Robin Hood on Steroids

An Analysis of the Current Proposal for an EU FTT

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Key Terms & Abbreviations

**Key terms**

Alternative Investment Funds
An alternative investment fund is a collective investment undertaking with the aim to invest capital from several investors for the benefit of the investors and in accordance with a defined investment strategy, see art. 4.1(a) directive 2011/61/EU on alternative investment fund managers.

Alternative Investment Funds Managers
A legal person who is responsible for managing one or several alternative investment funds according to art. 4.1(b) of directive 2011/61/EU.

Bond
A bond is a security where the issuer agrees to pay the lender interest during the life of the security and a fixed amount at a determined date in the future.¹

Central Securities Depositories
Central securities depositories is defined by the European Central Bank as; an entity that makes the processing and settlement of securities possible. The entity should also play an active role in ensuring that the issuance of securities is conducted with integrity and the entity should also provide custodial services.²

Central Counterparty or Central Counterparty Clearing House
Is defined in art. 2(1) of regulation (EU) No 648/2012 as a legal person that takes a central role in the transfer of contracts traded on the financial markets. The central counterparty becomes the buyer to each seller and the seller to each buyer.

Commodity
Products that are perfect (or close to perfect) substitutes to each other, like for example wheat, cotton and crude oil. In order for the products to be trades as commodities on the financial markets there has to be a large organized worldwide trade. Usually a

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¹ Brockington, p. 32.
commodity is a raw material that needs to go through a manufacturing process before being provided to the consumer.³

Derivative
Derivatives can be formed as futures contracts, option contracts, swap agreements etc. The price of a derivative is dependent on an underlying asset. Derivatives create a market for the risk of an underlying asset. As an example a company might want to sell a large amount of commodities but has to wait until next year. If the company does not want the uncertainty of the asset value in one year they can choose to sell the risk of a price change to someone willing to hold it. The price is locked at today’s level and the risk for the company is decreased while an investor is able to make a possible gain if the asset price goes up during the year. The exemplified type of derivative is called a future’s contract.⁴

Hedging
Market participants hedging their positions means that they are trying to balance out the risks by, for example spreading investments on different sectors or using futures contracts (see derivatives) to decrease the risk of the company’s operations.⁵

International Central Securities Depositories
Is a central securities depository set up specifically to handle Eurobond trade or internationally traded securities from several domestic markets.⁶

Liquidity
Liquidity measures how easy it is to realize an asset with minimum loss of value. High liquidity means that an asset is easy to sell without losing value. Normally, high liquidity is associated with a working market. Money is usually considered one of the most liquid assets.⁷

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³ Adam, p. 123.
⁴ Maurer, Schulman, Ruwe, Becherer (a), pp. 404 ff.
⁵ Maurer, Schulman, Ruwe, Becherer (a), p. 729.
⁷ Adam, p. 319.
Multilateral trading facility
Multilateral trading facilities are defined under art. 4.1 (15) of the MIFID as: “multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provisions of Title II“.

Over the Counter Trading
Is also called off exchange trading and is a trade directly between two parties. This contrasts to for example stock trading on regulated markets like the London Stock Exchange where a central party is involved in the trade.⁸

Primary Market Transaction
A primary market transaction is the purchase of a security (for example a share) directly from the issuer. When a company gets listed the first transaction from the company to investors is a primary market transaction.⁹

Repurchase Agreement
The process in which a security is sold combined with an agreement that the seller has the possibility to buy back the security at a later date. The price is often fixed and higher than the sale price. The price is fixed and the repurchase agreements perform a function as a loan to fixed interest where the sold security is used as collateral, see art. 3.1(m) of directive 2006/49/EC on the adequacy of investment firms and credit institutions.

Reverse Repurchase Agreement
The inverted process of a repurchase agreement. For the buyer in a repurchase agreement (buying the security and agreeing to sell it back at a later date) the process is called a reverse repurchase agreement, art. 3.1(m) of directive 2006/49/EC.

Securities
 Tradable financial assets in any form. The company issuing the securities, for example shares, is usually called issuer. Securities make it possible to invest indirectly in companies limiting the investors’ liability to the invested capital.¹⁰

⁸ Maurer, Schulman, Ruwe, Becherer (b), pp. 1133 f.
⁹ Art. 5(c) of regulation (EC) no. 1287/2006.
Share
A security whose price is directly dependent on the valuation of a company. The share itself represents a specific part of the capital of the company. Each share gives the owner a part of the ownership of the company.\textsuperscript{11}

Structured product
Structured product is a collective term for a market linked investment strategy. A structured product can take many forms for example; securities, options, derivatives or practically any other financial product.\textsuperscript{12}

Volatility
Volatility measures the financial stability of a product. Higher volatility means higher variations in price and is synonymous with higher risk. Higher volatility leads to higher insecurity in the financial markets.\textsuperscript{13}

\textsuperscript{10} Maurer, Schulman, Ruwe, Becherer (b), pp. 1300 ff.
\textsuperscript{11} Adam, p. 460.
\textsuperscript{12} Brockington, p. 231.
\textsuperscript{13} Mannaro, Marchesi, Setzu, p. 446.
# Abbreviations

AIF | Alternative Investment Funds  
---|---  
AIFM | Alternative Investment Funds Managers  
CCP | Central Counter Party  
CSD | Central Securities Depositories  
ECB | European Central Bank  
EIB | European Investment Bank  
EUP | European Parliament  
EU | European Union  
FTT | Financial Transaction Tax  
GDP | Gross Domestic Product  
ICSD | International Central Securities Depositories  
IMF | International Monetary Fund  
MNE | Multinational Enterprise  
MTF | Multilateral Trading Facility  
OTC | Over the Counter  
ROI | Return on Investment  
SME | Small and Medium Enterprises  
SSPE | Securitization Special Purpose Entity  
SPV | Special Purpose Vehicle  
TEU | Treaty on European Union  
TFEU | Treaty on the Functioning of the European Union  
UCITS | Undertaking for Collective Investments in Transferable Securities  
VAT | Value Added Tax
1 Introduction

1.1 Background

In 1978 the Nobel Prize winner James Tobin published an article proposing an international tax on spot currency transactions.\textsuperscript{14} The tax, often referred to as the “Tobin tax” was meant to stabilize the currency market and solve problems caused by speculation and short-term trading.\textsuperscript{15} By reducing speculation and short-term trading the Tobin tax was supposed to decrease the volatility of the international monetary market and stabilize the economies of the world. The Tobin tax was suggested to be implemented on an international level. The proposed European Union (EU) Financial Transaction Tax (FTT) differs from the Tobin tax, as it is not a tax on spot currency transactions but on other financial activities.\textsuperscript{16} However, the same thoughts characterize the FTT proposal as the Tobin tax. Transaction taxes, like the Tobin tax and the FTT, produce disincentives for short-term speculation and encourage long-term investments.\textsuperscript{17}

For many years the Tobin tax and other similar proposals for international taxation on financial transaction was nothing else but ideas. After the latest financial crisis the taxation of the financial sector became a hot topic. The crisis had led to high fiscal costs for governments around the world.\textsuperscript{18} In 2010 the International Monetary Fund (IMF) estimated the direct fiscal costs to be 2.8 \% of Gross Domestic Product (GDP) in the G-20 countries.\textsuperscript{19} For the G-20 countries experiencing a system crisis the average total costs were 26 \% of GDP.\textsuperscript{20} The Commission estimated the total costs of the financial crisis to be at least 15-20\% of GDP of the EU member states (MS).\textsuperscript{21} The costs lead to an increase of government debt.\textsuperscript{22} One of the main arguments for imposing a tax at the financial sector is that it can help to pay off the debt that the financial crisis, and

\textsuperscript{14} Tobin, pp. 153 ff.
\textsuperscript{15} Tobin, pp. 157 ff.
\textsuperscript{16} Spot currency transactions are excluded from the current proposal of an EU FTT, COM (2013) 71 final, pp 8 ff. There are of course other differences, but this is the difference that makes the EU FTT proposal and the Tobin tax fundamentally different taxes.
\textsuperscript{17} A tax levied upon every transaction naturally, by its design, discourages high volume trading by imposing a higher tax burden the more transactions that are carried out and therefore discourages short term transaction.
\textsuperscript{18} IMF, pp. 31 ff.
\textsuperscript{19} IMF, pp. 6 ff.
\textsuperscript{20} IMF, p. 6.
\textsuperscript{22} IMF, p. 7.
indirectly the financial sector, gave birth to.\textsuperscript{23} Another reason for imposing a tax aimed at the financial sector was the view that the financial sector is under-taxed in comparison to other sectors because it is excluded from Value Added Tax (VAT).\textsuperscript{24}

The FTT could be used in order to influence the behavior of the financial sector.\textsuperscript{25} This idea corresponds to the thoughts behind the original Tobin tax.\textsuperscript{26} One important aspect that has been lifted is that the FTT should limit high-risk trading.\textsuperscript{27} For the FTT to efficiently target high-risk trading, the tax rate has to be high enough to reflect the externalities that are causing the market participants to engage in high-risk trading.\textsuperscript{28} The tax also has to target the risk-enhancing transactions of the financial institutions.

A good example of the previous risk-situation is the recent financial crisis. Before the financial crisis 2007 market participants undertook high-risk investments and because of this also registered record-breaking gains.\textsuperscript{29} After the crisis taxpayers around the world rescued the risk takers (mainly banks). The profits go to the bank but if a high-risk project leads to a loss that jeopardizes the financial system, then taxpayers have to pay the bill. The problematic situation is often referred to as “too big to fail”.\textsuperscript{30}

The IMF published a report for the G-20 meeting 2010. The report investigated different tax alternatives for the financial sector.\textsuperscript{31} Among the discussed alternatives, even though the IMF favored another alternative, was an FTT.\textsuperscript{32} Some countries opposed a worldwide FTT leading to the effect that an international implementation would not be possible.\textsuperscript{33}

\section*{1.2 Prelude}

The existing literature on the area of the EU FTT (hereinafter FTT) is in many cases characterized by its subjectivity. Few reports about the FTT, taking both legal and economic effects into account, have been made in an objective manner. This paper has

\begin{footnotesize}
\begin{enumerate}
\item COM (2013) 71 final, p. 4.
\item European Parliament, p. 34.
\item Af Ornä, Wiberg, p. 506.
\item Tobin, pp. 153 ff.
\item COM (2013) 71 final, p. 4.
\item Af Ornä, Wiberg, p. 509.
\item Keen, Krelive, Norregaard, pp. 131 ff.
\item Af Ornä, Wiberg, p. 510.
\item IMF, A Fair and Substantial Contribution by the Financial Sector.
\item IMF, pp. 19 ff.
\item BBC 2009, http://news.bbc.co.uk/2/hi/uk_news/8348653.stm
\end{enumerate}
\end{footnotesize}
the ambition to combine the legal aspects as well as the anticipated economic outturn of the proposal for an FTT. It is however hard to foresee the future and calculate market scenarios after an introduction of the FTT. Analysis based on speculative reactions will therefore be made with caution.

For readers not used to read about the financial markets I recommend taking a deep look at the “key terms” (p. 4) before reading the rest of the paper. The understanding of the key terms is of vital importance in order to follow the on-going analysis in this report.

1.3 Purpose
Reading the existing literature on the FTT it is often hard to know what to think. Some authors are convinced about the horrifying effects of the FTT while others, equally convinced, means that this is a perfect instrument to get the financial institutions to contribute. This paper will make a serious attempt to analyze the effects of the FTT and how it corresponds to it objectives. The conclusions made in this paper will be presented with caution when the underlying assumptions are somewhat unsure in order not to produce yet another paper screaming for the success or failure of the FTT. During the research before writing this paper it has become evident that many of the big differences between different authors’ views lay within the insecurity of how the effects of the proposal will be depicted. In order to produce a relevant paper that successfully judges how the proposal corresponds to its objectives it is necessary to first investigate the effects of the current proposal. In the second step the effects will be used in order to analyze how well the proposal corresponds to its objectives.

1.4 Delimitation
In regards to the chosen purpose, the paper will not focus on the principle of subsidiary and the FTT-proposals compatibility with EU law. Further research could be performed on this topic. Instead the objectives of the proposal will be analyzed with ground in the anticipated effects of the FTT. Not all parts of the directive will be analyzed. Instead, the paper focuses on the parts important in order to conduct a study in line with the purpose.
1.5 Method
The paper is based on an extensive literature study. In analyzing the proposal, a EU legal method will be applied together with a classic legal method. The classic legal method is applied by analyzing the proposal by interpreting existing laws using relevant legal sources.\textsuperscript{34} A EU legal method means that the legal principles of the EU will be used in order to interpret the proposal.\textsuperscript{35} The primary EU law is the treaties Treaty on the Functioning of the European Union (TFEU) and the Treaty on European Union (TEU).\textsuperscript{36} The secondary law consists of directives and regulations.\textsuperscript{37} The supplementary law includes, among others, general principles of the EU and the case law from the European Court Of Justice (ECJ).\textsuperscript{38} The proposal for an FTT is secondary law and the proposal relates to many other sources of EU secondary law. The paper will therefore, mainly process EU secondary law and relevant literature will be used to interpret the provisions.

The analyzed proposal for an FTT is not yet implemented. This has the outcome that any effects of the FTT are, to some extent, speculative. In order to thoroughly examine the anticipated effects of the FTT; both legal and economic research will be used. The anticipated effects will be used in the following analysis on how the proposal responds to its objectives.

1.6 Disposition
The report will start with a short background explaining why an FTT is being discussed and explain the applicability of the proposed European FTT. Tax rates and enforcement will also be mentioned. The description of applicability will be extensive and in some parts technical. It is however important for the reader to get a good grip of the applicability and possible exemptions in the applicability as it is critical for the understanding of the later parts of the work. Once the applicability is explained the report will analyze the effects of the proposal. The anticipated effects will be used in order to determine whether the proposal fulfills its objectives.

\textsuperscript{34} Peczenik, p. 131.
\textsuperscript{35} Hettne, Otken Eriksson, p. 159.
\textsuperscript{36} Hilling, Ståhl, Persson Österman, Öberg, p. 24.
\textsuperscript{37} Hilling, Ståhl, Persson Österman, Öberg, p. 21.
\textsuperscript{38} Hilling, Ståhl, Persson Österman, Öberg, pp. 28 f.
2 The Process Towards an EU FTT

When a global implementation of a tax aimed at the financial sector was not possible, the EU began investigating the possibilities for a EU solution. The report from IMF “A fair and substantial contribution by the financial sector” investigated an FTT but ended up favoring a Financial Activities Tax (FAT). A FAT in its most extensive form is a tax levied upon the total profit and wages of a company, but the tax can also be designed to target specific risk factors like institutional size or excessive rents. In a communication 2010 the Commission analyzed the FAT and the FTT as two alternatives on taxing the financial sector within the EU.

The Commission recognized that an FTT ideally would target harmful or highly speculative trading but also acknowledged that it was impossible to distinguish harmful transactions from other transactions. Instead, the Commission argued that the tax base has to be broad, in order to avoid favoring certain instruments over others. A broad base also minimizes the possibilities to avoid the tax. In 2010 the Commission ended up recommending a FAT above an FTT. The recommendation was based mainly on the risk for relocation when a tax like the FTT is implemented at a unilateral level. After the communication COM (2010) 549 final, the Commission started working on an extensive impact assessment for the different alternatives. The consultation that followed showed a greater support for the FTT rather than the FAT among the MSs.

In 2011 the European Commission adopted a first proposal for a EU-wide FTT.

The FTT is an indirect tax as it taxes consumption of financial services, compare with art. 113 TFEU. Indirect taxes fall within the shared competence under art. 113 TFEU. During a council meeting in 2012 it became clear that the unanimity required under art.

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39 COM (2010) 549 final, see also Cortez, Vogel 2011, p. 16 and Henkow, p. 5
40 The IMF favoured the FAT over the FTT, IMF, pp. 19 ff.
113 TFEU could not be reached.\textsuperscript{50} While some countries were optimistic others countries were taking a clear stand against an EU-wide FTT. During the meeting a significant amount of delegations supported the idea of implementing an FTT under enhanced cooperation. As a result 11 MS decided to submit a request for enhanced cooperation in the area of an FTT. In January 2013 the European Council authorized the request.\textsuperscript{51} The latest proposal, COM (2013) 71 final (hereinafter “the proposal”) for an FTT was published in February 2013.\textsuperscript{52} The proposal have a lot of similarities with the earlier proposal from 2011 but some important alterations were made to prevent tax avoidance and to make sure that the proposal is in line with EU-law.\textsuperscript{53} For example transactions that are carried out as a part of restructuring operations were precluded in the proposal.\textsuperscript{54} Furthermore, the scope of the FTT was substantially widened in the proposal with the introduction of the issuance principle and the passport principle.\textsuperscript{55} The changes were made in order to reduce the risk of tax avoidance and to prevent financial transactions being relocated outside of the FTT-zone.\textsuperscript{56} The European Parliament (EUP) as well as the Committee on Economic and Monetary Affairs has proposed some amendments to the current proposal.\textsuperscript{57} The EUP does only play a consultative role, and it is not clear if the proposed changes will be taken into account.\textsuperscript{58} According to the proposal, the participating MS shall adopt the legislation necessary to comply with the directive by the 30\textsuperscript{th} of September 2013 and the provisions shall apply from the 1\textsuperscript{st} of January 2014.\textsuperscript{59} The Commission has indicated that the implementation will be delayed but still hopes for the FTT to be in effect in the middle of 2014.\textsuperscript{60} There are authors arguing that a realistic time frame is an implementation not earlier than the 1\textsuperscript{st} of January 2015.\textsuperscript{61}

\textsuperscript{50} Press release 11682/12, 3178th council meeting Economic and financial affairs.
\textsuperscript{51} Council decision 2013/52/EU.
\textsuperscript{52} COM (2013) 71 final.
\textsuperscript{53} COM (2013) 71 final, pp. 4 f.
\textsuperscript{54} Compare art. 1.4 COM (2011) 594 final with art. 3.4(g) COM (2013) 71 final. Not precluding group restructuring might be in breach of the Capital Duty Directive.
\textsuperscript{55} These principles will be explained and analysed below.
\textsuperscript{56} COM (2013) 71 final, pp. 4 f.
\textsuperscript{58} Art. 113 and art. 289.2 TFEU.
\textsuperscript{59} COM (2013) 71 final, p. 30, the proposed Directive art. 20.
\textsuperscript{60} European Commission 2013, http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm
\textsuperscript{61} Lappas, Ruckes, p. 120.
The Commission recognizes that an FTT could only minimize the risk of relocation induced by the taxation and generate sufficient revenues if introduced at a global level.\textsuperscript{62} The second best alternative would have been an EU-wide FTT. As neither the best nor the second best alternative was possible to achieve within a reasonable period of time, the enhanced cooperation was then seen as the best possible alternative.\textsuperscript{63} A broader base of participating countries reduces the risk of relocation and increases the chances for the FTT to work effectively.\textsuperscript{64}

3 The Objectives

The original proposal from 2011 had three main objectives; avoid fragmentation of the internal market, ensure that the financial sector contributes to the costs of the crisis and creating appropriate disincentives for harmful transactions.\textsuperscript{65} The objectives remain the same in the latest proposal from 2013.\textsuperscript{66} The three objectives will be investigated and explained individually. Later the fulfillment of the objectives will be analyzed.

3.1 Avoid Fragmentation of the Internal Market

- “...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,”\textsuperscript{67}

The first objective aims at avoiding that all MS’s adopts taxes individually and therefore distorts the internal market.\textsuperscript{68} This argument was used in order to motivate the enhanced cooperation. The logic behind the argument is that the harmonization by a group of MS’s is better than no harmonization.\textsuperscript{69} The Commission recognized that the second best solution, after a global implementation, would be full integration throughout the EU. When neither the best nor the second best was possible, the Commission meant that harmonization in a part of the EU is a better alternative than no harmonization at all.\textsuperscript{70} Non-participating MS’s have raised concerns that the FTT will fragment the internal

\textsuperscript{62} SWD (2013) 28 final, p. 8.  
\textsuperscript{63} SWD (2013) 28 final, p. 10.  
\textsuperscript{64} Cortez, Vogel 2013, p. 1003.  
\textsuperscript{65} COM (2011) 594 final, p. 2.  
\textsuperscript{68} COM (2013) 71 final, p. 4.  
\textsuperscript{70} COM (2013) 71 final, p. 7.
The Commission means that both participating and non-participating MS’s will benefit. The Commission's view is based on the thought that non-participating MS’s will benefit because companies from non-participating states will be confronted with one single system of an FTT instead of eleven different systems. This would in turn decrease compliance costs and simplify cross-border activity both for companies of non-participating MS’s and companies of participating MS’s, according to the Commission. In order for the first objective to be fulfilled the FTT have to improve the functioning of the internal market.

The first objective also states that national legislation was put in place or was going to be put in place in several MS’s. Indirect taxation on financial transactions existed in 11 MS’s at the time of the latest proposal making the statement realistic. There are however significant differences in the indirect taxes on financial transactions implemented by national governments, and the FTT proposed by the Commission. For example the French, Italian and UK taxes all have a considerably narrower scope of application.

In order for the FTT to fulfill the first objective it is also important that the proposal does not lead to double taxation, as this would harm the internal market and counteract against the objective. Double taxation gives competitive advantages to companies that do not engage in cross border activities and raises incentives against operating in several MS’s. The current proposal gives rise to situations where double taxation will occur. This has to be solved with double taxation treaties, as the proposal does not provide for any solutions to double taxation problems.

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71 See for example the Swedish „Skatteutskottets“ opinion; 2012/13:SkU33.
75 SWD (2013) 28 final, pp. 60 f.
76 Cortez, Vogel 2013, pp. 1000 f.
77 Cortez, Vogel 2013, pp. 1000 f. There are also a lot of similarities between the taxes. All taxes uses the issuance principle and both the French and the Italian seem to be inspired by the British Stamp Duty. All taxes have a much narrower scope of applicability than the FTT proposed by the commission.
79 Cortez, Vogel 2013, p. 1004.
3.2  Ensure that the Financial Market Contributes to the Costs of the Crisis

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

The second objective aims at making sure that the financial sector contributes to a fair part of the costs of the crisis.

The thought that the firms responsible for causing the crisis should have to bear part of the costs is comparable to the polluter pays principle. However, it is debated whether the polluter pays principle may rectify the FTT as not only the “financial polluters”, e.g. the financial institutions that contributed to the crisis, pays. To fulfill this objective the tax should ultimately target the financial institutions responsible for the crisis. Nonetheless, it is also possible to argue that all financial institutions (even those not responsible for the crisis) have benefited from the rescue of the financial institutions 2008-2012. This fact could motivate that all financial institutions should pay the tax, even though this interpretation does not directly correspond to the wording of the objective.

The second objective is not only targeted at covering the costs of the recent crisis but also aims to “create a level playing field with other sectors”. With this phrase the EU insinuates that the financial sector is under taxed compared to other sectors. This part can be motivated using several different arguments that will be investigated later.

3.3  Create Appropriate Disincentives

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

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81 See for example COM (2010) 495 final, p. 5, and Dietlein, p. 207.
82 Meaning that the FTT do not differ between taxing transactions dangerous to the financial system and exempting transactions that are not. Furthermore the tax does not differ between the institutions that were responsible for the crisis and those that were not.
83 SWD (2013) 28 final, p. 11.
The third objective could be divided into two different parts. The first part aims to limit transactions that do not enhance the efficiency of the financial markets by setting up disincentives for those transactions. In order for fulfill this part of the objective the FTT should ideally be targeted at harmful or speculative transactions. Furthermore, the tax has to be high enough to cancel out the externalities causing the financial institutions to engage in high-risk transactions. The tax should ideally be designed to avoid targeting transactions that enhance the market functioning. Creating a tax that only aims at the harmful speculations is, to say the least, complicated. It should be considered acceptable that some non-harmful transactions are covered as long as the overall effect on the market is positive.

The second part of the third objective is that the FTT should complement regulatory measures in avoiding future crises. By doing so the reader gets the impression that the transactions targeted by the FTT are a known cause of financial crises. In order for the FTT to prevent future crises there has to be a bond between the transactions limited by the FTT and their cause to financial crises.

4 The Current Proposal for an EU FTT

4.1 Applicability

For the FTT to be applicable some requirements set up in the proposal have to be met. First of all it has to be a financial transaction with a financial instrument. Furthermore, one of the parties needs to be a financial institution and the transaction somehow has to be linked to the FTT-zone. The criterions will be examined individually starting with financial instruments.

4.1.1 Financial Instruments

Central to all the applicable situations is the definition of “financial instruments”. The definition in art. 2.1(3) of the proposal refers to the definition of financial instruments in section C, annex 1 of the directive 2004/39/EC on Markets in Financial Instruments (MiFID). The definition of financial instruments in Section C in MiFID is broad (see

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86 The externalities in this case is the high profit potential.
87 This part of the first objective is also found in recital 1 of the proposal.
88 FTT-zone includes the eleven contracting states; Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia, COM(2013) 71 final, recital 2.
It includes, among others, transferable securities, options, money market instruments, swaps, derivate instruments and financial contracts.

The first part of the definition in section C, p. 1 of the MiFID includes transferable securities. Transferable securities are defined in art. 4.18 of the MiFID. The definition includes shares in companies or other equivalent securities, bonds and other forms of securitized debt as well as depositary receipts of shares, bonds and other forms of securitized debt. In addition, securities giving the holder the right to a cash settlement or the right to acquire or sell any transferable securities are included in the definition under art. 4.18(c) MiFID. The broad definition of transferable securities makes it hard to disguise a transferable security as something else by selling the right to dispose of it.

Money market instruments are defined in art. 4.19 MiFID. The definition includes instruments that are normally traded on the money market, for example; treasury bills, certificates of deposit and commercial papers. Excluded from the definition of money markets instruments are instruments of payment. Instruments of payment are not further defined in the MiFID. The European Central Bank (ECB) has defined instruments of payments as: “… a tool or set of procedures enabling the transfer of funds from the payer to the payee.”

Undertaking for Collective Investments in Transferable Securities (UCITS) are included under the definition of financial instruments, section C p. 3 of MiFID.

Section C p. 4 of MiFID is the first out of seven points defining derivatives. The methodology of the definitions of derivatives is the same in p. 4 –7 and in p. 10. First of all the form of instruments, which can be seen as a derivative, are defined. This definition is the same in all the provisions that address derivatives in MiFID section C. The technical aspects of derivatives are defined as options, futures swaps, forward rate agreements and any other derivative contract. The definitions are explained through the examples and then accompanied by “any other derivative contract”. This means that by definition all securities constructed as a derivative, will be covered by the technical aspects of the definition. Decisive for if a certain derivative is to be included in the definition under the MiFID section C is what underlying asset the derivative receives its value from. In p. 4 derivatives relating to all kinds of financial instruments, including other derivatives, are covered. Derivatives relating to commodities are contingent on

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90 Kokkola, p. 28.
that they have to be settled in cash or may be settled in cash by request of one of the parties.\textsuperscript{91} Derivatives related to commodities that are settled physically are included when they are traded on a Multilateral Trading Facility (MTF)\textsuperscript{92} and/or on a regulated market.\textsuperscript{93} Derivatives that relate to commodities that can be physically settled are mentioned in p. 6. In p. 7 derivatives that have the characteristic of other derivatives and that do not have a commercial purpose are included.\textsuperscript{94} Derivatives used for transferring credit risk are included under p. 8. Any financial contracts for differences are included under p. 9. Under p. 10 derivatives related to climatic variables or official economic statistics are within the scope when they must be settled in cash or may be settled in cash upon the request of one of the parties.\textsuperscript{95} Also any other derivatives that have the characteristics of other derivative financial instruments are included under p. 10. All together p. 4-7 and p. 10 cover all pure financial derivatives.\textsuperscript{96}

In addition to the definition of financial instruments in the MIFID, structured products are covered under art. 2.1(3) of the proposal. Structured products are defined under art. 2.1(7) and the definition involves tradable securities or financial instruments offered through securitization. Securitization is defined in art. 4(36)(a) and (b) of directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions. Securitization is the process whereby credit risk is divided into different parts with the attributes that the payment within the border of the transaction is dependent on the development of the exposure or the risk of exposures. Furthermore the priority of the different parts determines how losses before the maturity date are divided.

In summary, the definition of financial instruments is broad and includes almost all financial instruments.\textsuperscript{97} This is also the intention as financial instruments often have close substitutes.\textsuperscript{98} If certain instruments were precluded in the definition it would be

\textsuperscript{91} Annex 1 section C point (5) of MIFID.
\textsuperscript{92} MTFs are defined under art. 4.1 (15) of the MIFID as: “multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provisions of Title II in MiFID”.
\textsuperscript{93} Annex 1 section C point (6) of MiFID.
\textsuperscript{94} Annex 1 section C point (7) of MiFID.
\textsuperscript{95} Annex 1 section C point (10) of MiFID.
\textsuperscript{96} Henkow, p. 10.
\textsuperscript{97} As an example derivatives relating to a commodity as underlying asset not being traded on regulated markets are excluded.
\textsuperscript{98} COM (2013) 71 final, p 8.
possible to avoid taxation by simply switching the investments to other types of instruments.

### 4.1.2 Financial Transactions

Financial Transactions are defined under art. 2.1(2) of the proposal (see appendix B). First of all, the purchase and sale of financial instruments are included. This means that the tax will be liable both for the seller and the buyer, provided that the other prerequisites are fulfilled. The effective tax rate will therefore be twice as high for transactions between two financial institutions as the effective tax rate for the same trade between a non-financial institution and a financial institution. Using an intermediary as a measure to decrease the tax burden between to financial institutions will not be possible as the two financial institutions still will be liable to pay the tax when buying or selling the instrument to the intermediary resulting in the same tax effect as a direct trade. It is also defined that a financial transaction in the meaning of the proposed directive occurs before netting or settlement. Netting is defined in art. 2(k) of directive 98/26/EC on settlement finality in payment and securities settlement systems according to art. 2.1(10) of the proposal, and means the conversion in to one net claim that can be demanded or owned. By imposing the tax before netting or settlement the proposal targets gross transactions. The reason for applying the tax to gross transactions is to simplify the calculation of the tax. It is reasonable that the FTT is levied on gross transactions, as the thought with the FTT is to target the transactions and not the value added.

Transfers between entities of a group are also covered by the proposal. In order to reduce the risk of tax avoidance for intra group transfers, the scope also includes the transfer between entities that are not a sale or a purchase. The prerequisite that has to be fulfilled is that the right to dispose of the product has been transferred or a similar activity implying that the risk associated with the product has been transferred to another entity. Entities of a group are not defined in the proposal, which creates questions of the applicability on intra-group transfers. Noting the structure of the

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99 Only financial institutions are liable to pay the FTT, see section 4.1.3.
101 González-Barreda, pp. 212 ff.
104 Henkow, p. 9.
proposal, with several references to EU financial services regulation, it is probable that entities of a group refers to the same meaning as the same expression in MiFID art. 10b.1(d).\textsuperscript{105} There is an exemption to the tax liability for intra-group transfers that are made as a part of a restructuring operation in article 3.4(g) of the proposal. The exemption in article 3.4(g) refers to the directive 2008/7/EC concerning indirect taxes on the raising of capital (Capital Duty Directive). The Capital Duty Directive prohibits indirect taxation on transactions that are part of a restructuring operation according to art. 4. Through the exemption the proposal does not conflict with the Capital Duty Directive.\textsuperscript{106}

Conclusion of derivatives before netting or settlement is included in the definition. The definition of derivatives is broad and the conclusion of derivatives includes all those derivatives, which fall under the definition in MiFID section C. The earlier proposal also included a clause imposing liability for modification of derivatives in art. 2.1(1)(c) COM (2011) 594 final. The modification of derivatives has been replaced with a general clause that covers modification of all financial instruments where the modification involves a substitution by at least one of the parties, art. 2.2 of the proposal. The general clause also covers situations where the original operation would have had the effect that a higher tax was levied, art. 2.2 of the proposal. By replacing the specific clause for modification of derivatives with the general clause, the area covered for modification of derivatives have been reduced to only include those situations of modification when a substitution is involved.\textsuperscript{107}

The provision in art. 2.1(2)(d) covering exchange of financial instruments is new in the proposal in order to avoid tax circumvention by simply exchanging instruments.\textsuperscript{108} An exchange of financial instruments is considered as four taxable events (one sale and one purchase of each instrument). As a result the exchange of two instruments gives rise to two taxable transactions if all other conditions for tax liability apply. With this rule the proposal achieves the same tax effect for an exchange of financial instruments as if the exchange was instead made as two individual transactions. In doing so the proposal successfully reaches conformity in regards of acquisitions of financial instruments regardless of how they are acquired.

\textsuperscript{105} See Henkow, p. 9 for a deeper analysis of the expression.
\textsuperscript{106} COM (2013) 71 final, p. 9.
\textsuperscript{107} Compare COM 2011 594 final, art. 2.1(1)(c) with COM (2013) 71 final, art. 2.2.
The definition of repurchase agreements, reverse repurchase agreements and securities lending and borrowing agreements are found in directive 2006/49/EC on the adequacy of investment firms and credit institutions, in accordance with art. 2.1(5)-(6) of the proposal. Repurchase agreements, reversed repurchase agreements and securities or commodities lending are all included in the definition of financial transactions. The scope of financial transactions thereby goes beyond the transfer of legal title and also includes transfers where the risk and the legal owner are never transferred.\textsuperscript{109} Repurchase agreements, reverse repurchase agreements, securities lending and borrowing agreements give rise to one transaction instead of two, as the transaction is limited by time to a defined subject.\textsuperscript{110} The transfers in those cases are not a transfer of legal title but more to be compared with a loan and a security deposit.

In summary, the definition of financial transaction in art. 2.1(2) is broad and covers more or less all possible ways to transfer the financial instruments that are covered by the proposal. The broad scope is accompanied by a couple of exemptions. Primary market transactions are exempted under art. 3.4(a). The definition of primary market transactions is found in art. 5(c) of regulation (EC) no. 1287/2006. Art. 5(c) of the regulation covers primary market transactions of instruments falling under art. 4.1(18)(a) and (b) of MiFID. Shares or equivalent securities, partnerships and depositary receipts for shares are covered under art. 4.1(18)(a) MiFID. Securitized debt, for example bonds and receipts of such securitized debt falls under art. 4.1(18)(b) MiFID. Given the definition of primary market transactions issuance and redemption of shares are exempt from tax liability. The exclusion made for primary market transaction seeks to avoid aggravating the rise of capital. In the original proposal 2011 there was an exemption for UCITS and AIFs. This was not in line with the Capital Duty Directive (2008/7/EC) art. 5 and was therefore reviewed.\textsuperscript{111}

In order for the FTT not to affect the refinancing possibilities or monetary policies in a negative manner, both transactions with the ECB and the MSs’ central banks are excluded from the liability art. 3.4(b) and (c).\textsuperscript{112} Transactions with some EU bodies are also excluded as well as transactions with the EU regarding financial assistance falling

\textsuperscript{110} COM (2013) 71 final, p. 8.
\textsuperscript{111} La Mettrie, Songnaba, Murre, p. 73.
\textsuperscript{112} COM (2013) 71 final, recital 7.
under art. 143 TFEU and art. 122(2) TFEU according to art. 3.4(d) of the proposal. Transactions with the EU, European Atomic energy community, the European Investment Bank (EIB) and other bodies established by the EU are excluded when the protocol on the privileges and immunities of the EU applies, art. 3.4(c). Transactions with international organizations are excluded under art. 3.4(f). Finally, and as mentioned above, transactions that are part of a restructuring operation are excluded from the proposal.

The overall effect of the applicability means that most of the financial transactions intended for citizens and regular businesses remains outside of the scope of the FTT. As an example conclusion of insurance contracts, mortgage lending, consumer credits, enterprise loans etc. are all exempted from tax liability. Payment services are also exempted but subsequent trading of payment services through structured products is included under the proposal. Physical transactions of commodities are not included, but the trade on regulated markets of derivatives deriving their value from commodities is included.113

4.1.3 Financial Institutions

FTT only applies to financial institutions. For the tax to be levied, at least one part of the transaction has to be a financial institution within the definition of art. 3 of the proposal, see art. 3.1. The FTT only applies to financial institutions, as one objective of the tax is to make sure that the financial institutions contribute to paying for the costs of the recent crisis.114 Only applying the FTT to financial institutions narrows the application of the directive but the definition of financial institutions is wide. This means that individuals never (directly) will have to pay the tax.115 Financial institutions are defined in art. 2.1(8) of the proposal (see appendix C). There is no general definition of financial institution. Instead the proposal provides a list of entities that are regarded as financial institutions.

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115 There is a risk that part of the costs for the FTT will be passed on to the customers of the financial institutions (see section 6.2.3).
Art. 2.1(8) offers a comprehensive list, including all financial institutions regulated under EU law. The financial institutions mentioned in art. 2.1(8) are defined through references to the relevant EU-secondary law. Investment firms and regulated markets under art. 2.1(8)(a)-(b) of the proposal are defined in MiFID. According to art. 4.1(1) MiFID an investment firm is any legal person providing financial services to third parties on a regular basis and/or performing investment activities on a professional basis. Regulated markets are included and defined through art. 4.1(14) MiFID. A regulated market is defined as a multilateral system providing possibilities for multiple third parties buying and selling financial instruments. The system is operated or managed by a market operator. The trading within the system is regulated through non-discretionary rules.

Credit institutions under art. 2.1(8)(c) and Securitization Special Purpose Entity (SSPE) under art. 2.1(8)(h) of the proposal are defined through directive 2006/48/EC. In art. 4.1 of directive 2006/48/EC credit institution is defined as an undertaking that receives deposits or similar repayable funds from the public and grants credit for its own account. Electronic money institutions as defined in art. 1.3(a) of directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, are also seen as credit institutions under the proposal, art. 4.1(b) directive 2006/48/EC. SSPEs’ are defined in art. 4(44) of directive 2006/48/EC as an entity that is not a credit institution and is organized for carrying out the process of securitization or securitizations. The entity has the structure intended to isolate the obligations of the SSPE both from those of the originator credit institution and from the holders of the SSPE. In order to fall within the definition of SSPE in art. 4(44) of directive 2006/48/EC the activities have to be limited to those appropriate in accomplishing that objective.

Insurance undertakings, reinsurance undertakings and special purpose vehicles in art. 2.1(8)(d) and (i) of the proposal are defined through directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II Directive). Insurance undertaking is defined in art. 13(1) - (3) of the Solvency II Directive and includes both EU-undertakings and third country undertakings. Reinsurance undertaking is defined as an entity receiving an authorization under art. 14

116 Henkow, p. 10.
of the same directive, art. 13(4)-(6) Solvency II Directive. The definition of reinsurance undertaking also covers third country undertakings. Special purpose vehicles are defined under art. 13(2) of Solvency II Directive. The definition includes all undertakings other than reinsurance and an insurance undertaking, that obtains risks from insurance and also acquire full funding for the risk through debt issuance or any other financing possibility where the rights of repayment are subordinated the reinsurance obligations.

UCITS’ and management companies are financial institutions according to art. 2.1(8)(e) of the proposal and are defined under directive 2009/65/EC on the coordination of laws, regulations and administrative provision relating to undertakings for collective investment in transferable securities (UCITS Directive). The definition of UCITS’ are found in art. 1.2 of the UCITS Directive as an undertaking with the sole purpose of collecting investments in transferable securities or other liquid financial assets, including for example deposits with credit institutions and money market instruments. The capital shall be raised from the public and the UCITS exist in order to achieve risk spreading. Furthermore, the units of the UCITS shall be repurchased or redeemed out of the undertaking’s assets at the request of the holders. An UCITS may have different legal forms, including being a contract between holders or being a unit trust or an investment company. Management companies are defined under art. 2.1(b) of the UCITS Directive as a company whose regular business is the managing UCITS either in the form of common funds or in the form of investment companies.

Pension funds are included under art. 2.1(8)(f) of the proposal and defined in art. 6(a) of directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision. The definition includes companies who are operating for the purpose of providing benefits to retired individuals on the basis of an agreement or contract agreed. The definition includes both individual agreements and collectively agreements between employers and employees or self-employed persons.

Alternative Investment Funds (AIFs) and Alternative Investment Funds Managers (AIFMs) are financial institutions under art. 2.1(8)(f). The definition is found in art. 4 of directive 2011/61/EU on alternative investment fund managers (AIFMD). AIFs are defined as collective investment undertakings that raise capital from investors in order
to invest the capital for the benefit of the investors according to a defined strategy, art. 4.1(a) AIFMD. AIFMs are the legal persons whose business is managing AIFs according to art. 4.1(b) AIFMD.

If a legal subject does not fall under art. 2.1(8) (a)-(i) of the proposal there are still one possibility that it might be a financial institution under the proposal. According to art. 2.1(8)(j) of the proposal also other legal subjects might be included if the value of the financial transactions reaches over 50 % of its annual turnover. It is possible that some intra group treasury centers will be subject to FTT because of art. 2.1(8)(j) of the proposal.117 This is not the case when the transactions are part of a restructuring operation (see below 4.2.3).

The wide definition of financial institutions is combined with a couple exemptions under art. 3.2 of the proposal. The exemptions include Central Counterparties (CCPs) when performing a function as such. CCPs are defined in art. 2.1(9) of the proposal with a reference to art. 2(1) of regulation (EU) no. 648/2012. The definition comprises legal persons acting as a central party between counterparties trading contracts on one or more financial markets. By doing so the CCP becomes the buyer to all sellers and the seller to all buyers, art. 2(1) regulation (EU) no. 648/2012. Making an exemption for CCPs seems logical, as they are not buying the financial instruments, but only act as an intermediary between the buyer and the seller. In case no exemptions would be made the transaction cost should have been doubled when using CCPs to carry out the transactions.

Central Securities Depositories (CSDs) and International Central Securities Depositories (ICSDs) are also exempt from the definition of financial institution when performing the function as CSDs and ICSDs, art. 3.2 (b) of the proposal. CSDs and ICSDs are not further defined in the proposal. ECB defined CSD as an entity which plays an active role in ensuring the integrity of securities issues, enables transactions of said securities and settlement by book or entry. Finally the definition includes that the entity services shall have a custodial character.118 ICSD is a CSD with is set up to handle Eurobond trades or internationally traded securities from several domestic

117 SEC (2011) 1103 final p. 9, La Mettrie, Songnaba, Murre, p. 72.
markets.\(^{119}\) It is plausible that these definitions will be applicable to the CSDs and ICSDs regarding the proposal. A clarification would however be welcomed. It should be mentioned that there, at this moment only exists two ICSDs in the EU.\(^ {120}\) CSDs and ICSDs works like CCPs but the transaction instead of transferring the rights between owners as made by a CCP the transaction is transferred through the book entry. In other words it would be strange not to include ICSDs and CSDs when including CCP as they more or less have the same function but deferrer in the course of action. In the explanatory memorandum the exemption for CCPs CSDs and ICSDs are motivated upon their important role for the function of the financial market.\(^ {121}\) This is also in line with recital 17 of the proposal where it is stated that double taxation of any side of a single transaction should be avoided.\(^ {122}\) The CCPs CSDs and ICSDs simply perform the function of an intermediary.

MS’s and public bodies are also exempted when managing the public debt according to art. 3.2(c) of the proposal. The exemption is motivated by the important function of public debt management.\(^ {123}\) However, when MS’s and public bodies engage in other trading they are no longer excluded under, art. 3.2(c), see also recital p. 6 of the proposal.

**4.2 Conclusion of Applicability**

The proposal applies broadly to financial institutions engaging in financial transactions. A financial institution engaging in a financial transaction with another financial institution will therefore give rise to two taxable events, one sale and one purchase.\(^ {124}\) This section aims at giving the reader a summary of situations when the tax is applicable.

The definitions of financial instruments, financial transactions and financial institutions as described in section 4.1 gives the FTT a wide applicability. The wide applicability is motivated by the risk of relocation and tax avoidance by changing instruments or

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\(^{119}\) ECB, http://www.ecb.int/home/glossary/html/glossi.en.html#349

\(^{120}\) ECB, http://www.ecb.int/home/glossary/html/glossi.en.html#349

\(^{121}\) COM (2013) 71 final p. 10.

\(^{122}\) This statement is in consistence with the principle that intermediaries not being acting as a party of the transaction should not be liable to tax.

\(^{123}\) COM (2013) 71 final, p. 10.

\(^{124}\) Financial transaction defined in art. 2.1(2)(a)-(c) and 2.1(5)-(7), financial instruments are defined in art. 2.1(3) and derivatives in 2.1(4). Financial institution is defined in art. 2.1(8).
The fact that the proposal has a wide applicability leads to the fact that it is easier and more efficient to explain the applicability by outlining the exceptions to the applicability instead of explaining the applicability itself.

4.3 Conclusion of Transactions Not Covered by the Proposal
Transactions that are not covered by the proposal because of circumstances other than the place of establishment (see below, section 4.4) can be divided into two different groups. First of all the transactions that fall outside of scope of the proposal, and secondly transactions that fall within the general scope but are exempt from the liability. These two groups will be discussed under separate titles.

4.3.1 Outside of the Scope
The tax only applies to the transfer of financial instruments (see section 4.1.1). If the transfer does not include a financial instrument the transfer falls outside of the scope of the FTT. The tax is targeted at financial institutions. Anything not defined as a financial institution therefore falls outside of the scope of the tax. This means that no individual will be directly affected by the FTT. It is important to remember that the liability still arises to a financial institution that engage in trade with non-financial institutions if all other prerequisites are fulfilled.

Transactions that are usually conducted by natural persons fall outside of the scope. Those transactions include for example conclusion of insurance contracts, mortgage lending and consumer credits. Spot currency transactions do not fall within the scope of the proposal. This is the main reason for not calling the FTT a Tobin tax, as the original tax proposed by Tobin was a tax on currency transactions. However, any of the above mentioned financial products can be securitized and in case the structured products made through the securitization are traded it will be within the scope again.

4.3.2 Exempt
Transactions are exempt on different grounds. A couple of transactions are exempt because the financial institutions engaged in the transaction are exempted under art. 3.2 of the proposal (see section 4.1.3). In addition financial institutions making financial

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127 Tobin, p. 155.
transactions may be exempted because of the nature of the transaction carried out. These exemptions are found in art. 3.4 of the proposal and include transactions that are important for the financial systems like for example primary market transactions (see section 4.1.2). The proposal also makes exemptions for transactions in order for the proposal to be in line with the Capital Duty Directive. This is the case with the exemption for transfers being part of a restructuring operation in art. 3.4(g). Another important exemption is the one concerning financial institutions that act in the name of another financial institution under art. 10.2.

4.4 Territoriality

4.4.1 Residence Principle

In order for the FTT to apply it is not enough that there is a transaction of a financial instrument with a financial institution. The last criterion for the tax to be applicable is that the financial institution has to be deemed established in the FTT-zone. The FTT is based on territoriality. The residence principle is therefore of vital importance for understanding the scope of the FTT. A wide application of the territoriality principle will have the consequences that states outside of the FTT-zone will be affected by the legislation. The residence principle is found in art. 4 of the proposal, see appendix D.

The residence principle in the proposal is based on establishment according to art. 4.1. The list presented is hierarchical, meaning that if more than one of the conditions are fulfilled the institution will be deemed established in the country where the first listed prerequisite is fulfilled according to art. 4.4 of the proposal. Fulfilling one condition is enough for the financial institution to be deemed established within the FTT-zone, art. 4.1 of the proposal.

The first condition in art. 4.1(a) establish that a financial institution is deemed to be established in the country where it has been authorized to act as a financial institution, as long as the transaction is covered by that authorization. The first condition includes the scenario of a financial institution trading in its home country. The second criterion is the so-called passport principle. If the financial institution is entitled to operate from abroad, as a financial institution inside the MS, it shall be deemed to be established

129 La Mettrie, Songnaba, Murre, p. 74, COM (2013) 71 final, p. 10.
within that MS, art. 4.1(b) of the proposal. The second criteria makes it hard for a financial institutions to relocate outside of the FTT-zone and still conduct business in the original state without being liable to FTT.

The third criterion takes into account where the financial institution has its registered seat and the fourth criterion where the institution has its permanent address or usually resides, art. 4.1(c)-(d). The fourth criterion may seem odd but the fact is that a financial institution in some cases may be a natural person, art. 4.1(d) then reduces the risk of tax avoidance by natural persons.130

The fifth criterion, in art. 4.1(e) of the proposal, covers situations where a financial institution has a branch in a participating MS and carries out transactions with that branch. In those cases the financial institution is deemed to be established in the MS of the branch. The sixth criterion refers to transactions carried out with financial institutions that are deemed to be established within the FTT-zone, art. 4.1(f) of the proposal. In those cases also the financial institution outside of the FTT-zone is deemed to be established within the MS of the other party to the transaction. This also applies to financial institutions outside of the FTT-zone trading with a natural person who is deemed established within the FTT-zone. This provision is important as to avert tax avoidance. Even if a financial institution decides to move out from the FTT-zone all trade made with other parties within the FTT-zone will be subject to tax. The provision includes those cases where an FTT-zone financial institution uses a foreign branch to execute transactions on behalf of the FTT-zone financial institution. The rule does not include subsidiaries to the financial institution.131

The seventh criterion in art. 4.1(g), which is new in the proposal, contains the so-called issuance principle. The issuance principle was added as a measure to reduce the risk of relocation out of the FTT-zone.132 The principle has the effect that transactions with instruments issued within the FTT-zone will be liable for tax regardless of where the transaction is executed. The issuance principle covers financial instruments as defined in MiFID section C with the exception of instruments under p. 4 – 10 MiFID (derivatives) that are not traded on an organized platform. The issuance principle mainly

130 La Mettrie, Songnaba, Murre, p. 74. Henkow, p. 12.
131 This fact is also recognised by the commission in its impact assessment SWD (2013) 28 final pp. 42 f.
applies to transferable securities, money-market instruments and units in collective investment undertakings. Issuance principle leads to the effect that the FTT no longer only looks at who is trading with whom, but also at what is being traded.

Rules for determining the establishment of non-financial institutions are of value when foreign financial institutions trade with non-financial institutions established within a MS. The rules for determining establishment of non-financial institution are found in art. 4.2 of the proposal. The list for non-financial institutions is, like the list for financial institutions, hierarchical according to art. 4.4 of the proposal. The first criterion in art. 4.2(a) is registered seat for companies, and permanent address for natural persons. If no permanent address can be found for the natural person the establishment is instead determined on where the individual usually resides, art. 4.2(a). The second criterion in art. 4.2(b) comprises situations when the company has a branch within the FTT-zone and the branch carries out the transaction. The last criterion in art. 4.2(c) includes the issuance principle also for non-financial institutions. The issuance principle covers the product traded. And as the principle applies to financial institutions the sense of applying the issuance principle also to non-financial institutions seem to lack substance.\textsuperscript{133}

In conclusion, the principles of deemed establishment lead to a wide application and complicate relocation as a measure to avoid the FTT. Relocation may still lower the tax burden on transactions carried out outside of the FTT-zone with financial institutions of other countries outside of the FTT-zone when the instruments traded are not covered by the issuance principle.

The proposal does not provide clear guidance on how the issuance principle should be applied to derivatives. Over the Counter (OTC) derivatives are exempted from the issuance principle according to art. 4.1(g). It is unclear if the issuance principle applies to derivatives traded on an organized platform. If the issuance principle does apply to derivatives traded on an organized platform a wide interpretation includes all derivatives where the underlying asset has been issued in the FTT-zone.\textsuperscript{134} In other cases only derivatives issued within the FTT-zone (regardless of the underlying asset) are covered by the issuance principle.

\textsuperscript{133} See art. 4.1(g) for financial institutions and 4.2(c) for non-financial institutions.
\textsuperscript{134} Englisch, Vella, Yevgenyeva, p. 228.
The proposal contains an exception from the residence and issuance principle. The exception applies to transactions where there are no economic link between the transaction and the territory of any participating MS. It is however not clear from the proposition on how such a situation should be determined. The Commission has not provided any instructions for how the provision should be applied. In a technical fiche the Commission provides examples on how the residence principle would be used. This “non-paper” does however not provide any clear guidance.

4.4.2 Tax Bases and Tax Rates

For transactions involving financial instruments, excluding derivatives, the tax base should be everything that is considered paid or owed from the counterparty of the transaction or from a third party of the transaction, according to art. 6.1 of the proposal. Art. 6.1 of the proposal is applicable to purchases and sales as well as exchange of financial instruments. If the calculation of tax base leads to a value being lower than market price, then the market price should be used instead, art. 6.2(a) of the proposal. Market price should also be used when the transfer is an intra group transfer in accordance with art. 6.2(b) of the proposal. In terms of determining the market price in situations referred to in art. 6.2 the arm’s lengths principle shall be used, see art. 6.3. Arm’s length principle is based on how the terms of the transaction would look between two similar companies that are not related and could be applied using various methods. ECJ have applied the Arm’s length principle by replacing the terms under which the transaction was conducted with arm’s length terms (meaning the terms which would have applied between two similar non-related companies). The tax rate on financial instruments other than derivatives is to be set at least at 0,1 % of the transaction value, art. 9 of the proposal.

Tax base for derivatives are calculated in regards to the notional amount referred to by the derivative at the time of the transaction, art. 7 of the proposal. In cases when more than one notional amount exists, the highest one of them shall be used. The use of a

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135 COM (2013) 71 final, art. 4.3.
136 The technical fiche is a non-binding document meaning that it is hard to draw any definitive conclusions out of the examples provided in the fiche.
137 COM (2013) 71 final, art. 6.1 with reference to art. 2.1(2)(a)-(b) and 2.1(2)(d).
139 SGI v. Belgian State, C-311/08.
different tax base for derivatives is motivated by the desire to simplify the application of the tax (the economic value may be very hard to calculate) and to minimize administrative costs.\textsuperscript{140} Derivatives can be based on more or less any asset, which might complicate the mission to find the tax base in some cases.\textsuperscript{141} The relationship between the notional value and the market value of derivative varies. The tax rate for derivatives is 0.01\% in order to take into account that the notional value might be much higher than the market value of the derivative.\textsuperscript{142} Analyzing the typical relationship between the notional value and the market value of derivatives is not made without complications. One way is to pack all the derivatives together and compare the market value and the notional value. The Bank for international settlements (BIS) did exactly that and calculated the values. According to BIS the notional value for OTC derivatives totaled $633 trillion at the end of December 2012, the market value at the same point was calculated to be $24.7 trillion.\textsuperscript{143} In order to calculate the average relationship for the “market derivative”\textsuperscript{144} the total notional value is divided by the total market value of the derivatives.

\[ \frac{\$633}{\$24.7} \approx 25.6 \]

The equation shows that the notional value on average is 25.6 times higher than the market value of the derivative. If this relationship is representative for the “typical” derivative, then the effective tax rate seems to be higher for derivatives than for other financial instruments. Multiplying the average relationship between notional value and market value with the tax rate of the notional value will result in the effective tax rate on the market value for derivatives.

\[ 25.6 \times 0.01 \% = 0.256 \% \]

If the FTT was levied on the average derivative then the effective tax rate on the market value of derivatives would be 0.256 \%, resulting in the effective tax rate being 2.56 times as high as the tax rate on other financial instruments (0.1 \%).

\textsuperscript{140} COM (2013) 71 final, p. 11 and SWD (2013) 28 final pp. 30 f.
\textsuperscript{141} Murre, p. 29.
\textsuperscript{142} COM (2013) 71 final, pp. 11 f.
\textsuperscript{143} BIS, p. 1.
\textsuperscript{144} The market derivative represents the average relationship between the notional value and the market value of the derivative for the entire OTC market in 2012. It is not sure that this relationship reflects the “typical” derivative as extreme values might produce skewedness to the results.
If the transaction is executed in another currency than the currency of the state taxing the transaction, the exchange rate will be determined at the latest recorded exchange rate at the time that the FTT becomes chargeable, art. 8 of the proposal. The market used for determine the exchange rate shall be the most representative exchange market in the member state.

Tax rates for both derivatives and other financial instruments are given at a minimum level. It is questionable if minimum rates are a good tool for establishing an inner market in part of the participating MS’s. The fact that different MS’s may use different rates will distort competition even inside the FTT-zone. The EP suggested as an amendment that the tax rate should be fixed at the minimum amounts instead of providing minimum rates. 145

The tax rate may seem low. But looking at the possible 0-value of the transaction and the fact that the tax is levied upon every transaction, the effective tax rate will in many cases be significantly higher than 0.01% for derivatives and 0.1% for other securities. As an example a clearing set involves six transactions which each would be subject for the FTT. 146

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145 Text adopted at the sitting of wednesday 3 July 2013, EUP, p. 133.
146 González-Barreda, p. 217.
### 4.5 Examples of Applicability

<table>
<thead>
<tr>
<th></th>
<th>Part 1</th>
<th>Intermediary</th>
<th>Part 2</th>
<th>Type of instrument</th>
<th>FTT Due</th>
<th>Effective tax rate of the transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>EU11 FI</td>
<td>N/A</td>
<td>EU11 FI</td>
<td>Security</td>
<td>Yes, by both</td>
<td>0.2% of the transaction value</td>
</tr>
<tr>
<td>2</td>
<td>EU11 Individual</td>
<td>N/A</td>
<td>EU11 individual</td>
<td>Security</td>
<td>No,</td>
<td>-</td>
</tr>
<tr>
<td>3</td>
<td>EU11 Individual</td>
<td>N/A</td>
<td>EU11 FI</td>
<td>Security</td>
<td>Yes, by part 2</td>
<td>0.1% of the transaction value</td>
</tr>
<tr>
<td>4</td>
<td>Branch of EU11 FI in USA</td>
<td>N/A</td>
<td>Branch of EU11 FI in Russia</td>
<td>Security</td>
<td>Yes, by both</td>
<td>0.2% of the transaction value</td>
</tr>
<tr>
<td>5</td>
<td>US Individual</td>
<td>EU FI for part 1</td>
<td>US FI</td>
<td>Security</td>
<td>Yes, by both</td>
<td>0.2% of the transaction value</td>
</tr>
<tr>
<td>6</td>
<td>EU11 FI</td>
<td>EU11 FI (acts in own name)</td>
<td>EU FI</td>
<td>Security</td>
<td>Yes, by all</td>
<td>0.4% of the transaction value</td>
</tr>
<tr>
<td>7</td>
<td>US FI</td>
<td>N/A</td>
<td>US FI</td>
<td>Security issued in EU11</td>
<td>Yes by both</td>
<td>0.2% of the transaction value</td>
</tr>
<tr>
<td>8</td>
<td>US FI</td>
<td>Regulated market</td>
<td>US FI</td>
<td>Derivative issued in EU11</td>
<td>Yes by both</td>
<td>0.02% of the notional value</td>
</tr>
<tr>
<td>9</td>
<td>EU11 FI</td>
<td>CCP</td>
<td>EU11 Individual</td>
<td>Derivative</td>
<td>Yes by part 1</td>
<td>0.01% of the notional value</td>
</tr>
<tr>
<td>10</td>
<td>EU11 Individual</td>
<td>N/A</td>
<td>UK FI</td>
<td>Security</td>
<td>Yes by part 2</td>
<td>0.01 of the transaction value</td>
</tr>
</tbody>
</table>

Scenario 1 accounts for the standard application of the FTT. The case when two EU11 financial institutions engage in the transfer of a security. The tax is applicable to both parts at the rate of 0.1% adding up to a total of 0.2%. If the transaction would be an exchange of instruments the total tax would amount to 0.4 % (0.2% per security).\(^\text{148}\)

Scenario 2 illustrates the basic but important principle that in order for the tax to become applicable at least one of the parties has to be a financial institution, art. 3.1 of the proposal. The tax becomes liable also when financial institutions trade with individuals as shown in scenario 3. Scenario 4 shows the important rule in art. 4.1(f) regarding branches of EU 11 financial institutions. The rule makes it considerably harder for the domestic EU 11 financial institutions to avoid the tax by setting up

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\(^\text{147}\) Financial Institution from country within the FTT-zone.

\(^\text{148}\) One can assume that the traded instruments in those cases would have more or less the same value. The effective tax rate of the trade would then be 0.4% of ~half of the total transaction value.
branches outside of the FTT-zone. Scenario 5 illustrates the fact that there are no exemptions for financial institutions acting as intermediaries for individuals. Scenario 6 shows the effects of the cumulative effects when using an intermediary that acts in its own name resulting in an effective tax rate of 0.4% for a single transaction. Scenario 7 and 8 demonstrates the issuance principle in art. 4.1(g) of the proposal. Even though the two parties are established in the US and do not conduct business within the EU11 zone they will be liable to tax if the instrument traded was issued inside of the FTT-zone. There is an exemption for derivatives not traded on an organized platform, see art. 4.1(g) of the proposal. In scenario 9 the exception for CCPs in art. 3.2(a) of the proposal is applicable. The EU FI is liable on the same ground as in scenario 1. Scenario 10 illustrates how art. 4.1(f) applies when financial institutions outside of the FTT-zone act with a non-financial institution (in this case an individual) within the EU11.

4.6 Chargeability

The tax is chargeable by the tax authority in the country that the financial institution is deemed to be established. It is not possible to be deemed established in two or more countries within the FTT-zone, as the list in art. 4.1 of the proposal is hierarchical. The obligation to pay FTT occurs at the time of the transaction. For electronic transactions the FTT has to be paid directly. In all other cases the FTT has to be paid within three working days. The system for charging the FTT is not yet in place. There will be a considerably need for coordination between countries of the FTT-zone and other states.

4.7 Anti-Avoidance Measures

The wide scope of the tax makes it hard to avoid the tax. Some anti avoidance rules in the proposal further complicates the avoidance of the FTT. In art. 13 of the proposal there is a general anti-abuse rule. As an example the Commission states that it could be used if the notional amounts of derivatives are artificially divided into a bigger and a smaller part, where the derivative with the low notional amount is traded in order to decrease the tax rate. The anti-abuse rule is based on the Commission’s recommendation on aggressive tax planning. The rule aims at artificial arrangements which have been put in place in order to decrease the tax burden and which lead to a tax

149 There is an exemption for financial institutions acting as intermediaries to other financial institutions in art. 10.2 of the proposal.
benefit, art. 13.1. Arrangements that fall under this definition shall be ignored. An arrangement can include several steps and is broadly defined in art. 13.2 of the proposal. The proposal also provides a list of criterions, which shall be considered when determining if an arrangement is artificial. A tax benefit has emerged when the taxpayer through the arrangement pays a lower tax than what the same taxpayer would do if the arrangement were absence, art. 13.6.

In art. 14 of the proposal there is a specific anti-abuse rule for the use of depositary receipts based on the same principles as the general anti-abuse rule. A depositary receipt could be used to avoid the issuance principle. The principle is avoided by first depositing the security that has been issued within the FTT-zone, in a country outside of the FTT-zone. Then the depositary receipt is traded instead of the security itself. As the depositary receipt is issued outside of the FTT-zone, the FTT would not apply without the specific anti-abuse rule in art. 14 of the proposal.

A problem with the wide territorial scope is how the tax shall be enforced in relation to foreign financial institutions being liable to pay. Refusing to pay could be an effective way to avoid the taxation. Art. 10.3 of the proposal aims at effectively addressing this issue. The provision constitutes that if the tax is not paid within the time frame (instantly if the trade is made electronically and otherwise within three days) both parties of the transactions are jointly and severable liable for payment of the FTT. Art. 10.3 does not only include financial institutions but also any other party to a transaction. This is a powerful enforcement tool, which efficiently solves the situation with foreign financial institutions refusing to pay the FTT. Participating MSs further have the ability to choose that other persons shall be held jointly and severely liable to pay the tax according to art. 10.4 of the proposal. This gives MS’s the possibility to include parties, which are normally not included, in the definition. For example CCPs and other bodies may be included.

The avoidance of the tax is hard but could be made even more complicated by adding the “transfer of legal title principle proposed by the EUP.” The transfer of legal title

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principle means that the financial transaction is not legally enforceable in cases where
the FTT should have been levied upon the transaction but was not.\textsuperscript{154}

In conclusion the best anti avoidance measure taken by the proposed FTT is the really
broad base. The broad base has lead to countries that are not a part of the FTT to oppose
it as the extraterritorial effects might harm their financial sectors (see for example UK v
Council, Case C-209/13). In addition to the above-mentioned anti-avoidance measure,
art. 12 of the proposal states that the participating states shall adopt measures in order to
prevent tax circumvention. It is not further defined in the proposal what these measures
should aim at.

5 Possible Effects of the Proposal
When analyzing effects of the FTT it is important not only to look at the changes caused
by the FTT, but also at from where the change is coming. If simply analyzing the
relative change, it is impossible to declare if the change is positive or negative. As an
example it is not possible to assume that a smaller financial market has a negative effect
on the economy. A reduced financial market does not necessarily have to be something
negative. In other words the effects have to be analyzed in the relevant context.
Therefore this part will start with a part explaining the current situation if needed.

5.1 The Financial Sector
This is not an attempt to fully explain the current market situations, but rather an
attempt to give the reader a short understanding on how the market works with its
current resource allocation, how it should be, and how it will be affected by the
introduction of the FTT. Some authors believe that the financial sector should bee seen
as a support function and even a driving force towards economic growth.\textsuperscript{155} The
financial sector should not be measured on its profits or size, but on how well it
exercises its support functions to the economy and its function to provide a healthy
economy.\textsuperscript{156} The following analysis assumes that economic growth is good.\textsuperscript{157} The

\begin{itemize}
  \item\textsuperscript{154} Vogel, Cortez, 2012, p. 79.
  \item\textsuperscript{155} Cecchetti, Kharroubi, p. 1, Hassan, Sanchez, Yu, pp. 88 f.
  \item\textsuperscript{156} Greenwood, Scharfstein, p. 110.
  \item\textsuperscript{157} There can of course be different views on this assumption. But relating to the topic, the FTT:s impact
    on businesses and the market, this assumption must be seen as acceptable. Criticism may also arise
\end{itemize}
focus in the analysis will also be done in regards to the EU (developed economies) as the results may differ between underdeveloped and developed countries.  

Financial institutions play an important part in the current economic situation by providing loans and offer funding to innovative firms leading to economic growth. The financial sectors activities are not limited to lending and financing but can be divided into two different parts. The intermediation focuses on financing, lending and other classic interest generating activities. The second part focuses on the growth of the financial sector itself, which includes speculation and innovative financial instruments.

There are conflicting views on which impact the growth of the financial sector has on the growth of the economy. For example several studies show that the growth of the financial sector in developed countries (high Income) could have a negative impact on growth. One of the negative effects that can occur as a result of a too big financial sector is the misallocation of talent and investments. Other studies divide the financial activities looking on how the different activities affect the economy. Financial transactions, which do not contribute to the market function by for example financing the real economy through investments in companies, are a zero-sum game. One investor’s gain is another investor’s loss. A financial market that is too big does have negative effects on real productivity and hence the real economy. A financial sector that is too small does also have negative effects on the real economy and it is therefore important to find a good balance.

regarding the measurement “GDP” that is used in the studies and its correlation to “real” wealth. This discussion is outside of the delimitation of this paper.

Some studies also show that the financial sector is over established in some European countries, having a negative impact on growth.\textsuperscript{169} However, looking at the combined picture, the financial sector in the EU is in balance even though it would have to be equaled out between countries.\textsuperscript{170} While being over-established in Ireland, it is not over-established in France, Italy and Germany.\textsuperscript{171}

The combined results point at an over established finance sector has a negative impact on the economy. Establishing a good threshold is however hard, but some studies have found it to be around the size of a country’s GDP.\textsuperscript{172} If the growth is the result of non-profitable trading (when the sector do not perform its function as a support system for “the real economy”) the negative effects will be even higher.

Given the presented information, which merely represents a drop in the bucket of research on the subject, it is not possible to conclude that the financial sector in Europe generally is too big. Instead, some countries seem to have an over dimensioned financial sector while others have an under dimensioned financial sector. The presented studies also show a positive correlation between an excessive financial sector and higher volatility.\textsuperscript{173} The conclusion is that at this time the financial sector should not be subject to regulations that make it smaller. Most European countries have a financial sector that lies around the “ultimate” threshold and actions diminishing the sector might have repercussions for the real economy. It is important that the financial sector does resume to allocate capital effectively leading to a more efficient market.\textsuperscript{174} In other words the FTT should not lead to the financial sector being reduced but some redistributive effects would be desirable.

### 5.2 Volatility

From time to time taxes as the FTT are said to decrease market volatility. In a Communication from 2010 the Commission states that a FTT could decrease volatility on the financial markets.\textsuperscript{175} The Commission then hedged its bets stating that the effects

\textsuperscript{169} Arcand, Berkes, Panizza, p. 23 & p. 45.
\textsuperscript{170} Arcand, Berkes, Panizza, p. 23 & p. 45.
\textsuperscript{171} Cecchetti, Kharroubi, p. 10. Arcand, Berkes, Panizza, p. 23 & p. 45.
\textsuperscript{172} Cecchetti, Kharroubi, pp. 7 f, Arcand, Berkes, Panizza, p. 23
\textsuperscript{173} Arcand, Berkes, Panizza, pp. 23 f.
\textsuperscript{174} Wurgler, p. 187.
\textsuperscript{175} COM (2010) 549 final, p. 3
could also be the opposite. The effects of the FTT on the market volatility are worth analyzing. If the FTT actually decreases the volatility it might be a good complement to regulatory measures in improving the functioning of the financial markets.

The Stamp duty in China has been changed a couple of times making it a good first example to study. When the tax rate was increased, the trading volume was reduced and when the tax rate was reduced, the trading volume increased. Empirical studies show that the volatility increased both when the tax rate was reduced and increased. In one study the IMF noted on a similar tax that the effects on volatility are ambiguous. In another study the IMF reckons that the effect of an FTT on market volatility is either impalpable or gives higher volatility. The Bank of Ireland made a good compilation of different research of a transaction taxes impact on market volatility. The compilation shows that there are great uncertainties how an FTT will affect market volatility, but unlike the IMF the Bank of Ireland finds the possibility of a reduction in volatility to be palatable. The impact assessment to the first proposal mentions that many studies show that the price volatility will be higher with an FTT. The results of the research on FTTs’ impact on volatility are in other words ambiguous. Some authors believe that an FTT would increase market volatility. Others believe that it would decrease the volatility. Some authors think that an FTT both might increase and decrease the volatility.

An FTT raises transaction costs and therefore reduces volume. Higher volume can have both stabilizing effects and destabilizing effects on the market. Destabilizing effects submerge when so-called noise traders are driven out. Noise traders are traders that do not engage in investment because they analyzed the companies’ performance but

177 An increase in the tax rate of an existing tax on financial transactions should logically have the same effect as the introduction of a new tax on financial transactions. The effect on the volume is as anticipated, Vogel, Cortez 2012, p. 80.
178 Vogel, Cortez 2012, p. 80
179 Matheson, pp. 20 ff.
180 IMF, p. 20.
181 Central Bank of Ireland, pp. 22 ff.
184 Central Bank of Ireland, p. 22 ff, Hau, pp. 886 f.
185 McCulloch, Pacilio, p. 36.
rather because of speculation and stock price analysis.\textsuperscript{188} In those cases the purchase and sale do not serve market performance and hence do not bring the stock price closer to its “real value”.\textsuperscript{189} Ultimately the FTT should aim at noise-traders and transactions that do not enhance the market efficiency. An FTT aimed only at the noise traders could efficiently decrease volatility.\textsuperscript{190} The problem arises when the FTT not only target these transactions but rather all transactions increasing transfer costs and risk to increase market inefficiency and market volatility.\textsuperscript{191} Reduced transaction volume has the effect that single have a bigger impact on the asset prices and risk causing bigger market deviations.\textsuperscript{192} And due to a reduced volume, market mispricing is allowed to exist for a longer period of time.\textsuperscript{193} However, the risk for market runs would be decreased with a lower volume.\textsuperscript{194}

The only thing that can be certain about the FTTs effects on market volatility is that it is unclear. Reading other literature you will meet authors convinced both about a rise in volatility and a decrease in volatility as an effect of an FTT. At this current stage it is impossible to draw a definite conclusion on what effect the proposed FTT would have on the market volatility. The following analysis will have to take into account both scenarios.

5.3 Impact on Derivatives

Derivatives vary in form, size and function. The derivate instrument receives its value from an underlying asset.\textsuperscript{195} Three common derivative instruments are the interest rate swaps, forward rate agreements and repurchase agreements.\textsuperscript{196} Derivatives can be used for risk hedging leading to a more stable economy.\textsuperscript{197} On the contrary speculation with derivatives could result in increased risk for companies.\textsuperscript{198} Investors are concerned that some derivatives have become so complex that only a limited number of investors

\textsuperscript{188} Cortez, Vogel 2011, p. 19.
\textsuperscript{189} Cortez, Vogel 2011, p. 19.
\textsuperscript{191} Cortez, Vogel 2011, p. 19, Mannaro, Marchesi, Setzu, pp. 460 f.
\textsuperscript{192} Mannaro, Marchesi, Setzu, p. 460f, Cortez, Vogel 2011, p. 19.
\textsuperscript{193} Cortez, Vogel 2011, p. 19.
\textsuperscript{194} Cortez, Vogel 2011, p. 19.
\textsuperscript{195} Maurer, Schulman, Ruwe, Becherer (a), p. 404.
\textsuperscript{196} Maurer, Schulman, Ruwe, Becherer (a), pp. 404 ff.
\textsuperscript{197} Esposito, p. 60.
\textsuperscript{198} Esposito, p. 60.
understand the instrument.\textsuperscript{199} This could have the effect that the market might not be able to value the instrument at its market value. An effect not often accounted for when discussing the impact on volatility is the decrease in trade of derivative instruments.\textsuperscript{200} Derivatives are often used to manage risk in companies.\textsuperscript{201} A decrease in the use of derivatives might have the effect that companies are exposed to a higher market risk. The increase in market risk for individual companies by the decreased usage of derivatives might affect the volatility on the financial markets. These effects are speculative and it is hard to draw any definite conclusion.

Risk hedging with derivatives fills an important function on the market.\textsuperscript{202} In contrast the speculation in derivatives may cause a threat, both to single companies and to the market as a whole. It is therefore important to assess what derivatives are most commonly used for.

There is empirical evidence for derivatives reducing system risk when used for hedging.\textsuperscript{203} Some research indicates that derivatives are mainly used to hedge risk.\textsuperscript{204} Other research find that derivatives are used both to speculate and to hedge risk.\textsuperscript{205} On the other hand, when the use of derivatives exceeds the needs for hedging and the firm starts to speculate, it might have opposite effects.\textsuperscript{206} The risk of speculating does however, not exceed the risk of not using derivatives at all. This relationship implies that a decrease in derivatives would increase the risk and volatility of the economy as a whole.\textsuperscript{207} In other words the public and political worry over derivatives may be unfounded as a systematic risk. The evidence points towards the conclusion that the aggregated use of derivatives leads to lower risk than no use at all.\textsuperscript{208}

\begin{itemize}
\item \textsuperscript{199} Esposito, p. 60.
\item \textsuperscript{200} A significant decrease is expected as a result of the FTT, Cortez & Vogel 2011, p. 20.
\item \textsuperscript{201} Nguyen, Faff, pp. 831 ff.
\item \textsuperscript{202} Bartram, Brown, Conrad, pp. 997 ff, Nguyen, Faff, p. 842.
\item \textsuperscript{202} Nguyen, Faff, pp. 831 ff.
\item \textsuperscript{203} Bartram, Brown, Conrad, p. 997.
\item \textsuperscript{204} Chernenko, Faulkender, pp. 1749 f.
\item \textsuperscript{205} Nguyen, Faff, pp. 832 ff.
\item \textsuperscript{206} Nguyen, Faff, p. 841 f, this conclusion is conditioned upon the scenario that both risk hedging activity and speculating activity decreases, in case the decrease only leads to the speculative activity being increased there could instead be a decrease in systematic risk.
\item \textsuperscript{208} Nguyen, Faff, p. 841, Bartram, Brown, Conrad, pp. 995 ff.
\end{itemize}
Systematic concerns of risk include the CCPs taking on the role as counterparty and thereby being exposed in case of default by one of the parties. In combinations with CCPs’ being fewer and larger the systematic risk increases. When derivatives become more complex it might be hard to estimate the value for a large part of the market. The CCPs are exposed to a credit risk in assuming the risk of defaulting parties. This growing concern has made the ECB recommend CCPs insurance against defaulting counterparties as a key risk management tool. In combination with the size of the derivative market this risk should not be neglected.

The FTT is not only liable to transactions with derivatives but also to the conclusion and modification of derivatives according to art. 2.1(1)(c) of the proposal. In a derivative agreement there are usually three parts. The two parties that, for example, make an interest swap and the bank handling the transaction as a principal. In those cases the bank is not seen as an intermediary being exempted from tax, as it is not acting in the name or account of another financial institution. If all parties are financial institutions the tax will be levied four times upon the conclusion of a derivative in the above-described order. A general clause in art. 2.2 limits the problem but do not affect situations where the conclusion involves an exchange.

5.4 Other Effects of the FTT

5.4.1 Effects on Cost of Capital

When the cost for buying and selling stock and financial assets are being increased it does imply a higher cost for companies to raise capital. Initial offerings will be made at a lower price because of the knowledge that further transactions will be subject to the tax. Empirical research shows how transaction taxes can depress the share prices and thereby increasing cost of capital. Matheson created a model on how the imposition of FTTs affects asset valuation.

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209 Jones, Pérignon, p. 373.
210 Jones, Pérignon, p. 374.
211 Jones, Pérignon, p. 377.
212 The size of the OTC derivative market was estimated to a total worth of $ 633 trillion at the end of December 2013, BIS, p. 1.
213 Murre, p. 28.
214 The exemption for those situations is found in art. 10.2 of COM (2013) 71 final.
\[ \Delta = 1 - \frac{1 - e^{-RN}}{1 - (1 - T)e^{-RN}} \]

According to the model the change in value of a security (\( \Delta \)) is dependent on the holding period (N). This means that even though the initial offering, in alignment with the proposal, are exempt from taxation the cost of capital for companies probably will be higher than before a FTT.\(^{217}\) This could lead to companies finding other ways to raise capital, e.g. through bank loans.\(^{218}\) The impact on cost of capital is debated. Some authors mean that the effect will be very small and that the effects might not even be noticeable.\(^{219}\) Others mean that the increased cost on capital risk having a negative impact on the economy.\(^{220}\) This creates a possible risk for distorting the competition. As an example multinational enterprises (MNEs) might be able to relocate financial activities outside of the FTT-zone in order to decrease the tax burden. Small and Medium Enterprises (SMEs) rarely have the same possibility to relocate such activities building a preferable tax situation for MNEs in front of SMEs.

5.4.2 Effects on Non-Financial Institutions

EU constantly stressed the fact that the tax will not affect regularly people but only the financial institutions.\(^{221}\) Several reports have however, estimated that the FTT will affect other subjects than the financial institutions.\(^{222}\) In Germany calculations have been made on how much individuals saving in pension funds will be affected. With a yearly turnover of 40-80\% of the wealth the cost, for a 40-year possession and an estimated lifetime of 29 years after the pension, will be 2.5 – 5.5\%.\(^{223}\)

Another risk with taxing financial transactions is that it distorts investment decisions. A basic thought for providing optimal taxation is to avoid distorting production decisions.\(^{224}\) By taxing transactions between businesses the tax risk distorting the companies’ product decisions.\(^{225}\)

\(^{218}\) Henkow, p. 14 f.
\(^{220}\) Matheson, p. 14.
\(^{221}\) COM (2013) 71 final, p. 2.
\(^{222}\) Kaserer, pp. 8 ff.
\(^{223}\) Kaserer, p. 35.
\(^{224}\) Diamond, Mirrlees, pp. 8 ff, Matheson, p. 25.
\(^{225}\) Vella, Fuest, Eisenlohr, p. 618.
There is also a concern that the burden of the FTT will fall on the final consumer and not on the financial institutions.\textsuperscript{226} As a rule all taxation comes with negative effects on the economy.\textsuperscript{227} Taxes on gross transaction have been proved to distort more than taxes on the final consumer.\textsuperscript{228}

### 5.4.3 Avoidance

When discussing avoidance of taxes the focus often falls on measures that are clearly abusive to the tax using so called loopholes. In the case of the proposed FTT those loopholes seem to be efficiently remedied. Instead the avoidance of the FTT will be achieved mainly by relocation of trading activities. The tax will encourage financial institutions from outside of the FTT to seek trading partners outside of the tax jurisdiction. By doing so it is possible to decrease the tax burden and to increase revenues. In other words financial institutions within the FTT-zone will have a competitive disadvantage compared to other financial institutions.

It should be mentioned that the actors on the financial market tend to be innovative when it comes to the possibility of avoiding tax. It is therefore likely that other possibilities to avoid the tax will become visible once (if) the proposal is adopted.

### 6 How the Current Proposal Responds to its Objectives

The three objectives, earlier presented under section 3 are; avoid fragmentation of the internal market, ensure that the financial market makes a fair and substantial contribution and create appropriate disincentives. In this part the issue on how well the proposal responds to its objectives will be analyzed.

#### 6.1 Avoid Fragmentation of the Internal Market

The Commission states that the current situation (no harmonization) leads to a fragmentation of the internal market as MS’s are putting separate tax regimes to work in the area of a financial transaction tax.\textsuperscript{229} Furthermore, the Commission affirms that the

\textsuperscript{226} Vella, Fuest, Eisenlohr, p. 618. Matheson, p. 25.
\textsuperscript{227} Cortez, Vogel 2011, p. 28.
\textsuperscript{228} Diamond, Mirrlees, pp. 24 f.
\textsuperscript{229} COM (2013) 71 final, p. 4.
current situation may lead to double taxation or double non-taxation.\textsuperscript{230} According to the Commission no harmonization also leads to high compliance costs for the financial sector when having to comply with different tax regimes.\textsuperscript{231} It is also stated that financial institutions from non-participating MS’s will benefit from the FTT as it provides one conform system instead of multiple systems.\textsuperscript{232} As the impact assessment does not assess the impacts on non-participating MS’s, it is not simple to analyze if the first objective has been fulfilled. In order for the objective to be fulfilled the FTT has to improve the functioning of the internal market.

There are a certain amount of comprehensibility in the arguments of the Commission that harmonization of 11 MS’s taxation is better than no harmonization. The fact that 11 MS’s had implemented different types of FTTs at the time for the latest proposal makes the argument durable.\textsuperscript{233} Of the countries that had implemented some kind of FTT by the time of the latest proposal only three are within the enhanced cooperation.\textsuperscript{234} Since the latest proposal, Italy has implemented a new FTT.\textsuperscript{235} The argument that cooperation in nature is better than no harmonization cannot be accepted as such.\textsuperscript{236} Instead, it is important to look on what effects the current situation have and what effects the FTT will have.

One of the arguments to harmonize legislation regarding FTTs was that the current situation gave birth to situations of double taxation or double non-taxation.\textsuperscript{237} The problem with this methodology is that the proposal also gives rise to double taxation without providing solutions on how to solve it.\textsuperscript{238} As an example a financial institution from the FTT-zone buying shares on the London Stock Exchange could be subject both to the UK stamp duty reserve tax (SDRT) and to the FTT.\textsuperscript{239} The harmonization of 11 MS’s may decrease the extent to which double taxation occurs, but it does only address the problem with double taxation between MS’s incorporated in the enhanced

\textsuperscript{230} COM (2013) 71 final, p. 7.
\textsuperscript{231} COM (2013) 71 final, p. 7.
\textsuperscript{232} COM (2013) 71 final, p. 7.
\textsuperscript{233} SWD (2013) 28 final, p. 60.
\textsuperscript{234} SWD (2013) 28 final, p. 61.
\textsuperscript{235} Wiesenhoff, Egori, pp. 49 f.
\textsuperscript{236} In that case all types of harmonization would be accepted and seen as improving the internal market. There are of course situations when harmonization could harm the internal market.
\textsuperscript{237} COM (2013) 71 final, p. 7.
\textsuperscript{238} There are no paragraphs on how double taxation should be avoided in the proposal.
\textsuperscript{239} SDRT is explained in Bond, Hawkins, Klemm, pp. 3 f, compare with the applicability of the proposed FTT in section 4.4.
cooperation. By coordinating the FTT between those MSs the proposal risk giving birth to more double taxation than before, as there are no rules on how to address double taxation in the proposal.

It is arguable that the proposal also somewhat misleads the crowd. It is easy to get the perception of the FTT as simply a coordination of existing FTTs. The proposed FTT does however build a completely new, more comprehensive FTT, than those who exists in any MS today. A fairer first objective would include formulations like “…creating a new common FTT”.

It is obvious that the enhanced cooperation will have advantages. As stated by the Commission companies from non-participating MS will have the benefit to be confronted with one legal system instead of several separate legal systems when conducting business with companies inside of the FTT-zone. This could lead to lower compliance costs for companies and therefore enhances the internal market. The extent to

The current situation leads to distortions in the internal market. The distortions include double taxation between existing FTT regimes and a compliance burden for companies having to adapt to different FTT systems. Nevertheless, the proposed EU FTT does not efficiently abolish the current double taxation. The proposal does conversely simplify compliance by reducing the number of different tax regimes in the area of the FTT. The combined effect of the FTT on the internal market will therefore be positive, even though limited. In other words, the first objective can be considered as fulfilled even though it is not without hesitation. If the proposal would better address the double taxation issues it would correspond better to its first objective.

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240 Compare with for example the Italian FTT, Wiesenhoff, Egori, pp. 48 ff.
242 At this time only four countries of the eleven countries engaging in the enhanced cooperation have a national FTT.
6.2 Ensure that the Financial Market Contributes to the Cost of the Crisis

The second objective could, as shown above (section 3.2), be divided into different parts. To begin with the question if the contribution by the financial sector is “substantial” will be analyzed.\textsuperscript{243}

6.2.1 Is the Contribution Substantial?

The wording of the objective implies that it is a backward tax aiming to repay costs in the past. For determining if the tax makes sure that the financial sector makes a substantial contribution several factors has to be taken into account. For example the cost of the crisis and the help received. To start with the sum of the contributions could be evaluated. The FTT is estimated to generate around 34 billion euro annually in the participating states.\textsuperscript{244} In the impact assessment it is mentioned (when discussing the French tax) that 0.06% of GDP or 4-5 billion Euros is not a fair and substantial contribution.\textsuperscript{245} Instead, revenues between 0.3% and 0.5% of GDP annually is said to be a good magnitude of the contribution.\textsuperscript{246} The current proposal is estimated to generate around 0.4% of GDP in the participating states.\textsuperscript{247} This corresponds to around 1% of the participating countries total tax revenue and should be seen as a substantial contribution.\textsuperscript{248} At this point questions arise on how the substantiality should be measured. The absolute tax revenue seems to correspond well to the objective. Some might argue that the positive revenue should be settled against the estimated decrease in GDP. The decrease in GDP is estimated to amount to around 0.28%.\textsuperscript{249} It seems unsustainable to account for the negative impact of the tax in relation to if the contribution through the FTT is considered to be substantial.\textsuperscript{250} As mentioned in the impact assessment the negative effects could be limited by equally decreasing other taxes, or by redistributing the income of the FTT for public investments.\textsuperscript{251} The revenue from the FTT should in light of the above-discussed arguments be seen as substantial.

The next question is if the substantial contribution can be seen as fair.

\textsuperscript{243} Even though the word „substantial“ is not found in the objective itself it is used in the explanatory memorandum, COM (2013) 71 final, p. 4.
\textsuperscript{244} COM (2013) 71 final, p. 23.
\textsuperscript{245} SWD (2013) 28 final, p. 13.
\textsuperscript{246} SWD (2013) 28 final, p. 11.
\textsuperscript{247} SWD (2013) 28 final, p. 23.
\textsuperscript{248} MEMO/13/98, p. 3.
\textsuperscript{249} SWD (2013) 28 final, p. 45.
\textsuperscript{250} The negative effects on the GDP should of course be taken into account when assessing the FTT but not in relation to the objective of the financial institutions making a fair and substantial contribution or not.
\textsuperscript{251} SWD (2013) 28 final, pp. 45 f.
6.2.2 Is the Contribution Fair?

It is hard to determine whether a contribution is fair or not. In the proposal it is stated that the financial institutions had a significant role in causing the financial crisis, while the costs was mainly carried by governments and citizens.\(^\text{252}\) This could in turn be a good argument for why the financial institutions should make a contribution and it would also make the contribution fair to a certain extent. Several questions arise to this justification ground. First of all the FTT targets all financial institutions and do not separate between institutions who contributed to the financial crisis and those who did not. In regards to this issue it is argued that even though not all financial institutions contributed to the crisis they all benefited from the rescue of financial institutions after the crisis.\(^\text{253}\) If this justification also could include new financial institutions is discussable but without the financial aid the entire financial market would have crashed and therefore it may be argued that also new financial institutions today benefit from the aid, even though much more limited. In this case a better justification for only taxing the financial industry would be needed as more or less all industries benefited from the aid provided to certain financial institutions. In fact the economy as a whole can be said to benefit indirectly from the aid given to certain financial institutions through a working financial market.\(^\text{254}\) The financial sector was not solely responsible for the financial crisis. Other sectors like for example the insurance sector contributed to the crisis and a justification for not including them to the same extent would be welcomed. In the context it should be noted that an objective this broad hardly could not come without some collateral. Even though other market participants benefited from the rescuing of some financial institutions and the fact that there were other institutions responsible for the crisis, the financial institutions carried a major role in causing the crisis.\(^\text{255}\) It should therefore be seen as acceptable to only include those under the FTT. The proposed FTT should be seen as somewhat meeting the “fair” part of the second objective, even though better justification and explanation would be desirable. At may also be argued that there are better ways to fulfill this objective, like only including the part of the financial sector that was responsible for the crisis and/or the part that received help during the crisis.

\(^{252}\) COM (2013) 71 final, p. 4.
\(^{253}\) SWD (2013) 28 final, p. 11, see also COM (2013) 71 final, p. 2.
\(^{254}\) Kavelaars, p. 401
\(^{255}\) Af Ornäs, Wiberg, p. 506.
The second part of the objective implies that the financial sector is under-taxed. This would also help justify the first part of the financial sector making a fair and substantial contribution. One of the most accepted arguments for the financial sector being under-taxed is normally the VAT exemption.256 The reason for the VAT exemption could be built on several grounds. It is arguable that the exemption exists because of the difficulties of calculating the VAT for the financial sector.257 Other arguments involve the possible harm the VAT could have for the economy and maintaining competitiveness towards other parts of the world, as financial services are exempt from VAT in most countries.258 The VAT exemption means that the financial sector does not have to charge VAT on its output but also that it cannot deduct VAT on input. The exemption is estimated to lead to benefits between 0.11 % and 0.17 % of GDP.259 However these results are highly uncertain and in the impact assessment it is stated that even though the VAT leads to lower prices towards private customers it also leads to higher prices towards businesses.260 This leads to unwanted market distortions making financial services too cheap for private customers and too expensive for companies. If the VAT exemption really leads to a benefit in the range between 0.11 and 0.17% of GDP, this would be a working justification for increasing the tax burden on the financial sector. It would be desirable with better empirical evidence for the calculation of the benefits as it is uncertain to what extent the financial sector benefits from the VAT exemption. The Impact assessment does no reach further than stating that the VAT exemption “...possibly results in a preferential treatment...”261 In conclusion, the VAT exemption can be seen as a possible way of rectifying an increased tax burden on the financial sector, but the extent to which the tax should be levied remains unclear because of the ambiguous results trying to measure the advantage.262

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257 González-Barreda, p. 218.
258 González-Barreda, p. 218.
259 SEC (2011) 1102 final, vol. 1, p. 14, it is stressed that the estimations are very rough and should be interpreted cautiously. Problems are also raised with new financial institutions that obviously did not contribute to the crises and not directly benefited from the saving of the financial sector. In case the argument that they still benefited from the aid as it lead to a working financial sector is used, then all sectors should be incorporated under this argument as everyone benefits from a working financial market.
Another argument for increasing the tax burden on the financial sector is the implicit state guarantee that parts of the sector enjoy. This problem is often referred to as the so called “too big to fail” situation. The situation results in that governments save financial institutions that would have gone bankrupt in other situations. This disrupts the markets function as a value organ for companies. It is often argued that the banks are to complex for investors to valuate them correctly. When a big bank stands on the edge of bankruptcy and its bankruptcy would harm the system then it will probably be saved, as the alternative costs would be too high. The situation leads to that banks that are considered “too big to fail” enjoy an explicit or implicit state guarantee. Investors are of course aware of this situation and therefore the Return on Investment (ROI) demand is lower than on similar companies without the state guarantee. The lower ROI demand leads to a lower cost of capital for big banks. The lower cost of capital in turn leads to higher profits. The guarantee also creates incentives for short-term risk taking, as the profits will be privatized but the losses socialized. Earlier the banks did not pay anything for this guarantee even though all banks considered to be “too big to fail” benefitted from the situation. This is however not true as of today as many countries have imposed bank levies. In fact most European countries have introduced a bank levy for the banks to pay for the state guarantee. To also motivate an FTT on the same problem that have already, to a large extent, been addressed does not seem reasonable. In case the bank levies are considered to low the legislature should instead focus on addressing the level of the levy to better correspond to the benefits instead of imposing an FTT. The major problem with using an FTT to compensate for the implicit guarantee is that it is rather few financial institutions that are “too big to fail” and the FTT will therefore unfairly affect institutions that are allowed to go bankrupt. The non-uniformity in the tax system will, if a FTT is used to compensate for the state guarantee, not be addressed. Many of the bank levies in effect of today are only

264 For more reading about the too big to fail problem see for example; Morrison.
265 Normally the market decides which companies that will survive, Morrison, p. 501.
266 Not all authors agree to this point, but looking at the latest financial crisis it can be said to be the common view among european politicians.
268 This is not the case in all countries, for example many countries implemented a bank levy on the banks that are “too big to fail” in order to compensate for the guarantee, SWD (2013) 28 final, pp. 62 ff.
271 Morrison, pp. 501 f.
applicable to the banks that are considered too big to fail. As stated above bank levies are a better instrument to address the advantage granted by the state guarantee.

The analysis above examines if a contribution from the financial sector could be seen as fair, and also mentions the allocation of the distribution. In addition to the above-mentioned arguments, the fact that the FTT uses volume of transfers as measure of contribution size could be questioned. The FTT does not target one of the main problems behind today’s financial market, namely the banking size. The too-big-to fail problem creates a moral hazard where big banks are able to take excessive risk without the threat of going bankrupt. The issue that the FTT does not aim for the problem with the banking (size) sector but rather tax the entire financial sector based on trading volume has been lifted earlier. As an example the IMF provides information on how a FAT could be used in order to reduce the risk of the financial sector becoming too large. A bank levy can also be used in order to compensate for the explicit or implicit state guarantee that banks that are too-big-to fail enjoy.

In conclusion the contribution could be said to be both fair and substantial. The justification for the contribution should not be grounded on the VAT exemption but rather on the costs caused by the financial crisis.

6.2.3 Who Makes the Contribution?

The contributions can, as stated above, be seen as both fair and substantial. The next step is to investigate who will make the financial contribution. In the objective it is settled that the financial institutions shall make the contribution and hence the tax is raised only on financial institutions. This looks promising, but stopping here would be too naive. A problem with taxes on financial institutions is that the institutions may pass

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272 As an example the UK bank levy only targets banks over a threshold size and avoids placing a levy on banks that would be allowed to fail, Vella, Fuest, Schmidt-Eisenlohr pp. 615 f.
273 IMF, p. 19.
274 Morrison, pp. 500 f.
275 Rime, pp. 2 f, Dam, Koetter, p. 2.
276 Vella, Fuest, Schmidt-Eisenlohr, pp. 618 f.
277 IMF, p. 22.
278 IMF, p. 5.
279 There are several grounds for this. First of the the problems in calculating the benefits granted to the financial sector by the exemption and further more the FTTs unsustainability to address the non-uniformity.
on the tax to its customers. In this case it would render a situation where instead of the financial institutions making the fair and substantial contribution, the customers of financial institutions would make the contribution. In regards to this problem there is a benefit with the FTT being regional. The financial institutions in the FTT-zone will still stand in global competitions and passing the tax on to their customers might result in customers leaving the banks. The fact that the banks are in global competition is a theoretical advantage of regional taxes. The advantage consists in the banks inability to pass on the costs on the customers because of the risk for customers leaving the banks to other global banks. However, the wide applicability of the FTT makes it hard for any bank inside of the FTT-zone to avoid paying the FTT and hence the internal “FTT-market” will not stand in global competition with other FTT-free banks, but rather in competition with other FTT-banks. The advantage of the FTT being regional is therefore to a large extent eliminated. It is therefore probable that customers within the FTT-zone will face higher prices on banking services as an effect of the FTT. In this scenario the customers could be seen as the part doing the fair and substantial contribution. Some might argue that this approach is a circular argument. The risk of passing on costs is always present when discussing taxation. However, other types of taxes have proven to be more efficient in having the subject of the tax liable in the end.

Even if the costs are passed on to the customers of the financial institutions it is interesting to look at the effects. The situation leads to lower profitability, ceteris paribus, for the financial institutions. Lowering the profitability will cause the financial sector to shrink and negatively affect the value of the shares. The persons affected in this case are the shareholders. It is of course possible that the same shareholders benefited before the crisis but it is probable that also a lot of people that did not benefit now have to take the hit. The argument that the FTT affects shareholders rather than the institution itself has some weaknesses. Using the same argument it would be impossible to keep a legal person responsible for anything. At the same time the financial institutions are an extent of their shareholders wishes. Ultimately the financial

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280 Vella, Fuest, Schmidt-Eisenlohr, p. 618. Matheson, p. 25.
281 Shackelford, Shaviro, Slemrod, pp. 785 f.
282 Claessens, Keen, Pazarbasioglu, pp. 18 f.
283 Claessens, Keen, Pazarbasioglu, p. 22.
284 Shackelford, Shaviro, Slemrod, p. 785.
institutions did not cause the financial crisis (legal persons “cannot think and act” but their shareholders did by electing board members and taking the decisions on how the bank should act). Actions towards companies will always affect the share holders/owners of the company. In other words it should be seen as accurate that the negative effects hit both shareholders and the financial institutions. As shown above, it is however unclear, if the financial intuitions (and hence the share holders) will be the ones taking the hit.

6.3 Creating Appropriate Disincentives:

The last objective of the FTT is to create disincentives and complementing regulatory measures. Just like the last objective analyzed this objective could be split into different parts. The first part of the objective is that the FTT should create disincentives in order to reduce transactions that do not enhance the efficiency of the market. There are a couple of elements to this part of the objective. Ideally the tax should target at harmful or speculative transactions.\(^{286}\) The wording of the objective also implies that the FTT should not set up disincentives to transactions that enhance the functioning of the market. Designing a tax to only target specific transactions without opening easy ways for tax avoidance is, the least to say, complicating.\(^{287}\) In the light of this it should be seen as acceptable that also non-harmful transactions are covered as long as the overall effect on the market is positive.\(^{288}\) The FTT proposed is applicable to all financial transactions. The staggering effects of the proposal make the effective tax rate higher for transaction involving more parties (as long as the parties do not act in the name of another financial institution) and for instruments traded more frequently. By its design the FTT is aimed towards high frequency trading. The focus on the high frequency trading is to be considered good if the high frequency trading can be seen as increasing market risk and not enhancing the functioning of the market. The effects on a decrease in high frequency trading are not clear. There are high uncertainty of the effects from high frequency trading on volatility and the market functioning at large.\(^{289}\) The current proposal can therefore not be said to specifically target risk or transactions that does not enhance the market. Instead the proposal targets volume without consideration to the underlying risk. By doing so the FTT also risks harming transactions that contribute to

\(^{287}\) IMF, pp. 19 f.
\(^{288}\) This is a kind assessment of the objective and it is arguable that the objective should be re-formulated in order to better reflect the reality.
\(^{289}\) McCulloch, Pacillio, p. 36.
market stability. The aggregated market effects of an introduction of the FTT are not clear. Market mispricing is expected to exist for longer periods of time and the effects on volatility are ambiguous.\textsuperscript{290} To fully respond to its objective the FTT should target high frequency high-risk short-term transactions. This may be hard to achieve. The aggregated market effects of the FTT are not easy to evaluate.

The second part of the objective is to be a complement to regulatory measures in avoiding future crises. By using this formulation it is easy to get the perception that the FTT targets known causes of financial crises. This is not the case. The IMF criticized the use of an FTT on the ground that it does not target any of the key attributes which leads to financial instability.\textsuperscript{291} In conclusion the FTT does not respond well to any part of the last objective. Other instruments might be better suited to reach this objective and it is questionable if a “tax solution” is the way to go.

7 Conclusion

The current proposal for an FTT does not meet all of the objectives in the proposal. While the FTT might help harmonizing the internal market it is questionable if the contribution made through an FTT is fair. The FTT does not hit the target of the last objective in providing disincentives and complement regulatory measures in avoiding future crises. It is also notable that better solutions seem to exist for reaching the objectives. In pure revenue raising the FAT is mentioned as a better alternative by the Commission itself.\textsuperscript{292} The FAT was also favored over an FTT by both the EU and the IMF.\textsuperscript{293}

The combined effect of the FTT on enhancing the internal market will be positive. The FTT could further strengthen the internal market by adding a provision on double taxation. The FTT would make sure that the financial market contributed to the cost of the crisis. It is however questionable if the ones responsible for the crisis will be carrying the cost, as part of the burden will fall on financial institutions not responsible for the financial crisis. The contribution can only be seen as fair in regards to some of the companies where the tax will have an impact. As an example the companies

\textsuperscript{290} Cortez, Vogel 2011, p. 19.
\textsuperscript{291} IMF, 2010, p. 19.
\textsuperscript{292} Vella, Fuest, Schmidt-Eisenlohr, pp. 617 f.
enjoying a state guarantee (implicit or explicit) benefits from the guarantee and taxing those institutions should be seen as fair. In addition there are predominant reasons to suspect that the FTT will be passed on to the customers of the institutions. Passing on the cost of taxation to customers can be expected to a certain extent but the wording of the objective implies that the financial sector should bear the costs and not their customers. The FTT does not show an ability to distinguish between transactions that enhance the functioning of the market and transactions that do not. An FTT could be a good tool to decrease harmful transactions if the tax identified those and only applied to transactions that do not enhance the efficiency of the market. If the FTT only targeted harmful excessive trading, the proposal could lead to a reduced volatility. The current proposal risk resulting in the market being less efficient than before the FTT and hence counteracts the objectives of the proposal, but the effects are unclear.

According to the Commission the FTT shall complement regulatory measures in avoiding future financial crisis. It is not clear how the FTT would do so. One of the major problems with the financial market today, that many banks have grown big enough to jeopardize the entire financial system, will remain even after the possible imposition of an FTT. If the FTT is aimed at complementing regulatory measures in order to avoid future crises the tax has to be redesigned to target some of the known problems behind financial crises. Instead of targeting known causes to financial crisis the FTT increases transaction costs, which might affect the volatility. On the contrary, in the impact assessment to the FTT proposal from 2011, the Commission mentions that known causes to financial crises often involves markets with high transaction costs, like for example the housing market.

FTT probably leads to an increase in the cost of capital for many companies. This is one of the effects of the FTT, which has been debated and to a certain extent is uncertain. Predominant causes point towards the conclusion that the FTT will have an impact in increasing the cost of capital for companies. The increase in cost of capital

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295 Opinion of the European Central Bank, p. 3.
296 Vella, Fuest, Schmidt-Eisenlohr, pp. 618 f, Rime, p. 2 f, Dam, Koetter, p 2.
might have negative effects on the market in terms of return and financial growth.\(^{300}\) Others argue that the effects will be negligible.\(^{301}\)

It is apparent that there are better measures available to reach the objectives put up by the Commission. In revenue raising a FAT is favored. In terms of avoiding future financial crisis both a FAT and a more traditional bank levy would be preferable.

In addition to the FTT missing parts of its objectives there are issues with the proposal that are worth discussing. One of the issues is the fact that OTC derivatives are precluded from the issuance principle. By precluding OTC derivatives but not derivatives traded on a regulated market the proposal creates a preference to the OTC market for derivatives. It is questionable if this is desirable. OTC trade is subject to less control and the extensive OTC trade already taking place risk introducing more instability to the financial markets by making the trade harder to control for governments.

The FTT can lead to high costs due to its staggering effects. Some authors have proposed an exemption-limit, based on transaction volume.\(^{302}\) The thought is well in trying to limit the tax for active traders. It should however be lifted that the limit would give a greater benefit the more active the trading institution is. This would result in two unwanted effects. First of all it would benefit traders with large volume. It can be assumed that bigger institutions normally trade with larger volume than smaller institutions. Many of the institutions that are deemed too-big-to-fail would then be even more favored than the other institutions. The second unwanted effect is that it would create an (from the proposal) unwanted incentive to increase trading volume. The higher the trading volume, the lower the effective tax rate. With ground in the analysis above a transaction volume based exemption-limit cannot be recommended.

Another important effect to consider is how the FTT will affect the trade of foreign institutions. FTT-zone instruments falling under the Issuance principle will have a competitive disadvantage compared to other instruments. It is presumable that institutions outside of the FTT zone will rather trade with instruments issued outside of

\(^{300}\) Matheson, p. 14.

\(^{301}\) Baker & Jorgensen, p. 1.

\(^{302}\) Cortez, Vogel 2011, p. 28.
the FTT-zone. In the same way institutions outside of the FTT-zone would prefer to trade with other institutions outside of the FTT-zone before institutions established within the FTT-zone.

All in all FTTs could be a useful tool to curb volume and create better market conditions. This is not the case with the EU FTT. The proposal should be redesigned to better fulfill its objectives. It is questionable if the objectives could be reached without changing to other tax systems. Regulatory measures like those in Basel III together with a FAT or a levy would be a preferable solution to investigate. An FTT could be used if it was designed to successfully identify harmful transactions.
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Appendix A – MiFID Annex 1 Section C

MiFID Annex 1 Section C

Financial Instruments

1. Transferable securities;
2. Money-market instruments;
3. Units in collective investment undertakings;
4. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
5. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
6. Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
7. Options, futures, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;
8. Derivative instruments for the transfer of credit risk;
10. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.
Appendix B – art. 2.1(2) of the Proposal

COM (2013) 71 final, art. 2.1(2)

- 'Financial transaction' means any of the following:

(a) the purchase and sale of a financial instrument before netting or settlement;

(b) the transfer between entities of a group of the right to dispose of a financial instrument as owner and any equivalent operation implying the transfer of the risk associated with the financial instrument, in cases not subject to point (a);

(c) the conclusion of derivatives contracts before netting or settlement;

(d) an exchange of financial instruments;

(e) a repurchase agreement, a reverse repurchase agreement, a securities lending and borrowing agreement;
Appendix C – art. 2.1(8) of the Proposal

COM (2013) 71 final, art. 2.1(8)

(8) 'Financial institution' means any of the following:

(a) an investment firm as defined in Article 4(1)(1) of Directive 2004/39/EC;
(b) a regulated market as defined in Article 4(1)(14) of Directive 2004/39/EC and any other organised trade venue or platform;
(c) a credit institution as defined in Article 4(1) of Directive 2006/48/EC;
(d) an insurance and reinsurance undertaking as defined in Article 13 of Directive 2009/138/EC of the European Parliament and the Council10;
(f) a pension fund or an institution for occupational retirement provision as defined in Article 6(a) of Directive 2003/41/EC of the European Parliament and of the Council12, an investment manager of such fund or institution;
(g) an alternative investment fund (AIF) and an alternative investment fund manager (AIFM) as defined in Article 4 of Directive 2011/61/EU of the European Parliament and of the Council13;
(h) a securitisation special purpose entity as defined in Article 4(44) of Directive 2006/48/EC;
(i) a special purpose vehicle as defined in Article 13(26) of Directive 2009/138/EC;
(j) any other undertaking, institution, body or person carrying out one or more of the following activities, in case the average annual value of its financial transactions constitutes more than fifty per cent of its overall average net annual turnover, as referred to in Article 28 of Council Directive 78/660/EEC14:
   (i) activities referred to in points 1, 2, 3 and 6 of Annex I to Directive 2006/48/EC;
   ii) trading for own account or for account or in the name of customers with respect to any financial instrument;
   (iii) acquisition of holdings in undertakings;
   (iv) participation in or issuance of financial instruments;
   (v) the provision of services related to activities referred to in point (iv);
Appendix D – art. 4 of the proposal

COM (2013) 71 final, art. 4

Establishment

1. For the purposes of this Directive, a financial institution shall be deemed to be established in the territory of a participating Member State where any of the following conditions is fulfilled:

(a) it has been authorised by the authorities of that Member State to act as such, in respect of transactions covered by that authorisation;
(b) it is authorised or otherwise entitled to operate, from abroad, as financial institution in regard to the territory of that Member State, in respect of transactions covered by such authorisation or entitlement;
(c) it has its registered seat within that Member State;
(d) its permanent address or, if no permanent address can be ascertained, its usual residence is located in that Member State;
(e) it has a branch within that Member State, in respect of transactions carried out by that branch;
(f) it is party, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, to a financial transaction with another financial institution established in that Member State pursuant to points (a), (b), (c), (d) or (e), or with a party established in the territory of that Member State and which is not a financial institution;
(g) it is party, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, to a financial transaction in a structured product or one of the financial instruments referred to in Section C of Annex I of Directive 2004/39/EC issued within the territory of that Member State, with the exception of instruments referred to in points (4) to (10) of that Section which are not traded on an organised platform.