⁰⁹ Impact Assessment Volume I, page 51.

¹¹⁰ Impact Assessment Volume I, page 32.

¹¹¹ Impact Assessment Volume I, page 33.

¹¹² Impact Assessment Volume I, page 33.

transactions. This would put them at a disadvantage over larger investors and financial institutions that can invest directly in underlying securities.

Should the revenues arising from the FTT be used to finance the deficits of Member States?

70. We do not believe that a tax that would hurt businesses and individuals, especially savers and pensioners, reduce economic growth, create unemployment and damage an important industry, while bringing little guarantee of significant new revenue should be introduced. It is therefore premature to discuss proposed recipients of any tax receipts. In our view, growth must be legislators' priority at this stage in the economic cycle rather than the introduction of a new tax (be it the FTT, an FAT or some other alternative). But even on the Commission's own analysis, there is a strong possibility that an FTT will have economic costs that are very significant, and may even exceed the revenue raised.

Impact and effectiveness

9) Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation?

71. Most studies of the likely impact of an FTT on market volatility have been theoretical. Some of these studies have concluded that a tax could reduce volatility by crowding out speculators, but in most of the available empirical studies no statistically significant causal link has been found between an increase in transaction costs and a reduction in volatility.¹¹³ An IMF study paper concluded that:

*"[the] theoretical relationship between an [FTT] and short-term price volatility is ambiguous. In general, if an [FTT] reduces trading volume, it may decrease liquidity or, equivalently, may increase the price impact of trades, which will tend to heighten price volatility."*¹¹⁴

Other studies have reached the same conclusions.¹¹⁵

Would it reduce excessive risk-taking?

72. We remain unconvinced that an FTT would achieve this outcome; indeed, it may even be a disincentive to sound risk management by making it more expensive for businesses to hedge risk through derivatives.
73. Furthermore, we do not think that taxation alone is an appropriate instrument for addressing market behaviour; this should be addressed by the regulatory framework supplemented by taxation.

¹¹³ Werner, Ingrid M.: "Comment on 'Some Evidence that a Tobin Tax on Foreign Exchange Transactions may Increase Volatility'". *European Finance Review* 2003 7 (3): 511–514. [doi:10.1023/B:EUFI.0000022151.50261.40](https://doi.org/10.1023/B:EUFI.0000022151.50261.40)

¹¹⁴ Thornton Matheson "Taxing Financial Transactions: Issues and Evidence". Fiscal Affairs Department, IMF. p. 20]. (March, 2011). <http://www.imf.org/external/pubs/ft/wp/2011/wp1154.pdf>

¹¹⁵ A 2003 IMF paper concluded that FTTs are: "positively related to increased volatility and lower volume" Karl Habermeier and Andrei Kirilenko "Securities Transaction Taxes and Financial Markets". Monetary and Exchange Affairs Department, IMF. p. 178]. (May, 2001). <http://www.imf.org/external/pubs/ft/wp/2001/wp0151.pdf>

10) What would be the impact of the FTT on market liquidity?

74. There is limited evidence in respect of liquidity. The UK experience of SDRT would suggest some reduction in liquidity.¹¹⁶

What effect would the FTT have on speculation in sovereign debt markets?

75. Close analysis of the sovereign debt markets suggests that most have nothing to do with speculation.

11) How easily could the FTT tax be circumvented by market operators?

76. Please see our response to question 12 below.

Impact of the FTT in the UK

12) What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly?

77. An FTT will clearly damage European markets and the UK's position as a global financial centre. For example, the IA estimates a volume decrease in the derivatives market of 70% or 90%.¹¹⁷ It is perhaps of interest that in the Staff Working Document of 7 October 2010 (SEC/2010/1166), whilst the Commission supported an FAT at an EU level, it supported an FTT at a global level.
78. Thus, at that stage, the Commission was concerned that an FTT introduced on anything other than a global basis could be problematic because of the risks of relocation.
79. The IA suggests that the decrease in business that results from the FTT might include activities that it asserts could be negative, giving high frequency trading as an example.¹¹⁸ But, in fact, it will affect the entire industry and their customers, indiscriminately. As the Directive would not apply if both counterparties were established outside the EU, there is a strong disincentive for non-financial firms to conduct financial business in the EU. This will push this business into competitor jurisdictions, such as New York, Singapore and Hong Kong.
80. It is unlikely that the FTT will drive any benefits to Europe as a financial centre resulting from an improvement in the functioning of the financial markets. These would, in any case, be achieved more efficiently by regulation.

If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

¹¹⁶ The Oxera Report

¹¹⁷ Impact Assessment Volume I, page 32.

¹¹⁸ Impact Assessment Volume I, page 35

81. Given the proposed structure of the FTT, a significant proportion of the tax would fall on UK citizens. If the experience with SDRT is any guide, as much as 60% of the overall tax levied across the EU could fall on UK citizens.¹¹⁹

13) How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector?

82. We believe it is very likely. Those parts of the financial services sector dealing directly with EU citizens would have no incentive to relocate, given the manner in which an “establishment” is defined for the purposes of the FTT, but financial traders would have a strong incentive to relocate, especially given the lack of market maker exemption and the inclusion of derivatives within the tax base of the FTT.

Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

83. The version of UK stamp duty that applies to dematerialised trades in chargeable securities is known as Stamp Duty Reserve Tax (SDRT). This is charged at 0.5% on each acquisition.
84. We do not believe that the UK experience provides a useful lesson for the impact of the FTT in respect of the maintenance of a successful stock exchange, given the proposed structure of the FTT; it is more akin to the Swedish transaction tax. Two factors are critical. First, the existence in the SDRT regime of the market-maker exemption, which allows financial traders to ensure liquidity in the market, and second, the limited tax base for SDRT, which applies only to UK equities, certain UK bonds with equity like characteristics and certain derivatives. Crucially, for the SDRT principal charge (the rules are different for the version of SDRT that applies to the creation of units in UK-authorized funds), the derivatives charge does not apply to a derivative that is capable of being only cash-settled.
85. A great deal of inter-bank trading of equities does not in fact result in any SDRT being paid because a combination of the market maker exemption and the use of SDRT exempt derivatives (in particular, contracts for differences) are utilised in such trades. There is evidence that the increase in UK trading volumes has not been matched by a proportionate increase in SDRT paid and that a disproportionate amount of SDRT falls on pension funds, insurance companies and individuals rather than on financial traders.¹²⁰ More than 70% of the total UK stock market volume, including the entire institutional volume, remained (in 2005) exempt from SDRT.¹²¹ So, SDRT is manifestly not a tax on financial traders or a tax on speculation.
86. Although it is not absolutely clear from the Proposal, it seems that it is intended that there will be no market maker exemption for the FTT. Moreover, it is proposed that all, or most, derivatives will be caught by the FTT. Taken together, this means that inter-bank trading of securities will result in an FTT charge and IMA believes that this will

¹¹⁹ The Oxera Report

¹²⁰ The Oxera Report pages 3 & 7

¹²¹ The Oxera Report

result in a material relocation of trading activities out of the EU, resulting in significant damage to the UK's economy, and a tax yield from the FTT at the low end of the range of possibilities suggested by the Commission.

87. UK-authorized funds also suffer from an additional tier of transaction taxes under what is known as the "Schedule 19"¹²² regime, which imposes an SDRT charge of 0.5% on the surrender of units in a fund. One impact of the Schedule 19 regime has been to make the UK a less attractive location for the establishment of funds compared to other EU jurisdictions such as Ireland and Luxembourg. The UK has for a number of years seen an erosion of its competitive position in respect of competitor jurisdictions and UK investors have shown increasing willingness to invest in funds established in other EU jurisdictions. Although government and industry have worked hard in recent years to reduce any competitive advantage provided to other countries in respect of the tax regime governing funds, there is little sign that major fund management groups are looking to relocate funds into the UK. The evidence is that once the damage is done, whilst steps can be taken to erode any further competitive disadvantage, much of the damage will be permanent.

14) Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

88. An FTT is a tax on savers and IMA believes it will have minimal impact on financial traders who will relocate a significant part of their business to avoid the tax. Whatever the arguments for or against a bank levy, it does at least have the merit of being more closely targeted on that section of the financial service industry perceived as having been at fault. An FAT, if properly targeted, would in that sense duplicate the bank levy. In IMA's view, the proper parallel for the FTT in the UK, however, is SDRT. Therefore, the FTT would duplicate existing taxes (although under the Proposal, local country transaction taxes would have to be abolished).

Implementation

15) Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally?

89. Only the introduction of an FTT globally would result in a material extraction of tax from financial traders because of the serious risks of relocation. However, the *primary* cost would still fall on individual savers, as direct savers, insurance policyholders, and investors in collective investment schemes or pensioners. For this reason IMA remains opposed to the introduction of an FTT whether at EU or global level.

Should an FTT be introduced at EU level regardless of whether it is introduced at a global level?

90. No. The FTT is a poorly-conceived tax, which will not achieve its aims, but which will instead disproportionately impact savers rather than financial institutions. For this reason, it should not be introduced at all, whether globally or within the EU. But an

¹²² A reference to Schedule 19 of the Finance Act 1999, in which these rules were introduced.

introduction within the EU alone could have disastrous consequences for the economies of EU countries for the reasons mentioned above; moreover, it would impact particularly badly the UK.

In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

91. We do not believe that there would be a case for the implementation of an FTT by Eurozone countries alone. Moreover, the definition of an establishment in Article 3 of the draft Directive would still pull the UK within the scope of the tax if the counterparty to the transaction were a Eurozone member.

7 November 2011

Lloyds - Written evidence

General comments

1. We strongly support the UK Government's position that FTT should not be introduced in the EU and believe that the Government should remain committed to this view during negotiations. London's success as an international financial centre depends on a suitable balance being achieved between attractive conditions for businesses and appropriate levels of regulation. It may be appealing to view the financial sector as an easy source of additional revenue; however such measures are likely to damage the long-term success of the UK's economy.
2. We are in the process of carrying out an assessment to estimate the likely future cost of this proposal on the Lloyd's market in aggregate. At this stage our work is incomplete, but we estimate that it would impose an additional annual fiscal charge in excess of £100m on the Lloyd's market. Implementing new systems to account for and pay this new charge would give rise to additional costs.

1. Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

3. We do not believe that there is a case for the introduction of an additional tax on the EU insurance sector. The Commission's proposal refers to the "current under-taxation" of the financial services sector and to the need to ensure that:

"...financial institutions make a fair contribution to covering the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view."

4. Whether or not these arguments are justified in relation to other financial sectors, they are not valid in relation to the insurance sector. In June 2010, the IMF presented a report to G20 on financial sector taxation. The IMF's report noted that "*Insurance premiums are commonly subject to additional excises, so that the arguments which follow do not apply with the same force.*"¹²³ They could have said that the arguments did not apply at all.
5. In the UK, Insurance Premium Tax (increased to 6% for general insurance in January 2011) raised £2.4bn in 2010/11¹²⁴ and insurance contracts covering risks in other countries are taxed at local rates. In addition, insurance and reinsurance undertakings are subject to the corporation taxes (or similar) applicable in the countries in which they are established and the staff that they and their suppliers employ pay income tax locally. The Association of British Insurers (ABI)¹²⁵ has estimated insurers' contribution to UK public finances as £10.4bn for 2011. This includes £2.7bn in corporation tax, or 6.4% of total Government corporation tax receipts.

¹²³ IMF Report footnote 69, P. 64

¹²⁴ HM Revenue and Customs receipts. Office of National Statistics.

¹²⁵ ABI Research Paper No 29, 2011: *Total Tax Contribution, Study of the Contribution of the Insurance Industry to UK Tax Revenues, August 2011*

6. It is correct that insurance is VAT-exempt, but VAT charged between businesses is neutral, as a taxable trader can recover their input VAT. VAT is a tax on the ultimate consumer, not on business. The financial sector suffers irrecoverable VAT as a result of their supplies being exempt from VAT. This is an absolute cost to business and is trapped as a cost component of the onward exempt supply. So the financial sector's irrecoverable VAT represents a real revenue stream to member states. So it is incorrect to say that the financial sector is under-taxed due to a VAT exemption.
7. Insurance therefore already makes a fair and increasing contribution to government finances in the UK and other EU member states.
8. The global financial crisis was not the fault of the financial sector as a whole. Nor did the entire financial sector benefit from public support, which was concentrated on the banking sector. The small number of insurers who received support were either, like AIG, heavily involved in derivatives trading or, like ING, part of bank-insurance conglomerates, affected through banking, not insurance, activities. The financial crisis revealed shortcomings in the governance and behaviour of some, but not all, financial institutions.
9. It is therefore inappropriate to apply financial taxes to all financial services indiscriminately and regardless of their existing fiscal obligations and culpability for the global financial crisis.

2. What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

10. As noted above, we believe that the insurance industry already suffers a fair burden of tax and it is inappropriate to increase this further, In addition, any form of additional tax is likely to make the UK uncompetitive when compared to regimes outside the EU.
11. An FAT is a levy on the sum of profits and remuneration of financial institutions. The European Commission's *Communication on Taxation in the Financial Sector* (October 2010) included arguments for imposing a FAT. Our responses are set out below.
12. *To reduce the harmful effects of excessive risk-taking.* Insurers perform a valuable social function by arranging the transfer of risk for a premium. Concepts of "excessive risk taking" or of taking "too much risk" have no validity in this context: the fundamental consideration is adequate pricing of risk. By operating in this way, insurers benefit the rest of the economy by providing individuals and firms with protection against financial risks that they do not want to face by themselves.
13. In many areas, such as environmental liability, carbon capture and storage, cross-border healthcare and alternative investment management, the Commission and national governments have sought to persuade insurers to assume more risk, a stance that is at odds with the proclaimed objectives of an FAT. We note that the IMF commented, in its

June 2010 G20 report that the form of FAT intended to discourage risk-taking “*would need to be set at a fairly high statutory rate to have the intended effect.*”¹²⁶

14. *Because the financial sector bears an important responsibility for the occurrence and scale of the recent crisis and its negative effect on government debt levels. To reiterate the point made earlier: the insurance industry was not the source of the financial crisis and did not magnify its effects. Throughout the crisis insurers maintained relatively steady capacity, business volumes and prices. It is manifestly unfair to target insurers with a requirement to pay additional contributions as a result of a crisis that they played no part in bringing about or exacerbating.*
15. *Because financial services are exempt from value added taxation in the EU. As noted earlier, it is inaccurate to represent the insurance sector as “under-taxed”.*
16. *Lloyd’s is fundamentally opposed to the idea that there is a need to introduce special taxes at EU level for the entire financial sector. Member states should be left to impose such taxes as they consider appropriate to raise national revenue, setting rates and determining scope in accordance with their own perceptions of the needs of their national economies. A number of member states have already implemented various taxes and levies on individual financial sectors following assessment of national fiscal needs.*
17. *The world economy is going through a post crisis period and it is crucial that policymakers focus on economic growth in these unstable times. The financial sector plays a vital role in this process; ‘punishing’ it by imposing additional financial burdens will not facilitate growth, but will result in diminishing activities. This is something that the EU cannot afford at this time.*

3. What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

18. *We think that this is a highly relevant question to ask. The Swedish Securities Transaction Tax did not affect Lloyd’s and we have only a general understanding of the issue. As we expect that the Sub-committee will receive detailed and informed comments on this question, we do not propose to respond on this particular tax.*
19. *Nevertheless, we can confirm from our own experience that the international financial sector is sensitive to signals sent out by fiscal policy and that firms can and do respond to incentives provided by lowered rates of taxation. The Bermudan insurance market is a leading competitor to Lloyd’s and the London market of which it forms part. A key role in Bermuda’s rapid development as an insurance centre was played by its attractive fiscal environment (Bermuda does not levy income tax on insurers)¹²⁷.*
20. *Within the London insurance market, nine of the top ten operators are domiciled for tax purposes outside the UK. It is true that this relates to location for tax purposes, rather*

¹²⁶ IMF Report, footnote 30, P. 24

¹²⁷ For the record, we should note that the Bermudan insurance market plays an important and constructive role in the international insurance market. It is not only a competitor to Lloyd’s but also a significant provider of capital and purchaser of reinsurance. We do not seek a level fiscal playing field between London and Bermuda; rather we wish to ensure that UK policymakers bear in mind the existence of low-tax regimes when setting UK fiscal policy.

than to the locations where a firm operates. Nevertheless, an FTT would be chargeable on the basis of the location at which activity is carried out, not on tax domicile. It would therefore operate as a substantial disincentive to the performance of financial transactions within the EU.

8. How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

21. We do not believe that the European Commission's proposals take full account of likely changes in the behaviour of EU financial markets, including the likely relocation of businesses, if an FTT is introduced. Such changes are inevitable and are bound to reduce the revenue from an FTT.
22. The proceeds from a tax on financial transactions depend on the number and size of the transactions, which in turn depend on the willingness of persons within the applicable jurisdiction to enter into taxable transactions. As we have noted, it is open to those persons to move their activity to another jurisdiction and they will be heavily influenced by other considerations, such as the prevailing economic climate. The way in which an FTT is expected to bring a non-EU counter-party within the charge to FTT will also have significant behavioural implications and impact the way in which EU entities do business with non-EU businesses.

12. What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

23. London is a global financial centre and therefore stands to lose most if FTT is introduced in the EU. This will have a significant impact on the UK's economy. Companies that FTT will apply to will face increased business running costs in addition to tax obligations and will pass these expenses to customers.
24. In 2010, the financial services industry accounted for 10% of UK GDP and 11% of UK tax receipts. The sector currently employs 1 million people, more than 66% of whom work outside London, and underpins the businesses that drive jobs and growth. Added together with the further 900,000 employed in professional services, it is easy to see the importance of a sector that employs 6% of the working population¹²⁸.
25. The Commission's Impact Assessment accompanying their proposal estimates that an FTT of 0.1% would give rise to a reduction in GDP in the long run of 1.76%. We note and share the assessment's reservations about the reliability of this type of modelled conclusion about future economic consequences. Nevertheless, this is the best guide that we have. On the basis of the EU's 2008 aggregate GDP of EUR 12,500bn¹²⁹ this would constitute a reduction in the EU's annual GDP of EUR 220bn.

¹²⁸ Key Facts about UK financial and professional services, The CityUK, September 2011

¹²⁹ Eurostat Yearbook 2010

26. For the UK, and using the same data source, a 1.76% reduction in annual GDP would mean a reduction of EUR 32bn (£27.4bn at EUR 1 = £0.8578). As the UK's financial sector is larger than that of other EU member states, both actually and as a proportion of the national economy, one might expect the reduction in UK GDP to be rather larger and its impact more harmful:
27. Lloyd's expects that, if it is subject to an FTT, it will find it more difficult to attract the global capital on which it depends. Jurisdictions with active insurance markets which do not introduce an FTT will see their attractiveness as platforms from which to write international insurance enhanced.
28. The costs of an FTT – including the costs of the systems necessary to account for and pay FTT – will push up insurer expenses and therefore premiums. Ultimately, the costs would be borne by the policyholders of Lloyd's firms and other UK insurers. This is in line with one of the conclusions of the IMF's June 2010 G20 report on the FTT, which was that:

“Its real burden may fall largely on final consumers rather than, as often seems to be supposed, earnings in the financial sector. No doubt some would be borne by owners and managers of financial institutions. But a large part of the burden may well be passed on to the users of financial services (both businesses and individuals) in the form of reduced returns to saving, higher costs of borrowing¹⁹ and/or increases in final commodity prices. Indeed, this is more likely the more general the adoption of the tax, since that helps industry pass on the cost to its customers.”¹³⁰

13. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

29. As mentioned earlier, we believe that the risk of relocation of businesses and transactions is very significant.
30. We do not consider that the impact of UK stamp duty can be compared with the possible impact of an FTT. UK stamp duty is limited in its scope, being charged on the sale of UK equities only, whereas an FTT would apply to nearly all forms of financial transaction.
31. Lloyd's is subject to stamp duty in relation to the sale of UK equities. However, Lloyd's adopts a prudent investment strategy, in line with its key consideration of ensuring the security of policyholders, and most of its financial transactions do not therefore involve the sale or purchase of equities. An FTT would therefore have a substantially greater impact on Lloyd's than stamp duty.

15. Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT

¹³⁰ A Fair and Substantial Contribution by the Financial Sector, IMF, June 2010, p. 20

is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

32. Available information suggests that there is little or no enthusiasm on the part of policymakers outside the EU for the imposition of an FTT on their own national financial sectors. We do not therefore view its global introduction as a practical proposition.
33. The introduction of an FTT at EU level, regardless of its introduction at global level, will give rise to all the problems of competitiveness pointed out in this submission.
34. We would not presume to advise Eurozone countries on whether they should go ahead with the implementation of an FTT, irrespective of the wider EU. Nevertheless, all the problems that an FTT would create for the UK will also arise for Eurozone countries. We believe that, if the UK is not included in the FTT, enthusiasm among European policymakers for its introduction will significantly diminish.

7 November 2011

Mayor of London - Written evidence

Introduction

1. The Mayor of London has a legal duty to promote the city's economic and social development and hence a responsibility to safeguard the health of the financial services sector - a key London industry and a significant employer, accounting for around 330,000, or 8% of London's workforce and around 20% of London's Gross Value Added Tax.
2. Financial services are one of London's primary exports to the rest of the world and London is, effectively with New York one of only two genuinely global financial services centres in the world. Both compete with Singapore, Hong Kong and other Asian centres in particular. In simple terms, London is the EU's primary financial services centre and it competes globally for business. This submission therefore focuses on the Financial Transaction Tax's (FTT) impact on London.

Economic Stability

3. Given the ongoing economic crisis there is an urgent need to protect the EU economy, prevent and control systemic risk within EU financial systems, protect EU financial sustainability and protect consumers and taxpayers across member states. The Mayor shares the strong consensus on the need for reform. However, reform proposals must be designed and implemented in a way which supports strong and sustainable economic growth in the EU.
4. That stability and transparency must be achieved without hindering or constraining the economic performance of the EU as whole or any member state or region, or indeed any individual business sector. These principles have not been adopted in developing the FTT.

Negative Impact on Growth

5. An FTT would drive business to financial centres outside the EU and have a substantial negative impact on GDP across the EU - a point the Commission's own impact assessment makes. Given the preponderance of financial services in London – and the centrality of financial services to London's economy – the impact would be keenly felt in the UK's capital city, with firms moving and jobs lost.
6. If the FTT is implemented it is not just London that will be adversely affected, but the entire EU. Across the EU the financial services sector employs 6.5 million people. Related to this are the accountancy and legal firms which employ 3.3 million people within the EU. These in total account for close to 10 million people or 4.5% of the EU workforce. The introduction of an FTT could in the long run result in a loss of jobs, with a detrimental impact on member states if jobs are lost to other financial centres outside the EU.
7. The impact of such a tax will not just be limited to the financial services sector or related industries, but will have wider implications for EU citizens. Incidence of the tax will fall

largely on hard-hit businesses and consumers rather than the banks themselves by increasing the cost of capital and decreasing the value of pension funds. Any consideration of a FTT must, if to be considered at all, be at a global level.

8. The Commission's own impact assessment notes that a FTT will lead to higher transaction costs, lower asset prices and an increase in the cost of capital. Even in the best case scenario the impact assessment shows that a FTT would reduce EU GDP by more than 0.5%, and this could rise to 1.76% if the mitigating factors were removed. The economic models used to make the assessment have limitations, but it is difficult to see the case for introducing a measure which, by the EU's own assessment, would cause so much damage.

Conclusion

9. The Mayor is strongly opposed to the FTT and believes that the Commission should drop the proposal at the earliest opportunity. He would only consider a FTT if it were adopted globally by all our major competitors given the global market in which London's financial services operate. This is highly unlikely given the opposition to a FTT by the United States.

7 November 2011

NAPF – Written Evidence

The NAPF is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes set up by companies to provide pensions for some 15 million employees and ex-employees. As major investors with assets of around £800 billion, our members have a strong interest in the efficient functioning of the capital markets. More generally, pension schemes and the companies that sponsor them want to provide good quality pensions, but at a cost that they can afford.

Pension schemes will be affected by a Financial Transactions Tax both directly and indirectly. They will be affected directly by having to pay tax on the financial transactions that they undertake or that are undertaken on their behalf. One of our larger members has estimated that this will increase its costs by £40 million a year. Grossed up, this suggests direct costs for UK pension schemes in the region of £1.8 billion a year. This additional cost is for investment and risk mitigation undertaken to improve returns for the scheme over the long term and reduce risk. Such activities include rebalancing portfolios and hedging inflation, interest rate, foreign exchange and longevity risk.

The indirect impact of the tax is uncertain, but it could have an even greater effect on scheme returns. We envisage that the bulk of the tax paid by intermediaries will be passed back, in one way or another, to end-investors like pension schemes. Banks are currently being obliged to increase their capital resources: to the extent that they are unable to pass the tax back to their customers, they will be obliged to raise even more capital, in the process undermining the value of pension schemes' equity holdings.

One of the main purposes of the tax is to put 'grit' in the system, so as to discourage trading activity. The effect on market efficiency is hugely uncertain. What is certain is that a less efficient market will lead to less efficient allocation of resources, which will inevitably reduce investment returns. A particular concern is the impact of the tax on the functioning of the settlement system.

For Defined Benefit (DB) schemes, which account for about three quarters of pension scheme assets, increased costs and reduced returns are a charge on employers, already struggling with difficult economic conditions. For DC (Defined Contribution) schemes, they will reduce the pension that employees receive. We understand the anger about financial excess and the damage that this has done to the economy and ordinary people's standards of living. Both the Lamfalussy and the Turner Reports recognised that pension schemes were not responsible for the financial crisis. Increasing the cost of pensions and making it more difficult for employers to provide good quality pensions will do nothing to resolve the crisis.

25 November 2011

New City Initiative - Written evidence

Introduction

1. This submission deals broadly with the issues relating to the impact of the FTT in the UK raised by questions 12, 13 and 14 of the Committee's call for evidence. In our opinion, an EU-wide transaction tax presents grave risks to the City of London and consequently to the UK's economy as a whole. These risks stem from the near-certain relocation of operations and employees to areas outside the EU not subject to the tax. The knock-on effects of this relocation have negative implications for the UK's tax base, its ability to compete on a global scale and the prospect of a swift economic recovery.

2. We argue below that as a result of a transaction tax:

- The UK will suffer serious losses through forgone income and corporation tax;
- The City of London, as the UK and Europe's largest financial centre, will shoulder a disproportionate FTT burden and will suffer heavily as a result;
- The incentive for entrepreneurs to found and manage small and medium financial enterprises will be further diminished;
- Job losses will be incurred by more than just the financial services sector, as the "spillover" effect of financial redundancies takes hold.

3. As such, we would strongly urge that the UK Government take a firm stance in opposition to the implementation of a Financial Transaction Tax in the EU.

Relocation: Prospects

4. In the absence of an internationally-levied transaction tax, it is our opinion that firms would undoubtedly seek to relocate outside the EU. The impact assessment produced by the European Commission to accompany its proposal for an FTT cites the "intrinsic risk" of firms relocating or simply ceasing certain activities as a major consideration.¹³¹ The Swedish experience with a transaction tax in the 1980s provides historical evidence to support the contention that relocation is virtually certain. Ironically, London was a major beneficiary of the Swedish tax, as investors and firms simply took their business to non-taxed platforms such as the UK or switched to non-taxable instruments.¹³² Furthermore, the impact assessment contends that some relocation would be "positive", provided that the activities in question were considered to be "harmful".¹³³

¹³¹ Page 10, Executive Summary of the Impact Assessment, European Commission, Paper SEC (2011) 1103

¹³² Page 2, *Tobin Tax: Reason or Treason?*, Adam Smith Institute

¹³³ Page 49, Commission Staff Working Paper SEC (2011) 1102

5. This contention highlights two flaws in the Commission's proposal, one systemic, and the other thematic. Firstly, while undesirable activities may move outside of the EU, the stabilising effect would be minimal as member states would still be exposed to the volatility created by these activities, with the added problem of having relinquished jurisdiction over them.

6. Secondly, and more pressingly for the City of London, it confirms that the FTT is essentially a tax on risk, targeted at limiting activities such as high-frequency trading which are seen to contribute to market volatility. Firms which do not practice these activities and thus do not pose a systemic risk to the economy will bear a burden of regulation entirely inappropriate to their activities. Small and medium financial enterprises in the UK employ between 300,000 and 569,000 workers and contribute a great deal to the economy.¹³⁴ Many of the City's financial SMEs are owner-managed firms which already bear a debilitating burden of regulation designed to control the behaviour of larger financial institutions. The FTT would be another step toward creating a regulatory environment that is inimical to the small, entrepreneurial firms that serve as a bedrock of the City. Faced with this situation, many firms would surely choose to conduct their business from non-EU platforms.

Impact of Relocation: Primary

7. The Financial Services Sector in the UK contributed 11.2% of the Exchequer's total tax receipts for 2010.¹³⁵ During this period, UK financial services collectively paid more corporation tax than any other industry, including oil and gas.¹³⁶ One third of all financial services jobs in the UK are based in London, with these jobs accounting for 36% of the capital's entire workforce.¹³⁷ The UK is the world's largest exporter of financial services, raising one-third of all private equity funds in Europe, boasting a greater daily foreign exchange turnover than New York and Tokyo combined and serving as the largest hedge funds market in Europe.¹³⁸ On this evidence alone, it is clear that any regulatory measures which may encourage firms in the City either to move activities abroad or to cease them entirely would have a serious effect on the UK economy as a whole through forgone taxes and would deal a serious blow to the UK's role as a major global financial centre. The UK's economy is inextricably linked to the City, which is in turn, a vital component of the UK's economic recovery. At a time when job creation and the ability to compete globally is of vital importance to the UK, legislation like the FTT risks causing long-term harm to the economy by damaging the financial services sector, particularly SMEs which are proven innovators and job creators.¹³⁹

¹³⁴ See: *Start-up Britain is here in London: Why it is crucial to support financial SMEs*, (2011), New City Initiative

¹³⁵ *The Total Tax Contribution of UK Financial Service (2010)* City of London Corporation, 3rd Edition

¹³⁶ *Ibid*

¹³⁷ Page 13, *London's Competitive Place in the UK and Global Economies* (2011), City of London Corporation

¹³⁸ *TheCityUK Key Facts about UK Financial and Professional Services* (September 2011)

¹³⁹ See: *Start-up Britain is here in London: Why it is crucial to support financial SMEs*, (2011), New City Initiative.

Impact of Relocation: Externalities

8. The proposed FTT also has the potential to produce severe, undesirable externalities for the City and the UK more generally. In addition, to being major contributors to the UK's tax base, employees in the City of London are also consumers of services which generate additional employment and taxes. A study simulating the impact of a stock transfer tax in New York estimated that every loss of 100 jobs in the financial services sector would result in a loss of up to 112 jobs in the general services sector; 91 jobs in the business services sector; and further losses in the retail and restaurant sectors.¹⁴⁰ The "spillover" effect of a transaction tax would result in further reductions in the UK's income tax receipts and contribute to job losses outside of the financial sector at a time when UK unemployment stands at a 17-year high.

Conclusion

9. A global tax on financial transactions would be a workable, albeit unnecessary, punitive measure. Implemented regionally, such a tax would be little short of an explicit invitation for businesses to move their trades and employees to areas not covered by the tax. Individual NCI members have expressed to us the belief that the implementation of the FTT would precipitate London's demise as a major financial centre by 2015, a grim prediction under any circumstances, but particularly so at a time when the City has never been more important as both an engine for the economy and a provider of jobs, taxes and exports. The FTT is often seen as a simple solution to a complex problem. In our opinion, it is a simple way of inflicting serious damage on the City of London and the UK as a whole. Therefore, we are resolutely opposed to the implementation of an EU-wide transaction tax.

03 November 2011

¹⁴⁰ Page 206, Page, R (2010), *Financial-Industry Tax Law Reforms Proposed in the Wake of the Financial Crisis*, Tulane Law Review, pp: 191-214, citing Schwabish (2005).

Oxford University Centre for Business Taxation - Written evidence

Response from: *John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr**

PART I General questions on financial sector taxation

I. Is there a case for the introduction of a tax on financial transactions?

I.1. No. There are better instruments to obtain the objectives pursued by the Financial Transaction Tax (“FTT”) proposed by the EU Commission (“Commission”).

Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

I.2. The overall effect of the VAT exemption is ambiguous. It reduces the tax burden on services to consumers but it also increases the tax burden on transactions with businesses. Some studies do suggest under-taxation, however uncertainty remains around this issue. The Commission’s Impact Assessment (“IA”) states:

“[t]he extent to which applying VAT to the financial sector (and its clients) would raise additional tax revenues and – consequently – the extent to which the exemption constitutes a tax advantage for the financial sector is *an unsettled empirical question*.”¹⁴¹

I.3. The IA reviews some estimates of the potential tax advantage and presents a new estimate which suggests an advantage in the range of 0.11% and 0.017% of GDP. The IA is careful in stressing that “all these estimates are very rough approximations and should be interpreted with caution.”¹⁴² It then concludes cautiously: “...the VAT exemption for a large share of financial services is an important issue. It *possibly* results in a preferential treatment of the financial sector compared with other sectors of the economy as well as in distortions of prices.”¹⁴³

I.4. Even if one assumed that the sector is under-taxed because of this exemption, the FTT would not be the best tax to correct this. In fact, the IA states:

“[t]he transaction taxes as discussed in this paper are not really effective to compensate for the VAT exemption for mainly two reasons...The FAT and namely the addition-method FAT could be more effective in addressing the VAT exemption in the sense that the tax base has similarities to the VAT base. However, the integration of VAT and FAT is complicated and poses a number of unresolved problems.”¹⁴⁴

I.5. We agree. A Financial Activities Tax (“FAT”) would be a better option, as would the removal of the VAT exemption.

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

¹⁴¹ Impact Assessment, accompanying the document ‘Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, Vol. 1’, SEC(2011) 1103 final, (September 28, 2011), (“IA Vol.1”), 14.

¹⁴² IA Vol.1, above, 14 (emphasis added).

¹⁴³ IA Vol.1, above, 15 (emphasis added).

¹⁴⁴ IA Vol.1, above, 34-35 (emphasis added).

2. What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e. g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

2.1. In order to determine what is the most appropriate form of taxation of the financial sector, it is first necessary to set out the objectives pursued by the tax. If the tax is simply meant to raise revenue, one should then establish why the extra revenue is being raised. We find the following reasons for raising further revenues from the financial sector compelling:

To claw-back some of the direct and indirect costs of the financial crisis. This is reasonable given that the financial sector was partly responsible for the crisis.

To compensate for the implicit state guarantee enjoyed by financial institutions which are “too-big-to-fail”. This guarantee leads to a lower cost of capital (through underpriced debt finance), and, in turn, excessive profits. Steps have been taken, and further proposals have been made, to remove, or at least, reduce this implicit guarantee. However, it can never be removed completely. Financial institutions do not pay for the guarantee, so a further tax on the financial sector can be justified as compensation for the guarantee.

2.2. Both are good reasons. However, an FTT is not the best instrument to tax the financial sector in furtherance of these rationales.

2.3. Clawing-back the costs of the crisis from the institutions/individuals who were (partly) responsible for it might be better achieved through an FAT. This is because certain types of FATs¹⁴⁵ are more likely to be borne by its intended target. On the other hand, there is much uncertainty as to who actually bears an FTT.

2.4. An FTT taxes all institutions alike, whether or not they enjoy the implicit state guarantee. A Bank Levy is preferable in this regard. The bank levy found in the UK, for example, excludes small banks that do not enjoy the guarantee. It also increases with the riskiness of the bank and therefore the likelihood of its need to be bailed out.

2.5. The FAT and the Bank Levy are thus better tools to raise revenues from the financial sector given the justifications set out above. However, even if one wished to raise further revenues from the sector on different grounds, the FAT would still be a better instrument. This is so for at least three reasons: the FAT is less easily avoided through relocation, (depending on the type of FAT in question) its incidence appears more certain and it can generate the same amount of revenue whilst creating a lower economic cost. The first two of these reasons are considered in the answer to question 8. The third reason is considered here.

2.6. It appears that an FAT would extract the same level of tax revenue from the financial sector at lower costs for the economy as a whole. The IA investigates this issue and concludes:

¹⁴⁵ One should note that the FAT is actually a “family” of taxes. Different types of FATs have different strengths and weaknesses. To keep matters simple, we do not discuss, at each turn, which type of FAT would be best suited to deal with a specific issue.

“[t]he analysis of macroeconomic impacts (and the relocation issues mentioned above) suggests that the *economic distortions related to raising revenue could be lower with a FAT compared to an FTT.*”¹⁴⁶

2.7. Despite being state of the art, there are known limitations to the models used by the Commission to estimate the revenue potential of these taxes and the size of the economic distortions they produce. This suggests that we should approach the conclusions reached with caution. It is interesting to note, however, that using these models the Commission finds that the FAT would allow revenue to be raised at a lower economic cost in terms of impact on GDP growth.

2.8. At a more fundamental level, a weakness of the FTT is that it taxes business-to-business transactions and distorts production decisions. It is a basic principle of optimal taxation that tax systems should be designed so that a distortion of production decisions is avoided.¹⁴⁷ Taxes like the standard VAT or the income tax achieve this to a large extent.

3. What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

3.1. The FTT introduced in Sweden led to massive relocation.¹⁴⁸ The extent to which a particular FTT is susceptible to avoidance through relocation will vary depending on its design. However, unless adopted globally, an FTT will always be subject to this risk.

3.2. The Commission’s proposal takes this risk very seriously when arguing for the need to introduce the tax at an EU level rather than a Member State level.¹⁴⁹ When considering the consequences of adopting the tax at an EU level despite the lack of agreement at a global level, this issue appears to be given less weight. Clearly the concerns should apply with equal force.

PART II Specific questions on the Commission’s proposal for an FTT

Rationale for an FTT and scope

4. What is your assessment of the Commission’s objectives as contained in its proposal for an FTT? Are they fair and appropriate?

4.1. The Commission refers to the following four objectives. We comment on each in turn.

4.2. *to raise revenue from the financial sector*

This is a reasonable objective for the two reasons given in the answer to question 2. Other reasons given in favour of raising revenue, such as the alleged preference resulting from the VAT exemption, are less compelling.

¹⁴⁶ IA Vol. I, above, 33.

¹⁴⁷ P. Diamond and J. A. Mirrlees, “Optimal Taxation and Public Production”, (1971) *American Economic Review* Vol. 61(1), 8-27.

¹⁴⁸ For example, the trading in futures on bonds fell by 98% within the first week of the application of the tax.

¹⁴⁹ “...it is useful again to refer to the example of Sweden ... which clearly shows the limits of a unilateral introduction of such a measure given the high mobility of the sector.” IA Vol. I, above fn. 6, 24.

4.3. The Commission is proposing an FTT partly as an own source of funding for the EU. The question as to how the EU should be funded is not considered in depth here. However, we do make the following points:

- it is not clear why the EU should be funded by the financial sector to a larger extent than by other sectors of the economy;
- due to its unstable tax base and the uncertainties surrounding it, an FTT is not an obvious choice as a source funding for the EU;
- it is expected that a high percentage of the revenues generated by the FTT would come from the UK. The geographical unevenness of the tax base across the EU member states raises further questions on the use of the FTT as a source of funding for the EU.

4.4. *to create disincentives for transactions that do not enhance the efficiency of financial markets*

A central problem here is that there is great uncertainty as to which transactions “do not enhance the efficiency of financial markets”. The Commission appears to have high-frequency trading in mind, however, it admits that the “the empirical economic literature is still *rather inconclusive* on effects from this trading form in terms of increased volatility or price deviations.”¹⁵⁰

4.5. *to avoid a fragmentation of the internal market that might be caused by uncoordinated tax measures of the member states*

The Commission argues that its proposal wants “to avoid fragmentation in the internal market for financial services, bearing in mind *the increasing number of uncoordinated national tax measures being put in place*”.¹⁵¹ It is right in pointing out that Member States are introducing uncoordinated national financial sector taxes. But these are not transaction taxes! Ten Member States introduced bank levies which differ in base, rate and rationale, and which give rise to double taxation issues. An EU-wide FTT would not address the lack of co-ordination on these levies. Taxes on certain financial transactions also exist at a Member State level, but these have not been introduced recently.

4.6. *to demonstrate how an effective FTT can be designed and implemented, generating significant revenue and pave the way towards a coordinated approach beyond the EU.*

Other countries, including the US, Australia and Canada, have declared their lack of interest in adopting an FTT. The question thus arises whether the introduction of an FTT in the EU or a subset of EU member states would increase or decrease the incentives for other countries to follow. This is clearly a difficult question, however, it appears evident that the unilateral adoption of an FTT by the EU could act as an incentive for other state not to follow suit and thus to attract relocations from the EU.

4.7. In summary, whilst the first objective appears reasonable, the remaining three are questionable. We also note, in closing, that the FTT does not seek to address any of the recognized causes of the past crisis, such as excessive leverage or insufficient liquidity provision.

¹⁵⁰ Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC Brussels, COM(2011) 594 final, (September 28, 2011), (“Proposal”), 3.

¹⁵¹ Proposal, above, 2.

5. Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission?

5.1. If an FTT is adopted, it is best for its coverage to be broad to minimise the possibility of avoidance through substitution.

7. On which transactions should the FTT be levied? What should be the rate of the FTT? Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?

7.1. We do not express an opinion as to what the rate of an FTT should be. We do note however that whilst the rate in the proposed FTT appears small, in fact, the actual charge on a transaction can be higher. First, such is the design of the tax, that multiple charges may be due. For example, if a financial institution purchases an option to buy equities from another financial institution, they both pay the tax when the option is bought/sold, and, at least, again if the option is exercised and the equities are bought/sold. Secondly, the FTT on derivatives is charged on the nominal amount involved, which can thus create much higher effective tax burdens. In a simple example given by the Commission the effective tax rate reaches 22% when calculating the tax paid to the actual price paid for the instrument.¹⁵²

7.2. The residence principle cannot stop avoidance through relocation. Note that two EU institutions can avoid the tax completely by transacting via their subsidiaries located outside the EU.

8. How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

8.1. Threat of avoidance through relocation unless FTT is global

Relocation risk is clearly central to the effectiveness of an FTT as a revenue-raiser. After reviewing the issue the IA concludes:

“[a]gainst this background, it is difficult to make unequivocal conclusions on the exact size of the elasticities and relocation risks (although there are strong risks of relocation). Our revenue simulations consider a relocation of securities markets by 10%, a relocation of spot currencies by 40% and a relocation of derivatives instruments of 70% or 90% ...”¹⁵³

8.2. There is thus considerable uncertainty surrounding this issue and how much revenue the tax would raise. Overall, the predictions seem rather gloomy, with the prediction on the OTC derivative markets being particularly so. The IA notes that “the application of the tax

¹⁵² Commission Staff Working Paper Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, Vol. 12, SEC(2011) 1102 final, (October 21, 2011), 21 - 22.

¹⁵³ IA Vol. I, above fn. 7, 47 (emphasis added). The IAES goes on to state “[s]uch disappearance could be seen as positive if the activities targeted are considered as harmful. To the extent that High-Frequency Trading is considered as harmful, one has to bear in mind it is estimated to be about 40% of total transactions.” This point is considered below.

in this highly mobile market (i.e. OTC derivatives) will be difficult and reduce the taxable base significantly... the tax base could largely disappear leaving no substantial revenue”¹⁵⁴

8.3. Incidence

The IMF has noted that the FTT’s real burden may fall largely on final consumers rather than the earnings in the financial sector.¹⁵⁵ Along the same lines, the IA concludes:

“[a]s far as the FTT is concerned, a large part of the burden would fall on direct and indirect owners of traded financial instruments. Moreover, levying the tax on secondary markets generates cascading effects, which might have non-transparent consequences, and thus make incidence more complex. In fact, if business transactions are non exempt, the tax will be cascading through the production process and affect the price of non-financial products and services.”¹⁵⁶

8.4. In the case of the FAT, in particular the FAT types 2 and 3,¹⁵⁷ it is much more likely that the economic burden of the tax falls where it is intended to fall. This is because the FAT taxes excessive wages and profits generated in the financial sector. The possibilities and the incentives to pass on the tax are more restricted in this case.

Impact and effectiveness

11. How easily could the FTT tax be circumvented by market operators?

11.1. We believe that market participants will find ways of circumventing the FTT. As noted in the answer to question 7, the FTT can be circumvented by carrying out transactions through subsidiaries located outside the EU. One would thus expect institutions to move their treasury operations to subsidiaries in non-EU jurisdictions.

12. What impact would the FTT have on the UK’s financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

12.1. Interestingly, the IA reports a geographical distribution of the tax base for the FAT but not for the FTT. Hemmelgarn¹⁵⁸ reports from Schulmeister¹⁵⁹ the following predicted revenues from a 0.1 percent tax on stocks, bonds and derivatives at a medium reduction of trading activities:

Country	BEL	GER	FRA	ITA	AUT	NLD	UK
Revenue	3.3	35.5	15.0	5.1	1.6	5.1	162.8

¹⁵⁴ Commission Staff Working Paper Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, Vol. 12, above fn. 40, 22.

¹⁵⁵ IMF, above fn. 9, 20.

¹⁵⁶ IA Vol.1, above fn. 7, 53.

¹⁵⁷ For an explanation of the differences between these types of FATs, see IMF A fair and substantial contribution by the financial sector – Final Report for the G-20, (June 2010).

¹⁵⁸ Thomas Hemmelgarn, *Steuern und Abgaben im Finanzsektor*, Finanzen und Steuern Schrift Nr. 468 (2011).

¹⁵⁹ Stephan Schulmeister, Margit Schratzenstaller and Oliver Picek, *A General Financial Transaction Tax Motives, Revenues, Feasibility and Effects*, (March 2008).

12.2. While the absolute size of these predictions is debatable, their relative size informs about the size of the UK tax base relative to the other countries listed. Of the seven countries list, 71.3 percent of revenue is expected to come from the UK. In particular, according to these numbers, revenue raised in the UK should be 4.6 times higher than revenue raised in Germany and 10.9 times higher than revenue raised in France.

Impact of the FTT in the UK

13. How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

13.1. The FTT appears to create strong incentives for financial services to migrate outside the EU.

13.2. The UK's experience is instructive, however, it should be viewed with caution. Some compliance was achieved by creating a real incentive to pay the duty. A transferee of a share in a company registered in the UK must pay the relevant stamp duty in order to be included in the register of members and have a share certificate issued in his name. A similar registry system and therefore compliance mechanism is not available for other financial instruments covered by the FTT proposed by the Commission.

13.3. A further point to keep in mind is that the base of the UK stamp duty is narrow. A number of transactions producing similar economic effects to a transfer of shares thus fall outside its ambit.

14. Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

14.1. The bank levy is quite different to an FTT. Of course, both seek to raise revenue from banks but they do so in a very different manner. The bank levy also seeks to address some of the recognised causes of the past financial crisis, namely excessive leverage and insufficient liquidity provision.

Implementation

15. Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

15.1. The main problem with introducing an FTT at a national or EU level is relocation risk. An FTT adopted globally clearly avoids this difficulty. However, it would still be problematic on a number of grounds such as incidence, cascading effects and production efficiency.

7th November 2011

Peter Sinclair¹⁶⁰ - Written evidence

1. Arguments in politics and economics can concur. But sometimes they fight. Politics teaches, for example, that there is strength in numbers: leaders should follow the crowd or face peril. In economics, blessed are the few, for they shall be scarce.
2. In 2011, politics says that bankers must be punished for their huge mistakes which the rest of us are now paying for. Never has the political climate for increasing taxation on financiers and what they do been more favourable. Michel Barnier and his colleagues in the European Commission have seized their chance of proposing that in their Financial Transactions Tax (FTT); great urgency is provided by the fact that M. Barnier's government occupies the Union's revolving Presidency and can set the policy agenda to meet its nation's interests; and the result is the document (European Commission, 2011), on which comments have been invited.
3. Economics says that you could hardly pick a worse time for doing that. Their massive losses since 2007 mean that many of the banks in the North Atlantic economies are still only just afloat. They face large rises in minimum capital requirements in the near future, at a time when the equity values of the weakest, which stand in greatest need of equity infusions, are at record lows. In the UK, the firewalls wisely recommended by the Vickers Commission will, if implemented, make it harder for retail banks to profit from proprietary trading, and spell an end to the implicit government subsidy for investment banks. Worst of all, massively elevated risk premia are starving smaller companies; they cannot raise equity or debentures from the markets; the bank loans they so sorely need to expand or survive are being squeezed by the unparalleled balance sheet pressures on their funders.
4. Economics teaches that the right course of action is rarely the same at all times and all places. It will vary by circumstance. And in our interrelated world, it depends on what others do, too.
5. In normal times, financial services should definitely bear some tax, and perhaps as much tax as most other categories of good or service. All agree that a handful of goods should have special fiscal privileges: charitable activity, for example. And no-one could oppose placing higher taxes on smoking and alcohol and petrol, if only to reflect their social cost, and the damage wrought to others. Financial activities play an invaluable role, by mobilizing surpluses and funding the risky innovations on which economic growth depends; and they can, as after 2007, lead to very serious and widespread economic injury. But on average, and without the jewel of hindsight, they are neither so beneficial to society that they merit exceptional subsidy, nor harmful enough to warrant exceptional taxation.
6. In normal times, a cogent case can be made for thinking that financial firms are best taxed indirectly, by VAT for example. This is very similar to what the IMF proposes, as a Financial Activities Tax (FAT), to be levied on their pay bill and profits. The indirect tax system in the UK, in common with other EU countries, barely touches financial firms; the odd service, here and there, is subject to the standard rate of

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VAT; and the exemption from VAT generally accorded to these firms implies a modest but complicated little stream of concealed imposts, reflecting the fact that (unlike “zero-rated” firms) they are disallowed from recovering VAT paid on inputs purchased from other enterprises.

7. There is little doubt that the UK financial sector in the UK and other EU countries has been undertaxed on average. What rate of VAT (or FAT, or any equivalent) should be applied is hard to answer. Probably the 5% VAT rate that the UK applies to electricity and gas and, pertinently, many insurance contracts, may be taken as a suitable benchmark to consider. Financial services are a utility; so are water (currently zero-rated in the UK) and telephony (20%). The costs of collection, official and private, imply that the present system of exemption for most financial activities is superior to VAT a low rate of, say, 2%. (Is FAT preferable to FTT? Yes: FAT is much broader, less avoidable, and less distorting than FTT. And the Commission’s statement that EU households would not suffer from FTT, which, unlike FAT, would leave retail banking activities untaxed, is misleading for reasons that will become apparent below; though the idea of a CTT - on currency trades – merits consideration).
8. The Mirrlees Commission (2011) expresses sympathy for the case for a uniform rate of VAT on all goods and services (though with the few special exceptions noted above, such as alcohol and charity). For one thing, if supply conditions hold, setting differing tax rates on different goods will impose an expected cost on consumers’ utilities: that will typically be inefficient, and wasteful. For another, opening the door to special treatment, that the political system may confer to an individual firm or sector that presents a glossy case, can only lead to more lobbying – and that is generally a pure waste of resources. Arguments for special treatment based on income distribution (food has a higher budget share for the poor than the rich) can be addressed less wastefully by amendments to the system of income tax and transfers. And financial services are unlike food in that respect. Eventually, this suggests, one might see a 20% VAT rate on *all* goods and services, including the set of “utilities” which embraces financial services. But moves in that direction would have to go in small steps.
9. Yet there is no magic figure that should apply in all conditions. The “ideal” rate of tax on financial firms should certainly be *state-contingent*. First, the spatial aspect to state-contingency. Sophisticated, wholesale financial transactions, of the kind on which the EU proposes to levy FTT, can be conducted anywhere. A bank in country 1 can, at the flick of a button, transfer the deal to a subsidiary in country 2. If it sees a tax saving because 2 taxes the transaction more lightly than 1, it will surely do so. The European Commission’s calculations assume that FTT would indeed induce relocation, varying from 10% for transactions in equity and bonds, to 40% for currency trading in spot markets and 70% or 90% of trades in derivatives¹⁶¹. What this means is that the best FTT (or FAT) rates for the UK must depend on what rates are being charged elsewhere. It is not right to imagine that other major financial

¹⁶¹ European Commission, 2011(0261), 28 September 2011: Impact Assessment Volume I, page 49. These assumptions are not based on econometric evidence, but do not appear implausible. In the long run, the size of relocation will probably be (almost) proportional to the difference in FTT or its equivalent between London and the rivals that attract it. If FTT were applied globally, relocation would be negligible. The PCD’s revenue projections therefore reflect the belief that non-EU countries will not increase such taxes as they levy on financial transactions.

centres, in Asia for example, levy no taxes on financial transactions, as Persaud (2011) shows. Nonetheless, some global agreement on the methods, rules and rates of tax on the more internationally “footloose” financial transactions would be highly advantageous. In its absence, one could see a worldwide race outside Europe towards the bottom. If it adopted FTT unilaterally, the EU could be marooned. And the ensuing losses in turnover and GDP (and tax receipts) would be heavily concentrated in just two places: the City of London, and the UK’s HM Revenue and Customs.

10. The other aspect of state-contingency is the state of the construction, credit or financial cycles. There is at present an urgent search for building systems of regulation that can nip financial stability threats in the bud. The key concept is known as macroprudential policy¹⁶². The aim is to identify a set of policy instruments that can be adjusted to reduce each or any of the three dimensions of potential financial instability – the probability, frequency and the gravity of financial crises. Past decades have witnessed large and sinister swings between dearth and plethora of loans, for example, extended by many countries’ financial sectors to property developers, builders and mortgagors in the residential housing market. Malfunctioning real estate markets are the root cause of virtually all the world’s financial woes since 2007. From the poison exuded through the world’s banks by the mis-selling of America’s abysmally overpriced sub-prime mortgage derivatives; from the run on Northern Rock and the collapse or near-collapse of Fannie Mae, Freddie Mac, Washington Mutual, HBOS, RBS, Wachovia, Bear Sterns, Lehmans, Kaupthing, Glitnir, Landsbanki, Dexia, Hypo AG, AIB and Bank of Ireland; to the sudden construction busts in Greece, Ireland, Portugal, Spain, and the US with their trail of ensuing sharp deterioration in governments’ budgets – the failure to stabilize real estate credit flows and prices was the chief and fundamental source of all these disasters. The most attractive way of limiting these risks involves raising taxation on financial firms and/or financial transactions when credit outpaces GDP, and cutting it when lending wilts in the crashes that follow. The dynamic provisioning, courageously enforced by the Bank of Spain during the credit and housing boom after 2000, turned out to help save most of its banks from the crash, and provide a cushion for new loans when it was most needed¹⁶³.
11. When lending dries up after a crash, the tax system needs to counter lenders’ panic by subsidizing them, or at least taxing them more lightly; when lending grows faster than GDP, and real estate prices race away, at least two standard deviations above what fundamentals would predict, lenders need to face increasingly stiff taxation and the prospect of still higher taxes. There is even a case for discriminating between individual banks at the same time: herding banks need to know they will be penalized while rates of effective tax on “contrarian” banks¹⁶⁴ could be lightened. All this could be achieved in many ways. There could be variations in VAT or FAT; or, were it to be adopted, in the generally less satisfactory system of FTT that the EU proposes; or through countercyclical adjustments to capital requirements; or, as in Singapore for example, by varying rates of stamp duty on real estate transactions.

¹⁶² Galati and Moessner (2011) review work on this well.

¹⁶³ See J. Saurina (2009) and an early article by Mann and Michael (2002).

¹⁶⁴ Park and Sabourian (2011) are eloquent on this general subject.

12. The European Commission has long claimed that completion of the single market is impeded by price or tax differences between member states. Its Common Agricultural Policy, first set up in 1963, was built on the notion that there should be an almost unique level of prices for foodstuffs, common across the countries, and fixed independently of world conditions. This fondness for unconditional and uniform prices is yet another example of where economic reasoning and political expediency point in opposite directions. Price uniformity suggests political unity; but it can also lead subtly to serious economic waste¹⁶⁵. The notion that Germany's and Spain's credit and housing markets should be subject to common rates of fiscal levy, on the ground that they belong to an economic and monetary union, is exploded by contrasting their countries' experiences after 2000. Spain's house prices series shot up, while Germany's stagnated. A common monetary policy was partly responsible for this destabilization, which, had it not been for the Bank of Spain's unilateral dynamic provisioning imposed upon its banks, would surely have been far greater. It follows that pressure to equalize rates of tax on banks within the EU could be perilous and highly ill-advised.
13. Although other possibilities are considered, the Commission's main FTT proposal is based on the principle that tax revenues accrue to the government(s) where the parties to a financial transaction reside. This is no a minor detail. Since most of the EU's wholesale financial transactions (the base of the proposed FTT) take place in London, but perhaps as much as 40% involve one financial firm (or sometimes two) headquartered or resident in another EU country, a substantial slice of FTT proceeds, perhaps 18% or so, would be transferred from the UK exchequer to other EU governments. Senhor Barroso opines that the FTT, if implemented in full, would build up to an annual EU-wide yield of some 55 billion euro. If these estimates proved correct, (and the Barroso figure may be much exaggerated) about 10 billion euro could be passed from London to other EU capitals. Yet when a British family buy dinner in France or pay a hotel bill in Italy, the VAT charged does not return to HMRC in London. Why the difference? There is also a hint that FTT revenues might be shared between the European Commission and the national governments; on that basis, FTT would constitute an even bigger conduit of funds from the UK to the rest of the EU. (It may be that the Commission's preference for (their version of) FTT over FAT has something to do with such covert transfers that FTT might entail, while FAT would presumably not).
14. The annual loss of 10 billion euro, and possibly more, actually understates the impact on HM Government's finances. This is because, as the authors of the Impact Assessment volume allow for, some financial activity at present located in London (and other EU financial centres) would be diverted to more clement fiscal environments elsewhere. That would entail a loss of revenues from corporation tax, national insurance contributions, and income tax on remuneration currently paid to UK-based staff. The providers of wholesale financial services (the currency conversion, equity and bond transactions, and derivatives trading) which FTT proposes taxing would account, in recent years, for an average of perhaps 5 to 6% of UK GDP and some 8% of central government tax receipts. Relocation of one third of these activities to other fiscal jurisdictions might, on this basis, be expected to lead to

¹⁶⁵ Newbery and Stiglitz (1981) provide a brilliant, classic analysis of the various ways in which attempts to stabilize primary commodity prices can induce waste.

an additional annual revenue loss of £10-£12 billion, and an annual GDP loss of around £23 billion. These magnitudes are not small. And this correspondent has yet to find any discussion of the diversion effects of FTT on aggregate GDP for the EU (still less for its individual countries).

15. Policy responses to the European Commission and to our EU partners should never be based solely on a narrow conception of national interest. This said, it would be interesting to see removal of the cloak that conceals the covert intra-EU transfers implicit in the FTT proposal. It would be unworthy to think that what most attracts M. Barnier to his scheme is that Britain suffers while its EU partners stand to gain (nor to imagine that the recommendations from Paris put to Germany to deal with the Greek Crisis in 2011, or the CAP in 1963, were based partly on the transfers Germany gave France). But at the least, the intra-EU transfer element should be acknowledged and (as accurately as possible) quantified. The European Commission's experts are far better placed to conjecture what they might be, in Britain's case, than this correspondent and his highly tentative estimates.
16. Your correspondents are invited to discuss Sweden's experience with its financial transactions levy. Sweden was not alone in abolishing its taxes on financial transactions in the early 1990s. Finland, Germany and New Zealand decided to do the same (Wrobel, 1996). These levies had produced disappointingly meagre revenues, barely a tenth of what their advocates had hoped. In addition, they were blamed for having depressed equity prices and the resulting receipts from capital gains taxes. There was also a growing acceptance at that time of the view that capital is mobile, both over time in any country and across borders even in the short run. Experts agreed that the attractiveness of taxing it, its yield, or its ownership changes, was greatly undermined when those factors were taken into account. Like flat income tax and inflation targeting, removing taxes on equity transactions was a big "new idea" for policy makers in the 1990s. Opinion among economists has not changed much on this question; nor, it seems, at least until recently, had public attitudes either. Now, with the growing awareness of increases in income inequality within countries, the huge social costs of the errors made by lenders in the past decade, and the sudden urgency of finding new macroeconomic policies for the short run, the pendulum might be starting to swing back. M. Barnier's FTT proposal gambles on such a change in political sentiment, and seeks to exploit it.
17. A major plank in the FTT proposal is the 0.1% tax on transactions in equities and bonds. It is worth emphasizing that this rate is very modest, when compared with the UK's current stamp duty rate of 0.5%. The studies conducted at the Institute for Fiscal Studies on the effect of UK stamp duty are instructive. Bond et al (2004) find non-trivial effects – upward on the equity cost of capital, and downward on the price of shares. Hawkins and McCrae (2002) conclude that stamp duty cuts turnover in equities by a fifth, and that halving the rate to 0.25% would raise share prices by over 6%. The political appeal of taxes on capital, on capital income, or on capital transactions is that their formal incidence seems limited to rich individuals and affluent financiers. The economic reality is that the incidence falls in the very long run in an open economy, and even in the shorter run in an economy with no controls on capital movement, not so much on the factor of production capital or its owners, but actually upon labour, and the pension funds of ordinary folk. The extreme view would simply be: tax capital, and eventually you will only impoverish your citizens;

and that the purgative effects of a financial crash, painful as they are, offer the consolation of “weeding the garden”.

18. The arguments for the existence of financial markets, and the benefits they bring, are several. One is that they should pass risk on those most able or willing to bear it. Another is that errors in the allocation of capital – while unavoidable, because the future is unknown and it is impossible to allow for all contingencies – will be reduced if market participants are rewarded for spotting anomalies. It is also claimed that speculation destabilizes markets if and only if it is unprofitable, and hence that curbing speculative activity or decreasing trading should lead to more volatility and uncertainty, and not less. Sharp swings in market prices are the consequence, on this argument, of the arrival of important new information, rather than conspiracies, manipulation, fraud, or the destabilizing activities of gamblers. But the truth is much more nuanced. Bankers have, in practice, been encouraged to gamble if the taxpayer stood over any serious losses; US monetary policy was much too lax from 2001 to 2004; US politicians encouraged mortgage lenders to lend too freely to the very poor; financiers knew little and often just copied each other; misled by the sudden availability of rich statistical data drawn from an extraordinarily tranquil recent period, banks sacked or ignored risk managers, and financial memories were too short; momentum traders who extrapolated short term trends exacerbated market volatility; outside the Bank of Spain, at least, few players and referees thought enough about the long run. Rewards paid to many senior bankers have been out of all proportion to the social value of their work (which in some cases has turned out hugely negative). And the volume of spot and future currency trading has grown to the point where the social benefit from permitting its continuation on a wholly untaxed basis is highly questionable. Equity transactions are very probably taxed at excessive rates in the UK – and FTT, were it to be introduced, would improve the situation if, and only if, the sum of these rates were reduced. But a low tax on foreign exchange transactions should certainly not be ruled out, especially if applied globally, and with the proviso that receipts were kept by the fiscal jurisdiction levying them on deals within its borders. Given these conditions, this part of FTT is promising. It could be pursued in addition to the wider FAT.
19. To conclude, FAT is the best way of taxing the financial sector, which, in the UK and elsewhere, has tended to enjoy too great a level of fiscal privilege in the past. But at present, its introduction, at anything but a very low rate, would be most ill-advised. Sick banks must be nursed back to health, with enhanced capital and probably new systems of separating banks’ retail and trading activities, before that can be entertained. The ideal time-path of FAT will vary according to the credit and construction cycle, and on a country by country basis; recent experience has shown that a uniform EU-wide set of FAT rates would be highly inadvisable; and the extent and character of financial sector taxes in other countries is crucial. Beneath the surface, FTT would, as proposed, be expected to channel large sums from the UK to its EU partners, and UK GDP would suffer from an unknowable, but potentially alarming, efflux of financial activity to non-EU destinations.

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6 November 2011

Stamp Out Poverty - Written evidence

FTTs: purpose and spread

1. The case for the introduction of a tax on financial transactions is composed of two main strands: the potential to raise substantial revenue, in the region of £20 billion in the UK, and to help bring greater stability to the financial system.
2. The increase in transnational financial transactions brought about by economic deregulation and unregulated globalisation has led to a concentration of wealth and an increase in systemic risk. The explosion in financial activity has resulted in some leading voices, such as Adair Turner, head of the Financial Services Authority, questioning the social utility of parts of the financial services sector. The arrival of high-frequency algorithmic trading has compounded this problem.
3. Furthermore, the current exemption from VAT for most financial and insurance services leads to a significant tax advantage for the financial sector. Moreover, large banks' 'too big to fail' status enables them to borrow at lower interest rates than if they operated in a truly free market. This is because there is an implicit understanding that the government will bail out bond holders if a large bank defaults on its debt payments. In addition to unfairly inflating their profits, this implicit subsidy gives large banks an important commercial advantage over their smaller counterparts, and exacerbates the barriers that new firms face when trying to enter the market. Furthermore, as long as a sentiment that the government will intervene exists, risks will not be fully borne by the risk-takers, which leads to excessive risk-taking.
4. In our analysis, the best form of taxation of the financial sector is a broad-based Financial Transactions Tax: rolling on from our current FTT on share transactions (the stamp duty) to bonds, derivatives and the wholesale market in foreign exchange.
5. There is clear evidence demonstrating that broad-based FTTs work. They have been introduced in over 40 countries either on a permanent or temporary basis in the last few decades, including 7 of the G8 countries. For example, in the US, an FTT known as the Section 31 fee is levied at a rate of 0.00257% (recently increased from 0.0017%) and raises \$1 billion a year to pay for the US regulator, the Securities and Exchange Commission. In the UK, we have a 0.5% stamp duty on share transactions which raises \$3bn a year. A number of countries, such as Brazil, Switzerland and Taiwan, apply taxes to equity, bond or derivatives transactions, and at least \$23 billion is being raised annually through this existing patchwork of FTTs. Please see the table on pages 2 and 3 of this submission for more details.
6. Opponents of the FTT often cite the transaction levy introduced in Sweden in 1984 and abolished in 1991 as proof that FTTs do not work. However, the existence of successful FTTs in many other countries demonstrates that the Swedish experience is the exception and not the rule. The crucial distinction between this FTT and successful FTTs such as the UK stamp duty on shares, is good design. The Swedish FTT was imposed on transactions which took place in Sweden, whereas the UK stamp duty falls on the purchase of shares in UK-registered companies wherever they are traded in the world, because its payment is connected to legal transfer of ownership. In the Swedish example,

Stamp Out Poverty - Written evidence

traders simply avoided the tax by relocating outside Sweden. This is not possible with the UK's stamp duty, and in any case most investors are willing to pay a modest tax to ensure legal title to their asset.

Table I: Financial Transaction Taxes around the world

Country	Capital Levy	Equity	Bonds/Loans	Forex	Options	Futures	Capital inflow
Argentina	na	Federal stamp duty on share transfers abolished 2001	Provincial stamp tax, usually at 1%, may affect bonds and debentures.	na	na	na	na
Australia	na	State-level taxes may apply to shares	State-level taxes may apply to loans and bonds.	na	na	na	na
Brazil	na	1.5% tax on equity issued abroad as depository receipts (reduced from 3% 2008)	1.5% tax on loans (reduced from 3% in 2008).	0.38% on forex; 5.28% on short-term forex (<90 days).	na	na	2% tax on capital inflows to stock and bond markets since 2009
Canada	na	na	na	na	na	na	na
China	na	0.1% of principal	na	na	na	na	na
France	5% of capital contributions not subject to VAT	15-30 bps tax abolished 1/1/2008	na	na	na	na	na
Germany	na	na	na	na	na	na	na
India	na	0.25% on stock price; 0.025% on intraday transactions; local stamp taxes may also apply	Local stamp duties may apply		0.017% on premium; 0.125% on strike	0.017% of delivery price	na
Indonesia	na	0.1% on value of shares; local stamp duties may also apply.	Local stamp duties may apply	na	na	na	na

Stamp Out Poverty - Written evidence

Italy	Euro 168 flat fee on share issuance; 3% on business purchases	0.01-0.14% of shares traded off exchange.	0.25-2% on loan principal	na	na	na	na
Japan	Registration tax of 0.4% on mergers and trusts.	na	na	na	na	na	na
Mexico	na	na	na	na	na	na	na
Russia	Capital duty of 0.2 % of value of new share issues, but not upon formation or IPO of company		Capital duty of 0.2% of value of new bond issues, but not upon formation or IPO of company				
Saudi Arabia	na	na	na	na	na	na	na
South Africa	na	0.25% of value; new share issues excluded.	na	na	na	na	na
South Korea	0.1-0.4% tax on capital formation	0.5% on value of shares in corporations or partnerships					
Turkey	Stock issuance charge 0.2%	Initial charge for obtaining stock market quote: 0.1%; annual maintenance charge 0.025%	0.6-0.75% bond issuance charge	0.1% tax on foreign exchange transactions by financial institutions eliminated 2008			
UK	na	Stamp duty 0.5% on secondary sales of shares and	na	na	50 bps on strike price, if executed.	50 bps on delivery price	na

Stamp Out Poverty - Written evidence

		trusts holding shares.					
US	na	SEC fees on stock trading: 0.0013%; NY state tax: \$0.05 per share up to \$350 per trade.	na	na	na	na	na
Non-G20 Countries							
Chile			0.1-1.2% tax on bond issuance				
Hong Kong		10 basis points					
Singapore		20 basis points					
Switzerland	1% on share issuance in excess of CHF 1mn.	15 bps on domestic shares; 30 bps on foreign shares.	6-12 bps on bond issuance				
Taiwan		30 basis points	10 basis points on corporate bond principal		10-60 basis points on premiums.	Up to 0.025 basis points on interest rate futures; up to 6 basis points on stock index and other futures	
Source: International Bulletin for Fiscal Documentation, IMF staff							

Extract from IMF Working Paper: WP/11/54 - Taxing Financial Transactions: Issues and Evidence by Thornton Matheson (March, 2011), p.8. Table I. Securities Transaction Taxes in G20 and Selected

Other Countries, 2010

7. Avoidance can be minimized through good design and use of electronic clearing houses for collection. Furthermore the possibility for (limited) avoidance is not a good reason to rule out a tax. As Professor Avinash Persaud, President of City think-tank Intelligence Capital and Senior Fellow at London Business School says:

“It is sometimes argued that, because it would be hard to design a financial transaction tax that would be completely immune from the ill-placed ingenuity of bankers, there is no point to doing so. This is a far tougher benchmark than we apply to almost any other tax. One of the principal sources of tax revenues in the United States is income tax, but the last study by the IRS suggested that non-compliance with the tax code amounted to \$345bn and 18-19% of income was not properly reported to the IRS...But this is not widely seen as cause for abandoning income tax collection altogether: 82% compliance is not as good as it should be, but the \$2,000bn that is raised and spent is not to be dismissed.”

(We highly recommend that Professor Persaud is called to give oral evidence to the committee).

Reaction to the Commission’s proposal for an FTT

8. We believe that the Commission’s proposal for an FTT does not reflect the most desirable design for an FTT. We are advocating for a broad-based FTT based on the model of the UK stamp duty on shares. Legal transfer of ownership (or enforceability of a derivatives contract) would be linked to payment of the tax, and the trading of UK shares and bonds or derivatives thereof, would be subject to a tax wherever and by whomever they are traded. Sterling currency transactions would be taxed via the Continuous Linked Settlement Bank or whichever alternative settlement system may be employed. The fee structure would be scaled to the type and expected life of the asset so that arbitrage across asset classes is minimized. For example, Pollin, Baker, and Schaberg (2002) suggest a fee structure as follows to match a 0.5% fee on stock trades:

Bonds – 0.01% for each year remaining until maturity

Futures – 0.02% of the notional value of the underlying asset

Options – 0.5% of the premium paid for the option

Interest Rate Swaps – 0.02% of asset value for each year until the expiration of the agreement

9. It is important to point out that the 0.5% stamp duty on shares in the UK is long-established and that this has not prevented the London Stock Exchange from being one of the largest and most robust stock exchanges in the world.
10. A serious omission in the legislation is the exemption of the taxation of foreign exchange transactions, which reduces total revenue significantly. The reason given for this is that it would contravene rules concerning ‘the free movement of capital’. However, this has been shown not to be the case by Professor Lieven Denys, who is widely regarded as one of Europe’s leading experts on tax law. (We also highly recommend that Professor Denys is called to give oral evidence to the committee).

Income and incidence

11. The report presented by Bill Gates at G20 leaders for the Cannes Summit in November 2011 (*"Innovation With Impact: Financing 21st Century Development"*) offers excellent evidence for the potential of FTTs to raise significant revenue: modeling suggests that even a small tax of 10 basis points on equities and 2 basis points on bonds would yield about \$48 billion on a G20-wide basis, or \$9 billion if by larger European economies, alone.
12. According to the IMF, FTTs are highly progressive, falling on the richest individuals and institutions in society. The IMF has also found that 14 G20 countries have some form of securities transaction tax. In the 7 countries where the IMF estimates revenue, these taxes raise an estimated \$15 billion annually.
13. From the point-of-view of the broad-based Robin Hood Tax campaign, we believe that the majority of revenue arising from the FTT should be used to protect public services, meet our international aid commitments and promote climate change initiatives, not finance the deficits of Member States. In other words, one set of banks should not be taxed in order to bail out another set of banks.

Promoting stability

14. In recent years, high-speed computer drive trading has become increasingly prevalent: 72% of trades on the New York Stock Exchange are now conducted using algorithms. These computer programs drive trading without human involvement, and the interaction between different algorithms can significantly reduce stability in markets. On 6th May 2010 a 'flash crash' took place in the US, when the Dow Jones Industrial Average plunged about 1000 points (and by 600 points in 5 minutes) or 9% of its value. High frequency trading (HFT) was implicated in the subsequent investigation, and several other instances of significant instability have been identified in other markets since.
15. This is exactly the type of speculative trading that even a very low rate FTT would reduce, as the business model for algorithmic HFT is based on wafer thin profit margins. An FTT would reduce churning and rebalance incentives in favour of long-term investment.

Would financial firms re-locate?

16. The extent to which a low-rate FTT would cause financial institutions to relocate outside the UK is frequently exaggerated. This submission has already touched on the way in which tax design can mitigate this risk, but it is also worth noting that there are significant advantages to being based in London, which would not be overturned by an FTT.
17. The recent financial crisis has dramatically illustrated the importance for the banking sector of the safety net provided by the state. This support only possible in countries with sufficiently large economies' to under-write large institutions. Furthermore,

London's infrastructure offers immediate access to information, support services, and trading partners. The gains from these so-called network externalities are significant, and when combined with London's location between the Asian and US markets, make relocation look unattractive. Germany, the main competitor in the European time zone, is already committed to implementing an FTT.

18. Experience bears this out: in 2010 the UK government implemented a one-off tax on bonuses in the City of London. Despite threats of relocation, no companies participated in the threatened exodus.

Would FTTs increase the cost of pensions?

19. Typically, only a small portion of a pension funds' investments are in hedge funds or other alternative vehicles which turnover their investments quickly. The vast majority of their capital is invested over long time horizons, where a micro-tax applied at entry and exit from the market would be negligible compared with other costs and benefits. The burden of the FTT falls principally on those who transact with the market on a very frequent basis, like high-frequency traders, not on those pursuing buy-and-hold strategies.
20. Furthermore, by reducing the systemic risks associated with HFT, the FTT would contribute to market stability, improving pension value over the long term.

Conclusion

21. In the wake of the financial crisis, there is a certain logic in arguing that the sector responsible should pay a greater burden of taxation in the forthcoming period. This VAT-exemption and implicit subsidy that banks currently receive add weight to this argument. The moves in Europe, driven by France and Germany, are consistent with this.
22. Various types of taxation are possible, including on balance sheets (the bank levy), on profits and remunerations (the Financial Activities Tax) and on transactions (the FTT). In 2011, we have seen most political energy focused on the FTT, which is widely viewed as having more potential than the other options, would raise more revenue, is simple and inexpensive to implement due to the automation of markets and would also generate a second dividend of making financial markets more stable.

11 November 2011

Trades Union Congress (TUC) - Written evidence

PART I General questions on financial sector taxation

1 Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

1.1 The TUC strongly supports the introduction of taxes on financial transactions for a number of reasons, including the potential use of the revenues to address the challenges of climate change, poverty at home and abroad, and addressing public sector deficits. We also believe that such taxes could form part of a re-balancing of the economy by addressing the under-taxation of the financial sector (as suggested, by levying a form of sales tax) and by reducing the current incentives for short-term investments and the excessive use of capital for trading purposes rather than investment in manufacturing and services. At the very least, financial transaction taxes would recompense the Exchequer for the reduced interest costs consequent on the implicit bail-out guarantee, estimated by the Bank of England to be up to £100bn a year in the UK.

2 What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

2.1 The TUC is not opposed to a Financial Activities Tax, and we do not consider FATs and FTTs to be mutually contradictory. However, we would prefer to see a tax covering wholesale foreign exchange transactions, securities and derivatives for three reasons. An FAT would tax all financial institutions' activities, regardless of how beneficial they are to the economy (i.e. banks which engage in nothing but retail banking would still be affected); FTTs would be more effective disincentives to undesirable financial activity; and FTTs would raise at least an order of magnitude more resources for global public goods.

3 What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

3.1 The Swedish experiment demonstrates the need to design a financial transaction taxes so that they minimise the risk that trading will move from countries applying taxes to those that don't, as the IMF have accepted. Such experiences indicate ways to design better FTTs.

PART II Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

4 What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?

4.1 The TUC believes in an FTT for the reasons given above. We are not convinced that the motivation for a specific public policy proposal is as important as its outcome.

5 Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

5.1 We do not believe that the Commission's initial proposals are the best possible proposals, especially in terms of defence against trading moving to other jurisdictions, but we

believe that these design problems can be resolved through discussion and negotiation. We will be contributing to civil society lobbying of the Commission, and to the considerations of the European Economic and Social Committee to propose improvements to the Commission's proposals.

6 On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?

6.1 We agree with the IMF that FTTs are more effective the wider their application, and therefore agree that the transactions listed by the Commission should be covered. However, we also believe that foreign exchange transactions should be taxed.

7 Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?

7.1 We are not convinced that the residence principle is the most effective method of implementing an FTT, and would wish to explore alternatives with the Commission.

8 How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

8.1 The TUC believes that FTTs could raise significant revenues. In the UK, we believe that they could raise a further £20bn on top of the sums already raised in Stamp Duty on shares. However, the revenue generated depends on a range of factors: principally the tax rate or rates, and the impact on the size of the market in financial products.

8.2 The TUC believes that a significant element of revenue generated by FTTs would be likely to come from financial sector profits and bonuses, but, as set out in the review of the evidence produced earlier this year by the Institute of Development Studies (IDS), we accept that some of the costs will be passed on to the customers of those institutions, principally the high net worth individuals who fund the trading of financial instruments. We therefore believe that even though some of the costs will be passed on to consumers, FTTs will have a progressive effect, and that the use of the revenues generated for global public goods will enhance this effect.

8.3 In terms of the use of revenues arising from FTTs, the TUC believes that revenues will have in some way to be passed to national Exchequers, and we believe that in the UK, these sums should be spent according to a formula where 50% of revenue is used domestically to tackle domestic poverty, including by offsetting the need to cut public services, and 50% used for tackling climate change and meeting the Millennium Development Goals in equal measure. We believe similar approaches should be adopted in other countries (as does the International Trade Union Confederation to which we are affiliated), but that is ultimately for each country to decide.

Impact and effectiveness

9 Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

10 What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?

9.1 We agree with those who say that the impact of an FTT on volatility and liquidity is difficult to predict, but we believe that it is extremely unlikely that even a negative impact

would be significant enough to cause problems, as FTTs would merely return the markets to where they were less than two decades ago. The TUC does believe that FTTs would reduce the incentive for high frequency algorithmic trading, which we consider to have a destabilising effect and to tie up capital which if released could be used to better effect.

11 How easily could the FTT tax be circumvented by market operators?

11.1 We believe that, as indicated above, FTTs could be designed in such a way to avoid circumvention. In particular, we agree with the IMF that the wider the scope of FTTs, the less potential for circumvention there would be.

Impact of the FTT in the UK

12 What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

12.1 The TUC believes that an FTT would have a beneficial effect on the UK economy, and on UK financial services. We do not subscribe to the view that trading in derivatives is a universally positive benefit to the UK or to the City of London, not least because we believe there are better uses for the capital involved, and the comparatively few employees engaged in such trading. We believe that the main impact of an FTT would be to redistribute wealth from the well off to the less well off both in terms of creating disincentives for the sort of activity that produces inflated salaries and huge bonuses, or at least taxing them more fairly, and in terms of the better use to which the tax revenue and capital would be put.

12.2 We would therefore expect the net impact on British citizens to be positive rather than negative.

13 How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

13.1 As indicated above, we consider that a well-designed FTT would minimise the risk of relocation, but we also believe that the risk is over-stated, especially for those financial institutions which, by their risky nature, need to be domiciled in a country able to fund any bail out. As the Financial Times and the City of London Corporation have argued, we do not believe that the rate of taxation of financial services is the main determinant of where a financial operation is based.

14 Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

14.1 The TUC believes that bank levies and FTTs are taxing different things, and are not therefore duplication. As indicated above, the £100bn implicit subsidy provided to banks alone suggests that the sector can absorb both the bank levy and FTTs.

Implementation

15 Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

Trades Union Congress (TUC) - Written evidence

15.1 The TUC believes that the more countries that implement FTTs, especially those with substantial financial transactions markets, the better, because of the revenue implications and the other beneficial outcomes that would flow for each country implementing such a tax. However, we believe that the large number of countries that have implemented FTTs unilaterally suggest that FTTs can be implemented by one, several or many countries. Like the European Trade Union Confederation to which the TUC is affiliated, we support an EU-wide FTT, or, failing agreement on that, an FTT covering a more limited number of EU countries.

15 November 2011

Trades Union Congress (TUC) – Oral Evidence

Trades Union Congress (TUC) – Oral Evidence

[Trades Union Congress \(TUC\) and Confederation of British Industry \(CBI\) Oral Evidence Questions 1 – 28](#)

Submission to be found under Confederation of British Industry (CBI)

Unite the Union - Written evidence

This response is submitted by Unite the Union. Unite is the UK's largest trade union with 1.5 million members across the private and public sectors. The union's members work in a range of industries including financial services, manufacturing, print, media, construction, transport, local government, education, health and not for profit sectors.

Unite is the largest trade union in the finance sector representing some 130,000 workers in all grades and all occupations, not only in the major English and Scottish banks, but also in investment banks, the Bank of England, insurance companies, building societies, finance houses and business services companies.

Unite welcomes the opportunity to provide written evidence to the Committee.

Unite supports the introduction of a financial transaction tax and the reasons are four-fold.

1. Firstly, the banks can afford it. It is looking like the finance industry is back to 'business as usual' with large profits being made by the banking sector which can more than compensate for the introduction of a transaction tax. To put things in context, prior to the crisis in 2007 the top 5 UK banks made profits amounting to £40 billion.¹⁶⁶ In 2010 the top 5 UK banks saw pre-tax profits of around £25 billion, a not inconsiderable sum. However, a National Audit Office (NAO) report shows the financial costs of the bailout to taxpayers was around £955 billion at its peak and in December 2010 was around £512 billion.¹⁶⁷
2. Proposals agreed by the banks on Project Merlin to curb bankers' bonuses, as well as the implementation of EU legislation which led to the deferment of bonus payments, appears to have had little direct effect on the level of remuneration paid to top bankers. Bonus payments in 2011 amounted to around £7 billion. There is an apparent disregard being paid by top level bankers to the outrage felt by taxpayers and the general public following the payment of such high bonuses given that the rest of the economy is facing a tight financial squeeze caused by the banks. We are not 'all in this together'.
3. Secondly, the cost of such a tax could be minimal; perhaps as low as 5p in every £1,000 traded and may only apply to trading between financial institutions. Therefore, for relatively little cost (the income is generated by volume) to companies who trade in stocks and derivatives, the finance sector can give something back to society towards repayment for the crisis it created in the global economy and the billions of pounds it has received to stabilise it.
4. Thirdly, Unite believes that the introduction of a financial transaction tax would limit quick gain speculative trading in financial transactions which are used by financial institutions to increase profits. This type of 'casino' banking, which Lord Adair Turner, Chairman of the FSA described as 'socially useless', has been identified as

¹⁶⁶ Information from relevant company financial reports

¹⁶⁷ http://www.nao.org.uk/publications/1011/support_for_banks.aspx

one of the main causes of the crisis. This type of trading also has little consumer benefit.

5. Some traders literally gamble on whether a commodity price will rise or fall, and will make or lose money on the outcome. While a transaction tax on individual dealings is likely to curb such speculative practices by some traders which will impact on the volume traded, transactions such as these are wide-spread, therefore a considerable amount of income is still likely to be generated. This, together with the Independent Commission on Banking (ICB) proposals for ring-fencing of retail and investment banking, should at least cause those individuals with significant influence functions to think twice before taking unfettered risks.
6. Finally, a financial transaction tax will provide much needed funds to repay the public purse. As a result of the financial bailout of the finance sector the Government has had to introduce measures which have led to a dramatic reduction in public sector spending as well as the banks themselves curbing lending to SMEs which has led to an increase in unemployment. This comes together with an increase in the price of fuel, food and utilities, all of which have increased household expenditure and lowered disposable income. Consumers feel they are paying the price for the Government bailout of the banks. A FTT will ensure public services and publicly funded projects are protected and could further aid global development on issues such as climate change and global poverty.

31 October 2011

Dr. Bart Van Vooren - Written evidence

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SUMMARY OF THE SUBMISSION

This submission is based on my legal academic research¹⁶⁸ on the EU and the financial transaction tax, and focuses predominantly on question 15 of the call for evidence: “*Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level?*”

This research draws the following conclusions:

- The *global option* in function of *market stabilization* and the provision of *global public goods* is the politically and legally most feasible avenue towards implementing a financial transaction tax.
- The EU Directive is technically a commendable piece of legislative craftsmanship, which *does much to mitigate some of the main concerns* militating against installing this tax. However, there are still *good reasons to shun a regional implementation* of the tax (geographic relocation, impact on European economy). Nevertheless, the EU Directive could form an important stepping stone to global implementation.
- At global level, setting up the Financial Transaction Tax Convention would require an *unprecedented change to international financial governance*, arguably to the *systemic benefit* of the international economic system. The regime would further introduce *legal commitment and a level playing-field*, thereby thoroughly improving regulation of the international system of financial governance which is currently governed by club-like international networks which generate non-binding instruments which trickle down to national jurisdictions in diverging ways. The financial transaction tax would thus contribute to the *regulatory objective of macro-economic stability*.
- In line with Article 4, 3 of the TFEU and Article 21 of the TEU, the 27 EU Member States must *cooperate loyally to act as one* to globally implement the FTT as a means of ensuring multilateralism based on the rule of law in global financial governance. Further, to be seen to realize an FTT at global level could be a *strong deliverable towards EU citizens*, whom broadly support taxing the financial industry to make good for the consequences of the financial crisis.

I. External Dimension of the EU Directive: Arguments for the Global

Implementation

2.1 Introduction

The goal of the financial transaction tax is to achieve a triple dividend. This section assesses each of the three objectives to be pursued by namely to 1) make the financial sector contribute more equally to society; 2) to stabilize markets; and 3) to raise extra funds for global public goods where funds are currently lacking due to significant public deficits. In the

¹⁶⁸ [BART VAN VOOREN](#), *The EU as a global Robin Hood: Proposal for a Multilateral Convention on a Global Financial Transaction Tax*, CLEER Working Papers 2011/4 (2011). www.cleer.eu

following paragraphs **I argue first, that the legal and political context is such that the tax should only be implemented at global level, and not at EU-27 or Eurozone-17 level.** This is because of the political perception that **geographical relocation** poses grave risks to the major financial centres and the economies of the countries that host them. As a consequence, the market corrective function can therefore only function with an FTT implemented at global level. Second, **the global political context is such that when designing the FTT, emphasis should lie on providing funds for global public goods as well as the market corrective function.** As a consequence, (EU Member) States should **not** view this as an opportunity to **replenish public coffers** of those nations which have bailed out financial institutions.

This section thus concludes that the **global option in function of market stabilization and the provision of global public goods is the only politically and legally feasible avenue towards implementing a global financial transaction tax.** To that end, **at the G-20 in Cannes 2011, or Mexico 2012, the EU has to propose a binding multilateral treaty which would establish the legal framework within which to levy, manage and disperse the proceeds of an international FTT.**

2.2. Public Coffers versus Funding Global Public Goods?

In its December 2009 Conclusions, the European Council '*emphasise[d] the importance of renewing the economic and social contract between financial institutions and the society they serve and of ensuring that the public benefits in good times and is protected from risk.*'¹⁶⁹ As the financial sector has boomed in size and profitability over the past two decades, it is expected to make a fair and substantial contribution to public finances. This argument can be made in general, or specifically in relation to the financial crisis. In general, there is the argumentation of fairness: where huge profits are reaped, there should be a contribution to society. Specifically to the financial crisis: given that the financial sector was seen to bear a major responsibility for the crisis, and having received substantial government support, the sector should now contribute to fiscal consolidation. The impact assessment connected to the proposed EU-FTT Directive elucidates that the EU underwrites these objectives. The tax is meant to serve as (i) a new source of revenue to meet post-crisis budgetary needs, (ii) to recover costs from the 'bailouts' of financial institutions, and (iii) to cover the costs of potential future financial crisis.¹⁷⁰

That being the EU's objectives, they are in rather strong contrast with the objectives for which civil society has advocated the financial transaction tax at global level.¹⁷¹

Often using the currency-specific Tobin Tax as the most popular example, the argument has traditionally been that proceeds should be earmarked for the funding of global public goods. This includes development and support for the MDG's, initiatives focusing specifically on health care, or the environment and combating climate change. Asked about any such

¹⁶⁹European Council Conclusions, 10-11 December 2009, 7.

¹⁷⁰ COMMISSION STAFF WORKING PAPER, *Impact Assessment accompanying the document 'Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC' – VOLUME I*, Brussels, 28.9.2011 COM (2011) 594 final, 25-26

¹⁷¹ Such initiatives include robinhoodtax.org or financialtransactiontax.eu; underwritten by diverse grassroots social movements.

earmarking at a press conference, Commissioner Segeta made clear that there was no such earmarking written into the EU proposal.¹⁷² He pointed to the fact that the EU together with its Member States is the biggest donor in the world. The FTT will contribute to Member State and EU budgets at a ratio to be decided in the multi-annual financial framework, but at any rate will contribute to public coffers. Thus, according to the Commissioner, through alleviating pressures on public coffers, the FTT will contribute to financing for development and climate change.

I submit that especially the argument of replenishing public coffers post-crisis bailouts will not provide sufficient traction towards installing the FTT at global level. Furthermore, the merely indirect contribution to global public goods will not suffice to garner global support. Indeed, and this is a purely political-strategic decision, if the EU wishes to have an FTT installed at global level it must **emphasize the ‘fair contribution’ perspective.** This is so because G20 significant countries such as China, India, Australia and Canada did not engage in bailouts as many European countries and the USA have done. This argument would therefore have less traction. Hence, in mustering political support for a global FTT, and in designing the distribution of FTT proceeds (see further below), it is best to focus on earmarking revenue for the provision of global public goods.

At the turn of the Millennium, countries gathered in the General Assembly agreed to root out extreme poverty and hunger, achieve universal primary education, and achieve six other development goals by 2015 (MDGs). Between 2012 and 2017, the shortfall in finance required to meet international development and environmental commitments is estimated to be in the range of USD 324-336 billion per year during that five-year period.¹⁷³ With those numbers and the 2015 deadline closing in, the financial crisis has severely compromised the potential for governments to sustain their financial commitment to the MDGs. Hence it has been suggested that the proceeds of taxing the financial sector would go towards supporting the MDGs. The dividend is double: the tax could make amends where UN members have previously faltered on delivering on their MDG commitment, with the financial sector thereby also contributing more fairly to society. An expert report from ‘The Leading Group on Innovative financing for development, composed of more than sixty countries, international organisations and prominent NGO’s, view the FTT as the ideal tool to reach this objective.¹⁷⁴ **A global financial transaction tax should thus be underpinned by a ‘global giving back’ argument. In other words, taxing the sector at global level, and dispersing them at global level, would ensure that the burden of payment for global public goods is spread throughout the global economy: A global contribution by all, to global goods enjoyed by all.**

2.3. Market Correction Function & Challenge of Relocation

The EU Directive on an FTT sets up a harmonized system in order to **limit financial transactions which are not desired for their rationale (speculative), large volume (compared to real economy) or high speed (high-speed algorithmic trading).** In setting up such a system, there are **three distinct concerns.** First, a targeted FTT would have to be **meticulously designed** to reduce the risk of geographic relocation to non-tax

¹⁷² Algirdas Semeta Press Conference, 28 September 2011, transcript on file with author.

¹⁷³ LEADING GROUP, *Globalizing Solidarity: The Case for Financial Levies*, www.leadinggroup.org Report of the Committee of Experts to the Taskforce on International Financial Transactions and Development (June 2010). 1.

¹⁷⁴ Idem, 14.

jurisdictions. Second, it is necessary to ensure that the FTT does **not hamper the real economy** by limited access to capital. Third it is necessary to ensure that **tax incidence does not befall individual citizens**, but financial institutions argued to be currently under taxed.

A commonly quoted statistic is that in 2007, the volume of financial transactions stood at a level 73,5 times higher than nominal world GDP, owing largely to the growth in derivatives trading.¹⁷⁵ In particular, trading in derivatives markets expanded significantly stronger than trading in spot markets: in 2008, the volume of derivatives trading was 66 times higher than world GDP, whereas spot trading amounted to only 8 times world GDP. The argument goes that this indicates the skewed relationship between needs of the real economy and the international financial markets. Intervention is then necessary because only a small share of transactions stem from 'useful' hedging activities and the greatest part of transactions is purely speculative.¹⁷⁶ Of speculative trading, high speed algorithmic trading is considered particularly harmful since it is based on the trades of others thereby amplifying fluctuations away from equilibrium based on real economic indicators.¹⁷⁷ The nature of the **EU's FTT is such that it would correct market behaviour through rendering speculative trades more costly**, in particular high frequency intra-day technical trading. The FTT would curb speculation and improve market efficiency, increase transparency, reduce excessive price volatility, and create incentives for longer-term investments with added-value for the real economy by freeing up resources for more productive uses.¹⁷⁸

Counterarguments to the FTT consider that it would limit parties' ability to hedge risk,¹⁷⁹ thereby reducing liquidity and increasing short-term volatility of asset prices. The IMF argues that it is not the best way to finance a resolution mechanism since the volume of transactions is not a good proxy for the benefits it conveys to particular institutions or the costs they are likely to impose on it.¹⁸⁰ For the IMF, an FTT does not focus on core sources of financial instability which give rise to systemic risk. Notably, the fact that the financial sector has become (too) large is no indicator of it being socially unproductive, and a tax focusing on the sum of profits and remuneration might be easier to implement and better achieve the fair contribution of the financial sector to society.¹⁸¹ The IMF also indicates that economists disagree as to whether market price volatility is reduced by an FTT and it states that *'it is now generally recognized that this is not always true either in theory (...) or practice (...).'*¹⁸² The question of seeking to limit transactions that are not considered useful points to a broader, and highly contentious issue of the FTT, that of relocation. This means that either the transactions would disappear altogether, or they would be avoided through engineering or geographic relocation. **Now more than ever, financial markets operate at global level. Implementing the financial transaction tax in a regionally or nationally fragmented way exponentially increases the risk of financial engineering to avoid the tax; with financial institutions fleeing the area where it has been implemented.** Furthermore, there would be the incentive to avoid taxes through

¹⁷⁵ S.Schulmeister, Short-term Asset Trading, long-term Price Swings and the Stabilizing Potential of a Transactions Tax, WIFO - Austrian Institute of Economic Research (October 2010), 19.

¹⁷⁶ *Ibid.*, 20.

¹⁷⁷ *Ibid.*

¹⁷⁸ D. Baker, 'The Benefits of a Financial Transactions Tax', *Centre for Economic and Policy Research* (December 2008), 3.

¹⁷⁹ K. Alexander, 'International Financial Regulatory Reform and Financial Taxes', *13Journal of International Economic Law* (2010), 900. (Himself a proponent of the FTT, but quoting a number of counter-arguments).

¹⁸⁰ *Ibid.*, 19.

¹⁸¹ *Ibid.*, 19 and 22.

¹⁸² *Ibid.*, 20. For a brief explanation of a number of pro – and contra – studies see: D.Baker, 'Responses to Criticisms of Taxes on Financial Speculation', *Centre for Economic and Policy Research* (January 2010).

integration (conducting transactions within businesses rather than between them), resulting into larger financial institutions. One oft-quoted example is Sweden, having unsuccessfully adopted such a tax from the mid-1980s. The tax was progressively widened in scope and heightened in rate, and by 1990 more than 50% of its securities trading activity moved to London and other financial centres.¹⁸³ Because of this real risk of geographical relocation, Sweden is urging other G-20 countries not to adopt the FTT, but rather to opt for a balance sheet tax.¹⁸⁴ Whether or not the Swedish example is due to design flaws in the tax, in political minds there is an undeniable apprehension towards any risk of geographical relocation with commensurate effects on financial centres and national economies. **It matters little whether the risk of geographic relocation is real or not, since the mere perception suffices to stop the FTT from ever becoming reality. This is the reason why in a previous paper I have argued for a global implementation of the FTT, excluding regional implementation as an option.** However, the EU proposal is **technically laudable for its drafting to mitigate these concerns, and for that reason merits thorough consideration for actual implementation.** To exclude tax avoidance through geographic relocation or financial engineering, while having the desired market corrective effect, the EU proposal includes two important mitigating design features:¹⁸⁵

- First, the tax is **broadly defined** in scope as regards products, transactions, types of trade and financial actors, as well as transactions carried out inside a financial group. For example, the definition of *financial institutions* includes investment firms, organised markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, holding companies, financial leasing companies, special purpose entities, and foresees in delegated powers to the Commission so that it may set targets for 'significant' activities of other entities whereby it would also be classed as a financial institution. As regards *financial transactions* the proposal includes spot transactions (shares, bonds, currencies) and derivatives transactions (forwards, futures, options, swaps, currency derivatives, commodity derivatives...),¹⁸⁶ and this both on organized markets and 'over-the-counter' (OTC) transactions between financial institutions. This aspect illustrates the need for an EU-wide harmonized approach, and Member States are only given discretion to impose a higher tax rate than required by the Directive, if they so desire. This has important implications at global level. It is indeed questionable whether the 'nature of governance' in the global financial system as it stands can accommodate the level of legal cooperation needed to install this tax?
- Second, the tax is levied on the basis of the residence principle. This implies taxation in a Member State of establishment of financial actors, independent from the location of the transaction. This aspect is meant to increase geographic distribution across its territorial field of application, i.e. to avoid that the burden of the tax is concentrated solely in the financial centres. However, it does illustrate that the tax can only truly be effective if participation is as inclusive as possible. Indeed, if the FTT would be implemented only in the Eurozone, might we not see simply see massive relocation from Euro countries to

¹⁸³ European Parliament, Special Committee on the Financial, Economic and Social Crisis, 'Crisis Management, Burden Sharing and Solidarity Mechanisms in the EU: A Follow-up Study to Financial Supervision and Crisis Management in the EU', (June 2010), 42.

¹⁸⁴ However, the Leading Group report argues that this is a poor example due to design problems in the Swedish tax. See note 37, 17.

¹⁸⁵ The proposal contains an excellent and brief summary of the impact assessment: EUROPEAN COMMISSION, *Proposal for a Council Directive, o.c.*, 4 -5.

¹⁸⁶ Impact assessment, volume I, 39.

The City, UK? Furthermore, if the FTT would be implemented at EU level, how does this impact EU financial markets? The simulations of the EU's impact assessment implementing the tax in the EU-27 considers "a relocation of securities markets by 10%, a relocation of spot currencies by 40% and a relocation of derivatives instruments of 70% or 90%."¹⁸⁷ Relocation here implies the move of activities outside of the taxing jurisdiction, as well as their disappearance altogether. However, this is partially desirable, and indeed the objective of the EU FTT: to the extent that algorithmic trading is considered harmful, such trading is currently about 40% of all transactions. It is these which would be rendered economically unviable, and which would be impacted the most.

The regulatory objectives of the EU directive are laudable, the impact assessment has done much thorough research to gauge the impact of the FTT, and the drafters of the EU proposal have done much to mitigate key concerns. However, the unknowns for national financial centres remain too great, and evidence of the risk of relocation does exist. Arguments that relocation would only concern harmful and speculative trading and would therefore actually be beneficial,¹⁸⁸ will undoubtedly not suffice to convince the more sceptical Member States. It matters little whether the risk of geographic relocation is real or not, since the mere perception suffices to stop the FTT from ever becoming reality. In sum, only the global approach will be able to alleviate the (political perception of) risk of relocation with negative effects on countries' current positions in the global financial system. In the words of one practicing lawyer **'EU companies really do not need another initiative limiting their global competitiveness'**. Hence, the **EU-27 Member States should forcefully pursue the financial transaction tax at global level, not at the level of the EU-27 or EU-17.**

2.4. The EU: Proposal for a Global Financial Transaction Tax Convention

In the light of the preceding considerations the EU should emphasize the rationale of contributing to global public goods. First, the argument of an FTT contributing to national public coffers is likely to fall on stony ground with a number of countries which did not engage in bailouts, and negotiating national apportionments could endanger the FTT project as a whole, with little added value over alternative and more feasible options. Second, the option to finance development and the environment through the FTT ('a Robin Hood argument') is likely to gain more support. **Given the global nature of the financial system, the fact that no-one is immune, and the preservation of global public goods being an equal responsibility for all, a financial contribution for their preservation can only be organised at the international level.** A number of important regulatory elements also require a global consensus, including the risk of regulatory arbitrage, the need to constrain the volume of financial transactions at a global level, the need to ensure that the global financial sector exists in function of the needs of the real economy, and the need for an agreement on levying and distributing proceeds of the transaction tax.

For all the aforementioned reasons, the European Union should seek the negotiation and ratification of a new multilateral framework agreement to

¹⁸⁷ Impact assessment, volume I, o.c., 49.

¹⁸⁸See note 10, 18.

establish the FTT: a Multilateral Framework Convention on the Financial Transaction Tax (hereafter: FTT Convention or FTTC).

2. The Legal & Institutional Features of The Multilateral FTT Convention

2.1 The Functions of the FTT Convention

As the Tobin Tax or Robin Hood Tax, this initiative sometimes had a rather utopian feel existing only in the minds of civil society and social movements. The EU proposal in effect discards the utopian perception of the FTT and the explanatory memorandum to the Directive therefore rightly states that “The present proposal demonstrates how an effective FTT can be designed and implemented, generating significant revenue. This should pave the way towards a coordinated approach with the most relevant international partners.”¹⁸⁹ This is however easier said than done. If the EU wishes to establish a global financial transaction tax, **it must forcefully support further legalisation and institutionalisation of the global financial governance system. Indeed, the level of legally binding harmonization required at global level is currently simply non-existent in the international financial system.** Hence, to install the FTT at global level, **a global, mature international institutional framework is required to oversee its various aspects:** A Multilateral Framework Convention on the Financial Transaction Tax. (hereafter: FTT Convention, or FTTC).

More concretely, **the legal and institutional regime of the FTT would at least have to fulfil the following functions:**

- (1) Political decision-making** during the negotiation on the existence and nature of the regime itself.
- (2) Substantive rule-making** and rule adjustment through institutions geared to ensure the dynamic nature of the legal regime.¹⁹⁰
- (3) Administration** and management of information for macro-prudential purposes.
- (4) Dispute settlement** between parties through judicial means.
- (5) Levying** the tax in cooperation with contracting parties.
- (6) Distribution** of proceeds of the tax in line with the objectives for which the tax is earmarked.

To attain these functions three options could be pursued.

First, setting up a limited international legal framework which is not an international organisation proper, but an intergovernmental conference without independent institutions endowed with decision-making powers. A limited secretariat would serve the needs of the IGC, and the framework would at most consist of a legal bringing together the current actors already active in the sphere of global economic governance. While politically possibly the most feasible avenue, this model could legally *not* properly accommodate a financial transaction tax.

Second, **setting up a standalone new international organisation with specific FTT purposes**, with legal personality and mature institutions to implement, oversee and manage

¹⁸⁹ EUROPEAN COMMISSION, *Proposal for a Council Directive*, o.c., 3.

¹⁹⁰ Dispute settlement and rule-making evidently overlap, but in this context rule-making is delimited to decisions by ‘legislative’ institutions of the FTT regime.

its complex legal and political system. This regime would co-exist with the current international financial institutions and draw on their expertise for substantiating, implementing and overseeing the FTT. While feasible to implement the FTT, it would have the problem of competition and resource duplication, notably with the IMF. This may be a politically viable option to negotiate since the standalone regime would be disconnected from issues such as IMF governance or linkage with the WTO and the Doha Round. However, instituting the FTT would provide an ideal moment for deeper overhaul of the global economic governance system as a whole, though the FTT might get lost in translation in such an ambitious project.

The third and final option is **integrating the new legal regime into the International Monetary Fund**. Negotiations on a framework convention for taxation of global financial transactions would likely trigger a more thorough overhaul of the Bretton Woods system. It would provide an opportunity to transform the functions of the IMF into a Global Economic Governance Organization (GEGO). The regime would take on the form of the WTO with institutions at its centre, managing a number of agreements: the FTT alongside the Articles of Agreement. Synergy with the WTO dispute settlement could be foreseen, though could also merely serve as inspiration.

In the next subsections I shall consider more in-depth which of these three options is most feasible in legal and political terms; in light of the six functions they are expected to fulfil, and in light of the design features in the proposed EU FTT Directive.

2.2 Function One –Political Decision-making on the FTT

Initial Chalk Lines for the FTT: Substantive choices

On the basis of the previous G-20 meetings, we can already draw some initial conclusions on the reception of such a proposal at global level. The June 2010 Toronto G-20 Summit Declaration mentioned rather cursorily financial taxation (without actually calling it that), in relation to the resolution of 'too-big-to-fail' financial institutions.¹⁹¹ In Toronto it stated its support for an FTT under the heading 'Financial Sector Responsibility', as follows:

21. We agreed the financial sector should make a fair and substantial contribution towards paying for any burdens associated with government interventions, where they occur, to repair the financial system or fund resolution.

22. To that end, we recognized that there is a range of policy approaches. Some countries are pursuing a financial levy. Other countries are pursuing different approaches. We agreed the range of approaches would follow these principles:

- Protect taxpayers;*
- Reduce risks from the financial system;*
- Protect the flow of credit in good times and bad times;*
- Take into account individual countries' circumstances and options; and,*
- Help promote a level playing field.*

*23. We thanked the IMF for its work in this area.*¹⁹²

On this basis we can already formulate four key points on the direction the G-20 ought to take with the FTT.

¹⁹¹ See note 48, 5.

¹⁹²*Ibid*, 18.

First, the language is deliberately vague on the national, regional or global level at which to pursue a financial levy. The reference to government interventions '*where they occur*' came at the request of countries such as India, Canada, Japan and China which did not bail-out their financial sectors. They therefore do not feel as compelled as Western nations to have the financial sector compensate them for their interventions. Furthermore, the distinction between some countries pursuing the financial levy and other countries having different approaches makes clear that while a global FTT is not excluded, enthusiasm is certainly highly limited. This passage points to a deeper schism between Western and Asian nations, namely the different approaches to banking regulation and supervision. Prior to the 2008 crisis, Western nations' approaches were broadly deregulatory, whereas in Asian countries such as Japan and China the opposite was true. Since Asian countries have been less averse to regulating their financial sectors,¹⁹³ they view this as one of the key reasons for not having had to bail out their financial institutions. Therefore, if the EU wishes to realize the FTT, it must emphasize the systemic market corrective function of international financial taxation, and push an FTT complementary with emerging powers' vision on regulating finance. In this sense, the EU is to actively engage the changed power structure of global economic governance as part of the process of installing the FTT.

Second, in the above quote there is no reference to a connection between a financial levy and dispensing the revenue towards the MDGs or other public goods. The objective of market correction is clearly present in the form of risk reduction and protection of the flow of credit. The only statement on the distribution of the revenue is the 'protection of taxpayers', language which is deliberately open-ended on connecting taxation to refunding taxpayers for the bail-outs in a number of advanced economies. Not all is lost for the FTT in function of global public goods, given the November 2010 Seoul Consensus on Shared Growth. The Union can make a good case for the FTT to contribute to the Consensus as a means of innovative financing for development. The Consensus document draws its title from the fact that because of global interconnectedness, the crisis has disproportionately affected the most vulnerable in the poorest countries. The document also argues that '*as the premier forum for our international economic cooperation, because the G-20 has a role to play complementing efforts of aid donors, growth must be shared*'.¹⁹⁴ That argument is in line with the reasoning behind the FTT: taxing a sector which is currently perceived not to hold up its end of the social contract, taxing its activities at global level and dispersing the proceeds at global level. In this fashion, benefits as well as the burden is shared throughout the global economic system. Thus, the EU must explicitly connect the FTT to the objectives of the Seoul Consensus.

Third, the reference to 'promoting a level playing field' is an intriguing one open to many interpretations. From a legal perspective, it could be the most important innovation to global financial governance. At present international trade law is based on non-discrimination in the form of MFN and national treatment, but hardly so in international financial law. Hence, implementation of the FTT could imply a highly desirable sea-change to this area of international economic law, by introducing the same principle in the international financial system.¹⁹⁵ The Union would do well to further the FTT for that reason, as it would be in line with its obligation in Article 21 TEU, namely, to support international multilateralism based on the rule of law.

¹⁹³Special Section on International Banking, *The Economist*, 15 May 2011.

¹⁹⁴Seoul Development Consensus for shared growth, Annex I to the Seoul G-20 Summit Declaration.

¹⁹⁵ T.Cottier and M. Krajewski, 'What Role for Non-Discrimination and Prudential Standards in International Financial Law?', 13 *Journal of International Economic Law*(2010), 817-835.

Fourth and finally, the G-20 would have to make a principled decision on the appropriate institutional setting for the FTT. Would this be a legal framework connected to the IMF, or would it stand as an independent international organisation? Answering this question would imply that the G-20 make a principled political decision on the role of the FTT in reforming or not reforming the Bretton Woods system. At the very least, for the FTT to function, the G-20 would have to recruit the necessary technical support from the IMF, Financial Stability Board (FSB) and other institutions. Aside from supporting the FTT negotiations, the IFI's position during the lifetime of the FTT regime could include formal incorporation of these bodies. Aside from the IMF, the regime would also require links with the FSB. It is hosted by the Bank for International Settlements and is composed of national supervisory financial bodies, financial ministries and central banks, and thus has been described as 'a network of networks'.¹⁹⁶ At present, the IMF, the FSB as well as the Bank for International Settlements already collaborate in support of the political organ that is the G-20.¹⁹⁷ In sum, during an initial phase, the IMF, FSB and other entities would provide the necessary private and public policy input to the negotiation process on the FTTC. However, formal institutionalisation will become necessary in order to levy the FTT, as will be shown further.

Those being the key elements emerging from the Toronto Declaration, it is then notable that the Seoul G-20 Summit of November 2010 did no longer include taxation of the financial sector in its final declaration.¹⁹⁸ This might change during the remainder of 2011, now that the G-20 is headed by France. The objective for France and the EU at the G-20 meeting in Cannes should be to agree to convene an intergovernmental conference to negotiate a multilateral binding agreement setting out the framework for a global financial transaction tax.

Institutional setting for the FTT: Need for Reform of the G20

The first function is political decision-making which is required both during the negotiation on the existence and nature of the regime itself, as well as during its lifetime; a role for which the G-20 is best suited. This body would have a dual role with regard to the FTT. First, political impetus to commence negotiations on the FTT Convention (FTTC) will have to come from this body, since at present it possesses the most political legitimacy in international economic governance.¹⁹⁹ In the words of the Toronto summit declaration, it is 'the premier forum for our international economic cooperation.'²⁰⁰ The G-20 would provide the political impetus and draw the initial chalk lines for the several rounds of undoubtedly challenging negotiations to follow. Second, it would need to establish for itself a firm leading political role during the lifetime of the FTT regime. As we shall see in considering the substance of the FTTC (Function five: levying), it will require regular legal and political follow-up with appropriate adjustments as markets adapt and evolve. While the G-20 might thus initially suffice to generate political momentum, over time this body would have to

¹⁹⁶ S. Sterckx, J. Wouters and T. Corthaut, 'The International Financial Crisis, Global Financial Governance and the European Union', 52 *Leuven Centre for Global Governance Studies Working Paper*(2010), 12.; T. Porter, 'Why International Institutions matter in the Global Credit Crisis', 1 *Global Governance*(2009), 5.

¹⁹⁷ For example: International Monetary Fund, Financial Stability Board, Bank for International Settlements *Macroprudential policy tools and frameworks - Update to G-20 Finance Ministers and Central Bank Governors*, (14 February 2011).

¹⁹⁸G-20, TheG-20 Seoul Summit Leaders' Declaration, 11-12 November 2010.

¹⁹⁹ I deliberately use 'most' to indicate that while there are certainly many debates on the inclusiveness of the G-20 (developing nations notably), at present the body is nevertheless the premier political forum for global economic governance.

²⁰⁰G-20 Toronto Summit Declaration, 26-27 June 2010, 1.

develop a more formal, institutionalized stature in the system of global economic governance, as outlined further.

At this juncture the G-20 is a flexible, open-ended, high level policy-deliberation mechanism that gained political clout due to the 2008 global financial crisis. Legally, the G-20 is not an international organisation, but an informal body without a formal constituting document, without formal requirements for memberships, and with no formalized voting mechanism.²⁰¹ It has no legal personality, and no powers have been formally conferred upon it. It possesses a two-level structure, with (bi-) annual meetings at head of state level, and meetings (as before) by the finance ministers and central bank governors. Substantively, the G-20 can discuss any matter it chooses, because there is no formal link with an international organisation with limited conferred competences. The deliverables from summit meetings take on the form of G-20 leaders' statements or summit declarations, and it does not produce legally binding instruments. The implementation of its policy agenda depends on formally instituted international organisations (IMF, WTO, OECD),²⁰² national governments, or other bodies such as the FSB or the Basel Committee. Hence, the G-20 is characterized by its informal nature, which would require formalisation in support of the FTT.

Given its crucial role during the initiation and mature phases of the FTT legal framework, the present form of the G-20 is not suited to decide on something as fundamental as a harmonized global tax to ensure funding for global public goods. First, it does not possess the legitimacy to decide central issues which also concern the 172 non-member countries. This is because it lacks formal rules for membership based on objective indicators, and as a consequence it requires more formal stature. Second, its informal nature implies that it drew its post-2008 political clout from the atmosphere of crisis, with questionable longevity in the long run. Hence, while from a pragmatic perspective the G-20 would initiate the FTT process, subsequent negotiations would have to be as inclusive as possible and reform the G-20 in the process. Because the FTT would essentially imply deep reform to global economic governance, countries excluded from the G-20 could only support this body's central role if the rules for membership of the G-20 are clearer and formalised. Hence, in support of the FTT one could ascribe to the suggestion to reform the G-20 into a Global Economic Council (GEC).²⁰³ The GEC would transform the G-20 into a more formalized decision-making body within the institutional framework of the existing Bretton Woods institutions,²⁰⁴ and would have formal rules of membership. These rules would bring long-term durability to the main body overseeing global economic governance, through a regime that is appropriately reflective of the relative and evolving importance of nations and regions. In relation to the IMF, this transformed G-20 would be institutionally positioned above the IMF's Board of Governors, which is politically the equivalent of the earlier and first format in which the G-20 met, the Ministers of Finance.²⁰⁵ In this model, the G-20 would take on a role and position similar to that of the European Council in the European Union, a role of political steering, grand decision-making and the general direction in global economic governance. Only in this fashion is it possible to attain the geographic inclusiveness that will allow the global implementation of a financial transaction tax.

²⁰¹N. Woods, 'The G-20 Leaders and Global Governance', *GEG Working Paper 2010/59* (October 2010).

²⁰²*Ibid.*

²⁰³J. Vestergaard., 'The G-20 and Beyond: Towards Effective Global Economic Governance', 4 *Danish Institute for International Studies DIIS Report*(2011).

²⁰⁴*Ibid.*, 9.

²⁰⁵*Ibid.*, 44. Vestergaard suggests that it would function as the Board of Governors, whereas I suggest it should be hierarchically placed above it.

As I shall point out further (Function two: rule-making), a number of new institutions will be necessary to implement a global financial transaction tax, notably institutions which have the ability to respond dynamically to evolution, innovation and engineering in the financial sector. A fixed, legitimate, high-level decision-making body mustering the political weight the G-20 currently enjoys is integral to that objective.

2.3. Function Two – Rule-making and Rule Adjustment

The FTT regime would not only require top level political decision-making, but would also require institutions with the power to adopt dynamic revisions of the content of the framework agreement as needed. It would be particularly important to have a ‘legislative’ mechanism that deals with financial innovation which might be created in the future across different jurisdictions.²⁰⁶ In the European Union, the special legislative procedure is applicable to adopting the Council Directive, e.g. requiring unanimity in the Council and consultation of the European Parliament. The proposed Directive then foresees that the Commission shall submit a report on the application every five years and for the first time by end 2016.²⁰⁷ There are thus (i) legal-institutional aspects and (ii) legal-principled aspects to be considered: On the institutional side, a similar substantive legislative follow-up would be required, through dynamic decision-making authorities to avoid that the regime quickly becomes obsolete through financial innovation and engineering. The institutions of the FTT Convention below G-20-level would thus include a ministerial level to make decisions on a yearly basis, as well as a permanent cooperation body for day-to-day management. In legal terms, the EU Directive foresees delegated powers to the Commission to ensure that specific measures to address avoidance, evasion and abuse are defined. For example, to avoid the FTT new legal vehicles might be created which carry out certain financial activities on a significant basis.²⁰⁸ These should swiftly be considered financial institutions to bring them within the scope of the global FTT, and similar powers are indispensable at global level. Additionally, there should be some kind of formalised cooperation between countries’ relevant supervisory authorities and central banks to commonly agree on which instruments to include in preparation of the high-level decision making body of the FTTC.

On the side of legal principles, we should also consider the legal effects of Directives in the EU legal order: The Member States have an obligation to implement them in their national laws, and failing such, the provisions of the Directive can have vertical direct effect with Member States possibly being held liable for failing to do so. It seems entirely utopian to imagine any such legal effects being created at the global level. Failing such, strong top-down administration supervision would be required to ensure uniform application of the FTT. Given this, the most feasible option is to thoroughly reform the IMF and strengthen its institutions notably by connecting it more formally to the G-20 at the highest level, and the FSB and similar bodies at the civil servant level, thereby creating the necessary decision-making bodies disposing of the required technical expertise.

2.4 Function Three – Administration & Management

²⁰⁶ European Commission, see note 16, 14.

²⁰⁷ Proposal for a Council Directive, (Article 16 Review clause), p 22.

²⁰⁸ Commission proposal, 7.

As regards management, the previous section already pointed to the need for in-depth follow-up to the functioning of the global FTT regime in legislative terms. In managerial terms, the FTT requires a strong secretariat to provide secretarial and administrative services, at EU level provided mainly by the Commission. At global level, this would include, first, liaison between its political decision-making structures, other international actors, national authorities responsible for levying the tax, and organisations dispersing proceeds of the tax. Second, in line with the market corrective function of the FTT, it would also have an important function as regards information gathering, record keeping, data analysis and information dispersal.²⁰⁹ The EU Directive structures these managements need as follows, and no doubt they would also exist at global level:

- Centralised direct management by the Commission, day-to-day management and long term follow-up
- Centralised indirect management, focusing on record-keeping.
- Shared management with the Member States, notably as regards levying accurately and timely, including verification measures.
- Decentralised management with third countries.
- Joint management with international organisation, to be specified.²¹⁰

As with the previous section, here too the conclusion is that a strengthened and reformed IMF is the best option to provide these functions. Given the market corrective function of the FTT, it is useful to briefly expand on this point from a managerial perspective. Levying a broad based FTT in itself poses significant technical challenges as regards availability of information, but it would also generate large amounts of data. The IMF Research Department underlined that one of the key problems of the 2008 financial crisis was the lack of transparency and the lack of information available to decision-makers. IMF staff thus argues that obtaining better information is an essential step in order to improve systemic risk assessments.²¹¹ In a nutshell they conclude that information should be: more accessible, more timely, go beyond traditional statistical approaches and should draw on new sources.²¹² The FTT could thus contribute to macro-financial stability not merely through its own expected impact on speculative trading, but the novel and comprehensive nature of the information generated by and required to run a global FTT could be used to achieve market corrective function of the tax. The FTT legal framework would therefore have to be equipped with strong institutions to manage this information flow. Given that such expertise is most readily present at the IMF, efficiency mandates that this organisation be reformed to accommodate the FTT regime. In interpreting, generating and using those data, it could then be contemplated to formalize a connection between that reformed IMF and the FSB and the Committee on the Global Financial System hosted at the BIS (Function two). Such connections would be further supportive of strengthening macro-financial analysis and constructing early warning mechanisms to identify risks and underlying vulnerabilities at an early stage.

2.5. Function Four – Levying the Tax

²⁰⁹ The EU proposal here refers to article 49 of the financial regulation 'Keeping of supporting documents by authorising officers'.

²¹⁰ Commission proposal, 25.

²¹¹ G. Dell'Ariccia, et al., 'Lessons and Policy Implications from the Global Financial Crisis', *WP/10/44 IMF Working Paper* (2010), 26.

²¹² See note 7.

Implementation and levying of the FTT in accordance with internationally agreed rules would occur at regional and/or national level. Much like the choice for a Directive at EU level, the multilateral convention should provide the framework with minimum choices and definitions at global level. “As stated in the impact assessment for the EU proposal: there are strong economic (and technical) reasons for a high degree of harmonization and coordination in order to avoid substitution and loopholes.”²¹³

In popular discourse, the financial transaction tax is commonly stated to ‘simply imply a low rate’ that would hardly be felt by the financial system. In reality the technical complexities related to setting the tax rate and levying the tax on very different kinds of financial transactions is much greater than this popular statement implies. In order to work effectively, the product coverage and the tax rates should be equal across different members to the FTT regime. This to avoid financial institutions relocating to markets with lower tax rates, different definitions of financial transactions, or smaller product coverage.²¹⁴ As a consequence, for an FTT to work effectively it is necessary that a global consensus is attained on the *tax rate* (how high), on the *scope of the tax* (which instruments to include, e.g. derivatives or not?), the *tax base* (tax notional value or alternatives?) as well as the *taxable event* (what is a financial transaction?).

As regards the *scope of the tax*, either the legal framework should aim at a scope as wide as possible, or conversely, as narrow as possible, such as only taxing currency transactions (Tobin Tax). This is so, because the risk of diversion to other products or to other legal entities would be too great. Because taxing spot transactions on EU currencies would likely be a violation of EU free movement of capital rules, and because taxing transactions with non-EU currencies only would be seen as protectionism, the former have been excluded, and the EU has opted for the widest possible definition of financial transactions. The EU currently defines financial instruments in the ‘Markets in Financial Instruments Directive’, and the EU FTT uses this as its starting point.²¹⁵ In line with the wide scope, the EU proposal includes spot transactions (shares, bonds, currencies) and derivatives transactions (forwards, futures, options, swaps, currency derivatives, commodity derivatives...),²¹⁶ and this both on organized markets and ‘over-the-counter’ (OTC) transactions between financial institutions. The EU has also chosen ‘the more expansive’ route when it comes to *defining financial institutions* covered by the tax: included are banks, investment firms, insurance companies, hedge funds, etc. and the EU Directive provides for delegated powers for the Commission to lay down rules for intra-group trade. This so that financial groups would not simply integrate to avoid the tax. As regards the *tax rate* it is not simply ‘wet finger work’ of deciding that 0.01% seems an politically acceptable or appropriately low tax rate, but rather the number would have to depend on considerations related to (i) how much the relevant market will decline given the tax rate charged, (ii) the limitations the chosen rate imposes on liquidity, (iii) the amount of avoidance and circumvention as it relates to the height of the tax, and (iv) the wish to have a tax that is neutral across different asset classes or taxes assets differently.²¹⁷ In the Commission’s proposal, shares and bonds are taxed at 0.1% and derivatives at 0.01%, the latter because the proposal opts to tax the notional value of

²¹³ Impact assessment, volume I, 44.

²¹⁴ European Commission, *supra*, 18.

²¹⁵ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1)

²¹⁶ Impact assessment, volume I, 39.

²¹⁷ D. Baker, *supra*, 2.

derivatives due to administrative simplicity. Finally, to ensure that individual citizens, SME's and national banks are spared, the proposed Directive has appropriate exceptions.

The nature of the European Union as a 'regulatory environment' is such that – in spite of the difficulties associated with unanimity in the Council – such an ambitious regulatory is not impossible. At global level the challenges multiply due to the nature of global financial governance: the FTT requires a level of harmonisation currently unseen to the global financial system. This regime is currently composed of informal and formal networks, and a variety of hard but often soft legal binding documents. Consequently, the FTT would require a legal and institutional revolution to the international financial system, which explains the hesitant stance of earlier reports drawn up at technocrat level: The staffs of the Commission and the IMF have shown an understandable scepticism given that it is highly implausible that such a far-reaching regime will ever see the light of day.

2.6. Function Five – Dispute Resolution

Given that it is indispensable to avoid distortion of competition and geographical relocation (e.g. 'a level playing field' – see above), the regime requires a robust system to settle disputes over differences in interpretation and implementation. A binding dispute settlement mechanism as instituted in the WTO in 1994 would be necessary to ensure smooth application of the FTT, and to ensure parties' continued commitment to the principles laid down in the FTTC. Proposing a dispute settlement mechanism under international financial law is not entirely new. In November 2009 the former IMF Chief Economist proposed the establishment of a dispute settlement mechanism for exchange rate controversies, such as that between the US and China.²¹⁸ It is, however, highly unlikely that China would agree to such binding dispute settlement. Nonetheless, Johnson argued back in 2009 that consensus was shifting to the idea that the WTO would have more legitimacy over exchange rates too: first, because smaller and poorer countries can bring and win cases against heavyweights such as the USA and the EU; and second, because the WTO also has proven tools for violations of acceptable trade practices with specific sanctions. Both arguments could be transposed to the FTT context. The financial transaction tax would require such a regime to ensure the level playing field to which the G-20 committed. As part of reforms to that end, one could even envisage a global economic governance organisation as an umbrella over the IMF and the WTO, with broader institutionalised dispute settlement, connecting FTT proceeds to the Doha compromise, and with the G-20 as the global economic council to provide political direction of the overall economic system. If not feasible, the reformed IMF or the autonomous FTT organisation could independently organise a WTO-inspired dispute settlement system specifically related to its taxation purposes.

2.7. Function Six – Distribution of FTT Proceeds

If the tax is introduced at global level, all countries supposedly carry its burden and should benefit from it. However, financial transactions are concentrated in financial centres such as London, Frankfurt, New York, Singapore or Hong Kong. Hence, both the burdens and benefits of the tax (risk of relocation, revenue, etc.) would be borne by a small number of

²¹⁸ S. Johnson, 'Obama in China: Breaking the Exchange-Rate Deadlock', *The New York Times*, 5 November 2009.

countries. Although levying would occur in the relevant national jurisdictions, the global approach needs to incorporate a mechanism to share the risks and benefits of the system. First of all, one part of the levied tax would have to go to the countries hosting the exchanges or where the OTC trade occurs. The other part would be used towards contributing to global public goods. As regards national apportionment, this would be limited to a form of compensation for public costs related to hosting these financial activities, and not part of a greater scheme of national apportionment. National apportionment as the chosen method to disperse the proceeds of the tax to fund global public goods would have two significant drawbacks: first, it would be difficult to negotiate respective national shares. Second, the funds would likely disappear in national general budgets with no direct linkage to the financing of global public goods. It is therefore preferable to directly earmark FTT income for the financing of the MDGs and the provision of global public goods such as the environment, health, etc.

The problem with earmarking is one that is commonly discussed in literature on taxation, and in fact a number of EU countries explicitly prohibit the earmarking of tax revenues to specific objectives.²¹⁹ Two key points explain this attitude to earmarking: first, this practice causes budgetary inflexibility, by restricting decision-makers in redirecting public income, as is necessary now or in the future.²²⁰ Furthermore, earmarked revenues lead to rigidity by mismatching tax revenue to costs of the earmarked project or objective, since the income earmarked does not necessarily reflect the true costs of achieving the set policy objective (either by providing too little or too much funding). Arguably, the risk of inefficient allocation of funds and pre-committing future income applies also at international level.²²¹ However, earmarking of FTT revenues could mobilise funds directly for global public goods where otherwise they might suffer from lack of funding. The FTT Convention would thus have to balance such concerns with a principled commitment to a number of global public goods, and then possess sufficiently flexible structures (institutions and decision-making) to continuously evaluate the rationale for earmarking proceeds to specific global public goods (MDGs, climate change, and so on).

The institutions of the FTT Convention would then have the responsibility to accord the proceeds according to the distributive formula laid down in secondary law of the FTTC. Indicatively, revenue could be committed to either or all of the following international sources:

- Funds could be allocated as *resources to the IMF* which would utilize them to support further its lending activities with specific earmarked objectives. The IMF already has special arrangements such as the Poverty Reduction Facilities, the Heavily Indebted poor Countries Initiative, and the Poverty Reduction and Growth Facility. In this field cooperation with the World Bank is already tight-knit, which would continue. However, this option is likely to be the least preferable, since the role of the IMF in development is certainly not viewed as positive by all, certainly by some developing nations.
- The proceeds could serve to fund so-called *debt swaps*, whereby heavily indebted poor countries are relieved of a certain amount of their debt burden, and in return receive grants for specific purposes such as health, environment, and so on.

²¹⁹Belgium, for example.

²²⁰European Commission, see note 68, 13.

²²¹*Ibid*, 14.

- To other *multilateral/regional development banks*, the international development agency or the African Development Fund. Such an earmark would be in line with the G-20 Pittsburgh communiqué which committed itself to ensuring that the development banks would have sufficient capital to fulfil their core challenges.
- *Contribution to funds of UN Specialized Agencies*, specifically to UNICEF, UNEP, UNDP, UNAIDS, UNHCR, WFP etc., depending on the decision on which public goods should be supported by the FTT proceeds.
- Innovative financing through special regimes such as the *International Finance Facility for Immunisation (IFFI)* could provide a useful example. This functions through donors providing long-term pledges which are converted by the IFFI by selling bonds on the capital markets, and through that fashion has access to capital more readily available to support its health care objectives. The proceeds of the financial transaction tax could take the place of, or figure alongside such long term pledges, and the capital raised in this fashion could be disbursed to donors in accordance with their own mechanism.

These are but a few suggestions, the choice of which partially depends on the legal structure chosen to implement the FTT. Particularly the relationship to the World Bank and the IMF will be crucial. In the case of the IFFI, for example, the World Bank acts as adviser and treasurer for the charity, which itself is incorporated as a charity in the United Kingdom. Conversely, an IMF-run FTT Convention would require either distribution of funds within its mandate (lending, debt relief) or a revision of its functions and relationship to for example UN specialised agencies and the provision of grants to other donors. In substance, the debate in the context of the FTT would have to draw on such initiatives as the Monterrey Consensus on Financing for Development (2002 and its follow up conference in Doha in 2008) as well as the work of the Leading Group on Innovative Financing for Development.

3. The FTT and the Union as a Global Actor

In this paper I have argued that the global implementation of a financial transaction tax is the only viable option for political, legal and economic reasons. Such a tax would have as its purpose to finance global public goods, and thus ensure a fair contribution of the global financial sector to global public goods. Additionally, such a tax would have a significant regulatory impact towards a more stable financial system and therefore require a sea-change to international financial institutions. Beyond these international arguments there are also strong EU-focused imperatives as to why the Union should pursue the *global* FTT with commensurate beneficial effects on the legalisation and institutionalisation of global economic governance. Namely, the Union would reap a double dividend from lobbying for – and possibly realizing the global implementation of the FTT. First, success in this regard would be supportive of the Union’s self-imposed promise and image of the value-based international actor;²²² and second, it would do much to provide post-Lisbon legitimacy towards its own citizens through effectiveness as an international actor. The 2001 Laeken Declaration on the future of the European Union strongly asserted both points in its characteristically grand language:²²³ ‘Does Europe not, now that is finally unified, have a leading

²²² U. Khaliq, *Ethical Dimensions of the Foreign Policy of the European Union - A Legal Appraisal* (Cambridge, Cambridge University Press, 2008); R. Petrov and P. Leino, ‘Between ‘Common Values’ and Competing Universals - The Promotion of the EU’s Common Values through the European Neighbourhood Policy’, 15 *European Law Journal* (2009).

²²³ European Council, Laeken Declaration on the Future of the European Union, 14-15 December, 2001, subheading ‘Expectations of Europe’s citizens’.

role to play in a new world order, that of a power able both to play a stabilising role worldwide and to point the way ahead for many countries and peoples?' Further in the Declaration, the European Council argued that leading role is one of the key expectations of Europe's citizens: 'The image of a democratic and globally engaged Europe admirably matches citizens' wishes. (...) they also want to see Europe more involved in foreign affairs, security and defence, in other words, greater and better coordinated action to deal with trouble spots in and around Europe and in the rest of the world.' This role for the Union whereby it 'stabilizes' the world, and 'points the way ahead' is not merely a moral imperative, but a legally binding obligation embedded in primary law. Article 3(5) TEU states that in its relations with the wider world, 'the Union shall (...) contribute to peace, (...) the sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty (...) as well as to the strict observance and the development of international law, including respect for the principles of the United Nations Charter.' Thus, the Union is morally and legally obliged to pursue equality amongst wealthy and poorer nations, to support their development and ensure 'fairness' between them. In doing so, the TEU not only imposes substantive requirements on EU international relations, but also a strong methodological imperative: according to Article 3 TEU and confirmed in Article 21(1) TEU, the EU 'shall be guided by the principles which have inspired its own creation and which it seeks to advance in the wider world: (...) respect for the principles of the United Nations Charter and international law.' In other words, the Union must pursue a global order reflecting its own values of fairness and justice, entrenched in multilateral solutions based on the rule of law. The global implementation of a financial transaction tax through a multilateral, binding international convention requiring unprecedented positive change to international financial governance arguably checks all those boxes. This is also why Barnier, Barroso, Sarkozy, Merkel and others have argued that the Union 'should lead by example.'²²⁴ However, given the market corrective function, the risk of regulatory arbitrage and the connection to global public goods, we have argued that the global solution is the only viable one.

If the argument stemming from EU primary law is perhaps slightly abstract and legalistic, the connection to expectations of European citizens should be less so. Indeed, the financial transaction tax is a concrete iteration of where the Laeken Declaration in the abstract spoke of EU citizens' wishes. This is underlined by the Commission's public consultation on the FTT which ended in April 2011. That consultation clearly showed that civil society across the European Union broadly supports the financial transaction tax.²²⁵ From the Commission's summary report,²²⁶ it is clear that NGOs and trade unions are strongly in favour of a broad-based financial transactions tax and that individual citizens also 'generally favour' such a broad-based levy. Conversely, and unsurprisingly, financial organisations and businesses, consultancies and their relevant representative organisations generally oppose any and all types of additional tax burden on the financial sector or financial markets in general.²²⁷ Thus, given the broad popular support amongst European citizens it is submitted that successfully working towards the FTT at global level would bring the Union *legitimacy through effectiveness*. Individual Member States will be unable to exert sufficient influence in

²²⁴See section 2 in this Working Paper.

²²⁵All responses to the consultation as well as a summary by the Commission are available at: <http://ec.europa.eu/taxation_customs/common/consultations/tax/2011_02_financial_sector_taxation_en.htm> (Last accessed 16 August 2011)

²²⁶Commission summary report, May 2011, available at: <http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/financial_sector/summary_results_en.pdf>.

²²⁷Banks and markets oppose financial transaction tax, *EurActiv*, 18 August 2011 <<http://www.euractiv.com/en/euro-finance/banks-markets-oppose-financial-transaction-tax-news-507022>>.

the G-20 to realize a global financial transaction tax, but should the Union manage to speak with its proverbial single voice in a sustained lobbying effort at the highest echelons, success may be within reach with commensurate effects on the EU's standing in the hearts and minds of European citizens.

4. Conclusion

If the European Union wishes to establish a global financial transaction tax, it must forcefully support further legalisation and institutionalisation of the global economic governance system. The proposed directive certainly provides an important stepping stone to such a tax ever seeing the light of day at global level: mitigating global systemic risk posed by the financial system, sharing the benefits and burdens of the tax, and avoiding engineering are all best tackled internationally. Achieving these objectives is furthermore only possible by setting up a new international legal regime with a mature institutional set-up. This institutional set-up is either delivered by a reformed IMF, or by a new international financial organisation working in close cooperation with existing bodies such as the IMF, WB, FSB, BIS, etc. The FTT would require the G-20 to provide initial political impetus to the negotiation of the regime, and during the process would itself have to be transformed into the top political institution of the FTT regime. The framework convention would have mature institutions to ensure dynamic rule-making adapting the regime to financial engineering and innovation, and a dispute settlement system would ensure harmonious implementation across its member states. Distribution would occur through classical or more innovative means of financing. Consequently, in November 2011 at the G-20 Meeting in Cannes, the EU should propose the negotiation of a multilateral financial transaction tax convention.

Overall, setting up the Financial Transaction Tax Convention would require an unprecedented change to international financial governance, arguably to the systemic benefit of the international economic system. The regime would further introduce legal commitment and a level playing-field, thereby thoroughly changing (for the better) the international system of financial governance which is currently governed by club-like international networks which generate non-binding instruments which have failed to contain the financial system from spinning out of control.

For the Union as an international actor, to be seen to realize such an initiative could be a strong deliverable legitimizing the Union itself. Popular support for the financial industry to make good for the consequences of the financial crisis is broad, and positive support for the FTT could be the kind of success the Union needs for it to be viewed as legitimate in the eyes of European citizens.

28 October 2011

Wellcome Trust - Written evidence

KEY POINTS

- We are concerned that the proposed financial transaction tax (FTT) would have a serious impact on charities with investment portfolios, including the Wellcome Trust, reducing the funding available to achieve our charitable objectives.
- As charities are not within the intended scope of a FTT, if the tax is introduced a mechanism must be found to relieve charities of the burden that it will impose.

INTRODUCTION

1. The European Commission is proposing to introduce a FTT, with the stated goal of ensuring that financial institutions make a fair contribution to covering the costs of the recent economic crisis. The Wellcome Trust takes no position on whether this is an appropriate policy objective. However, we are concerned that the proposal as framed would have a serious adverse impact on charities with investment portfolios, limiting their ability to advance their charitable missions.
2. The Wellcome Trust's mission is to achieve extraordinary improvements in human and animal health. We seek to advance this through a range of charitable activities including funding biomedical research and research in the medical humanities; supporting science education and public engagement with science; and fostering the application of research to improve health. We support these activities in the UK and internationally, with a growing proportion of our funding dedicated to supporting research in low-and-middle-income countries. In 2010 we committed a total of £678 million to our charitable activities.
3. According to the European Foundations Centre, the Wellcome Trust is the largest of the 55,000 European private independent charitable foundations, which have been endowed by generous philanthropists. These foundations collectively have investment assets of £160 billion (€ 175 billion); they directly employ over 500,000 people; they give away £45.5 billion (€ 50 billion) each year to benefit the public good.
4. A financial transaction tax would impact negatively on many UK charities that fund research. The UK is relatively unique internationally for the strength and importance of its medical research charity sector. In 2009-10, AMRC's 120 member charities spent over £1 billion on medical research in the UK – approximately one third of all public expenditure on medical research in the UK. Approximately half of AMRC member charities draw on investment income to sustain their charitable activities, alongside public donations and other sources of revenue.
5. The Wellcome Trust is unique among UK charities in that our charitable activities are entirely dependent on the income from our £14 billion investment portfolio, which is managed by an investment team with the aim of generating a 6 per cent real return over the long term. We are concerned that the imposition of a financial transaction tax would reduce our investment income, with consequences for the level of funding we can make available for biomedical research in the UK and internationally, and for our other charitable activities.

6. The amounts of tax that could be imposed on transactions to which the Trust is a party is potentially significant. For example, based on our 2010 investment figures²²⁸, we estimate that charging FTT on our transactions in listed equities at rates ranging from 0.1% to 1% (depending on the number of market intermediaries that are taxed – see paragraph 14 below) would result in an additional tax burden on the Trust of around £31 million, plus an additional £1 million from a 0.01% tax on derivative transactions. For comparison purpose, £32 million would be sufficient to fund either of the following:
- More than 120 Sir Henry Wellcome Postdoctoral Fellowships, which support the most promising newly-qualified postdoctoral researchers to make a start in developing their independent research careers.
 - A major overseas programme to carry out vital research on HIV, malaria, tuberculosis and other diseases that cause high levels of morbidity and mortality in low-income countries. £32 million is approximately the value of the Wellcome Trust's major overseas programme in Kenya, which employs over 600 people, 95 per cent of whom are Kenyan.
7. From an investment perspective, a FTT would reduce our flexibility and make it more difficult to tailor investment to manage our cash flow. If Europe were to introduce a FTT in isolation, this would decrease the Trust's incentives to invest in European markets.
8. We note that the Commission's proposal does not involve the setting aside of any part of the revenue raised by the FTT for the benefit of charitable organisations, as has been suggested in some quarters. If a FTT is introduced, we would argue that it should not apply to charities. This would be consistent with the existing charity exemptions from stamp duty taxes.

RESPONSE TO CALL FOR EVIDENCE QUESTIONS

9. We have responded only to those questions of relevance to the Wellcome Trust.

General questions on financial sector taxation – questions 1-3

10. The Wellcome Trust takes no position on whether there is a general case for the introduction of a tax on financial transactions. However, we question whether the stated objectives of the FTT, as proposed by the Commission, will be met and whether the FTT is an appropriate instrument for achieving those objectives. We note that the conclusion of representatives at an October 2011 Oxford University conference was that better targeted measures should be used, such as a financial activities tax, bank levies and/or regulatory measures²²⁹. We would also draw the Committee's attention to reservations about the FTT in previous Commission documents and more recent commentaries by professional advisers.

Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

²²⁸ Total value of purchases and sales of quoted investments in year end 30 Sep 2010 was £5.6 billion.

²²⁹ Conclusions presented by the University of Oxford Centre for Business Taxation Said Business School at the conference "Taxing banks: the role of tax in post crisis bank regulation".

Q4 What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?

11. While the Commission's objectives appear to be fair and reasonable we question whether the FTT is an appropriate instrument to achieve them.

Q5 Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

12. The FTT proposals are defective in a number of respects:

- **The “financial transactions” that are taxed:** The Commission proposals treat all transactions in financial instruments as taxable, with few exceptions. The most notable omission is the failure to provide an exemption for intermediary parties, which will produce a cascading effect on the aggregate tax rate borne by the customer (see further the response to Question 6 below).
- **The definition of the “financial institutions” that are primarily liable to pay the tax:** The definition of “financial institutions” includes a residual category of other “undertakings”. The term “undertaking” is not defined, but in other EU contexts (e.g. State Aid and employment law) it has been interpreted broadly to encompass any entity that is wholly or partly engaged in an economic activity including a charity. The adoption of such an interpretation would be likely to bring many charitable organisations within the scope of the definition, with the result that those charities with significant endowments would become primary liable to the tax. As they would be engaging in financial transactions for their own account the tax liability would reduce the resources available for application to their charitable purposes.
- **The imposition of secondary joint and several liability for the tax on the customer:** The imposition of secondary liability for the tax on the customer is objectionable in principle, particularly at a time when the financial stability of several financial institutions is in question and even more so if the cost of the tax has been passed on to the customer in the pricing of the transaction.

Q6 On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?

13. The scope of the FTT is highly relevant to the identification of which customers and other parties will bear the burden of the tax. It is not only customers with a high risk tolerance that make use of derivatives; it is now common practice for larger charities, pension funds, collective investment funds and other savings institutions to employ derivatives as part of their strategies to reduce the risks that are inherent in all investment portfolios.

14. It should also be noted that the current FTT proposal contains no exemption for most market intermediaries. Consequently, the proposal will have a significant cascading effect on the effective tax rate on a single transaction. A purchase of securities on the London Stock Exchange, for example, ordinarily involves the sale and purchase by a number of parties, including brokers, clearing members and the central counterparty to the clearing system. Each sale will be subject to the FTT (with only the central counterparty exempt),

so a typical purchase by a charity or pension fund would result in the FTT “cascading”, taking the effective rate for the transaction to 1% (if the original vendor is a financial institution) or 0.9% (if it is not). If the securities pass through market makers as well then the rate will be even higher. This represents a very significant hidden cost increase for UK charities – which currently pay no transfer taxes on bond purchases or on the purchase of UK equities, and do not generally incur material transfer tax liabilities on similar transactions elsewhere in the EU .

Q7. Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?

15. It is likely that the use of the residence principle as a connecting factor for the imposition of FTT will prompt some institutions to relocate or divert business outside the EU.

Q8. How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

16. Although the Commission suggests that the FTT could raise an additional EUR 56 billion (0.08% of GDP) per year from 2014 onwards, its impact assessment also estimates that the tax would reduce long-term GDP in the EU within a range of 0.53% to 1.76%. Such a contraction in the long-term growth rate of the EU would inevitably raise questions about the effect on the revenue yield from other taxes and the additional costs to governments of a prolonged period of limited economic growth.

17. Another facet of the FTT proposal that needs to be factored into the overall assessment of its revenue raising potential is the requirement for Member States to abolish existing taxes that are considered to be incompatible with the FTT. For the UK this would mean an immediate loss of the annual £4 billion tax revenue raised by the imposition of stamp duty and stamp duty reserve tax on share purchases.

18. The nature of the FTT is such that its cost can easily be passed on to the customer in the pricing of the transaction. Accordingly, it is likely that at the least a significant part of the tax burden will be borne not by the financial sector but by individual savers and other customers.

19. In contrast to stamp tax revenues, which are wholly retained by the UK Government, it is proposed that part of the FTT revenues should be used to fund the EU budget. This would result in a disproportionate contribution by the UK due to the significantly higher tax base of the UK financial sector compared to that of other Member States.

Impact and effectiveness

Q9. Would the Commission’s proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

20. The proposal should be effective in curbing speculation and excessive risk taking to the extent that the imposition of the tax makes such transactions uneconomic. However, it also runs the risk that similar transactions by customers seeking to manage financial risk in a responsible manner will likewise become uneconomic. For example, the distinction between foreign exchange transactions that are conducted on a spot basis (exempt) from

those that are planned in advance (taxed) has the potential to incentivise inefficient behaviour.

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