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Towards a European Financial Transaction Tax?

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Foreword

The EU Commission proposal for a Financial Transaction Tax (FTT) is under intense scrutiny. A wide and open debate on the current Directive proposal and its aims is underway involving member States, think-tanks, business associations, and academia. From a purely institutional viewpoint, if an agreement among the 11 participating States were to be found before the end of 2013 within the framework of the "enhanced cooperation" procedure, a fast transposition of the Directive into national laws would be possible allowing a common FTT to enter into force as early as mid 2014. But this timetable is highly unlikely.

First of all, the European FTT appears increasingly intertwined with the domestic FTTs that are being discussed and/or introduced by countries such as Germany, France, the UK and Italy.

More importantly, the difficulties of the timetable reflect fundamental doubts and concerns that arise when the new tax is looked at from the broader perspective of the financial reform and the financing requirements of the real economy.

On both the European and the domestic version of the so called "Tobin Tax", the Italian business associations have expressed their comments and concerns before the Italian Government. A joint letter (in annex) was sent in May 2013 by Italian Banking Association (ABI), National Association of Insurance Companies (ANIA), Italian Association of the Investments Management Industry (Assogestioni), Association of Italian Joint Stock Companies (Assonime), Association of Financial Intermediaries (Assosim), Confederation of Italian Industries (Confindustria) and Italian Banking, Insurance and Finance Federation (Febaf). Basically, financial associations fear that the current version of the EU FTT may produce undesirable side effects in terms of commercial and financial transactions, costs of financing, and relocation of business towards financial areas where the FTT is not being implemented.

For the reasons above, FeBAF and Assosim have been promoting the idea that a more in-depth and informed discussion is needed at the national and international level, and that all efforts should be made to extend and enrich such discussion. The papers published in this issue of the Febaf "f" series, and its related comments, provide a valuable contribution to this end.

The analytical contribution of Carlo Cottarelli, Director of the Fiscal Affairs Department of the International Monetary Fund, and the related comment of Giacomo Ricotti, Head of Tax Analysis Division of the Bank of Italy, provide such "food for thought", developing arguments, assessments and insights that are sound, balanced and thought-provoking.

We are very grateful for their contribution and commit ourselves to continue investing in an open dialogue on such a controversial and politically charged issue.

This is in our view the best way to show concretely how the financial community in Italy, in all its major components (as represented in Febaf), is fully engaged and committed on the FTT debate both at the national and European level.

The discussion, among other things, points out that competition in and outside Europe, and a level playing field among financial institutions, have to be preserved and enhanced in the ultimate interest of savers and investors.

A special word of thanks has to be addressed to Michele Calzolari and his Assosim colleagues, for two reasons: first his contribution – included in this volume - is of utmost interest for the FTT stakeholders community, and second, as his association has just joined the ranks of our Federation membership, his participation demonstrates to what extent the perspective and insights coming from Assosim members can complete, strengthen and enrich the dialogue and the common "vision" of the Italian financial community.

Rome, October 2013

Paolo Garonna
Secretary General

1. Towards a European Financial Transaction Tax?

Carlo Cottarelli* – International Monetary Fund

The recent financial crisis has caused public finance economists to rethink how the financial sector should be taxed. Before the crisis, it was generally assumed that no special tax regime for financial services was necessary, and that divergences from the general tax regime were likely to be distortive. For example, the IMF generally recommended against having a higher rate of corporate income tax on the financial sector, which some countries impose[1], because it can distort the allocation of capital and deter financial sector development. It was recognized, however, that imposing a standard credit-invoice VAT on the financial sector is difficult, because payment for financial services is often bundled into a financial margin, such as loan or deposit interest, which obscures the VAT tax base. For this reason, financial services have generally been exempted from the VAT.[2]

Things changed with the financial crisis: First, the crisis produced a desire to recoup revenues lost due to the crisis by taxing the companies that precipitated it. In the years leading up to the crisis, the financial sector logged exceptionally high levels of profit and compensation, which in retrospect reflect its assumption of large tail risks. Realization of these risks during the crisis, coupled with

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[1] Currently, Algeria, Bangladesh, Jamaica, Jordan, Morocco, Panama, Sudan and Tunisia have higher CIT rates for financial firms.

[2] Modern VATs, such as those in New Zealand and South Africa, also minimize the VAT exemption for financial services by taxing all fee-based services.

implicit public guarantees for too-big-to-fail institutions, imposed a heavy burden on public coffers: The direct costs of bailing out financial institutions in the most affected countries averaged about 7 percent of GDP through 2012, slightly more than half of which has been recovered for a net cost of 3.3 percent of GDP.[3]

Second, the apparent inadequacy of existing financial regulations to curb excess leverage and risk-taking in the financial sector raises the question of whether tax policy can be used to help achieve that goal. The crisis made apparent that excessive risk taking had caused severe externalities, and raised the issue of whether a Pigouvian tax should be introduced to internalize these externalities. But, even leaving this aside, it has long been known that the standard corporate income tax, which gives a deduction for interest payments but none for dividends, encourages non-financial companies to prefer debt over equity finance. A recent study by Keen and de Mooij (2012)[4] shows that this also applies to banks, which usually carry more than minimal regulatory capital and are thus influenced at the margin by the tax benefits of interest deductibility.

It was in this context that the G-20 charged the IMF with designing a plan for a "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." In response, IMF (2010) proposed two new tax instruments to help accomplish this goal: a financial stability charge (FSC) on bank leverage and a financial activity tax (FAT) on financial sector profits and compensation. The 2010 report also examines the effects of a third tax widely considered to raise revenue and regulate financial markets in the wake of the crisis: a financial transaction tax (FTT), but, as we noted in our report, we regard an FTT as a much weaker option.

A broad-based FTT has been widely promoted in the wake of the crisis as a means of raising revenue and reducing financial sector risks. FTTs, which are quite common through both developed and developing countries, are imposed on a wide variety of transactions ranging from real property transfers to bank deposits/withdrawals to securities trading. Post-crisis debate has focused on security transaction taxes (STTs), with numerous governments and civil soci-

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[3] Countries include Belgium, Cyprus, Germany, Greece, Ireland, Netherlands, Spain, UK, US.
[4] M. Keen and R. de Mooij (2012), "Debt, Taxes and Banks," IMF Working paper 12/48.

ety organizations supporting introduction of a multilateral transaction tax on securities and derivatives trading to prevent future crises and help pay for the past one. Imposition of new STTs reverses the trend of the past two decades toward reducing financial transaction taxes: Since the 1990s, most major European countries have eliminated their FTTs on equity trading in an effort to develop their financial markets. (A notable exception to this is the UK, which maintains its stamp duty at the fairly high rate of 50 basis points; however, it has a fairly narrow base insofar as all market-makers and equity derivatives are exempt.).

Belief that STTs can reduce risk is a major reason for their promotion following the crisis, but the evidence for this is at best mixed. Numerous studies confirm that imposition of an STT, like any increase in transaction costs, reduces asset prices and trading volume or liquidity. The more controversial question is whether they can reduce price volatility, and hence one form of financial risk. Numerous studies relate trading volume positively to price volatility, so in theory a tax that reduces trading volume could reduce volatility as well. However, reduced trading volume is also associated with reduced liquidity and wider bid-ask spreads, which can also result in higher price volatility. So the relationship between an STT and price volatility is unclear, and it may be non-linear: A small STT in a highly liquid market may reduce short-term price volatility, while a large STT may reduce liquidity sufficiently to increase volatility. Major price swings, or financial bubbles, are believed to be driven by excessive leverage, not by trading activity. Since STTs do not in general reduce leverage—and depending on their design may even increase it—it is unlikely that they would reduce the risk of bubbles.

The revenue-raising capability of an STT depends not only on trading volume, but also on the availability of substitute assets and trading platforms. Imposition of an STT eliminates trades that do not yield at least the increase in transaction costs related to the introduction of an STT, especially short-term trading. If close substitutes for the taxed security (such as derivatives) are available, or the security also trades on untaxed platforms (such as offshore exchanges), then some of the trading volume will be displaced into those activities. For example, the 50 basis point U.K. stamp duty on share trading has encouraged the growth of the market for "contracts for difference" (CFDs), or daily-settled equity swaps; and Sweden's imposition of transaction taxes on stock and bond trading in the early 1990s displaced stock trading activity to London. Thus, base elasticity can undermine the anticipated revenues from an STT.

The EU's FTT proposal seeks to limit this form of displacement by design. The proposed tax would be imposed on a wide array of financial products—both equity and fixed income securities as well as their derivatives—which would limit displacement between instruments. The EU FTT would also seek to limit geographical displacement of trading by taxing all trading in securities issued by EU-headquartered corporations, regardless of where in the world it takes place. While this would in theory prevent transactions from migrating outside the EU to escape tax, it is likely that the tax on extraterritorial transactions would be very difficult to enforce. Concern that a European FTT would drive trading outside of Europe is a major reason for the UK's opposition to a European FTT.

Indeed, opposition by some EU members, Sweden in addition to the UK, led an 11-country coalition to pursue a reduced version of the proposed FTT under the EU framework for "enhanced cooperation". This narrowing of geographic scope lowered the estimated revenue from the FTT from approximately EUR 57 billion to EUR 30-35 billion. Although the official proposal is still for a 10 basis point tax on stocks and bonds and 1 basis point on derivatives (levied on both buyer and seller), more limited versions are reportedly being discussed, which could reduce the expected revenue by as much as an order of magnitude.[5]

The new STTs introduced by France and Italy could reportedly serve as models for this reduced-form STT, so it is worth examining their design and impact in greater detail. They have many similarities: Both tax transactions in the shares of domestically headquartered companies and their derivatives, regardless of where in the world they are traded. The tax charged on equity trades is generally much higher than the tax charged on derivatives.[6] New share issues and

[5] "Europe Rows Back on FTT Plans," Daily Telegraph, May 30, 2013

[6] France charges a 10 basis-point tax (on both buyer and seller) on equities issued by French companies with at least EUR 1 billion in market capitalization, and 1 basis point tax (on buyer and seller) on transactions in their derivatives. Italy charges a 10 basis-point tax (on buyer only) on equities issued by Italian registered companies; the rate is doubled if the shares trade over-the-counter, and in 2013 only an additional 2 basis points is charged on all trades. Derivatives of equities subject to the Italian FTT are taxed with a series of flat fees that rise with the notional value of the underlying securities.

market maker trading are exempted. Innovatively, both FTTs also levy a very low-rate transaction tax on high-frequency trading in the domestic market.[7]

Despite their fairly modest rates, the French and Italian FTTs can be expected to depress trading activity. Early empirical studies of the effect of the French FTT on the market for French equities show that it reduces trading volume by about 15 percent and decreases market depth; however, no appreciable effect on share market volatility was found.[8]

The French and Italian FTTs increase to some extent existing tax incentives for leverage. Taxing equity but not debt trading increases the relative cost of equity finance, thus compounding the debt bias of the corporate income tax. Levying a substantially higher tax rate on equities than on their derivatives encourages trading in the latter; and since derivatives carry inherent leverage, this may increase financial market risk. A uniform tax rate based on notional value would discourage use of leveraged instruments, but would disproportionately raise transaction costs in derivatives markets, which are generally much lower than those in securities markets.

One major difference between the French and Italian FTTs and the proposed EU FTT is their treatment of market makers: While the French and Italian taxes, like the UK stamp duty, provide a broad exemption for market makers (except in the case of HFT), the EU proposal would fall in particular on taxable transactions executed by financial institutions, regardless of whether they were proprietary or on behalf of a second party. The EU proposal would potentially produce significant "cascading", or multiple taxation of a single economic transaction, since some financial arrangements such as unit trusts can introduce intermediate entities between final transactors. The unusual design of the EU FTT appears to be aimed at reducing the size of the financial sector and discouraging financial complexity, whereas the more conventional exemption for market-makers allows the FTT to function more as a realization-based wealth tax on securities holders.

[7] The effective rate of both taxes is 2 basis points. The French FTT also levies a 1 basis point tax on "naked" (unhedged) sovereign credit default swaps (CDSs).

[8] M. Haferkorn and K. Zimmerman (2012), "Securities Transaction Tax and Market Quality – the Case of France", mimeo; S. Meyer and M. Wagener (2013), "Politically Motivated Taxes in Financial Markets: the Case of the French Financial Transaction Tax", mimeo. Given the recent introduction of the Italian FTT, no empirical studies are yet available.

These new FTTs offer a couple of innovative features with quasi-regulatory impact. Both the French and the Italian FTT target high-frequency trading in particular. Despite their very low-rate, these taxes should be sufficient to eliminate most HFT due to its high speed and ultra-thin margins. Although high speed and automation are not inherently pernicious—indeed the majority of algorithmic trading is used to improve execution for third parties—proprietary HFT is frequently associated with practices that can distort markets. Although it can improve liquidity, it is also thought to produce higher short-term volatility and sudden cascades (such as the "flash crash" of May 2010). However, since the HFT taxes are territorial, they will likely just displace HFT outside of France and Italy.

Another innovative feature of Italy's FTT is its heavier tax rate on OTC trades. This may have quasi-regulatory benefits of channeling equity trading to organized exchanges, which offer greater transparency and control. This would likely offer the greatest benefit to securities other than equities, since equities are most likely already to be traded on organized exchanges.

However, the Italian derivatives tax could arguably be better designed. The series of flat rates charged according to the level of the notional value of the underlying security leads to sharp discontinuities in the effective tax rate. And as the underlying value gets larger, the effective rate goes to zero. A flat rate, such as the two basis points that Italy levies on HFT, would arguably make more sense for derivatives as well.

Altogether, the specific design of FTT does affect their effectiveness and distortionary effects, as this discussion has shown. Not all FTTs are equally good or bad (depending on the standpoint. This said, the IMF remains of the view that, if the goal of these new financial taxes is to raise revenues and reduce systemic risks, there are better options than FTTs. In particular, in our report to the G20 we gave preference to two different taxes, which we called the financial stability contribution (FSC) and the financial activities tax (FAT).

An FSC is a Pigouvian tax on bank balance sheet debt aimed at internalizing bank incentives to use excessive leverage and at raising revenue to offset the costs of potential bailouts. If deposits, a relatively stable source of funding compared to interbank loans, are adequately insured then they should be excluded from the base. If larger institutions are more likely to rely on excessive debt due to market perception of an implicit government guarantee, the rate of the FSC can be progressive to offset this effect. IMF (2010) estimates that too-big-to-fail institutions have a funding advantage of 20-60 basis points over smaller institutions, which can serve to indicate an appropriate top tax rate for an FSC on larger banks.

FSCs, or bank levies, have been widely adopted since the financial crisis, particularly across Europe. The most common base for these taxes is balance sheet liabilities net of equity and insured deposits, although there is significant variation: Portugal and Cyprus include deposits in the tax base; and France, Hungary and Slovenia tax different types of assets rather than liabilities, and thus do not alter financing incentives. Korea's bank levy is based specifically on cross-border short-term funding in order to deter foreign exchange risk. Several countries (Austria, Germany, Hungary, Netherlands, and the UK) levy progressive rates, imposing higher burdens on larger banks, and the UK and Korea also offer reduced rates for longer-term debt, reflecting its reduced refunding risk.

However, existing bank levies appear modest in terms of incentives and revenue yields: The tax range for these levies runs as high as 53 basis points, but is typically much lower: Only three countries in Europe (France, Hungary and Slovakia) have a top rate above 10 basis points. On average, they thus appear too low to internalize the implicit government guarantee of the large banks. Expected revenues from the bank levies are quite modest: In Europe, median yield should be around 0.14 percent of GDP.

Nonetheless, preliminary analysis shows that bank levies have been successful in increasing bank reliance on equity and deposits as funding sources. Analyzing data for European banks, Devereux et al. (2013) show that each basis point increase of the levy rate increases bank equity by approximately one quarter of a percentage point. Similarly, each basis point increase in the levy rate raises the ratio of customer deposits to total assets by about one half of a percentage point. However, the results in this paper also shows that, in tandem with this reduction in funding risk, banks increased the riskiness of their assets: A one basis point increase in the levy rate increases the ratio of risk-weighted to total assets by one third of a percentage point.[9]

As I noted, our report also proposes a "financial activities tax" (FAT), which comes in three different versions: The most comprehensive version (FAT-1) would be levied on total cash-flow profits and compensation in the financial sector, and thus would be equivalent to an addition-method VAT. This version of the FAT would be most useful for addressing the potential under-taxation of financial services due to their exemption under current VATs. Because this tax would probably not be credited on a per-transaction basis, it would contribute to VAT cascading on business purchases of financial services; however, it would correct for the under-taxation of consumer financial services under VAT exemption. Keen and others (2012) estimate that the tax base for this version of the FAT averages just under 5 percent of GDP among developed countries, but varies substantially depending on financial sector development, from as much as 23 percent in Luxembourg to less than 2 percent in Finland.

Iceland introduced the first FAT-1 in 2012, imposing a 5.45 percent tax on payroll and a 6 percent tax on profits above one billion Icelandic krona in the financial sector. In contrast to an ideal FAT, the base of the profit tax is accounting rather than cash-flow profits—that is, investment is depreciated rather than expensed—so it taxes the normal return to capital. Moreover, the FAT is imposed on top of Iceland's payroll tax for VAT-exempt businesses, so it serves more to raise revenues than to correct for VAT exemption. It was expected to raise 0.28 percent of GDP in 2012.

Depending on how it is structured, an FAT can also serve as a Pigouvian tax aimed at correcting financial sector externalities. As noted, the implicit bailout option encourages excessive risk-taking that produces abnormally high profits and compensation for large financial firms in good years, and large losses in bad years, which are put to the public sector. A surtax on abnormal profits and compensation in the financial sector could reduce this incentive, as well as generate a fiscal buffer to offset abnormal losses in bad years. This is the idea behind the "FAT-2" and "FAT-3" versions of the FAT. A FAT-2 is levied on financial sector cash-flow profits and extraordinary compensation above a certain level, howev-

[9] This result is driven by banks for which regulatory constraints on risk-weighted assets were initially binding.

er defined. Like a FAT-2, a FAT-3 would also tax extraordinary compensation, but would also exempt a certain level of cash-flow profits, taxing only the extraordinary profits associated with excessive risk assumption in the financial sector. Keen and others (forthcoming) estimate that the average base of a FAT-2 among developed economies is about 2.5 percent of GDP, while that of a FAT-3 is about half as large.

No countries thus far have introduced a full-fledged FAT-2 or FAT-3, but the bonus taxes enacted after the crisis can be viewed as partial FATs on compensation. The UK and French taxes, at 50 percent of variable compensation, were sizeable but temporary, levied for a year or less beginning in 2009. The Italian bonus tax is permanent, but much more modest in scope: It imposes a 10 percent tax rate on bonuses that exceed three times fixed remuneration. In contrast to an FAT, which would tax extraordinary compensation regardless of form, a bonus tax affects only incentive compensation (and sometimes only bonuses paid in cash or options, rather than stock). Financial institutions could thus avoid it by increasing regular compensation, which is fact what was observed in the UK[10].

Let me conclude by noting that achieving the right balance of taxes on the financial sector requires that the role of taxes in determining leverage or risk-taking must be coordinated with the role of financial regulation. With full information, and where revenue is irrelevant, either instrument could be used, but these restrictions are clearly unrealistic. The focus of the international community has been so far on the use of regulation to address financial stability issues. Broadly speaking this is appropriate. But I think that not enough attention has been paid to looking at the implications of taxation for financial sector decisions. Much more work is needed in this area.

[10] M. von Ehrlich and D. Radulescu (2012), "The Taxation of Bonuses and its Effect on Executive Compensation and Risk Taking – Evidence from the UK Experience," mimeo, April 6 2012.

2. The Commission Proposal of a Financial Transaction Tax: Some Remarks

Giacomo Ricotti* - Bank of Italy

Last February the European Commission released a new proposal (hereinafter referred to as the Proposal) for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT)[11]. As it is well known, the new Proposal replaced the original one[12], which failed to get support from all the Member States.

Due to the impossibility to reach an agreement, Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia Slovenia, and Spain, (hereinafter, EU11) requested the Commission to submit a proposal to the Council for authorizing enhanced cooperation in the area of financial transaction tax.

The main features of the new proposal are described in the remarks of Carlo Cottarelli. I would just like to provide some reflections about the objectives of the Proposal and its possible effects on financial markets.

The objectives of the Proposal

In the Explanatory Memorandum of the Proposal, the Commission specified the

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* Bank of Italy, Tax Department. The views expressed in this note are those of the author and do not involve the responsibility of the institution to which he belongs.

[11] COM (2013) 71, 14.2.2013.

[12] COM (2011) 594, 28.9.2011.

main objectives of the former and the current proposal:

harmonizing legislation concerning indirect taxation on financial transactions, which is needed to ensure the proper functioning of the internal market for transactions in financial instruments and to avoid distortion of competition among financial instruments, actors and market places across the European Union;

ensuring that financial institutions make a fair and substantial contribution to covering the costs of the recent crisis and to creating a level playing field with other sectors from a taxation point of view;

creating appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures to avoid future crises.

In this note I would like to discuss only the first two objectives; as far as the third objective is concerned, I share Cottarelli's point of view, i.e. that the relationship between the FTT and the price volatility is at least unclear.

With reference to the harmonization of legislations concerning indirect taxation on financial transactions, EU Member States apply different types of FTT, if any: e.g., UK and France tax only transfers of stocks and shares; Italy also equity derivatives; Belgium taxes any purchase or sale of any security; and so on. A harmonization of these taxes may therefore improve the functioning of the internal market and avoid distortion in the allocation of financial resources.

At the same time, as regards the taxation of financial sector, indirect taxation on financial transactions is not the only field which needs to be harmonized.

Most part of the European banking sector is subject to so called "bank levies", proposed also by the IMF as Financial Stability Contribution. More than half of the Member States (among others, France, Germany and UK) introduced a bank levy after the financial crisis: in terms of total assets, around 75% of the banking sector is subject to these taxes[13]. These bank levies have different tax bases (in some cases, the tax base is equal to the total assets, in other cases to the debts and/or to the notional amount of derivatives), different rates,

[13] Source: evalution on ECB, *Statistics on consolidated banking data,* 2011.

as well as different definitions of persons subject to the tax. This lack of co-ordination entails double taxation, mainly due to the fact that some Member States tax not only resident banks, but also not resident branches and subsidiaries of resident banks; at the same time, these branches and subsidiaries could be taxed in the host Member State. These cases of double taxation may occur e.g. among France, Germany and UK and cannot be managed by existing Double Taxation Agreements. In order to solve this problem, UK signed ad hoc treaties with France and Germany.

As a matter of fact, also bank levies necessitate to be coordinated, in order to have a leveled playing field: the coordination ought to concern both the tax base and the definition of taxable entities; more specifically, not only banks, but also other financial institutions and the shadow banking system should be subject to the tax.

The second objective of the proposal concerns the taxation of the financial sector: this must be subject to a new tax both to compensate the cost of the crisis and to reduce the under-taxation of the financial sector.

With regard to the first point, ignoring the question of the size of the direct and indirect costs of the crisis and of the alleged responsibility of the financial sector, there are some perplexities on the capability of the FTT to raise revenue. According to the Commission, the revenue estimates of the EU11 FTT could be around EUR 31 billion annually. These figures are based on the revenue estimates for the EU27 FTT proposal, in turn derived from some hypotheses: among others, a 15% reduction of transactions for securities market and a 75% reduction on derivatives due to relocation and evasion phenomena; an elasticity of the transactions to the cost of the FTT equal to -1.5.

The perplexities about these figures come from the following elements:

the estimates do not consider that the FTT could be deductible from other taxes (e.g., the corporate income tax or the personal income tax); if any deductibility is allowed, a reduction in other taxes revenues would follow;

the reduction of market transactions entails that the tax base of other taxes decreases; e.g., there would be fewer fees for financial intermediaries, causing narrow corporate income tax base;

according to the impact assessment accompanying the Proposal[14], the FTT would have a negative effect on GDP. The GDP reduction would also cause a revenue decrease, not considered in the Commission estimates;

the estimates are based on an elasticity of the transactions to the cost of the FTT equal to -1.5 for any financial instrument. The estimates reported in some papers[15] show that this elasticity can range from -0.4 to -2.6, depending on the market and on the financial instrument, pointing out a higher elasticity for derivatives. In addition, the elasticity also varies between short and long term, with a greater impact in the long run. A reduction of derivatives transactions could have a substantial impact on revenue, considering that, according to the Commission estimates, FTT on derivatives contributes to two-thirds of the revenue.

The necessity of a FTT relies also on the presumed under-taxation of the financial sector.

Analyses carried out on corporate income tax and personal income tax on labor do not show any remarkable differences in tax law between financial and non financial firms.

According to the European Commission[16], the under-taxation could be due to the VAT exemption of the financial services, which has been provided for the difficulty to tax financial services whose prices are given by margins (e.g., the granting of a mortgage) [17]. But it is not clear whether the VAT exemption results in an under- or over-taxation of financial system, from both the theoretical and the empirical point of view.

On the theoretical side, most scholars think that financial services must not be VAT exempted. Nevertheless, other analyses argue that financial services are to be considered as intermediate consumption and therefore to be subject to

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[14] Commission Staff Working Document, SWD(2013) 28.

[15] Matheson, T. (2011), "Taxing Financial Transactions: Issues and Evidence", *IMF Working Paper* 11/54; McCulloch, N. e G. Pacillo (2011), "The Tobin tax: a review of the evidence", Institute for Development Studies, Report No. 68; Copenhagen Economics (2012), "Tax elasticities of financial instruments, profits, and remuneration", European Commission, *Taxation Papers* No. 30.

[16] Commission Staff (2011), "Vol. 6: is the financial sector undertaxed? Empirical part".

[17] Chiri, S., Borselli, F. e C. Barsotti (2009), "Il regime IVA dei servizi finanziari", Bancaria, N. 6-7- 8/2009.

a "zero rate" VAT[18]. In this case, most part of financial services would be over-taxed.

On the empirical side, it is difficult to estimate the effects on VAT revenue due to the taxation of the financial services. The empirical evidence is not conclusive: some analyses suggest an over-taxation of the financial system[19].

The assumption that the financial system is under-taxed, therefore, does not seem to be proved.

Possible effects of the Proposal on financial markets

The Proposal provides for the taxation of any type of financial transaction made by at least one subject resident in EU11 on any type of financial instruments. Moreover, according to the issuance principle, also transactions on any instrument issued in a EU11 Member States are taxed, whoever the counterparty is.

The broad application of the tax could have implications for financial markets.

As regards money market, the taxation of repurchase and reverse repurchase agreements as well as of securities lending and borrowing at a 0.1% rate implies a relevant impact on the shortest maturities, because they would be taxed several times per year: as the Commission too acknowledged, repurchase and reverse repurchase agreements could easily be substituted by loans (which would not be taxed) or by untaxed transactions with the central bank[20]. That means a shift of transactions from secured to unsecured markets and/or an increase of the role of the EU central banks in the money market[21]. The reduction of liquid-

[18] Lockwood, B. (2010), "How should financial intermediation services be taxed?", Oxford University Centre for Business Taxation, Working Paper 10/14.; Devereux, M.P. "New bank taxes: why and what will be the effect." in R. de Mooij and G. Nicodeme, eds. "Taxation of the financial sector", MIT Press, forthcoming.
[19] Lockwood, B. (2011), "Estimates from national accounts data of the revenue effect of imposing VAT on currently exempt sales of financial services companies in the EU", in PwC (2011), 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, 18 October. Huizinga, H. (2011), "Is the financial sector undertaxed?", Brussel Tax Forum 2011.
[20] Commission Staff Working Document, SWD(2013) 28.
[21] The Proposal provides for an exemption of transactions with the ECB and with the central banks of EU Member States. As EU11 FTT would apply to transactions with non-EU central banks, they could be discouraged from trading on euro money markets.

ity on repo market must therefore be carefully assessed also with reference to the transmission of monetary policy.

As regards fixed-income market, the exemption of primary market transactions could not avoid an increase of the cost of capital for issuers. There could be indeed feedback effects due to the taxation of transactions on secondary market; the FTT would imply a reduction of liquidity on secondary market and, therefore, an increase of yields requested by investors on the primary market.

These effects could also affect government bonds, with greater impacts on short maturities. In the case of government bonds the interest rate increase would be due also to the fact that government bond markets are based on a market makers business model: as market makers are subject to FTT, the increase in transaction costs borne by the market makers would result in a yield increase.

Lastly, the issuance principle could achieve the objective of reducing the relocation of transaction, preventing from some cases of FTT elusion. At the same time, it could have another feedback effect: in order to avoid the FTT, foreign investors could substitute financial instruments issued in EU11 with similar financial instruments not issued in EU11, with negative effects on funding capacity of EU11 resident issuers (Member States, companies, banks, etc.).

The Proposal: possible evolutions

After the release of the Proposal, the EU11 Member States started to discuss the implementation of the FTT and the modifications to the Proposal. If the EU11 Member States reach an agreement, they will have to transpose the Directive into national legislation. Considering the time required for the participating Member States to transpose the Directive into national law, a common framework for the FTT could enter in force not before the middle of 2014.

Some clues about possible modifications of the Proposal may be found in the European Parliament legislative resolution of 3 July 2013. In this resolution the Parliament approved many amendments to the Proposal; inter alia, the amendments provide that:

"any harmonisation of FTT amongst participating Member States should not result in extra-territorial taxation infringing the potential tax base of non-participating Member States", in order to avoid the effects on which the UK challenged the legality of the decision of 22 January 2013 of the Council to authorize enhanced cooperation on the FTT[22];

market makers should be exempted;

a reduced rate (0.01%) should apply to repurchase and reverse repurchase agreements with a maturity of up to three months;

over the counter transactions could be subject to higher rates;

until 1 January 2017, a reduced rate (0.05%) should apply to government bonds and pension funds for the same period a reduced rate (0.005%) should apply also to financial derivative instruments.

The above brief remarks on the FTT Proposal point out that the effects of the introduction of the EU11 FTT must be carefully assessed; some of the amendments proposed by the European Parliament ought to be taken into account in order to mitigate the FTT side effects.

[22] Case C-209/13 UK v Council.

3. The impact of the financial transaction tax on financial markets

Michele Calzolari* – Italian Association of Financial Intermediaries

With no expectation to add new elements to the current debate concerning the Financial Transaction Tax (FTT), I would like to seize this opportunity to draw your attention on the potential impacts that the tax could have on market efficiency and on the role played by the market itself as a means to provide new financial resources to companies, financial intermediaries and governments.

Far from the need to achieve the broad policy objectives targeted by the European Commission in its proposal for a directive in terms of limiting financial speculation and requiring the banking sector to contribute to the costs arising from the crisis, the Italian initiative moves from our Government's need to cover a liquidity requirement amounting to about €1 billion within the framework of the corrective measures provided for within the "Stability Law" ("Legge di Stabilità"), adopted in December 2012.

The Government itself, within the technical report accompanying the aforementioned law, set out that the tax would entail a 30% contraction over share trading volumes and a 70% contraction over derivatives volumes. It is clear that no business sector could survive a similar decrease in its turnover.

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* Assosim's Chairman.

For such reason, Assosim has promptly been on the front line, highlighting that due to the likely economic translation of the tax and the reduction in efficiency and liquidity of secondary markets, investors would require higher returns on their savings thereby increasing the cost of funding for issuers (corporates and governments).

Furthermore, having in mind the globalization of financial markets and their ability to operate within a dimension not necessarily restricted within the jurisdiction of a single country, Assosim outlined that the application of the tax may lead to (i) a re-localization of domestic financial transactions to foreign (and potentially less transparent) markets, (ii) a capital flight to countries not imposing similar taxes and (iii) severe impacts on occupational levels.

Thanks also to the advocacy initiatives carried out by the industry, the provisions eventually adopted by the Italian Parliament prove to be less pervasive than those initially proposed by the Government. Still, a quite large number of fundamental issues remain unsolved. And it starts to be clear by now that the tax is taking along a number of distorting effects which were widely foreseen by many opponents and that it is ineffective in terms of both the political target pursued by the government to fight speculation and its more practical needs to find new financial resources for the public coffers.

According to a survey carried out by Assosim among its members, despite the tax has substantially confirmed, since its entry into force, the contraction in the market volumes foreseen by the Government, at the same time it has nonetheless missed its targets in terms of total revenues. As a matter of fact, we estimate that on an annual basis the tax income shall be equal to less than one-third than its expected income.

Furthermore, notwithstanding the exemption provided for by the provisions in force as regards intra-day transactions, the most active traders and a large number of foreign investors (mainly hedge funds) are moving their business towards untaxed markets. This brings along two additional unintended consequences: on the one side, it implies a further reduction in the (already meager) liquidity of our market and, on the other side, it leaves the burden of the tax on the most stable (long-term) investors. This is exactly the opposite of what the Legislator imagined when it introduced the tax!

On the EU side, after the failure at Council level of the negotiations on the original proposal for a directive put forward by the European Commission at the end of 2011, on 14 February this year it initiated a new legislative process within the framework of the enhanced cooperation, involving only 11 (Italy included) out of the 28 EU countries. The envisaged tax income – according to the Commission's estimates – amount to €34bn, to be contributed to the Commission's budget. Still the actual accomplishment of this target would entail severe recessionary effects on the real economies of the countries adhering to the "enhanced cooperation" and, in particular, on the Italian, German and French economies. As a matter of fact, considering the relative dimension of their markets with respect to those of the other countries adhering to the enhanced-cooperation procedure (Austria, Belgium, Portugal, Slovenia, Greece, Slovakia, Estonia and Spain), they shall have to contribute for more than two thirds of the aforementioned 34bn.

The provisions in the new proposal give rise to the same issues and concerns pointed out by Assosim with regard to the previous one.

First of all, as regards the scope of the directive and its alleged inconsistency with the international principles on tax regulations agreed within the OECD, we are concerned that the Commission could reconsider the so-called issuance principle, namely the application of the tax to all transactions on financial instruments issued in one of the countries adhering to the enhanced cooperation, and thereby exempt the transactions carried out by parties not established in one of them. As a matter of fact, in the absence of a broad scope of application of the tax, there would be a risk of re-localization of financial transactions towards alternative untaxed markets. This would in turn have serious detrimental effects on the occupational levels of the markets involved and nullify the income objectives envisaged by the Commission. As a matter of fact, the investment firms established in any of the countries within the enhanced-cooperation scope would be discriminated against with respect to the firms established outside.

It is also worth considering the very serious consequences that an indiscriminate taxation on derivatives entered into by banks and corporates for hedging purposes could entail. As a matter of fact, due to the well-known features of such instruments, a tax levied on their nominal value, no matter how low its rate might be, would carry out strongly distortive effects, leading to paradoxical results in terms of very high and disproportioned effects on the economic content of the underlying transactions.

Their potential consequences could be very serious, as they would strongly influence (if not completely thwart) the feasibility of the following transactions:

- Hedging transactions carried out by corporates in order to protect themselves from common day-to-day risks, such as interest rates (in particular, short term and long term interest rate swaps), forwards contracts on currencies or goods, etc.;
- Hedging transactions carried out by banks within their ordinary management of liquidity positions and, in general, within their Asset and Liability Management; it is self-evident that an efficient management of ALM has a direct impact on a bank draw-down capacity in favor of families and corporates; and
- Hedging transactions carried out by professional or single investors in connection to their investment portfolios.

Another legislative innovation is represented by the "ownership principle" pursuant to which a financial transaction in relation to which no FTT has been levied is not legally enforceable and does not result in a transfer of legal title of the underlying instrument. According to the EU Parliament such principle would represent the optimum in order to increase the cost of tax avoidance up to an effectively dissuasive level; and it should be up to the Member States to adopt all necessary steps to ensure its functioning. However, it is worth considering the very high litigation risks deriving from proceedings aimed at ascertaining the voidness of a transaction and its possible implications with respect to cross-border contracts.

Finally, it has to be mentioned that the implementation of the directive risks nullifying the costs already borne by market operators in those countries which have already introduced such a tax.

The legislation process appears extremely rough, though. Significant objections have been advanced by several countries (Italy included) and doubts may be raised regarding the effective adoption of the Commission proposal. On the one side, this is going to be good news in the light of all the issues and concerns which I have pointed out so far. On the other side, there is the risk that the tax would remain in force only in France and Italy, the banking systems of which were certainly not the main cause of the international financial crisis.

In conclusion, I believe that there is a serious risk that the FTT, which was introduced mainly for political (if not demagogical) reasons, will eventually remain in force within too few countries the markets of which will be disadvantaged (in terms of decrease in trading volumes and transparency) while speculation would not be defeated. As such, I wonder whether it is really worth it.

4. The FTT proposal by the EU Commission: questions and concerns

Giovanni Sabatini* – Italian Banking Association

Italian firms (financial, industrial or commercial) are worried about the possible implementation of the proposal forwarded by the EU Commission regarding a financial transaction tax under enhanced cooperation (FTT).

The original directive proposed in 2011 already highlighted critical points for the financial market. These critical points do not seem to have been considered by the new proposal.

Following the introduction of an Italian tax on financial transactions it was evident that the result, nationally, confirmed the validity of the worries pointed out at the time. Above all, the necessity to ensure correct functioning and safeguarding in the financial markets.

This is fundamental to protect the interests of both investors/intermediaries and the issuing companies. They have trust in the correct functioning of the financial markets in order to find financial sources.

The national and international debate on the European FTT mainly concerned the uncertainty regarding the structure of the tax: for example it is not clear what are the real objectives and also more consideration should be dedicated to

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* Director General of ABI.

the possible downfalls of its implementation.

In general terms, as pointed out by the Commission, more evaluation is needed regarding the setbacks which might occur in the single States that have adopted the FTT.

It is obvious there must be communal agreement to avoid the implementation of a different version of the FTT in each state. There must be faith and trust in a set of common regulations.

With this in mind, the legislator can play a positive role by harmonizing the initiatives already in place instead of revolutionising everything.

The fact that first France then Italy have used the same strategy is to be considered. The legislator must be as cautious as the national governments regarding equity.

Let's briefly touch upon the perplexities: the first concerns a series of presumed benefits that this tax would have: correct malfunctioning in the financial markets, solve bad financing, force banks to pay the cost of the crisis, increase the States' intakes and possibly that of the same UE.

This is not the place to go over the numerous studies and researches already done, by the FMI to start with. These perplexities only distract the attention from the real importance of the effective implementation of the FTT.

The task of controlling the markets seems to be entrusted to the legislator. It is not clear how the UE Commission can achieve a sole efficient and competitive market.

In second place, the objective areas of interest should be considered: this includes all financial matters and is not to be limited, as in Italy and France and the United Kingdom - firmly opposed to the UE tax - to taxing on just the stock section, as is the case in Italy, also on stock derivatives.

Besides, the European project includes derivatives on commodities underestimating efficiency in the demand curve and the stabilization of the cost of raw material.

It is important to remember the positive role that these financial instruments play in price formation and in covering market risks. Finance, the real finance, helps efficiency and competitiveness. To lose competitiveness and to lose market rating means, in the first place, to lose jobs.

The mechanisms of financing companies together with the mechanisms that guarantee the smooth investment of public debt are too delicate to be exposed to a tax like the one that is being considered. In these circumstances, it is unadvisable to introduce a tax experiment with unclear mechanisms.

The fear of seeing some of the most solid sectors of the economy of the UE countries hit irremediably increases also due to the lack of aimed regulations to protect important components of the financial market.

The funds industry risks being penalized.

Also unjustified is the lack of acknowledgement concerning internal operations which are in general connected to business matters and only concern the efficient organization of investing.

In some parts, the proposal questions some issues without taking into account operational consequences.

One of these issues concerns the anti-avoidance of taxing in cases when the transactions take place in a non-participating State.

The proposal states that the tax is payable if any party to the transaction is established in a participating Member State regardless of where the transaction takes place.

This decision is the same found in the French and Italian FTT. It intends to safeguard any kind of avoidance of the tax. However it remains unclear how this will be done, for example an Italian, French or German stock is being negotiated in the English market between an American bank and a Japanese bank.

On this point, the proposal affirms that the tax be paid by the financial borrower but it is up to the participating Member States on deciding the best way to implement and ensure this.

To this end it is useful to quote what was said by the Commission's representative in the House of Lords during a meeting held last March 19th: "There is no obligation whatever on non-participating member states of whatever kind as a result of legal acts on enhanced co-operation. It is up to Germany, to France, to Italy or to Spain to get the tax from this transaction. That is why we have, for example, foreseen joint and several liability. If the UK side does not want to pay then the German side might have to pay twice the tax, as an illustration. If it always ends up like this, at a certain point in time the German side might want to factor that into its prices or say, "Okay, my counterpart never pays the tax and I always have to take it over, so I do not enter into deals with them any longer", but there is no obligation as a result of enhanced co-operation on this".

It seems that such an exclusion of duty concerns also the intermediaries of non-participating States leaving the 11 participating States to carry the burden.

In other words, the German bank, as mentioned above as an example, would pay the tax twice and would sooner or later be forced to increase its prices to cover the double tax.

So also in this respect the lack of clearcut rules in the proposal is critical. It is absolutely necessary to clarify this.

Lastly, a look at the issues in the proposal that can also be considered critical.

Above all the anti-abuse provisions. They are detailed and complicated and should be evaluated carefully. In the first place one wonders how such provisions can work together with the rules in internal law. It is particularly delicate in Italy where this issue is still awaiting a solution.

Further attention should be given to the regulations which allow the Commission the power to force Member States to take measures for the registration, accountancy and results as well tax collecting.

It is important to ensure the maximum uniformity amongst the States. Ultimately, it is advisable to simplify the fulfillments foreseen by the regulations.

In particular, the idea of a monthly bulletin must be reconsidered, bearing in mind the lengths of time in these matters.

The idea of instant payment or a three-day limit for electronic transactions does not seem very practical.

To summarize it is not very promising as due to the crisis there is even more need for clarity and stability.

Annex:

Joint Statement from ABI, ANIA, Assogestioni, Assonime, Assosim, Confindustria and FeBAF to the Italian Minister of Economy and Finance (in Italian)

Roma
2 maggio 2013

Fabrizio Saccomanni
Ministro dell'Economia e delle Finanze
Via XX Settembre, 97
00187 Roma

Illustre Ministro,

le imprese italiane di tutte le categorie, finanziarie, industriali o commerciali, sono estremamente preoccupate di fronte all'eventualità di veder attuato il progetto presentato dalla Commissione Ue per l'attivazione di una forma di cooperazione rafforzata in tema di tassazione delle transazioni finanziarie (FTT).

Si tratta, e ne abbiamo chiara consapevolezza, di una proposta con portata assai più ampia e dirompente rispetto a quella dell'imposta recentemente introdotta in Italia, già di per sé carica di implicazioni di grande delicatezza.

Sappiamo bene che la proposta nasce dall'intento di dotare l'unione europea di una fonte propria di entrate, un obiettivo che in sé appare certamente condivisibile. Più discutibile, e con incerti fondamenti analitici e sistemici, è l'obiettivo di tassare le transazioni finanziarie, viste come una possibile fonte autonoma di entrate senza ricadute sull'economia reale e il buon funzionamento dei mercati finanziari. Non possiamo che ribadire, a questo riguardo, quanto già hanno ampliamente dimostrato innumerevoli studi e ricerche, a partire dallo stesso Fondo monetario internazionale, circa l'illusorietà di tali promesse – dato che si tratta di una base imponibile straordinariamente mobile che tenderebbe ad evaporare nel momento dell'applicazione dell'imposta. Come è stato anche recentemente confermato dalla breve esperienza di applicazione in Svezia, poi rapidamente abbandonata. Né si comprende come si possa procedere in tale direzione, in un certo senso appaltando al legislatore fiscale misure che possono risultare in contrasto con l'obiettivo di costruire un mercato finanziario efficiente, integrato e non distorto per l'Unione. Non può sfuggire, al riguardo, che il più importante mercato finanziario dell'Unione, quello del Regno Unito, sarà certamente esentato dall'imposta, cerando un immediato e consistente svantaggio competitivo per i mercati dei paesi aderenti all'iniziativa.

A noi preme, in questa sede sottolineare gli effetti avversi che si potrebbero verificare per l'attività d'impresa e gli scambi commerciali se l'imposta – che è prevista applicarsi a tutte le transazioni, inclusi i derivati di copertura estesamente impraticabili sui nostri mercati, spingendo le imprese a rivolgersi a intermediari dei mercati non colpiti dall'imposta con complicate operazioni estero su estero, distorsive e inefficienti. O se lo stesso costo finale dei finanziamenti ne risultasse accresciuto, tra l'altro a causa del ridimensionamento dei flussi di intermediazione. Maggiori costi che potrebbero tradursi in perdite di competitività e posti di lavoro. Né appare giustificato il mancato riconoscimento dell'esenzione per le operazioni infragruppo, che in genere rispondono a logiche di business che non hanno nulla di speculativo ma sono solo dettate dall'esigenza di organizzare nel modo più efficiente gli investimenti dei componenti del gruppo stesso.

I meccanismi di finanziamento delle imprese, unitamente a quelli che consentono di garantire il fluido collocamento del debito pubblico italiano, sono troppo delicati per poter accettare l'idea di un intervento fiscale potenzialmente molto dannoso, limitato inoltre a soli undici paesi. Il dubbio che le conseguenze dell'imposta siano gravemente sottovalutate è concreto.

Anche la mancanza di norme dirette a salvaguardare particolari figure e funzioni che rivestono un ruolo importante nei mercati finanziari, quali ad esempio le disposizioni italiane che disapplicano l'imposta per i fondi pensione e per i market makers, non può che aumentare la preoccupazione di veder colpiti in modo irrimediabile alcuni assi portanti dell'economia dei Paesi Ue.

L'industria dei fondi comuni rischia di essere penalizzata, fino a porre in discussione le funzioni che tali organismi possono svolgere come strumento di favore nella raccolta del risparmio di durata, diretto anch'esso, in ultima analisi, al finanziamento delle imprese.

In tale contesto, quindi, non si può che rinnovare l'auspicio di un ripensamento complessivo dell'intera proposta e a tale riguardo le imprese e gli intermediari con le rispettive Associazioni di categoria sono a disposizione per ogni contributo.

Con i migliori saluti.

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