The EU Commission’s Proposal for a Financial Transaction Tax

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Outline

I. Background

II. Objectives and instrument choice

III. Conclusions

(2011) *British Tax Review* 607-622, with Clemens Fuest and Tim Schmidt-Eisenlohr
I. Background

- 09.09: G-20 asked IMF to prepare a report “as to how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system”

- 06.10: IMF proposed:
  - Financial Stability Contribution (primarily a bank levy), and
  - Financial Activities Tax (a tax on remuneration + profits)
  - FTT “does not appear well suited to the specific purposes set out in the mandate”

- 10.10: EU Commission’s preliminary examination: “there is greater potential for a FAT at EU-level”
I. Background

• Comprehensive IA launched
• 28.09.11: FTT proposal + IA published (19 docs!)
• Pro: France, Germany, Italy, Spain, Austria, Belgium, Finland, Greece and Portugal
• Anti: UK, Netherlands, Sweden, Denmark, Czech Republic, Bulgaria, Cyprus and Malta
• Talk of compromise solution – narrow FTT following UK stamp duty model?
II. Objectives and instrument choice

Stated objectives:

1. to raise revenue from the financial sector
2. to create disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures aimed at avoiding future crises
3. to avoid a fragmentation of the internal market
4. to pave the way towards a global introduction of the tax

We ask:

→ Is the objective reasonable?
→ Is the FTT the best instrument to achieve the objective?
II. Objectives and instrument choice

1. To raise revenue from the financial sector

(i) To recover part of the costs of the crisis from the financial sector

• Reasonable justification
• FTT?
  – The incidence of the tax might fall on consumers
  – FAT might be better in this regard
II. Objectives and instrument choice

(ii) To compensate for under-taxation as a result of the VAT exemption

- Commission Press Release: “[t]he financial sector enjoys a tax advantage of approximately €18 billion per year because of VAT exemption on financial services”
- IA: “the extent to which the exemption constitutes a tax advantage for the financial sector is an unsettled empirical question”
- 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 per cent and 0.017 per cent of GDP.
- “all these estimates are very rough approximations and should be interpreted with caution…”
- “…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”
- New study by Lockwood (October 2011) - commissioned by PwC - found neither under-taxation nor over-taxation
II. Objectives and instrument choice

• FTT?
  – IA: “[t]he transaction taxes as discussed in this paper are not really effective to compensate for the VAT exemption”
  – FAT could be better for these purposes
  – Commission (IA. p.35) and Mirrlees (TBD p. 215): removal of exemption better solution
II. Objectives and instrument choice

(iii) To create a new revenue stream for the EU

- Proposal unclear on how funds raised by FTT will be used
- 23.03.12: Commission: 2/3 to EU budget as new OR; 1/3 directly to national budgets
- FTT?
  - Given the volatility and uncertainty surrounding the tax base of an FTT, is it a stable and secure source of funding for EU budget?
  - Why should the EU be funded by the financial sector to a larger extent than any other sector?
II. Objectives and instrument choice

(iv) To compensate for implicit state guarantee - (not explicitly argued by Commission)

- Guarantee leads to lower cost of capital and excessive profits
- There are estimates of guarantee (Haldane, 2010)
- Steps to reduce it: SRR, ring-fencing, loss-absorbing capital
- It can never be eliminated
- FTT?
  - FTT taxes financial institutions whether or not they enjoy guarantee
  - Better to tax banks enjoying guarantee & to vary tax according to likelihood of bail-out
  - UK bank levy is better: smaller banks excluded, riskier banks pay more tax
II. Objectives and instrument choice

General considerations on FTT as a revenue raiser

i. Threat of avoidance through relocation

- IA: “it is difficult to make unequivocal conclusions on the exact size of the elasticities and relocation risks (although there are strong risks of relocation).”

- IA on OTC derivatives markets: “the application of the tax in this highly mobile market will be difficult and reduce the taxable base significantly...the tax base could largely disappear leaving no substantial revenue”

- Double standards? Proposal takes this issue very seriously within the EU but much less seriously when it comes to relocation to non EU countries.
II. Objectives and instrument choice

(ii) *In pure revenue-raising terms, are there more efficient instruments?*

- IA: “[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.*”
  
  – IA’s estimations of the cost of the tax in terms of GDP losses: FAT would lead to output losses of appr. 0.5% of GDP; FTT would lead to output losses of appr. 0.5-1.76% of GDP

- New estimates by Commission apparently show a lower loss – not public yet

- There are issues with the macro-economic models used
II. Objectives and instrument choice

(iii) Incidence

- IMF (2010) suggested it might fall on final consumers
- Mirrlees (2011): “More general financial sector transaction taxes would likely be passed on to savers in the form of lower returns” (TBD p. 153)
- IA: “[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.”
- Cf. Proposal: private households and SMEs not actively investing in financial markets “would hardly be affected”
- FAT: incidence still uncertain but more likely that burden falls on intended parties
II. Objectives and instrument choice

2. To create disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures aimed at avoiding future crises

• Commission’s target: short-term trading and particularly high-frequency trading

• Report commissioned by S&D in EP:
  
  — “...we think reducing High Frequency Trading could actually have a positive long term effect on growth, given that it could reduce systemic risk and thus the likelihood of crises.”

  — “Should the FTT, for example, decrease the probability of crises by a mere 5%, (which is a very low assumption), and the cost of GDP lower growth in the long term due to crises were around 7 % which consistent with the above estimates, then the positive impact of the FTT on the level of GDP, due to crisis avoidance, could be a 0.35% of GDP.”
III. Objectives and instrument choice

• *But* IA states: “the empirical economic literature is still *rather inconclusive* on effects from this trading form in terms of increased volatility or price deviations”

• Commission’s consultation paper on MiFID: “Existing evidence is *inconclusive* about the impact of HFT on market efficiency.”

• In fact, some studies suggest that HFT has added liquidity to the market, reduced spreads and helped align prices across markets

• FTT?
  – Taxes both “good” and “bad” transactions
  – EU regulation is being put in place to deal with concerns HFT raises:
    • European Securities and Markets Authority guidelines, and
    • Commission’s revised Markets in Financial Instruments Directive
II. Objectives and instrument choice

• Some under false impression that the FTT addresses the causes of the past crisis

• FTT does not address excessive leverage, insufficient liquidity cover or other acknowledged causes of the past crisis

• Bank Levies targets these issues
II. Objectives and instrument choice

3. To avoid a fragmentation of the internal market

- Proposal: FTT is also needed “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” ...“[s]everal EU Member States have already taken divergent action in the area of financial sector taxation. The purpose of this proposal is to provide a common European approach to this issue that is consistent with the internal market.”

- Uncoordinated tax measures are being introduced by MS but they are bank levies not FTTs

- National FTTs do exist but they have been around for some time
II. Objectives and instrument choice

4. To pave the way towards a global introduction of the tax

- Proposal: “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.”

- US, Australia, Canada etc opposed to FTT

- Will unilateral adoption of FTT by the EU act as an incentive for non-EU states to follow suit?

- Will it act as an incentive in the opposite direction?
III. Conclusions

• Some objectives are reasonable others questionable

• Given those objectives, is the FTT the best instrument to achieve them?

• Commission: after analysing the FTT and the FAT the IA “concluded that an FTT was the preferred option”

• The objectives set out by the Commission are better achieved through other instruments: Bank Levy, FAT, regulation