TREASURY, RISK
AND FINANCE
PROFESSIONALS

The Association of Corporate Treasurers

Comments in response to
Call for evidence: towards a Financial Transaction Tax
Issued by the House of Lords European Union Committee
October 2011

4th November, 2011

The Association of Corporate Treasurers (ACT)

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 companies[1]. 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

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

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 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 is 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=downloadsedo&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.