Global Counsel

Is some form of European Financial Transaction Tax now inevitable?

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Summary

- There is now a significant probability of some form of new Financial Transaction Tax at some level in Europe.
- The fact that the UK is strongly opposed to such a tax and will veto any such measure at the EU level will not preclude an FTT being introduced among the Eurozone countries. The tax would impact on any financial institution selling or buying financial assets with Eurozone counterparties.
- The likelihood is that the Eurozone would levy the tax on the basis of a combination of residency and change of ownership of assets and this means it would impact on financial centres that specialize in financial intermediation such as London.

Twenty years after his death, James Tobin's idea of a tax on certain financial transactions to 'throw some sand' in the wheels of international financial markets is now more likely to be realized than at any point in the last two decades. What will not happen is a global tax on currency trades, as in Tobin's original model. Nor is there likely to an international agreement on any kind on a tax.

However, the balance of probabilities has now shifted in favour of the creation of a similar tax among Eurozone states. Although the usual reaction is to write off such a prospect as an act of economic self-harm by Eurozone states, the likely design of the tax is such that it will have implications for financial centres and market participants across the global economy.

It is striking, however, that even the states that are likely to implement such a tax do not agree on what it is for. They do, however, agree on its political necessity. This Global Counsel Insight note looks at the politics that have made some kind of financial transaction tax a plausible prospect Europe, and some of the implications for financial businesses, whether they actually transact in the Eurozone or not.

One tax, many motives

The idea of a new tax on financial transactions in the EU emerged quickly after the financial crisis. Its logic was generally punitive, but often somewhat contradictory: it would disincentive purely speculative low margin trading and would raise revenue to supply (or compensate after the fact) bailout funds for the banking sector. The French Presidency of the G20 produced a third variant, strongly endorsed by Bill Gates and a wide coalition of NGOs: a tax whose revenues could be used to fund global development programmes. The fact that the financial services sector was exempt in some respects from sales tax, and thus 'undertaxed', was also cited as an argument for additional taxation. So too was the fact that different jurisdictions in the European single market tax financial transactions in different ways which militated in favour of harmonisation.

In 2011 the European Commission surprised most observers by proposing such a tax not as a means of financing bailout funds, or third world development, but as a means of funding the EU budget itself. The Commission knows that in the long run it needs to establish sources of 'own revenue' independent of the direct budget contributions of member states, as its key source of such funds is currently the dwindling revenues from the EU's external tariffs. A financial sector tax is a politically palatable possibility, popular with the European Parliament and many member states. In some respects the Commission services are playing a long game, and will be content to allow the idea to percolate through EU budget negotiations, even over a decade or more.

The debate in the EU can move in two directions at this point. There will be a continued discussion on such a measure at the EU level, in which the Parliament can be expected to be the strongest advocate. However, without international agreement, such a tax at the EU level was and is a political non-starter while the UK remains in the EU. Tax remains a national competence and EU measures are subject to unanimity at the EU level. London will never agree to an imposed tax on a key comparative advantage.

Even if the European Council shifts the debate to a 'Financial Activities Tax' levied not on transactions but on balance sheets, London is likely to remain deeply hostile. Although the UK already levies balance sheet tax in the form of its bank levy, it is also likely to show zero enthusiasm for harmonising this tax at the EU level, especially if the funds were essentially retargeted to EU-level initiatives. The political toxicity of any kind of cooperation with the wider EU on financial services taxation make UK engagement in any kind of tax agreement very unlikely even in the long term.

A tax on skis: bad news for Switzerland

More likely is an initiative that circumvents UK resistance by acting at the Eurozone level through the enhanced cooperation procedure. Eurozone states - or even a smaller group of states within the Eurozone, in theory - are free to pursue such a measure as a group, even if states such as the UK or Sweden (which pursued such a tax on equities in the 1990s and saw much of the business decamp to London) would explicitly reject such proposals at a wider level. This would probably take the form of a Eurozone tax on securities and derivatives transactions.

If Berlin and Paris were sufficiently politically committed to implementing such a tax, they could do so. Both President Sarkozy and his challenger for the French Presidency, Francois Hollande, are strong supporters of such a tax. Indeed, Sarkozy has pledged a unilateral version in France should he win the May Presidential election. Berlin has endorsed such a tax, and has actually written revenue from such a tax into its 2013 budget. Mario Monti's Italian government is more tentative, but is likely to find its negotiating hand badly weakened by the circumstances.

Officials in Brussels and national capitals believe that the answer to avoiding the Swedish problem of relocation is to tax secondary market transactions with financial institutions not at the point of exchange, but on the basis of residency *and* change of ownership (either buying or selling) of the asset in question. This would mean that a bank parented in the Eurozone selling or buying assets in London (or New York, or Shanghai for that matter) would still be subject to the tax, even if London itself implemented no duty. Given that a very large number of Eurozone financial institutions currently book securities trade through London, the potential impact is not insignificant.

Obviously, many of London's current non-Eurozone customers could avoid the tax by trading with counterparties not based in the Eurozone, but the large number of institutions within the Eurozone for whom relocation out of the zone is not a viable option would see the costs of transacting in London or elsewhere rise. London would feel the impact simply as a market in which this business was conducted, in much as the same way as a Eurozone tax on skis would be felt in Switzerland. US and Asian governments would complain about the extraterritorial reach of such a tax, but the US does not have much of a record in applying a check on extraterritorial effects in in own policy.

The politicians take it to the speculators

So will it happen? Obviously, Eurozone governments are coming under sustained pressure from banks and others not to implement such a tax. Tough rhetoric from politicians on such a tax measure does not guarantee action. Merkel is not enthusiastic about French plans for incorporating such a tax in the new European Treaty to be signed in March, but this has more to do with a general German strategy of keeping the Treaty as narrow and politically uncontroversial as possible.

But Merkel has personally committed to such a tax although her junior coalition partner the FDP are strongly opposed. However, Merkel also knows that she will face a run-off in 2013 against a Social Democratic Party that endorses the tax. The Finns are broadly in favour of a Eurozone tax, as are the Spaniards. The Dutch are broadly opposed, as are the Irish, although the latter are negotiating with a very weak hand.

Critics will point to the fact that the Commission's slightly threadbare impact assessment suggests that a tax is unlikely to be both a significant revenue generator *and* a disincentive to high frequency or 'speculative' trading. The Commission's own assessments of the likely impact on European GDP caused by the suppression of certain forms of trading suggest little or no positive revenue effect.

Politically this is beside the point. The tax is viewed chiefly as a political symbol: of a willingness to tackle 'speculation' and of a willingness to ensure that the financial sector 'pays its fair share' of the costs of the current and future crises. In Finnish politics, for example, the explicit trade-off demanded by the Social Democrats for support of any further Eurozone bailouts is support for a financial transaction tax. This captures the basic political logic pretty well.

The current direction of travel also reinforces something fundamental about what is happening in the EU, in both financial services and other areas. Although it is sometimes argued that London's isolation after the December 2011 Summit weakens its ability to block such measures, this is not really the case. The UK retains the ability to ensure that no new financial services taxation is implemented at the EU level.

However, as this issue highlights, it has little or no ability to block a concerted effort by Eurozone states to implement new taxes, irrespective of their extraterritorial effects. Therefore, this is not a question of the UK's place in the EU, but in the Eurozone. As the Eurozone begins to move, however incrementally, towards a more politically integrated economic future, there will be an inevitable diminution of the UK's ability to determine its economic direction. It should also leave the UK financial services sector in no doubt that it continues to have a serious political problem in Europe, and one in which London cannot be its only ally.

On balance a financial transaction tax in the Eurozone now looks narrowly more likely than not, especially if economic conditions continue to deteriorate or if further public bank support is required in the Eurozone. The fact that Eurozone leaders have differing views on what the tax is actually for is in itself unlikely to exert much of a check on it being levied. Certainly, financial institutions in France and Germany and those that transact with them - *even where they transact outside of the Eurozone* - should have contingency plans for its implementation at some point in the short to medium term.

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