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Towards a Financial Transaction Tax?

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Sub-Committee Staff

The current staff of the Sub-Committee are Stuart Stoner (Clerk), Laura Bonacorsi-Macleod (Policy Analyst) and Sarah Yusuf (Committee Assistant).

Contacts for the European Union Committee

Contact details for individual Sub-Committees are given on the website.
General correspondence should be addressed to the Clerk of the European Union Committee, Committee Office, House of Lords, London, SW1A 0PW
General enquiries 020 7219 5791. The Committee's email address is euclords@parliament.uk

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Q refers to a question in oral evidence;
Witness names without a question reference refer to written evidence.

SUMMARY

This Committee has undertaken a detailed analysis of the European Commission's controversial proposals for a Financial Transaction Tax (FTT). We have been disappointed in what we have discovered. We have found the Commission's proposed model wanting in many respects, and unlikely to fulfil the objectives that the Commission itself has set. We find the Commission's proposed residence principle to be impractical and unworkable, and conclude that there is a significant risk that financial institutions would relocate outside the EU if an FTT is introduced. In the light of these flaws, it is our view that the Government should refuse to agree to this proposal. Yet the debate on taxation of the financial sector should not be lightly dismissed. It has been suggested that an FTT may be adopted by some or all euro area Member States, or that a tax of a similar kind to the UK Stamp Duty might be pursued. The implications for the UK and the EU as a whole are considerable, and we urge the Government to redouble their efforts to ensure that the UK is able to influence the ongoing debate.

The continuing debate over the introduction of a Financial Transaction Tax has been highly contentious. Commission President José Manuel Barroso has justified it as a "question of fairness". A number of Member States, led by Germany and in particular France, have pushed hard for its introduction. And a high-profile group of economists, trade unions, celebrities, charities and faith groups, has spearheaded a vocal campaign for the introduction of a tax. Its advocates argue that a Financial Transaction Tax is desirable to recoup the costs of the financial crisis from those who bear responsibility for it. Yet leading economists have criticised the concept as fundamentally flawed, and the financial sector has been fervent in its opposition to the idea.

It is in this feverish atmosphere that the House of Lords European Union Committee has conducted this inquiry into the European Commission's proposals for a Financial Transaction Tax (FTT). Our conclusion is that there are significant shortcomings in the Commission's proposal.

The Commission sets out five objectives behind its proposal: i) To avoid fragmentation of the internal market for financial services; ii) To ensure that financial institutions make a fair contribution to covering the costs of the recent crisis and to ensure a level playing field in taxation; iii) To deter transactions that do not enhance the efficiency of financial markets; iv) To generate money for the EU budget; and v) To contribute to the development of an FTT at global level. We are not convinced that the proposed model would meet any of them.

Given the opposition to an FTT in the USA, the suggestion that the Commission proposal will pave the way for a global tax is in our view wholly unrealistic, whilst the case for using an FTT as a new revenue stream for the EU budget is contentious even amongst its supporters, many of whom favour revenue being put to other uses such as tackling global poverty and climate change. Whilst there is a stronger case for asking the financial sector to make a contribution to the costs of the financial crisis, or indeed for seeking to deter certain transactions, in neither case is the Commission's position compelling. Whilst we acknowledge the strength of public anger against the financial sector, and the widespread view that those who contributed to the current financial crisis should contribute to its costs, we fear that a Financial Transaction Tax is the wrong way to meet such demands.

In particular, the design that the Commission proposes has significant flaws. The 'residence' principle is impractical and unworkable. There is a significant likelihood that financial institutions will relocate outside the EU in order to avoid the tax. It is uncertain who will shoulder the burden of the tax incidence. A cascade effect threatens to increase the potential tax burden. We are alarmed at the degree of criticism to which the Commission's Impact Assessment has been subjected. And, most concerning of all, the proposal seems destined to lead to a reduction in EU-wide GDP. In the context of the current financial crisis and the economic pressures being faced by many Member States, this is highly undesirable. If a proposal on a question of such importance as this is to be seriously contemplated then it is imperative that any proposed tax is as technically well-designed as possible. Given the flaws in the Commission's proposed design, we conclude that the Government should refuse to agree to this proposal.

That is not to say that the debate on whether and how the financial sector should be taxed can be ignored. It has been suggested that an FTT could be taken forward by some or all of the euro area Member States. Other models have also been put forward. There is increasing political momentum, led by President Sarkozy of France, behind the adoption of a tax on the trading of shares, similar to the UK Stamp Duty model. It remains to be seen whether there is any prospect of the adoption of such a tax more broadly across the EU, or what the consequences would be for the UK Stamp Duty regime.

Whatever shape the debate takes in the future, the implications for the UK are extremely significant. The UK financial sector, based in the City of London, is of fundamental strategic importance, not only for the UK economy, but also for the EU as a whole. The Chancellor of the Exchequer has said that an EU-wide tax would be "a bullet aimed at the heart of London", but on the other hand the Government maintain that they have no principled opposition to a global tax. In the evidence they put to us, the Government's support for a global tax was lukewarm at best. We find this distinction unconvincing. If the Government's true position is that they oppose a Financial Transaction Tax outright, then they should say so.

Whatever the Government's view, it is imperative that they remain engaged in the debate. Much uncertainty remains about the impact of any financial taxation proposal on the UK, whether it is established at EU level or amongst euro area States alone, or whether an alternative model on the basis of the UK Stamp Duty is proposed. Given the vital role of its financial sector not only for the UK but for the EU as a whole, the UK must seek to play a constructive role in the continuing discussions on the introduction and design of any proposal for taxation of the financial sector. The implications for the UK are far too great for the debate to be dismissed.

Towards a Financial Transaction Tax?

CHAPTER 1: INTRODUCTION

1. The period since the eruption of the global financial crisis in 2008 has been one of perpetual flux in the political, economic and financial spheres. As politicians have grappled with the crisis, there have been increasing efforts to deal with its consequences. The European Commission has brought forward a large number of proposals since 2009 (see Box 1 below). The financial sector has been a focus of these efforts. Before the crisis broke, there was widespread (although not universal) support for light-touch regulation of financial practices and markets. The conclusion in many quarters that the unwise practices of various financial institutions was a significant cause of the crisis has caused attitudes to change. In addition, there is a common perception that the financial sector does not pay its fair share, as well as widespread anger at the level of pay and bonuses in the financial sector at a time of economic austerity. In this context, there is a desire amongst many to see the financial sector make amends for its perceived mistakes.

BOX 1

Recent Commission Legislative Proposals in Relation to the Financial Sector[1]

- 2009: Proposal for a new European Systemic Risk Board (ESRB) and European Supervisory Authorities (ESAs) for banking, securities and markets, and insurance;
- 2009: Alternative Investment Fund Managers Directive (AIFMD);
- 2010: Regulation on over-the-counter (OTC) derivatives;
- 2010: Regulation on short selling and certain aspects of credit default swaps;
- 2011: Revision of the Capital Requirements Directive for banks (CRD4);
- 2011: Revision of the Markets in Financial Instruments Directive (MiFID) and new measures on market abuse;
- 2011: Amendment of the Transparency Directive;
- 2011: Directive and Regulation on Credit Rating Agencies (CRA3).

2. It is in this context that the proposal for a Financial Transaction Tax has emerged. Yet the model on which it is based is not new. In the early 1970s, an influential American macroeconomist and recipient of the Nobel Prize for Economics, James Tobin, brought forward a proposal in the aftermath of the

1 The dates refer to the year in which the proposal was first brought forward.

1971 collapse of the Bretton Woods exchange rate system.[2] His eponymous proposal was to levy a tax of 0.1% on every amount exchanged from one currency to another. The intention of the proposal was to reduce exchange rate volatility by discouraging short-term currency speculation, but at a rate small enough not to inhibit trade.

3. Although the Tobin Tax idea did not gain traction immediately, it has returned to the agenda from time to time, particularly during periods of financial crisis. In the midst of the Asian financial crisis in the late 1990s, a Tobin Tax was advocated by the anti-globalisation movement. And now, in the context of the current crisis, the idea has once more been resurrected, albeit in a modified way, in the form of a 'Financial Transaction Tax' (FTT). According to the European Commission, an FTT is designed to tax the value of single transactions of a broad range of financial instruments, including equities, bonds, currencies and derivatives. However, others have advocated a more limited application, for instance on currency transactions.[3]

4. The push for such a tax is broad-based, and a number of different reasons for introducing the tax have been advanced. A high-profile campaign, including some economists, trade unions, celebrities, charities and faith groups, has advocated the tax as a means of reducing poverty and/or tackling climate change. The Robin Hood Tax campaign, who have spearheaded support in the UK, describe it as "a tax on banks that would give billions to tackle poverty and climate change, both here and abroad."[4] National leaders, including the German Chancellor Angela Merkel, and, most prominently, the French President Nicolas Sarkozy, have pushed hard for the tax to be introduced as a means by which the financial sector can make a contribution to recouping the costs of the financial crisis. At the European Council meeting on 11 March 2011 the heads of state or government of the euro area agreed that "the introduction of a financial transaction tax should be explored and developed further at the Euro area, EU and international levels."[5] Others have stressed the value of an FTT along the same lines as Tobin's original proposal, in seeking to curb perceived harmful speculation.[6] And the European Commission, led by the Commission President José Manuel Barroso, has advocated the tax as a "question of fairness".[7]

5. However, support for an FTT is far from universal. Leading economists such as Professor Charles Goodhart and Paul Volcker have criticised the proposal as technically flawed.[8] The financial sector has warned of the damaging impact such a tax would have on that industry, and several world economic heavyweights, most notably the USA, remain steadfastly opposed to its introduction. The UK Government too, whilst stating that they would not

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2 An arrangement of fixed exchange rates ultimately based on the US dollar's peg to gold. See 'The Tobin Tax explained', by Martin Sandbu, *Financial Times*, 28 September 2011.

3 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Taxation of the Financial Sector, COM (2010) 549 FINAL.

4 http://robinhoodtax.org/

5 See European Commission proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, footnote 2, COM (2011) 594 FINAL.

6 See paras 27–39 below.

7 José Manuel Durão Barroso, President of the European Commission, *European renewal—State of the Union Address 2011*. http://ec.europa.eu/commission_2010-2014/president/pdf/speech_original.pdf.

8 http://en.wikipedia.org/wiki/Reaction_to_the_Tobin_Tax

oppose its introduction at global level, have remained consistently opposed to the introduction of a tax at EU level. The Prime Minister, David Cameron, has called such a proposal "madness", whilst the Chancellor of the Exchequer, George Osborne, has called it "a bullet aimed at the heart of London".[9]

6. Notwithstanding these objections, the European Commission has been actively considering the case for the introduction of an FTT. It first exposed the idea in October 2010, in its Communication on Taxation of the Financial Sector. Although at that stage it appeared to favour the introduction of a Financial Activities Tax (FAT) as a tax on the total value added generated by a financial sector company,[10] in September 2011 the European Commission published its own proposals for an FTT.[11] It was in that context that this inquiry was launched. In October 2011, we announced our intention to investigate the rationale behind the introduction of a financial sector tax, focussing primarily on the Commission's proposal for an FTT. We sought to consider the potential risks, benefits and shortcomings of an FTT, its potential to dampen speculation on the financial markets, and its significance for the City of London. We also sought to assess whether an FTT could plausibly be implemented at an EU level, or whether it would only work effectively if implemented globally.

7. Since the Commission's proposals were published, the debate has gathered pace. Most notably, in January 2012, President Sarkozy announced that France would introduce a tax on share trades in August 2012. This proposal has been interpreted as broadly based on the UK stamp duty. In the meantime, the Commission's proposals remain under consideration, with the UK continuing to make clear that it intends to oppose an EU-wide tax. However it was reported in March 2012 that the Commission were being encouraged to consider "alternatives" to their proposal, potentially including the stamp duty model. We have sought to reflect these developments in the report.

8. During the course of this inquiry, we received written evidence from 34 witnesses, and have heard oral evidence from economists, campaigners, financial institutions, representative organisations, as well as from the Financial Secretary to the Treasury, Mark Hoban MP, and from the European Commissioner for Taxation and Customs Union, Audit and Anti-Fraud, Algirdas Šemeta. There appeared to be a considerable degree of uncertainty and misunderstanding about the effect of the Commission's proposals. In addition, a stark division of views was apparent in the evidence that we received. Whilst the campaigning organisations, trade unions and those MEPs who got in touch with us were fervently in favour of an FTT, financial institutions and other financial sector representatives were equally firm in their opposition. Whilst this division of opinion was perhaps to be expected, we are grateful to all of our witnesses for their assistance. We recommend this report to the House for debate.

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9 See http://www.telegraph.co.uk/news/politics/david-cameron/9040929/David-Cameron-stop-the-madness-of-Europe-red-tape.html, 26 January 2012 and "Fix this euro crisis with the smack of firm government", by Rt Hon George Osborne MP, *London Evening Standard*, 14 November 2011.

10 COM (2010) 549 FINAL, op. cit. See Chapter 5 below.

11 COM (2011) 594 FINAL, op. cit.

CHAPTER 2: ASSESSING THE COMMISSION'S OBJECTIVES

9. The European Commission proposal for a Council Directive on a Common System of Financial Transaction Tax was published on 28 September 2011. The Commission set out five broad objectives behind the tax:

   (a) To avoid fragmentation in the internal market for financial services, bearing in mind the increasing number of unco-ordinated national tax measures being put in place;

   (b) 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;

   (c) To create appropriate disincentives for transactions that do not enhance the efficiency of financial markets, thereby complementing regulatory measures aimed at avoiding future crises;

   (d) To create a new revenue stream with the objective of gradually displacing national contributions to the EU budget, resulting in a lesser burden on national treasuries;

   (e) To contribute to the ongoing international debate on financial sector taxation and in particular to the development of an FTT at global level.[12]

10. Commissioner Šemeta told us that "modern tax policy allows taxation to serve several objectives at the same time", and he did not see any contradiction between them. On the contrary, the Commission saw them as mutually reinforcing.[13] We now consider whether these are reasonable objectives to pursue, and whether an FTT is an effective way to do so.

a) To avoid fragmentation in the internal market

11. The Commission's first priority is "to avoid fragmentation in the internal market for financial services, bearing in mind the increasing number of unco-ordinated national tax measures being put in place."[14] Whilst this priority was listed first in the Commission's Explanatory Memorandum, it has been given less prominence than any of the other objectives. The Commission's written evidence to the Committee barely refers to it, and Commissioner Šemeta made clear that it was not the primary focus for the Commission.[15]

12. Tellingly, few of our witnesses commented specifically on this aim. John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr from the Oxford University Centre for Business Taxation argued that, though it is right to point out that Member States are introducing unco-ordinated national financial sector taxes (for instance bank levies), these are not transaction taxes, and an EU-wide FTT would not address the lack of co-ordination on these levies.[16] The International Swaps and Derivatives Association (ISDA)

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12 Ibid.

13 Q 122.

14 COM (2011) 594 FINAL, op cit.

15 Q 122 and European Commission Directorate-General Taxation and Customs Union.

16 Oxford University Centre for Business Taxation. See also Association for Financial Markets in Europe (AFME), and Association of British Insurers (ABI).

cited the Chancellor of the Exchequer's argument that the EU's energies would be better spent harmonising bank levies.[17]

13. The British Bankers' Association (BBA) considered that a blend of national measures is a reasonable price to pay to maintain competitive tax systems and fiscal sovereignty. They argued that national measures that threaten the free movement of goods, services, persons or capital within the single market can already be challenged under the EU Treaty, and they had not seen any evidence that the levies introduced in a number of Member States have caused any fragmentation in the European financial services market.[18]

14. The Government noted that the Commission cites article 113 of the Treaty on the Functioning of the European Union (TFEU) as the legal basis of the proposal, which is to ensure the functioning of the single market. However, the Government argued that it is unclear why the Commission feels that an EU FTT would deliver on its stated objectives better than domestic taxes.[19]

15. **Whilst an attempt to avoid fragmentation in the internal market for financial services may be a commendable aim, it is not at all clear how the Commission's proposal for a new tax would help achieve this.**

b) To ensure financial institutions make a fair contribution

16. The Commission's second objective is "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". This was in light of the fact that "the financial sector has played a major role in causing the economic crisis whilst governments and European citizens at large have borne the cost."[20]

17. Commissioner Šemeta told us that it was the Commission's 'key priority' to ensure a "fair and substantial" contribution from the financial sector to the costs of the crisis.[21] He argued that, given that the total costs of the bailout have been estimated at €4.6 trillion across the EU, it is legitimate to expect the financial sector to pay this money back sooner or later.[22] Indeed, the Commission's written evidence asserted that the financial sector has "hugely benefitted from massive rescue operations undertaken by the tax payers in Europe". In its view, "asking the financial sector to contribute to the financing of these rescue operations is simply applying a key principle of effective policy making, i.e. that those who benefit from a policy should also be those that should pay for it, unless there is a political consensus that others should pay." The Commission also argued that the financial sector benefits from preferential treatment since it is exempt from paying VAT for most of its operations.[23]

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17 International Swaps and Derivatives Association (ISDA).

18 British Bankers' Association (BBA).

19 HM Treasury, Explanatory Memorandum on European Legislation: Proposal for a Council Directive on a common system of Financial Transaction Tax and amending Directive 2008/7/EC, EM 14942/11, paras 17, 32–35.

20 COM (2011) 594 FINAL, op cit.

21 Q 122.

22 Q 123.

23 European Commission Directorate-General Taxation and Customs Union.

18. Some witnesses sought to reinforce the Commission's arguments. Sylvie Goulard MEP thought that there was "genuine legitimacy in asking these services to take a fair share of their responsibilities."[24] Stamp Out Poverty claimed that the VAT exemption created a significant tax advantage for the financial sector. They also argued that "large banks' 'too big to fail' status" resulted in an "implicit subsidy", since it enabled them to borrow at lower interest rates on the basis of an implicit understanding that the government will bail out bond holders if a large bank defaults on its debt payments.[25]

19. Unite cited "an apparent disregard being paid by top level bankers to the outrage felt by taxpayers and the general public following the payment of such high bonuses given that the rest of the economy is facing a tight financial squeeze caused by the banks."[26] Indeed, in the view of Owen Tudor, the TUC's Head of European and International Relations, an added advantage of an FTT was that it would be a popular tax reflecting popular feelings that the financial sector is under-taxed.[27] Commissioner Šemeta cited recent opinion polls which suggested that approximately two-thirds of European citizens, and one-half of the UK population, are in favour of a Financial Transaction Tax, although we question the extent to which the general public can be expected to understand all the implications of such a proposal.[28]

20. Other witnesses disagreed strongly, several disputing the Commission's contention that the VAT exemption constituted preferential treatment. Nigel Fleming, International Head of Tax, BlackRock, argued that it was "misguided" to regard this as a tax break since the major effect of the VAT exemption is that the financial institutions themselves do not recover the input VAT that they suffer on their costs, and they then do not charge VAT to the consumer of the supply.[29] Mr Fleming also pointed out that bank levies, bank bonus taxes and other taxes apply to the financial sector but not elsewhere.[30]

21. Some witnesses claimed that the Commission's diagnosis was simplistic. The Association of British Insurers (ABI) argued that the Commission had predicated its arguments on "the false notion that all elements of the financial sector are taxed in equal manner and proportion."[31] Other witnesses pointed out that the effect of the tax would not be limited to those firms or those sectors of the financial sector that had caused the crisis.[32] ISDA cited pension funds, unit trusts, holding companies and leasing companies as examples of groups that bear no responsibility for the financial crisis and which received no taxpayer support.[33]

22. Other witnesses were concerned that the difficult economic climate made the introduction of an FTT an unwise proposition. Richard Woolhouse, Head of

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24 Sylvie Goulard MEP, European Parliament.

25 Stamp Out Poverty.

26 Unite the Union.

27 Q 2.

28 Q 128.

29 Q 59. See also, for example, Investment Management Association (IMA) and ABI.

30 Ibid. See also AVIVA plc.

31 ABI.

32 See for example Confederation of British Industry (CBI) and Lloyds. See paras 27–39 below.

33 ISDA.

Tax and Fiscal Policy, Confederation of British Industry (CBI), argued that the priority at the present time should be to encourage economic growth rather than promoting a tax that could be extremely damaging not only for the financial sector but also for the broader economy in terms of investment and job creation.[34] The Mayor of London, Boris Johnson, agreed.[35]

23. The Financial Secretary to the Treasury agreed that the financial sector should pay a fair contribution to the Exchequer, and pointed to the UK bank levy as a way that the banking sector did so. Whilst he acknowledged that financial services are exempt from VAT, he cited a recent estimate that financial services firms incurred £6 billion of irrecoverable VAT. He told us that "we have to be very careful. There are some who use the financial services sector as a scapegoat. It is quite easy to point to big bad speculators as the cause of your country's problems, when actually the problem is more around tackling your fiscal problems and getting the competitiveness and growth agenda right in your country."[36]

24. **The Commission's proposal combines two distinct issues—firstly, whether the financial sector should make a financial contribution to dealing with the effects of the ongoing financial crisis, and secondly, whether the financial sector is under-taxed.**

25. **The issue of whether the financial sector is under-taxed is particularly nuanced. The evidence we heard focussed on whether or not the financial sector's exemption from VAT could be regarded as preferential treatment. In our view, whilst the financial sector *may* derive some advantage from the VAT exemption, it is also clear that financial institutions incur a large amount of irrecoverable VAT. Any case for increasing taxation of the financial sector needs to rest on more solid foundations than this.**

26. **Furthermore, whilst we acknowledge the strength of public anger against the financial sector, and the widespread view that a form of taxation should be introduced to ensure that those who contributed to the current crisis should contribute to its costs, it is important to recognise that not all elements of the financial sector bear equal (or even any) responsibility for the crisis. Caution should therefore be observed before introducing any proposal that would have a blanket effect on all elements of the financial sector. Therefore, whilst there may be a case for increased taxation of at least some parts of the financial sector, it does not follow that the Commission's Financial Transaction Tax proposal is the most appropriate means by which to achieve this. Much depends upon the specific details of the Commission's proposals, which we examine in Chapter 3.**

c) To create disincentives for transactions that do not enhance the efficiency of financial markets

27. The Commission's third objective is "to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures aimed at avoiding future crises". The

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34 Q 1.

35 Mayor of London.

36 QQ 105, 107, 112.

Commission stated that the market segments expected to be affected most will be automated high-frequency trading and highly-leveraged transactions (see Box 2 below).[37]

BOX 2

High-Frequency Trading[38]

High-frequency trading (HFT) has been defined as the use of computers to implement various highly active trading strategies to trade at exchanges where automated electronic systems arrange trades. Electronic dealers post standing limit orders to buy or sell securities or contracts and wait for others to trade with them. After they trade, they generally try immediately to trade on the other side of the market to divest themselves of their positions. They hope to profit by buying low and quickly selling high. When this happens, they often profit. But if they believe that the market will move against them, they may be unwilling to wait to trade. Instead, they will actively trade out of their positions by submitting market orders or marketable limit orders. In these cases, they often lose. Traders frequently adjust their orders to respond to changing market conditions. These adjustments may occur several times a second. High-frequency traders use extremely fast computer systems to implement their trading strategies. The time between when an event takes place on an exchange and when a trader is able to respond to that event is often less than one millisecond. During this period, electronic systems will disseminate information about the event. The high-frequency trader's computer will analyse the information, choose a response and submit instructions to the exchange. The electronic systems will route those instructions to the exchange.

28. Commissioner Šemeta told us that there had been significant growth in this phenomenon, and warned of the risks associated with it. Whilst he denied regarding high-frequency trading as immoral *per se*, he argued that the growth in this segment of the market meant that, as well as regulatory measures, complementary measures such as taxation need to be used.[39]

29. Some witnesses stressed the need to target such activity, described by Unite as "casino" banking. They pointed out that Lord Turner of Ecchinswell, Chairman of the Financial Services Authority, had described such activity as "socially useless".[40] Stamp Out Poverty told us that 72% of trades on the New York Stock Exchange are now conducted using algorithms, asserting that "these computer programs drive trading without human involvement, and the interaction between different algorithms can significantly reduce stability in markets." They pointed to the May 2010 'flash crash' in the USA, when the Dow Jones Industrial Average plunged by 600 points in 5 minutes, when high-frequency trading was implicated in the subsequent investigation.[41]

30. Duncan Weldon, Senior Policy Officer, TUC, told us that there is a legitimate need for interest rate swaps and forward exchange rate contracts,

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37 COM (2011) 594 FINAL, op cit and European Commission Directorate-General Taxation and Customs Union.

38 With thanks to http://lexicon.ft.com/Term?term=high_frequency-traders.

39 Q 130.

40 Unite the Union.

41 Stamp Out Poverty.

which are useful for real corporations in the real economy. His concern was that "the volume of these contracts far outweighs their use in the real economy."[42] Likewise, Owen Tudor cited the dangers of "vast amounts of money simply going around and around in a spiral that is not being used productively."[43]

31. Sony Kapoor, Managing Director, Re-Define, argued that high-frequency trading provides "what is essentially spurious liquidity. True liquidity in a financial market actually comes from a diversity of opinion: somebody should want to buy when I want to sell, and somebody should want to sell when I want to buy." With high-frequency trading, "even a small transaction will trigger changes and further transactions, which in turn would trigger even further transactions and cause different exchanges for different high-frequency traders."[44]

32. Richard Gower, Senior Policy Advisor, Oxfam, cited the view of economist Paul Krugman that an FTT would help cure banks' addiction to short-term finance.[45] He told us that the emerging evidence showed that the frequency of market abnormalities and contagion across markets had increased as a result of such trading.[46] John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr disputed this, citing the Commission's own admission that the empirical economic literature is still rather inconclusive on the effects of such trading on volatility or price deviations.[47] Nigel Fleming told us that much high frequency trading would in fact decrease risk or volatility.[48]

33. Some witnesses defended the role of high-frequency trading and of derivative markets more broadly. Joanna Cound, Managing Director, BlackRock, told us that high-frequency trading is generally beneficial from the point of view of their investors. She told us that it reduced bid offer spreads, which in turn helped investment performance.[49] The CBI argued that the use of derivatives sensibly to manage risk is essential for the majority of types of business, allowing firms to manage risks, invest over the longer term, export to customers outside the UK and manage the price of their raw materials.[50]

34. Several witnesses argued that a tax would in any case be too blunt an instrument to have any beneficial effect. The Institute of Economic Affairs (IEA) argued that it would have had no effect upon either the 2007–8 financial crash or the continuing euro area crisis, since the markets that would have been affected by an FTT were the foreign exchange (FX), futures, options and stock markets, including high-frequency trading. In contrast, Mortgage Backed Securities (MBS), Collateralised Debt Obligations (CDO), Credit Default Swaps (CDS) and the leverage of the banks themselves, which did cause the problems in 2007/8, would not have been affected.[51] The CBI pointed out that whilst the FTT is supposedly

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42 Q 16.

43 Q 23.

44 Q 94.

45 Q 29.

46 Q 40.

47 Oxford University Centre for Business Taxation.

48 Q 64.

49 Q 63.

50 CBI.

51 IEA.

aimed at reducing the number of 'risky' practices, in reality it does not discriminate since all transactions would be affected, "from risk management products to long term pension investments."[52]

35. Joanna Cound argued that any concerns arising from high-frequency trading should be dealt with through regulation, citing the Commission's current Markets in Financial Instruments Directive (MiFID) and Market Abuse Regulation (MAR) proposals.[53] The CBI agreed that "as a matter of principle, undesirable market behaviour should be dealt with through regulation."[54] John Vella also thought that "targeted regulation" was the preferable approach.[55]

36. The Financial Secretary to the Treasury told us that "the initial evidence suggests that high-frequency trading does not have an adverse impact on volatility but does improve liquidity and efficiency in markets." In his view, financial market instability and the financial crisis "was not really about the volume of transactions; it was about the structure of banking in the UK and the rest of the world, and the inadequate regulation and supervision of that banking model." He was not convinced that reducing the volume of transactions would make that system any more stable. In his view, "those who propose an FTT as a means of delivering financial stability need to provide some more evidence for their views."[56]

37. **We heard divergent views as to whether high-frequency trading and other related transactions, regarded by the Commission as inefficient, should be discouraged. We note the equally divergent evidence as to the impact of such transactions on market volatility. In our view, it is not yet clear whether and to what degree such activity has a detrimental effect on the national, EU and global economy.**

38. **Yet even if the case is made that such transactions should be discouraged, it is far from clear that a Financial Transaction Tax is the best way to achieve this. We note the concerns of several witnesses that such a tax would be too blunt an instrument to tackle the issue effectively, since it would impinge upon other transactions and parts of the financial sector that are not seen to be problematic. Again, much depends upon the specific details of the Commission's proposal, which we explore in detail in Chapter 3.**

39. **We note that the Commission itself has brought forward proposals to improve regulation of these markets, for instance through the current Markets in Financial Instruments Directive (MiFID) and the Market Abuse Regulation (MAR) proposals. Whatever the merits or otherwise of these specific proposals, it is our view that focussed regulation is likely to be a more effective means by which to tackle undesirable market behaviour arising from the use of such transactions.**

d) To create a new revenue stream

40. The Commission's fourth objective is to create "a new revenue stream with the objective to gradually displace national contributions to the EU budget,

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52 CBI.

53 Q 63.

54 CBI.

55 Q 37.

56 QQ 110, 117.

leaving a lesser burden on national treasuries".[57] Commissioner Šemeta told us that, alongside the desire to secure a financial contribution from the financial sector, this was one of the Commission's main priorities.[58] In light of our current inquiry on the Multiannual Financial Framework 2014–2020, we stated in our Call for Evidence that this inquiry would not consider the debate as to whether an FTT could form a possible revenue stream for the EU budget. Notwithstanding this, we note that a number of witnesses expressed concerns about the Commission's objective.

41. John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr argued that it is not clear why the EU should be funded by the financial sector to a larger extent than by other sectors of the economy.[59] Likewise ISDA argued that it would be imprudent for the EU's budget to become dependent upon one sector of the economy.[60]

42. We also note that those who supported an FTT tended to stress alternative uses of revenue. Arlene McCarthy MEP, the TUC and Unite advocated the potential use of the revenues to address such challenges as development and climate change, poverty at home and abroad, and public sector deficits.[61] Stamp Out Poverty argued that the majority of revenue should be used to protect public services, meet international aid commitments and promote climate change initiatives, rather than financing the deficits of EU Member States. In their view, "one set of banks should not be taxed in order to bail out another set of banks."[62] Duncan Weldon was conscious that "the European Commission may not be entirely in agreement with us about exactly what should be done with the money that is spent. In fact, I am not entirely certain the European Commission is in tune with anybody about how the money should be spent".[63] David Hillman, Director, Stamp Out Poverty, pointed out that even the most vociferous national proponents of a tax, Germany and France, rejected the Commission's proposal to use an FTT as an own resource for the EU budget.[64]

43. The Financial Secretary to the Treasury told us that the Government had made clear in their negotiating position on the budget that they are opposed to an increase in the EU's own resources, and that they therefore opposed using FTT to fund the EU budget.[65] Noting the other proposals for use of revenue that had been put forward, he stressed the Government's view that, in general, hypothecation of revenues limits the scope of government to demonstrate flexibility in using the public finances to support priorities and economic needs at any given time.[66]

44. **The question of the EU budget, and whether an FTT could form a potential revenue stream for it, lies outside the scope of this inquiry. Notwithstanding this, we note the concern with which this objective**

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57 COM (2011) 594 FINAL, op cit.

58 Q 122.

59 Oxford University Centre for Business Taxation.

60 ISDA.

61 Arlene McCarthy MEP, TUC, Unite the Union.

62 Stamp Out Poverty.

63 Q 21.

64 Q 30.

65 Q 104.

66 Mark Hoban MP, Financial Secretary to the Treasury, supplementary written evidence.

was viewed by several of our witnesses, including, notably, those who advocated the introduction of an FTT, many of whom have stressed that revenues should be used to tackle such issues as global poverty and climate change. The use to which any revenues from an FTT would be put is evidently a matter of contention amongst its supporters. That the Commission has so far failed to secure support for its objective of using an FTT as a revenue stream for the EU budget suggests that such an objective is unlikely to be met.

e) To pave the way for a global FTT

45. The Commission's final objective is to make a contribution to "the ongoing international debate on financial sector taxation and in particular to the development of a FTT at global level. In order to best minimise risks, a co-ordinated approach at international level is the best option. The present proposal demonstrates how an effective FTT can be designed and implemented, generating significant revenue. This should pave the way towards a co-ordinated approach with the most relevant international partners."[67]

46. We explore the questions of the geographical scope of the tax and the threat of relocation in more detail in Chapter 3. Therefore at this point we only consider the likelihood that an EU tax would pave the way for a global FTT.

47. Commissioner Šemeta pointed to policy issues such as climate change, where the EU had set an example that others later followed. He argued that "somebody has to start in order to reach a global agreement, and I believe that, with the design of the tax which we propose, we can do it."[68] Some witnesses defended the Commission's position. Arlene McCarthy MEP argued that an EU tax would be "a powerful demonstration of the potential of an FTT, and could advance the cause of global agreement".[69]

48. However, the majority of witnesses who commented felt that this was unrealistic. The Financial Secretary to the Treasury cast doubt on a consensus emerging.[70] John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr asserted that the USA, Australia and Canada had already declared their lack of interest in adopting an FTT, and that, far from encouraging a global tax, the unilateral adoption of an FTT by the EU could act as an incentive for other states not to follow suit and thus to attract financial transactions from the EU.[71] Lloyds perceived "little or no enthusiasm on the part of policymakers outside the EU for the imposition of an FTT".[72] Richard Woolhouse thought that "the chances of this being implemented globally are zero."[73] Commissioner Šemeta conceded that the USA were "rather sceptical" about the idea.[74]

49. **Seeking to set a pioneering precedent in the development of a new policy is often to be commended. Yet given the palpable lack of**

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67 COM (2011) 594 FINAL, op cit.

68 Q 133.

69 Arlene McCarthy MEP.

70 QQ 98, 103.

71 Oxford University Centre for Business Taxation.

72 Lloyds.

73 Q 9.

74 Q 134.

appetite for the introduction of a tax amongst other nations, most notably the USA, the Commission's argument that an EU-wide FTT will pave the way for the introduction of a global tax appears to us to be wholly unrealistic.

Overall conclusion

50. **The Commission has set out a number of objectives behind its proposal for a Financial Transaction Tax. Yet we are not convinced that the proposed model would meet any of them. It is difficult to see how the Commission proposal can pave the way for a global tax, whilst the case for using an FTT as a new revenue stream for the EU budget is contentious to say the least. Whilst there is a stronger case for asking the financial sector to make a contribution to the costs of the financial crisis, and for seeking to deter certain transactions, in neither case is the Commission's position compelling. Furthermore, whilst we acknowledge the strength of public anger against the financial sector, and the widespread view that those who contributed to the current financial crisis should contribute to its costs, we fear that a Financial Transaction Tax is the wrong way to seek to meet such demands. In our view, the case for introducing a new tax needs to be based on an assessment of its efficiency, simplicity, the ease with which it can be collected and whether it is open to abuse. Much depends on how well the FTT might be designed. In the next chapter we consider the Commission's proposal in detail.**

CHAPTER 3: ASSESSING THE COMMISSION'S PROPOSAL

51. We asked our witnesses for their assessment of the specific details of the Financial Transaction Tax model as set out by the Commission (the main elements of the proposal are set out in Box 3 below).

BOX 3

The principal design elements of the commission's proposal[75]

The principal design elements of the Commission's proposal include:

- A broad-based tax applying to secondary trading in equities and bonds, as well as equity, interest rates, foreign exchange and commodity derivatives.
- A tax rate of 0.1% for bonds and shares and 0.01% for other transactions including derivatives;
- The application of the 'residence principle'—defined as taxation in the Member State of establishment of the financial institution, regardless of where the transaction took place;
- The exclusion from the scope of the FTT of transactions on primary markets both for securities (shares and bonds) and currencies;
- The exclusion of certain financial transactions, for example with the European Central Bank (ECB) and with national central banks, from the scope of the FTT.

a) The residence principle

52. The so-called 'residence principle'—defined as taxation in the Member State of establishment of the financial institution, regardless of where the transaction took place—is a key aspect of the Commission's proposal for an FTT. A financial institution is to be treated as established in an EU Member State (and therefore liable for the tax) where any of the following apply:

- It has been authorised by a Member State to act as a financial institution;
- It has a registered seat in a Member State;
- Its permanent address or usual residence is located in a Member State;
- It has a branch within that Member State; or
- It is a party to a financial transaction with a financial institution or other party established in a Member State.[76]

53. We discussed with witnesses how the residence principle was likely to work in practice.[77] The Government's understanding was that the tax would apply to each counterparty to the transaction established in the EU. So, for example, if a derivatives transaction took place between two EU financial institutions, this would mean that the tax rate applied to the transaction would be 0.02% (regardless of where the trade took place, whether in the EU

[75] See COM (2011) 594 FINAL, op cit.

[76] COM (2011) 594 FINAL, op. cit, Article 3. See also Mark Hoban MP, Financial Secretary to the Treasury, supplementary written evidence.

[77] See for example AIMA.

or otherwise). If a derivatives transaction took place between an EU financial institution and a non-EU business the tax applied would be on the EU financial institution, therefore 0.01%.[78]

54. The Commission itself confirmed that, in the event that both counterparties were deemed as resident in the EU, then they would both pay in their country of establishment. It also added that a transaction between two counterparties not deemed resident in the EU would not be a taxable event. This would hold in cases where two EU banks or brokers only act as an intermediary or broker a deal such as an interest-rate swap in the name of two other banks which are not deemed to be resident in the EU. Thus the 'booking-centre function' of financial centres will not be affected by the FTT. However, the Commission stressed that in the event of a transaction between an EU-resident counterparty and a counterparty situated outside the EU, both parties would have to pay, in the country of establishment of the counterparty resident in the EU. The Commission added that the safety net of 'joint and several liability' would facilitate tax collection from non-EU parties. The Commission concluded that this means that counterparties not resident in the EU would indeed be subject to the tax.[79] In addition, the Commission's Explanatory Memorandum refers to EU and international instruments for cross-border recovery of taxes through mutual assistance.[80]

55. Even those who were sympathetic to the case for an FTT were sceptical about the effectiveness of the Commission's proposal. Sony Kapoor told us that he had doubts about the legitimacy and the effectiveness of the residence principle.[81] David Hillman argued that the principle was "not robust enough",[82] and the TUC were not convinced that the residence principle was the most effective method of implementing an FTT.[83]

56. Likewise, the BBA asserted that the residence principle was "a misnomer" because many of the determinants of residence are quite unrelated to where the institution was actually 'resident'. They foresaw significant difficulties in terms of the practical application of the residence principle.[84] The Investment Management Association (IMA) argued that the definition of 'residence' was very wide and was intended to ensure that "the FTT net is far-reaching."[85] In Nigel Fleming's view, the residence principle was "extraordinarily extraterritorial".[86]

57. Other witnesses questioned the practical difficulties arising from the residence principle. The BBA argued that the FTT would be a costly tax to collect, since there will be multiple charging points.[87] AIMA stressed the enormous

78 Mark Hoban MP, Financial Secretary to the Treasury, supplementary written evidence. For an explanation of the proposed tax rate see paras 93–101 below.

79 European Commission, supplementary written evidence. Joint and several liability is defined as when a number of parties make a joint commitment under a contract and agree to be liable as a group as well as individually (jointly and severally) for that obligation to be fulfilled. See http://lexicon.ft.com/Term?term=joint-and-several-liability.

80 COM 594 (2011) FINAL, op. cit.

81 Q 88.

82 Q 43.

83 TUC.

84 BBA.

85 IMA.

86 Q 78.

87 BBA.

difficulty which the Commission would face in convincing international trading intermediaries to bear additional administrative costs in collecting and remitting the tax back to Europe.[88] The Financial Secretary to the Treasury stated that in a number of cases it is uncertain how the residence principle will operate in practice, where the participants are not clearly identifiable or their place of residence is not easily established. He added that it was far from clear how the proposal would work where, for example, a non-EU bank engaged with a non-EU broker regarding a transaction involving multiple investors based in different jurisdictions but including at least one based in the EU. He said that this would entail the non-EU bank knowing the proportions of transaction relating to each individual investor, and how much and to whom to pay for each element of the transaction.[89] On the other hand, the Commission argued that enforceability of the residence principle was relatively easy, as existing EU regulations provide the necessary information for effective tax collection. It added that details of enforcement will have to be implemented by Member States.[90]

58. **Commissioner Šemeta has sought to defend the proposed residence principle. Yet we find the widespread criticism of the proposal, including by advocates of an FTT, chastening. The Commission has made clear that counterparties not resident in the EU would nevertheless be liable for the tax when engaging in a transaction with an EU-resident counterparty. The Commission point to the provisions for joint and several liability, and the operation of mutual assistance. This is bound to be controversial. It is likely that non-EU financial institutions and countries would react to the proposal extremely negatively, with potentially serious consequences for the EU financial sector. Our witnesses have also pointed to particular practical difficulties, for instance in defining the place of residence and in determining how it would work in practice. In the light of this, it is our view that the residence principle proposed by the Commission is both wholly impractical and unworkable.**

b) Scope and the potential for relocation

59. Commissioner Šemeta justified the residence principle on the basis that it would prevent the significant relocation of financial activities. He argued that it was "very innovative", since "it does not matter where the transaction takes place; what matters is whether the person involved in the transaction has an economic link with the EU or not. If this is the case, even if the transaction takes place in Singapore or Hong Kong, it will be subject to taxation." As a result, he argued, also taking into account the low tax rate that the Commission proposed, relocation would not make sense.[91] Yet the Commission's Impact Assessment itself suggests that an EU-wide FTT would entail a relocation of transactions on securities markets by 10%, on spot currencies by 40% and on derivatives instruments by 70% or 90%.[92]

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88 AIMA.

89 Mark Hoban MP, Financial Secretary to the Treasury, supplementary written evidence.

90 European Commission, supplementary written evidence.

91 Q 130. See paras 93–101 below for a discussion of the rate of the tax.

92 *Commission staff working paper Impact assessment accompanying the document* "Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC (COM (2011) 594 final)", p. 49.

60. In our view, the residence principle would create a strong incentive for financial institutions to bypass the FTT by themselves relocating. This could be achieved either by the institution itself physically relocating, or by setting up a subsidiary outside the EU.

61. Several witnesses referred to the risk of relocation. The Association of Corporate Treasurers (ACT) believed that larger international groups would divert group funding or group hedging to more favourable regimes to the detriment of European financial markets.[93] Nigel Fleming agreed, warning that it could make firms' products uncompetitive.[94] Similarly, the Alternative Investment Management Association (AIMA) pointed to the risk of both transaction and physical migration away from Europe (especially London[95]) to New York, Singapore or Hong Kong. They argued that the FTT would encourage market participants who are not based within the EU to seek counterparties based outside the EU and thus avoid the FTT. They also argued that it would discourage investors based outside the EU from using EU asset managers to make transactions on non-EU exchanges.[96]

62. Likewise BlackRock suggested that it was highly likely that financial institutions were going to invest considerable energy in seeking to limit their exposure to an FTT.[97] Bart Van Vooren, Assistant Professor, Faculty of Law, University of Copenhagen, warned that "implementing the financial transaction tax in a regionally or nationally fragmented way exponentially increases the risk of financial engineering to avoid the tax; with financial institutions fleeing the area where it has been implemented."[98]

63. For John Vella, the risk of avoidance was one of the principal weaknesses of the FTT proposal. In his view, "a broad-based residence-based FTT, like that proposed by the Commission, is easy to avoid". However, the stamp duty model is much more difficult to avoid.[99] Mr Vella felt that there was a "double standard" in the Commission's case. He argued that, since the Commission warns that taxes adopted by individual countries would create a risk of relocation, then, by the same token, that argument would also apply if the EU adopts an FTT and the rest of the world does not.[100]

64. Several witnesses referred to the experience of Sweden as an illustration of the risk of relocation. Sweden introduced a 0.5% tax on the purchase or sale of shares in 1984 and, according to the BBA, by 1990, some 30% of all Swedish equity trading had moved offshore, and more than 50% of all Swedish trading had moved to London. The volume of bond trading declined by 85%.[101] However, Commissioner Šemeta sought to reassure us that the Commission had "studied very carefully" the Swedish experience with an FTT and that they would avoid the same pitfalls. The Commissioner also told us that Sweden did not achieve a critical mass for introducing such a tax, which was why the Commission was pushing for a tax across all 27

93 ACT.

94 Q 78.

95 We consider the impact on London in Chapter 4 below.

96 AIMA.

97 BlackRock.

98 Bart Van Vooren.

99 Q 32.

100 Q 42.

101 BBA.

Member States.[102] Other witnesses stressed that the Swedish tax was "badly designed" and fundamentally different from the Commission's proposal.[103]

65. Some witnesses argued that the risk of relocation was exaggerated. Richard Gower argued that a well-designed FTT could significantly reduce the risk of business relocation. He cited international examples as demonstrating that it is possible to operate a tax successfully even on a regional basis. He also pointed out that every tax is avoided to some extent, and that to apply a "zero avoidance" bar to an FTT was unreasonable.[104] The TUC did not think that the rate of taxation of financial services was the main determinant of where a financial operation is based.[105] David Hillman pointed out that, when a bank bonus tax was introduced in the UK, many financial institutions threatened to relocate. In the event, none did.[106] However, the Financial Secretary to the Treasury disagreed, stating that one of the defining characteristics of the financial services sector is "just how mobile the industry is."[107]

66. **We have concluded that the residence principle proposed by the Commission is unworkable. Furthermore, we strongly disagree with the Commissioner's argument that the residence principle will overcome the significant risk of relocation to avoid the FTT. We remain deeply concerned that, should the Commission implement its Financial Transaction Tax model within the EU alone, financial institutions would relocate outside the EU, either by the institution itself physically relocating, or by setting up a subsidiary outside the EU, with serious consequences for the EU financial services industry and for the health of the EU economy as a whole. In our view, only an FTT implemented on a global scale will prevent EU-resident institutions being placed at a significant competitive disadvantage in comparison with leading global competitors. Yet, as we have already concluded, the chances of a global tax being introduced are extremely slim.**

c) The economic impact of the tax on economic growth and market liquidity

67. The potential economic impact of an FTT was a major point of discussion during the course of the inquiry. Witnesses focussed on two key concerns: the negative implications for growth and the potential reduction in liquidity in the financial markets. They are discussed in turn below.

i) Growth

68. The European Commission's own Impact Assessment suggested that the introduction of an FTT would result in an overall total decrease of EU GDP in the long term of between 0.5% and 1.76%, depending upon the impact of certain "mitigating elements".[108]

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102 Q 133 and European Commission Directorate-General Taxation and Customs Union.

103 Duncan Weldon, Q 14. See also David Hillman, Q 32 and Owen Tudor, Q 9.

104 Q 47.

105 TUC.

106 Q 50.

107 Q 108.

108 COM (2011) 594 FINAL, Commission Impact Assessment, op. cit., pp. 33, 50 and Box at pp. 51–2. Commissioner Šemeta told us that the time period that the Commission had in mind for these calculations was approximately 40 years. See para 71 below.

69. The majority of witnesses were highly alarmed at these figures, arguing for instance that an FTT would act as a "tax on growth".[109] The BBA considered it "extraordinary and counterintuitive that the European Commission should countenance introducing a tax which it acknowledges would significantly reduce the GDP of the EU."[110] The Association for Financial Markets in Europe (AFME) argued that "at a time when the risk of recession in Europe is increasing, the focus of EU policy should be on measures that enhance growth and jobs and not on measures that both discourage investment and fail to take account of the new regulatory requirements that are in train."[111]

70. The CBI argued that the Commission's lower estimate was based on a number of questionable assumptions, including only factoring in the tax on securities and ignoring the tax on derivatives. They further pointed out that the Commission "has been unable to factor in the impact of a reduction in GDP caused by the new tax and points out that the deterioration of the tax base 'could go well beyond revenue shortfall'".[112] Richard Woolhouse told us that "this may be one of the only taxes proposed that will fail to raise any revenue."[113]

71. Commissioner Šemeta regretted that "some of the figures that were derived in the preparatory stage of the impact assessment, such as the famous impact on GDP of 1.76%, were used to undermine the proposal." He explained that the design of the tax led the Commission to estimate the negative impact on GDP to be 0.53% in the long run. He told us that, since the approximate timeframe for this impact is a period of 40 years, the annual impact would be "negligible"—about 0.01% per annum. He further argued that all taxes have a negative impact on GDP when viewed in isolation, and that, in comparison with corporate income tax, the impact of an FTT would be low.[114]

ii) Liquidity

72. Several witnesses argued that an FTT would reduce liquidity and increase volatility in the marketplace.[115] For example, ISDA argued that a sudden reduction in the number of financial transactions would decrease liquidity and make the markets more volatile, thereby affecting the ability of banks to build up capital reserves.[116] The BBA agreed.[117] BlackRock argued that the experience of other countries which have adopted similar financial sector

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109 AFME.

110 BBA.

111 AFME.

112 CBI.

113 Q 1.

114 Q 125.

115 Liquidity is defined as "cash, cash equivalents and other assets (liquid assets) that can be easily converted into cash (liquidated). In the case of a market, a stock or a commodity, the extent to which there are sufficient buyers and sellers to ensure that a few buy or sell orders would not move prices very much. Some markets are highly liquid; some are relatively illiquid. The term also means how easy it is to perform a transaction in a particular security or instrument. A liquid security, such as a share in a large listed company or a sovereign bond, is easy to price and can be bought or sold without significant price impact. With an illiquid instrument, trying to buy or sell may change the price, if it is even possible to transact." See http://lexicon.ft.com/Term?term=liquidity.

116 ISDA.

117 BBA.

taxation schemes points to reduced liquidity in financial markets. With fewer trades the tax base would shrink and revenues from the tax would decrease. They argued that this meant that an FTT would not be a reliable source of revenue.[118]

73. Notwithstanding this, others argued that the effect of an FTT on market liquidity was in fact difficult to predict, or could even be beneficial. The TUC told us that it was "extremely unlikely that even a negative impact would be significant enough to cause problems", as the FTT would simply reduce the incentive for high-frequency algorithmic trading, which, as we have seen, they considered to have a destabilising effect in any case. Duncan Weldon told us that was "the point of the financial transaction tax—as well as raising revenue, to stop certain types of trading."[119]

iii) The Commission's Impact Assessment

74. As some of these observations suggest, much of the criticism that has been expressed has revolved around perceived flaws in the Commission's Impact Assessment. Several witnesses were deeply critical of the Impact Assessment. The BBA pointed out that "the [mitigating] factors are described in the Impact Assessment as being 'at the expense of scientific rigour' and carrying 'large caveats and uncertainties'."[120] AIMA noted the "extremely broad range" of revenue estimates that were "based upon many assumptions. We would certainly hope that, for a proposal with such significant implications, the analyses and estimates as to potential impact would be calculated with considerable precision."[121] David Hillman, a supporter of an FTT, told us that the models in the Impact Assessment "are now widely seen as flawed; therefore, the conclusions drawn from them are also flawed."[122]

75. John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr agreed that there were limitations in the models used by the Commission to estimate the revenue potential of these taxes and the size of the economic distortions they produce.[123] The IMA claimed that the cost assessment set out in the Impact Assessment underestimated the cost by half as it considered the tax effect on only one side of the transaction. They argued that, since the proposal is for the tax to apply both to the buyer and the seller, the fall in GDP could therefore be twice as high as the Commission's estimate.[124]

76. Similarly, BlackRock argued that the figures in the Impact Assessment were based on a tax on purchases only and therefore underestimated the harm done to the real economy. Furthermore, they argued that these figures only took into account the increased costs of capital without modelling the cost of any decline or relocation of the financial sector outside the European Union.[125] ISDA added that the Commission's model was of limited value since it did not reflect the increased cost of hedging for corporate

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118 BlackRock.

119 Q 27.

120 BBA.

121 AIMA.

122 Q 45.

123 Oxford University Centre for Business Taxation.

124 IMA.

125 BlackRock.

institutions, and also failed to reflect the multiple and cascading charges of the FTT.[126]

77. Commissioner Šemeta told us that "it was our political decision to be fully transparent with our impact assessment, which was why we published not only the impact assessment but in the annexes ... all the work that was done in preparing the impact assessment." Yet, as he acknowledged, this assessment had been used to undermine the Commission's own case.[127]

78. **It is vital that the potential impact of a proposal with such significant implications as the Commission's Financial Transaction Tax model should be calculated with more rigour and reliability. We are therefore alarmed at the degree of criticism to which the Commission's Impact Assessment has been subjected. Whilst we note the Commissioner's argument that preparatory material was published in order to promote transparency, it remains the case, as he has conceded, that the document has significantly undermined the Commission's case.**

79. **We are particularly concerned that the Commission's model may have failed to take into account all of the potential negative impacts on growth, and that the effects could therefore be more pronounced than the Impact Assessment suggests. The impact would be exacerbated further should our fears of significant relocation be realised. Commissioner Šemeta has suggested that the impact may be limited to a decrease in GDP of 0.53% in the long term. Yet even that figure is concerning. The potential impact on liquidity is also uncertain. At a time of ongoing financial crisis and at best fragile economic growth across the entire EU, we consider that a new tax which could have a substantial detrimental impact on EU GDP should be resisted.**

d) Incidence

80. 'Incidence' refers to the question of who bears the true economic burden of a tax. With regard to the incidence of an FTT, the Commission's Impact Assessment states that a large part of the burden would fall on owners of traded financial instruments.[128] Yet we heard conflicting evidence on this issue.

81. Stamp Out Poverty argued (citing research by the IMF) that an FTT would be highly progressive, falling on the richest individuals and institutions in society.[129] As David Hillman asked: "Who is primarily doing the trading of the bulk of the financial assets? They are the proprietary desks of banks, they are hedge funds, and the hedge funds' clients are high net-worth individuals. So the primary incidence is actually going to be borne by financial actors—it is progressive as a tax. The question is: will it be passed on? Will a bank then pass this through on to other services? That depends on the level of competition between banks."[130]

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[126] ISDA. We discuss the potential cascading effect at paras 98–100 below.

[127] Q 125.

[128] COM (2011) 594 FINAL, Commission Impact Assessment, op. cit., p. 53.

[129] Stamp Out Poverty.

[130] Q 40.

82. Richard Gower agreed that the initial incidence of the FTT would be on the consumers of the assets being traded—"overwhelmingly high-income individuals". He contested the argument of some that pension funds would bear the costs of the tax, arguing that "it is difficult to avoid the assertion that certainly the initial incidence is highly progressive."[131]

83. Other witnesses disagreed. The CBI argued that the ultimate impact of the FTT would be felt by end-users, not large financial firms and that, in most circumstances, the final tax burden would rest with investors and customers of financial services firms, in the form of higher prices for financial services or products, in affecting consumers' savings, and in reducing firms' ability to raise funds from banks or the market.[132]

84. The ABI argued that the incidence of the tax would be felt by pension-holders, savers and insurance policy-holders, and would have an impact on a wide range of products, including mortgages, utility bills, and advance travel fares.[133] The IEA claimed that the incidence of the FTT "will be upon workers in the form of lower wages, upon consumers of financial products in higher prices and ... the loss [of income] will be greater than the revenues raised."[134]

85. In John Vella's view, "we know that companies cannot bear tax, so the tax has to be passed on to somebody. Who exactly it is passed on to is always difficult to understand ... [but] the likelihood is that it will be passed on to final consumers through lower interest rates or through higher borrowing costs."[135]

86. The Financial Secretary to the Treasury noted that the IMF report to the G20 in 2010 did indeed say that an FTT would likely be a progressive tax given that those with higher income levels engage in financial market activity to a greater extent than those with lower income. However, he pointed out that the same report also highlighted that in the long run the incidence of the tax would be likely to be passed to those on lower incomes. More broadly, he noted that the IMF did not endorse the introduction of an FTT, arguing that it would not be the most economically efficient way of taxing the financial sector.[136]

87. **The divergence of views that have been put to us demonstrate that it is difficult to predict with any accuracy what the true incidence of a Financial Transaction Tax would be. Whilst it may be the case, as the Commission suggests, that a large part of the initial incidence would fall on owners of financial instruments, we remain concerned that the tax burden will ultimately be passed on to consumers. In the current economic context, we do not believe that this is a risk worth taking.**

e) The base and rate of the tax

88. In this section we focus on discussions around the tax base and the rate of tax proposed by the Commission.

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131 Q 40.

132 CBI.

133 ABI.

134 IEA.

135 Q 39.

136 Mark Hoban MP, Financial Secretary to the Treasury, supplementary written evidence.

i) Tax base

89. The Commission proposes that an FTT should cover a broad range of financial instruments and derivatives, including secondary trading in equities and bonds, as well as equity, interest rates, foreign exchange and commodity derivatives, in line with the provisions of the Markets in Financial Instruments Directive (MiFID). The Commission justified this on the grounds that a narrow-based FTT would distort the market through the differentiation of various instruments, and would allow circumvention through the use of other instruments that are not subject to tax. It pointed to the UK Stamp Duty on shares as an example of where such circumvention had taken place, as traders were encouraged to trade in derivatives, such as contracts for difference. The Commission therefore advocated "the AAA approach—of all actors, all markets and all products".[137]

90. Witnesses were divided on whether the tax should have a narrow or a broad basis. The IMA argued that a narrower based FTT (excluding bonds and derivatives) might be less harmful than a broad-based tax, but that this would produce other problems such as a distortion of market behaviour in order to take into account tax arbitrage opportunities.[138]

91. Although they did not advocate an FTT, John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr told us that a broad base would minimise the possibility of avoidance.[139] Stamp Out Poverty advocated a broad-based FTT, building on the model of the UK Stamp Duty on shares to include bonds, derivatives and the wholesale market in foreign exchange,[140] whereas BlackRock argued that restricting an FTT to currency transactions would reduce the impact of an FTT on investment returns but would still be detrimental to investors, particularly those outside the major currency zones.[141]

92. The Commission's proposal would not apply to spot currency transactions.[142] Stamp Out Poverty described this exemption as "a serious omission" in the legislation.[143] Commissioner Šemeta told us that the Commission had been advised that there was a legal obstacle since the inclusion of currency transactions would be in contradiction to the principle of free movement of capital.[144]

ii) Tax rate

93. The Commission proposes that the minimum rates of tax that should be applied by Member States are 0.1% for bonds and shares and 0.01% for other kinds of transactions including derivatives. Commissioner Šemeta told us that these would be minimum rates, giving individual Member States the

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137 European Commission Directorate-General Taxation and Customs Union and Q 139.

138 IMA.

139 Oxford University Centre for Business Taxation.

140 For a discussion of the UK Stamp Duty model, see Chapter 5 below.

141 BlackRock.

142 A spot foreign exchange transaction involves the purchase of one currency against the sale of another at an agreed price for delivery on a value date which is usually the trade date plus two working days, the traditional 'spot value'. See http://www.icap.com/markets/foreign-exchange/spot-fx.aspx.

143 Stamp Out Poverty.

144 Q 143.

capacity to impose higher rates if they wished.[145] As we have seen, the Commission argues that the proposed rates are set low in order to minimise relocation risks.[146]

94. Some witnesses made a favourable comparison with the 0.5% rate of the UK Stamp Duty on shares. The Commission argued that the UK's experience showed that a successful stock exchange could be maintained with such a rate of tax.[147]

95. Dr Bart Van Vooren told us that setting the tax rate was not simply a question of guesswork to determine whether 0.01% was a politically acceptable or appropriately low tax rate, but rather that consideration was based on (i) how much the relevant market will decline given the tax rate charged, (ii) the limitations the chosen rate imposes on liquidity, (iii) the amount of avoidance and circumvention that are likely to occur, and (iv) the question of whether it is preferable to have a tax that is neutral across different asset classes or one that taxes assets differently.[148]

96. Some witnesses expressed concern about the proposal to levy different rates of tax on shares and bonds compared with derivatives. According to AIMA, the use of different rates of tax could encourage market participants to trade more using over-the-counter (OTC) derivatives, which appears to be contrary to one of the Commission's objectives, i.e. to encourage market participants, instead, to trade more on exchanges.[149]

97. In addition, AIMA argued that it is more important to distinguish tax rates based on product characteristics and market conditions than to use equal tax rates on notional amounts of different types of product class. They explained that a notional amount underlying interest rates futures with a short maturity is often a tenfold of the notional amount underlying equity index futures. As such, the tax burden for trading interest rates products with a short maturity normally comprises a relatively high taxable amount. It would therefore exponentially and excessively increase the tax burden of transacting financial instruments in a particular product class, in comparison with others.[150]

iii) A cascade effect?

98. Several witness expressed concern over a potential "cascade effect", in that, whilst the rate on a particular transaction appears low, the overall rate to effect a complete transaction could be much larger due to the long chain of trading and clearing that is often involved in securities transactions. A purchase of securities on the stock exchange, for example, ordinarily involves the sale and purchase by a number of parties, including brokers, clearing members and the central counterparty to the clearing system. It was argued that under the Commission's proposals, each sale will be subject to the FTT (with only the central counterparty exempt).[151] John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr explained to us that "if a financial institution

[145] Q 138.

[146] COM (2011) 594 FINAL, op. cit and Q 131. See para 59 above.

[147] European Commission Directorate-General Taxation and Customs Union.

[148] Dr Bart Van Vooren.

[149] AIMA.

[150] Ibid.

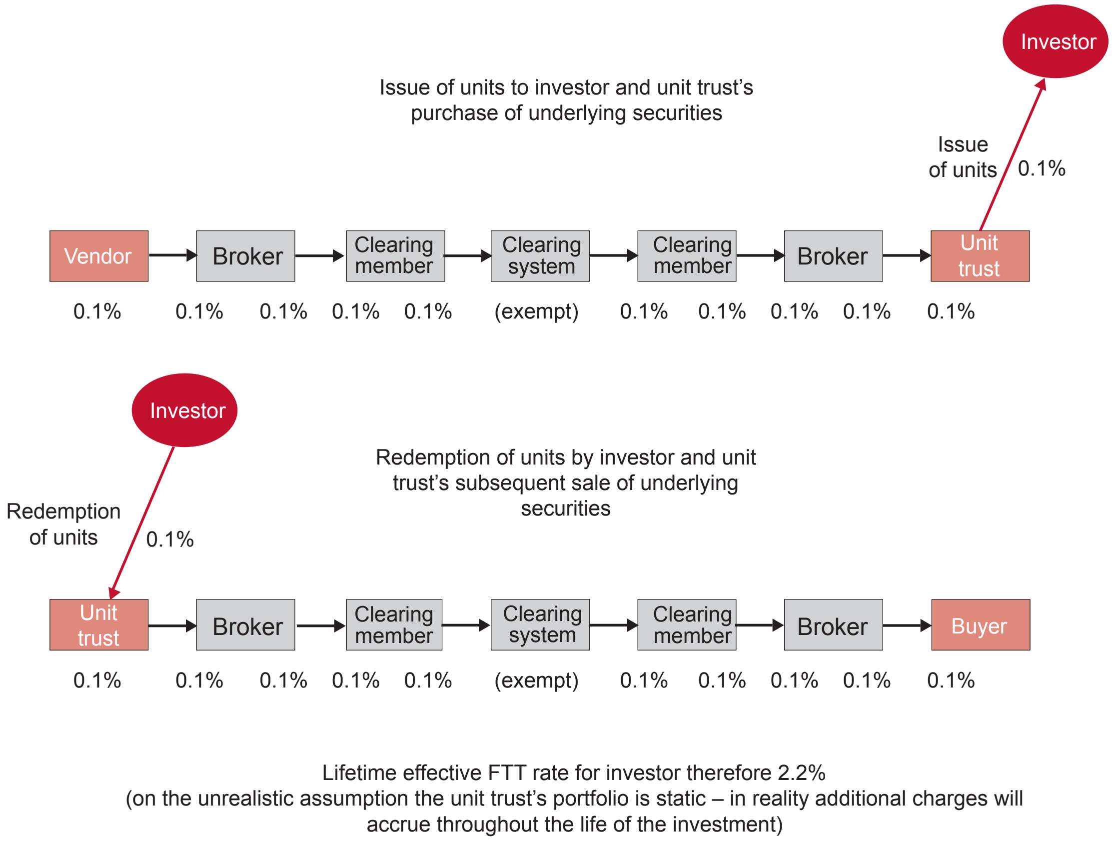
[151] BlackRock.

purchases an option to buy equities from another financial institution, they both pay the tax when the option is bought/sold, and, at least, again if the option is exercised and the equities are bought/sold."[152]

99. AIMA provided us with an illustration of the "potentially onerous" cascade effect on a relatively simple transaction by a unit trust (see Figure 1 below). Commissioner Šemeta has argued that this threat is overstated since intermediaries would be exempt from the tax.[153] It is true that there are exemptions in Article 1 of the proposal which include central counterparties, but it is not clear to us to what extent this alleviates the threat of a cascade effect.[154]

FIGURE 1

Illustration of a potential cascade effect[155]



100. **Whilst the proposed rate of transaction tax appears relatively low, for instance in comparison to the rate of the UK Stamp Duty, the concerns of several of our witnesses about the danger of a potential cascade effect must be taken seriously. The likely effects are difficult to predict, but it does appear probable that the effective tax burden would tend to be considerably higher than the underlying base rate proposed by the Commission. This, in turn, would have an adverse knock-on effect on economic growth and the likelihood of relocation.**

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152 Oxford University Centre for Business Taxation.

153 Chairpersons meeting, Finance and Fiscal Affairs Committees, Copenhagen, 19–20 March 2012.

154 COM (2011) 594, op. cit.

155 AIMA.

Overall conclusion

101. The Commission's model for a Financial Transaction Tax has been subject to a considerable degree of criticism by our witnesses. We note in particular that even the advocates of an FTT were critical of this element of its proposal. Richard Gower told us that "I think we can probably all agree that the design of the FTT proposed by the Commission is not a particularly good one".[156]

102. The evidence that we have heard bears this assessment out. Witnesses have pointed to the flaws in the proposed residence principle and have warned that a tax restricted to the EU alone would lead to significant relocation of financial institutions outside the EU. Furthermore, the Commission's modelling has been criticised, in particular in the context of its "flawed" Impact Assessment. Specific concerns have been raised that the Commission has not taken account of the potential for a cascade effect, nor of the danger that the true incidence of the tax will largely fall on consumers. However, perhaps the most damaging criticism relates to the likely impact on GDP. Commissioner Šemeta was at pains to point out to us that the Impact Assessment's most pessimistic forecast of a reduction in GDP of 1.76% was unlikely to be accurate. Yet in the context of the current financial crisis and the economic pressures being faced by many Member States, any reduction in GDP is highly undesirable. It has been argued that a well-designed EU tax could work effectively, yet we heard few concrete examples from our witnesses as to how the Commission proposal could be practically improved.

103. **In Chapter 2, we concluded that the proposed FTT would not meet the objectives that the Commission has identified. However, if a proposal on a question of such importance as this is to be seriously contemplated then it is imperative that any proposed tax is as well-designed as possible. In the light of the evidence that we have received, it is our view that the Commission's proposed model for a Financial Transaction Tax is both impractical and unworkable.**

104. Nevertheless, significant support for the introduction of a tax on the financial sector remains. It is therefore necessary to consider the likely impact of an FTT on the City of London, and the UK in general, as well as whether other potential models for taxation of the financial sector would be more viable. We turn to these issues in the following chapters.

[156] Q 38.

CHAPTER 4: THE EFFECT OF AN FTT ON THE UK

a) The significance of the financial sector in the UK and EU economy

105. One key element of our assessment of the Commission's proposal concerns its likely impact upon the City of London and upon the wider UK economy. This question is of vital importance given the importance of the financial sector, not only for the domestic UK economy, but also for the EU as a whole.

106. Several witnesses stressed the strategic importance of the UK financial sector. The Mayor of London told us that it was "a key London industry and a significant employer, accounting for around 330,000, or 8% of London's workforce and around 20% of London's Gross Value Added Tax ... London is, effectively, with New York one of only two genuinely global financial services centres in the world ... In simple terms, London is the EU's primary financial services centre and it competes globally for business."[157]

107. The New City Initiative stated that the financial services sector in the UK contributed 11.2% of the Exchequer's total tax receipts for 2010, and that one-third of all financial services jobs in the UK are based in London, accounting for 36% of the capital's entire workforce. They pointed out that the UK accounts for one-third of all private equity funds in Europe, with a higher daily foreign exchange turnover than New York and Tokyo combined and the largest hedge funds market in Europe.[158]

108. AIMA stated that the UK has the largest financial derivatives market, with an average daily turnover in interest rate derivatives of just over $1.4 trillion, equivalent to approximately 46% of the total. Furthermore, the UK has the largest asset management business in Europe, accounting for just under a third of the entire market.[159]

b) Assessing the impact of an FTT on the UK

109. In the light of this, several witnesses expressed to us their concern that an FTT could have an extremely damaging impact on London and the UK. Members of the New City Initiative warned that its introduction "would precipitate London's demise as a major financial centre by 2015, a grim prediction under any circumstances, but particularly so at a time when the City has never been more important as both an engine for the economy and a provider of jobs, taxes and exports."[160] The BBA agreed that London's pre-eminence as an international financial centre could not continue in the wake of an EU FTT.[161]

110. One particular concern was that, because of the size of its financial sector, the Commission's proposal would have a disproportionate effect on the UK compared with other EU Member States. The City of London Corporation argued that the concentration of EU and international financial services

[157] Mayor of London.

[158] New City Initiative.

[159] AIMA.

[160] New City Initiative.

[161] BBA.

activity in the London markets, in areas including bond and equity issuance and trading, foreign exchange, asset management, insurance and reinsurance, meant that the impact on the UK would be unfavourable and disproportionate.[162] John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr estimated that, on the basis of the Commission's figures, revenue raised in the UK would be 4.6 times higher than revenue raised in Germany and 10.9 times higher than revenue raised in France, and that 71.3% of overall revenue would be expected to come from the UK.[163]

111. Some witnesses told us that the proposal that tax revenues would accrue to the government(s) where the parties to a financial transaction reside would result in a net transfer of revenue from the UK to other Member States. Peter Sinclair, Professor of Economics, University of Birmingham, argued that a substantial slice of FTT proceeds, as much as 18%, would be transferred from the UK exchequer to other EU governments.[164] Richard Woolhouse agreed.[165]

112. Others expressed concern at the threat of significant relocation away from the City. The City of London Corporation cited trading in non-EU or euro and Sterling denominated equities and bonds, foreign exchange transactions in non-EU currencies and insurance or reinsurance contracts, as examples of transactions that could relocate.[166] BlackRock cited Clifford Chance's estimate that this could amount to a loss of about £60 billion in revenue a year.[167] The Mayor of London agreed that "an FTT would drive business to financial centres outside the EU and have a substantial negative impact on GDP across the EU ... Given the preponderance of financial services in London—and the centrality of financial services to London's economy—the impact would be keenly felt in the UK's capital city, with firms moving and jobs lost."[168]

113. On the other hand, the European Commission argued that the impact on the City of London and on the UK would be "rather limited", as traders would simply adjust their business models. It argued that the elements that would be affected most, namely high-frequency trading (HFT) and highly-leveraged transactions, were "typically not very labour intensive." Furthermore, since the City of London is often the booking centre for financial transactions only, it was argued that the burden would not necessarily fall on British citizens.[169]

114. In the TUC's view, an FTT had the potential to raise £20 billion in revenue in the UK on top of the sums raised by the Stamp Duty on shares. They argued that an FTT would have a beneficial effect on the UK economy by redistributing wealth from the well off to the less well off both in terms of creating disincentives for the sort of activity that produces inflated salaries and huge bonuses, and in terms of the better use to which the tax revenue and capital would be put.[170]

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162 City of London Corporation.

163 Oxford University Centre for Business Taxation.

164 Peter Sinclair.

165 Q 12.

166 City of London Corporation.

167 BlackRock.

168 Mayor of London.

169 European Commission Directorate-General Taxation and Customs Union.

170 TUC.

115. Others were sceptical about the threat of relocation, citing London's compensating overriding strengths as a financial centre. Stamp Out Poverty pointed to the importance for the banking sector of the safety net provided by the state, which was only possible in countries with sufficiently large economies to under-write large institutions. They also argued that London's infrastructure offers immediate access to information, support services, and trading partners, which, combined with London's location between the Asian and US markets, made relocation look unattractive.[171]

116. Owen Tudor pointed to the advantage of scale, in that "there are more people there to do business with so it makes sense to be there."[172] David Hillman asserted that financial institutions are here "because London provides them with this unique trading window: the eastern markets at the beginning of the day and the US markets at the end of the day." As we have seen, he pointed out that financial institutions did not relocate when a UK bank bonus tax was introduced.[173]

117. Commissioner Šemeta told us that the Commission estimated that it would collect around €10 billion per year in revenue from the UK, or 21% of the overall total.[174] In terms of the threat of relocation, he told us that "London is a good financial centre in which to do business. You have perfect trading platforms and a perfectly developed financial sector, with very educated people engaged in this activity. That creates huge added value for the financial sector here in London ... we do not see any incentive to our financial institutions to move from London to third countries."[175]

118. **We have heard divergent views concerning the likely impact of an FTT on the City of London and on the wider UK economy. This once again emphasises that considerable uncertainty remains in terms of the likely impact of an FTT. Such uncertainty is alarming, not least given the UK financial sector's strategic importance not only for the UK economy, but for the economic health of the EU as a whole. The UK financial sector is a major asset to the EU, in particular in terms of the single market, in providing a more developed capital market than existed before. We remain deeply concerned that an EU-wide FTT such as the Commission propose could have a serious detrimental impact on the UK, in particular by giving financial institutions an incentive to relocate away from London, either by the institution itself physically relocating, or by setting up a subsidiary outside the EU. Noting the evidence we have heard that over 70% of revenue could be expected to come from the UK, we also question the appropriateness of a proposal that would have such a disproportionate impact on one Member State above all others. On these grounds alone, the Commission's proposals are unacceptable.**

c) The impact of a euro area FTT

119. In the light of these fears, the UK Government have remained consistently opposed to the introduction of an EU-wide tax. Given that EU-wide taxation

171 Stamp Out Poverty.

172 Q 9.

173 Q 50. See above, para 65.

174 Q 136.

175 Q 131.

proposals require unanimity amongst Member States, the likelihood of an FTT being introduced across all 27 EU Member States appears remote. Speculation has therefore grown as to the likelihood of an FTT being adopted amongst a smaller group of Member States, centred on the euro area, from which the UK would almost certainly stand apart. We asked our witnesses to assess the likely impact of such a tax on the UK.

120. AIMA argued that, whilst the introduction of an FTT by certain euro area countries alone would be less damaging on the UK economy than an EU-wide tax, nonetheless the UK financial services industry would still be affected. They pointed out that UK banks would often still have euro area counterparties and operations in euro area countries. Similarly, banks based in the euro area countries might have operations in the UK which could be subject to the tax.[176]

121. Nigel Fleming told us that UK financial institutions conducting transactions with EU counterparties would become liable, and that "the level of connectivity between the London market and eurozone market is too great" for its impact to go unfelt.[177] Joanna Cound pointed out that 30% of the European asset management industry is based in the UK, and such cross-border activity would suffer dramatically.[178]

122. Some witnesses pointed to the implications of the residence principle for the City if the FTT was introduced only amongst euro area Member States. Nigel Fleming imagined that Deutsche Bank would ensure that it conducted its London activities through a subsidiary rather than a branch so that it was not caught by the tax.[179]

123. On the other hand, some witnesses thought that the impact on the UK of such a tax could be beneficial. The BBA and Sony Kapoor both argued that a euro area FTT could result in a migration of business towards the UK from euro area countries.[180]

124. The Financial Secretary to the Treasury told us that "if the eurozone wishes to proceed on this by themselves, then that is clearly a matter for them. If they wanted to use EU institutions, they could do that through the enhanced co-operation mechanism and that would clearly be a choice that they would need to think about. In that sort of situation, London would be affected in the same way that Hong Kong, New York or Singapore would be."[181]

125. Prior to appearing before us, Commissioner Šemeta was reported as stating that "the UK would lose a lot if other members decide to move ahead with a financial transactions tax. Because of its design, [Britain] will be subject to the tax, but at the same time, it will not receive any money from it."[182] In his oral evidence, the Commissioner stressed that "we are promoting this proposal for all 27 member states and we would like to have the United Kingdom on board. We consider the United Kingdom a very important element in all these efforts, and we will continue to push for this solution."

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176 AIMA.

177 QQ 80–1.

178 Q 80.

179 Ibid.

180 BBA, Q 96.

181 Q 98.

182 'Britain will pay Tobin tax anyway, EU warns', by Stanley Pignal, *Financial Times*, 23 January 2012.

Yet, "if the United Kingdom is outside but the transactions in the United Kingdom are initiated by any financial intermediary inside the FTT, the tax will be due to that country where that financial institution is resident."[183]

126. As we have seen, the Commission has made clear that counterparties resident outside the EU would still be liable for the tax when conducting transactions with EU-resident counterparties. The Commission explained that the same principle would apply if the UK were outside the jurisdiction of the FTT. For instance, a transaction between a UK and a German bank would trigger the tax, with the result that revenues from both sides would go to the German authorities rather than the UK ones.[184]

127. The fact that a euro area-only FTT Directive would not apply to the UK would not prevent it being collected from UK financial institutions. Using the Commission's example, the German tax authorities could request the UK tax authorities to collect the FTT from the UK institution: the legal basis for the request would be the EU regime for mutual assistance on tax matters, and such requests would have to be met. More likely the German tax authorities would rely on the provisions of the proposal imposing on the German bank joint and several liability for the FTT imposed on the UK bank.[185] Knowing this, the German bank would be likely to ensure, through its contractual relations with the UK bank, that it would be indemnified by the UK bank.[186]

128. **We note the conflicting views of our witnesses as to the potential impact of an FTT comprising some or all of the euro area Member States on those who choose not to participate, such as the UK. If, as is likely, the Directive creating a euro area FTT equates the UK with third countries, there would still be very significant effects on the UK financial sector. UK financial institutions entering into financial transactions with euro area financial institutions would still be liable for the FTT, which could be collected through EU mutual assistance for the recovery of tax or as a result of the provisions of joint and several liability. We urge the Government to work to ensure that UK financial institutions are not damaged, and that UK tax authorities' workload is not increased, by an FTT introduced by certain EU Member States.**

d) Assessing the Government's position

129. As we have seen, the UK Government, whilst not opposed to a global tax, have consistently opposed the introduction of an EU-wide Financial Transaction Tax. A number of witnesses discussed the UK Government's position. Some such as the New City Initiative strongly urged the UK Government to continue to "take a firm stance in opposition to the implementation of a Financial Transaction Tax in the EU."[187]

130. On the other hand, Richard Gower was fearful of "the extent to which the Treasury acted as a lobbying outfit for the financial sector. There is

183 Q 137.

184 European Commission, supplementary written evidence.

185 COM (2011) 594 FINAL, op. cit., Article 9(3).

186 Directive 2010/24/EC, implemented in the UK by the Finance Act 2011.

187 New City Initiative. See also Lloyds.

significant regulatory capture going on."[188] Owen Tudor thought that the Government had adopted "a fundamentally inconsistent view". In his opinion, "politics is being played ... they are willing to buy a bit of credibility and a bit of goodwill by saying that they want it to happen globally when they do not think it is going to happen."[189] David Hillman referred to the reported remarks of President Sarkozy, that "when people speak about how they would like to see a global FTT, that is really code for the fact that they do not ever want to see an FTT".[190]

131. Arlene McCarthy MEP stressed the importance of UK engagement in the EU legislative process, since an FTT introduced by some EU Members, even without UK participation, is likely to have significant effects on the City of London, as the major European financial centre. In her view, the UK faced a practical choice: "to closely engage with this proposal and argue for a well designed tax that could raise much needed funds, support financial stability and the real economy and would have strong public support, or to step back from the debate, veto UK participation from the outset, and ignore the public will while risking a damaging outcome for both our financial sector and our real economy." She warned of the danger of the UK losing any influence over the design of the FTT but still being affected by its operation.[191]

132. The Financial Secretary to the Treasury told us that "the Government's position is that we do not disagree with FTTs in principle, but that these should only be considered at a global level." This was because a key risk with an FTT introduced at a sub-global level is that it would provide an incentive for financial institutions to relocate to avoid the tax, particularly given the global nature of the financial services sector.[192]

133. On the Government's contribution to the ongoing debate, he said that the UK continues to debate these issues at ECOFIN, and that the Chancellor engages in that discussion with his European counterparts.[193] He told us that it was "very clear that the Commission and other member states value our expertise ... No member state is better equipped to advise on the intricacies of a transaction tax than the UK, given the complexity and sophistication of the UK markets. What is always very challenging is to ensure that we are seen not as lecturing other member states but offering helpful advice where appropriate."[194] He added that "there are numerous potential variants of FTTs, and it is sensible not to dismiss any such proposals without full and careful consideration."[195]

134. Commissioner Šemeta told us that "it is in the overall European interest to have strong financial centres in London as well as in Paris and Frankfurt. In this context, we need the UK on board, actively engaged in the discussions on the design, fine-tuning and implementation of the financial transaction

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[188] Q 30.

[189] Q 12.

[190] Q 54.

[191] Arlene McCarthy MEP.

[192] Mark Hoban MP, Financial Secretary to the Treasury, supplementary written evidence.

[193] Q 103.

[194] Q 120.

[195] Mark Hoban MP, Financial Secretary to the Treasury, supplementary written evidence.

tax ... the United Kingdom is also a very active participant in this discussion and I sincerely welcome its participation."[196]

135. **Whilst noting the Financial Secretary to the Treasury's assertion that the UK has no objection in principle to a global FTT, the Government's support for a global tax has been lukewarm at best. We find the Minister's explanation unconvincing. If the Government do support the introduction of a global tax then they should make the case for it. If, however, their true position is that they oppose a Financial Transaction Tax outright, then they should say so.**

136. **Like all EU-wide taxation proposals, the Commission's proposal for an FTT requires unanimity amongst Member States. Given our conclusion that the Commission's proposed model is both impractical and unworkable, it is our view that the Government should refuse to agree to this proposal. Notwithstanding this, we recognise that the debate on whether and how the financial sector should be taxed will nevertheless continue. Given this, and given the potential consequences not only for the UK but for the EU as a whole, it is vital that the Government remain actively engaged in this debate. The UK has considerable expertise to bring to bear, and we are pleased to hear from both the Minister and the Commissioner that the UK has been an active participant in these discussions. We urge the Government to redouble such efforts.**

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[196] QQ 121, 133.

CHAPTER 5: ALTERNATIVES TO A FINANCIAL TRANSACTION TAX

a) A Financial Activities Tax (FAT)

137. In addition to considering the case for a Financial Transaction Tax, we also asked our witnesses for their view on other potential models of financial sector taxation.

138. Our witnesses gave particular emphasis to the case for a Financial Activities Tax (FAT). An FAT is essentially a tax on remuneration and profit. The concept has been mooted by the IMF in the context of discussions by the G20,[197] and the European Commission's October 2010 Communication on Taxation in the Financial Sector also considered the case for introducing an FAT, appearing at that stage to favour it over an FTT.[198]

139. Some of our witnesses were in favour of an FAT. For example, John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr argued that it was preferable to an FTT for three reasons: an FAT would be less easily avoided through relocation; its incidence would be more certain; and it could generate the same amount of revenue at a lower economic cost.[199] According to Peter Sinclair, an FAT represented "the best way of taxing the financial sector". However he added that in the present economic climate, its introduction at anything but a very low rate would be most ill-advised.[200]

140. Nigel Fleming conceded that an FAT had some benefits in comparison to an FTT, since it could be less easily passed on to end consumers, and it applied to the balance sheets of financial institutions rather than to transactions that they conduct for their customers. He also suggested that the most preferable option would be a tax on banks' short-term funding.[201] Peter Sime, Head of Research, ISDA, agreed that "the FTT would be indiscriminate, whereas with an FAT you are looking more at the bank's specific balance sheet and earnings".[202]

141. Other witnesses were less enthusiastic about the introduction of an FAT. The BBA argued that an FAT would impede growth and constrain lending. They noted that such a tax would run counter to regulatory efforts to boost the strength of the financial system via increased capital and liquidity, and claimed that it would result in increased costs to consumers because, while it could not be passed on directly like an FTT, it would be factored in to higher pricing models.[203]

142. Sony Kapoor argued that the FTT, FAT and bank levies all have their advantages, but that bank levies and financial transaction taxes may be complementary to each other. Whilst bank levies fall mostly on regulated financial institutions on the balance sheets of banks, with financial

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[197] Q 31.

[198] COM (2010) 549 FINAL, op. cit.

[199] Q 31 and Oxford University Centre for Business Taxation.

[200] Peter Sinclair.

[201] Q 68.

[202] Q 69.

[203] BBA.

transaction taxes the primary point of incidence would arise in the shadow banking system.[204]

143. The TUC did not consider FATs and FTTs to be mutually contradictory. However, they preferred to see a tax covering wholesale foreign exchange transactions, securities and derivatives since an FAT would tax all financial institutions' activities, regardless of whether they had a beneficial or detrimental effect on the economy. In their view, FTTs would provide a more effective disincentive to undesirable financial activity, and would raise more resources for global public goods.[205]

144. Commissioner Šemeta told us that whilst the Commission concluded that both an FTT and FAT were feasible, the tax rate for an FAT would need to be about 10% to match the revenue-raising potential of an FTT. He also argued that an FTT would more effectively target high-frequency trading.[206]

145. **Several witnesses strongly advocated the introduction of a Financial Activities Tax (FAT). Whilst we note that this model may hold certain advantages in comparison to a Financial Transaction Tax, notably making it more difficult for financial institutions to pass on the tax burden, it may also hold drawbacks, for instance in taxing all financial institutions' activities regardless of how beneficial they are. Whilst there may be a case for further exploration of the case for an FAT, in the current economic climate there is a need for caution before introducing any new taxation of the financial sector that might impair economic growth.**

b) The UK Stamp Duty model

146. The UK Stamp Duty is a tax on share transactions in UK incorporated companies.[207] In 1974, the UK introduced a Stamp Duty Reserve Tax (SDRT) of 2%. Its rate was reduced in 1984 to 1% and then again in 1986 to the current level of 0.5%. The Commission's proposal states that it would forbid Member States from maintaining existing national transaction taxes, which would presumably include the UK Stamp Duty.

147. The UK Stamp Duty was widely discussed during the course of the inquiry. Several witnesses (including the Financial Secretary to the Treasury) argued that the UK's Stamp Duty was not a useful comparison in seeking to determine the probable effects of an FTT on the EU market.[208] Witnesses also stressed the superiority of the Stamp Duty model over the FTT proposal. The BBA told us that the Stamp Duty is levied on market participants, but not on financial intermediaries, regardless of where the buyer and seller are located, at a rate of 0.5% of the value of purchases of UK listed companies. By contrast, the FTT has a broader scope[209] and is

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[204] Q 87.

[205] TUC.

[206] Q 124.

[207] See 'Stamp Duty on Share Transactions: is there a case for change?', by Mike Hawkins and Julian McCrae, *Institute for Fiscal Studies*, http://www.ifs.org.uk/comms/comm89.pdf.

[208] Q 119.

[209] The BBA state that "FTT applies to financial transactions, which includes the purchase and sale of a financial instrument ([including] shares, bonds and other securities, options, futures, derivatives, units in unit trusts and other funds/collective investment schemes), repos and stock lending, the conclusion or modification of derivatives, and in the case of group transactions only, 'the transfer of the right to dispose of a financial instrument as owner and any equivalent operation implying the transfer of the risk'." See BBA.

levied on all intermediaries except the central counterparty, resulting in a cascade effect, making the effective rate of the FTT much higher than the headline rate of 0.1%. Because the Stamp Duty applies to UK shares regardless of where the buyer and seller are located, there is no incentive for the financial sector to move elsewhere. The proposed FTT, however, applies wherever a party is located in the EU, thereby encouraging relocation.[210]

148. Peter Sime told us that the UK Stamp Duty was "something people are happy to live with", and as it applies to everything listed in the UK, there was a "known population of which you capture 100%, and where the players are and where the trade takes place is irrelevant."[211]

149. During the course of the inquiry, there was considerable discussion as to whether the UK Stamp Duty could be a model for an EU tax on the financial sector. This question became particularly topical in January 2012 when President Sarkozy announced his intention to introduce a French tax on the trading of shares, a proposal which closely resembled the UK Stamp Duty model, but which would be set at a lower rate of 0.1%. There were suggestions that other Member States were sympathetic to such a model. Philipp Rösler, German Economy Minister, was reported to have said that "if the British aren't willing to get closer to the European model of a financial transaction tax, it would make sense to talk with the British and other European states about the British model."[212] The German Finance Minister, Wolfgang Schäuble, was also reported to have mooted the possibility of a stamp duty that would include derivatives, after it became clear from a meeting of EU finance ministers in March 2012 that consensus around the Commission's proposal remained a long way off. The Danish Finance Minister, Margrethe Vestager, said that officials would now draw up "alternatives" to the Commission's original proposal.[213]

150. Several witnesses argued that the UK Stamp Duty structure could indeed provide a good framework on which to develop an effective tax. David Hillman argued that the Stamp Duty was a good example of a financial transaction tax since anyone trading on the London Stock Exchange, regardless of where they are in the world geographically, has to pay the tax. Richard Gower added that "for those interested in buying a share for the long-term benefits ... the impact of quite a high-rate FTT on that sort of investment is not particularly large. The London Stock Exchange is one of the most successful exchanges in the world at attracting new listings despite the fact that there is a 0.5% ... FTT applied that raises £3 billion a year for the Exchequer."[214]

151. Sony Kapoor argued that the UK Stamp Duty was a "much fairer model" than the proposed FTT. He argued that it was "less politically controversial" since each country would tax something that belongs to it or at least originated in it and is related to the real economy within that country. He

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210 BBA. See also IMA.

211 Q 60.

212 See 'France pulls punch on financial tax', by Hugh Carnegy, *Financial Times*, 30 January 2012 and 'Britain will pay Tobin tax anyway, EU warns', op. cit.

213 'EU looks at stamp duty to settle tax impasse', by Alex Barker, *Financial Times*, 14 March 2012, and 'Ministers consider alternatives to financial tax', by Ian Wishart, *European Voice*, 15 March 2012.

214 Q 32.

also argued that the UK Stamp Duty created a "first mover advantage".[215] He argued that 60% or more of UK Stamp Duty revenue comes from non-UK tax payers. In Mr Kapoor's view, HM Treasury were opposed to other countries implementing this because the UK would lose its relative advantage. By contrast, the Commission's residence-based principle led to a first mover disadvantage.[216]

152. At the same time, some witnesses brought to our attention the unintended consequences that had followed the introduction of the Stamp Duty in the UK. BlackRock told us that it had resulted in "a shift from cash equity investment to investing in equity derivatives which are not subject to the stamp duty. It also causes a performance drag, especially for lower velocity, derivatives-adverse investors ... Contracts for Difference (CFD)[217] investors obtain the economic rights, but not the legal privileges that come from direct ownership of shares themselves, nor do such investors have a say in corporate governance". In their view, Stamp Duty inflates bank's balance sheets, levers the system, hides the true ownership of companies thus diminishing shareholder engagement, obliges investors to favour derivatives over shares, and gives banks revenues based on the market makers exemption.[218] They argued that, were an FTT to similarly exempt market makers, this would point an FTT away from the very institutions that the European Union is actually seeking to target and thus fail the European Union's own test of making those responsible pay.[219]

153. Furthermore, IMA observed that a great deal of inter-bank trading of equities does not, in fact, result in any SDRT being paid because of a combination of the market maker exemption and the use of SDRT exempt derivatives (in particular, Contracts for Differences) in such trades. They concluded that, as of 2005, more than 70% of the total UK stock market volume remained exempt from SDRT. In their view, "SDRT is manifestly not a tax on financial traders or a tax on speculation."[220]

154. The Financial Secretary to the Treasury told us that "Stamp duty in the UK is a modest transaction tax. It is very carefully defined. Its collection points

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215 First mover advantage is defined as "the edge that a company gains by entering a particular market before any competitors. This advantage can be gained in many ways, such as having the first chance at accessing resources (and if a particular resource is scarce, another company might not be able to get enough to have a chance at competing), gaining funding from the most-interested individuals, or by developing new technologies which other companies do not have access to. Although being the first-mover has the potential for many advantages, some disadvantages can arise as well, such as the ability of other companies to study and mimic the products and techniques of the first company." See http://www.investorwords.com/1977/first_mover_advantage.html

216 QQ 90–1.

217 A Contract for Difference (CFD) is essentially a contract between an investor and an investment bank or a spread-betting firm. At the end of the contract, the parties exchange the difference between the opening and closing prices of a specified financial instrument, including shares or commodities. See http://lexicon.ft.com/Term?term=contracts-for-difference.

218 Under this provision "market makers" (defined by the FSA as an entity that, ordinarily as part of their business, deals as principal in equities, options or derivatives (whether OTC or exchange-traded) a) to fulfil orders received from clients, in response to a client's request to trade or to hedge positions arising out of those dealings; and/or b) in a way that ordinarily has the effect of providing liquidity on a regular basis to the market on both bid and offer sides of the market in comparable size. Trading in circumstances other than genuinely for the provision of liquidity is not exempt) are exempt from certain short selling restrictions. See http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/stock-exchange-notices/2008/n2108pdf.pdf.

219 BlackRock.

220 IMA.

are very clear. My understanding is that the model suggested by President Sarkozy is something along those lines. One of the members of the German coalition Government has suggested something similar ... If people choose to adopt a stamp duty tax model, that is their prerogative, and I would not stand in the way of member states who wished to do so."[221]

155. **We note the growing interest amongst other Member States in adopting a model of financial sector taxation similar to the UK Stamp Duty. The Commission continues to stress the case, as it sees it, for an FTT, yet given the manifest weakness of the Commission's FTT proposal and the tentative moves being made in other Member States, led by President Sarkozy, it appears that a tax on the Stamp Duty model is more likely to be introduced. If it is accepted that a robust case for the introduction of a new tax on the financial sector can be made, then this proposal may bear further exploration. Yet whether the support for such a measure spreads beyond France to other Member States, whether there is any prospect of an EU-wide basis for such a tax, what the base and rate of the tax would be, and what the potential impact of such developments would be on the UK and its own Stamp Duty regime, remain uncertain. In this context we strongly urge the Government to continue their dialogue with EU partners and other Member States as they seek to determine whether the UK Stamp Duty model would be a more appropriate basis for taxation of the financial sector at the EU level.**

[221] Q 119. On the other hand the Mayor of London said "Bienvenue à Londres ... if your own President does not want the jobs, the opportunities and the economic growth that you generate, we do." See 'Boris to French bankers: Bienvenue à Londres', by Nicholas Cecil, *London Evening Standard*, 31 January 2012.

CHAPTER 6: CONCLUSION

156. This inquiry has found that the ongoing debate over the introduction of an EU Financial Transaction Tax is highly contentious. Whilst its advocates see the introduction of such a tax as an urgent "question of fairness", its opponents maintain that, at a time when growth is needed, an FTT would do significant harm to the economic health of the EU. These entrenched positions are almost impossible to reconcile.

157. We have assessed the five objectives set out by the Commission behind its proposal for a Financial Transaction Tax. We are not convinced that the proposed model would meet any of them. We find it wholly unrealistic to suggest that an EU tax will pave the way for a global FTT. Whilst there is a stronger case for suggesting that the financial sector should make a contribution to the costs of the financial crisis, and for seeking to deter certain transactions, in neither case is the Commission's position compelling. Whilst we acknowledge the strength of public anger against the financial sector, and the widespread view that those who contributed to the current financial crisis should contribute to its costs, we fear that a Financial Transaction Tax is the wrong way to seek to meet such demands.

158. We have analysed the design of a Financial Transaction Tax that the Commission proposes, and have found that it contains significant flaws. We note that even advocates of an FTT have criticised the Commission's model. We have concluded that the residence principle is both impractical and unworkable, and that there is a strong likelihood that financial institutions will relocate away from the EU. There is also considerable uncertainty about the likely incidence of the tax and its effect on consumers, the likelihood of a cascade effect, and, in particular, the potential negative impact on economic growth. The imposition of such a tax could have significant deleterious consequences in the current economic climate. If a financial taxation proposal is to be seriously contemplated then it is imperative that any proposed tax is as well-designed as possible. In our view, the Commission's proposed model is unworkable, and the Government should refuse to agree to the proposal.

159. Yet the debate about whether and how the financial sector should be taxed will go on. Other models have been put to us, notably the adoption of a tax on the trading of shares on the basis of the UK Stamp Duty model. Whilst there appears to be a growing political momentum behind this idea, it remains to be seen whether such proposals will come to fruition.

160. The UK Government have made clear that they would oppose any EU-wide Financial Transaction Tax. Yet it is vital that they remain engaged in the debate. The UK financial sector, based in the City of London, is of fundamental strategic importance, not only for the UK but for the EU as a whole. The Government should therefore seek to influence ongoing discussions as much as they can. However much the Government might oppose an FTT, the implications for the UK are far too great for the debate to be dismissed.

CHAPTER 7: SUMMARY OF CONCLUSIONS

161. This Committee has undertaken a detailed analysis of the European Commission's controversial proposals for a Financial Transaction Tax (FTT). We have been disappointed in what we have discovered. We have found the Commission's proposed model wanting in many respects, and unlikely to fulfil the objectives that the Commission itself has set. We find the Commission's proposed residence principle to be impractical and unworkable, and conclude that there is a significant risk that financial institutions would relocate outside the EU if an FTT is introduced. In the light of these flaws, it is our view that the Government should refuse to agree to this proposal. Yet the debate on taxation of the financial sector should not be lightly dismissed. It has been suggested that an FTT may be adopted by some or all euro area Member States, or that a tax of a similar kind to the UK Stamp Duty might be pursued. The implications for the UK and the EU as a whole are considerable, and we urge the Government to redouble their efforts to ensure that the UK is able to influence the ongoing debate. (summary)

Chapter 2: Assessing the Commission's objectives

162. Whilst an attempt to avoid fragmentation in the internal market for financial services may be a commendable aim, it is not at all clear how the Commission's proposal for a new tax would help achieve this. (paragraph 15)

163. The Commission's proposal combines two distinct issues—firstly, whether the financial sector should make a financial contribution to dealing with the effects of the ongoing financial crisis, and secondly, whether the financial sector is under-taxed. (paragraph 24)

164. The issue of whether the financial sector is under-taxed is particularly nuanced. The evidence we heard focussed on whether or not the financial sector's exemption from VAT could be regarded as preferential treatment. In our view, whilst the financial sector *may* derive some advantage from the VAT exemption, it is also clear that financial institutions incur a large amount of irrecoverable VAT. Any case for increasing taxation of the financial sector needs to rest on more solid foundations than this. (paragraph 25)

165. Furthermore, whilst we acknowledge the strength of public anger against the financial sector, and the widespread view that a form of taxation should be introduced to ensure that those who contributed to the current crisis should contribute to its costs, it is important to recognise that not all elements of the financial sector bear equal (or even any) responsibility for the crisis. Caution should therefore be observed before introducing any proposal that would have a blanket effect on all elements of the financial sector. Therefore, whilst there may be a case for increased taxation of at least some parts of the financial sector, it does not follow that the Commission's Financial Transaction Tax proposal is the most appropriate means by which to achieve this. Much depends upon the specific details of the Commission's proposals. (paragraph 26)

166. We heard divergent views as to whether high-frequency trading and other related transactions, regarded by the Commission as inefficient, should be discouraged. We note the equally divergent evidence as to the impact of such transactions on market volatility. In our view, it is not yet clear whether and

to what degree such activity has a detrimental effect on the national, EU and global economy. (paragraph 37)

167. Yet even if the case is made that such transactions should be discouraged, it is far from clear that a Financial Transaction Tax is the best way to achieve this. We note the concerns of several witnesses that such a tax would be too blunt an instrument to tackle the issue effectively, since it would impinge upon other transactions and parts of the financial sector that are not seen to be problematic. Again, much depends upon the specific details of the Commission's proposal. (paragraph 38)

168. We note that the Commission itself has brought forward proposals to improve regulation of these markets, for instance through the current Markets in Financial Instruments Directive (MiFID) and the Market Abuse Regulation (MAR) proposals. Whatever the merits or otherwise of these specific proposals, it is our view that focussed regulation is likely to be a more effective means by which to tackle undesirable market behaviour arising from the use of such transactions. (paragraph 39)

169. The question of the EU budget, and whether an FTT could form a potential revenue stream for it, lies outside the scope of this inquiry. Notwithstanding this, we note the concern with which this objective was viewed by several of our witnesses, including, notably, those who advocated the introduction of an FTT, many of whom have stressed that revenues should be used to tackle such issues as global poverty and climate change. The use to which any revenues from an FTT would be put is evidently a matter of contention amongst its supporters. That the Commission has so far failed to secure support for its objective of using an FTT as a revenue stream for the EU budget suggests that such an objective is unlikely to be met. (paragraph 44)

170. Seeking to set a pioneering precedent in the development of a new policy is often to be commended. Yet given the palpable lack of appetite for the introduction of a tax amongst other nations, most notably the USA, the Commission's argument that an EU-wide FTT will pave the way for the introduction of a global tax appears to us to be wholly unrealistic. (paragraph 49)

171. The Commission has set out a number of objectives behind its proposal for a Financial Transaction Tax. Yet we are not convinced that the proposed model would meet any of them. It is difficult to see how the Commission proposal can pave the way for a global tax, whilst the case for using an FTT as a new revenue stream for the EU budget is contentious to say the least. Whilst there is a stronger case for asking the financial sector to make a contribution to the costs of the financial crisis, and for seeking to deter certain transactions, in neither case is the Commission's position compelling. Furthermore, whilst we acknowledge the strength of public anger against the financial sector, and the widespread view that those who contributed to the current financial crisis should contribute to its costs, we fear that a Financial Transaction Tax is the wrong way to seek to meet such demands. In our view, the case for introducing a new tax needs to be based on an assessment of its efficiency, simplicity, the ease with which it can be collected and whether it is open to abuse. Much depends on how well the FTT might be designed. (paragraph 50)

Chapter 3: Assessing the Commission's proposal

172. Commissioner Šemeta has sought to defend the proposed residence principle. Yet we find the widespread criticism of the proposal, including by advocates of an FTT, chastening. The Commission has made clear that counterparties not resident in the EU would nevertheless be liable for the tax when engaging in a transaction with an EU-resident counterparty. The Commission point to the provisions for joint and several liability, and the operation of mutual assistance. This is bound to be controversial. It is likely that non-EU financial institutions and countries would react to the proposal extremely negatively, with potentially serious consequences for the EU financial sector. Our witnesses have also pointed to particular practical difficulties, for instance in defining the place of residence and in determining how it would work in practice. In the light of this, it is our view that the residence principle proposed by the Commission is both wholly impractical and unworkable. (paragraph 58)

173. We have concluded that the residence principle proposed by the Commission is unworkable. Furthermore, we strongly disagree with the Commissioner's argument that the residence principle will overcome the significant risk of relocation to avoid the FTT. We remain deeply concerned that, should the Commission implement its Financial Transaction Tax model within the EU alone, financial institutions would relocate outside the EU, either by the institution itself physically relocating, or by setting up a subsidiary outside the EU, with serious consequences for the EU financial services industry and for the health of the EU economy as a whole. In our view, only an FTT implemented on a global scale will prevent EU-resident institutions being placed at a significant competitive disadvantage in comparison with leading global competitors. Yet, as we have already concluded, the chances of a global tax being introduced are extremely slim. (paragraph 66)

174. It is vital that the potential impact of a proposal with such significant implications as the Commission's Financial Transaction Tax model should be calculated with more rigour and reliability. We are therefore alarmed at the degree of criticism to which the Commission's Impact Assessment has been subjected. Whilst we note the Commissioner's argument that preparatory material was published in order to promote transparency, it remains the case, as he has conceded, that the document has significantly undermined the Commission's case. (paragraph 78)

175. We are particularly concerned that the Commission's model may have failed to take into account all of the potential negative impacts on growth, and that the effects could therefore be more pronounced than the Impact Assessment suggests. The impact would be exacerbated further should our fears of significant relocation be realised. Commissioner Šemeta has suggested that the impact may be limited to a decrease in GDP of 0.53% in the long term. Yet even that figure is concerning. The potential impact on liquidity is also uncertain. At a time of ongoing financial crisis and at best fragile economic growth across the entire EU, we consider that a new tax which could have a substantial detrimental effect on EU GDP should be resisted. (paragraph 79)

176. The divergence of views that have been put to us demonstrate that it is difficult to predict with any accuracy what the true incidence of a Financial Transaction Tax would be. Whilst it may be the case, as the Commission suggests, that a large part of the initial incidence would fall on owners of financial instruments, we remain concerned that the tax burden will

ultimately be passed on to consumers. In the current economic context, we do not believe that this is a risk worth taking. (paragraph 87)

177. Whilst the proposed rate of transaction tax appears relatively low, for instance in comparison to the rate of the UK Stamp Duty, the concerns of several of our witnesses about the danger of a potential cascade effect must be taken seriously. The likely effects are difficult to predict, but it does appear probable that the effective tax burden would tend to be considerably higher than the underlying base rate proposed by the Commission. This, in turn, would have an adverse knock-on effect on economic growth and the likelihood of relocation. (paragraph 100)

178. We have concluded that the proposed FTT would not meet the objectives that the Commission has identified. However, if a proposal on a question of such importance as this is to be seriously contemplated then it is imperative that any proposed tax is as well-designed as possible. In the light of the evidence that we have received, it is our view that the Commission's proposed model for a Financial Transaction Tax is both impractical and unworkable. (paragraph 103)

Chapter 4: The effect of an FTT on the UK

179. We have heard divergent views concerning the likely impact of an FTT on the City of London and on the wider UK economy. This once again emphasises that considerable uncertainty remains in terms of the likely impact of an FTT. Such uncertainty is alarming, not least given the UK financial sector's strategic importance not only for the UK economy, but for the economic health of the EU as a whole. The UK financial sector is a major asset to the EU, in particular in terms of the single market, in providing a more developed capital market than existed before. We remain deeply concerned that an EU-wide FTT such as the Commission propose could have a serious detrimental impact on the UK, in particular by giving financial institutions an incentive to relocate away from London, either by the institution itself physically relocating, or by setting up a subsidiary outside the EU. Noting the evidence we have heard that over 70% of revenue could be expected to come from the UK, we also question the appropriateness of a proposal that would have such a disproportionate impact on one Member State above all others. On these grounds alone, the Commission's proposals are unacceptable. (paragraph 118)

The impact of a euro area FTT on the UK

180. We note the conflicting views of our witnesses as to the potential impact of an FTT comprising some or all of the euro area Member States on those who choose not to participate, such as the UK. If, as is likely, the Directive creating a euro area FTT equates the UK with third countries, there would still be very significant effects on the UK financial sector. UK financial institutions entering into financial transactions with euro area financial institutions would still be liable for the FTT, which could be collected through EU mutual assistance for the recovery of tax or as a result of the provisions of joint and several liability. We urge the Government to work to ensure that UK financial institutions are not damaged, and that UK tax authorities' workload is not increased, by an FTT introduced by certain EU Member States. (paragraph 128)

Assessing the Government's position

181. Whilst noting the Financial Secretary to the Treasury's assertion that the UK has no objection in principle to a global FTT, the Government's support for a global tax has been lukewarm at best. We find the Minister's explanation unconvincing. If the Government do support the introduction of a global tax then they should make the case for it. If, however, their true position is that they oppose a Financial Transaction Tax outright, then they should say so. (paragraph 135)

182. Like all EU-wide taxation proposals, the Commission's proposal for an FTT requires unanimity amongst Member States. Given our conclusion that the Commission's proposed model is both impractical and unworkable, it is our view that the Government should refuse to agree to this proposal. Notwithstanding this, we recognise that the debate on whether and how the financial sector should be taxed will nevertheless continue. Given this, and given the potential consequences not only for the UK but for the EU as a whole, it is vital that the Government remain actively engaged in this debate. The UK has considerable expertise to bring to bear, and we are pleased to hear from both the Minister and the Commissioner that the UK has been an active participant in these discussions. We urge the Government to redouble such efforts. (paragraph 136)

Chapter 5: Alternatives to a Financial Transaction Tax

183. Several witnesses strongly advocated the introduction of a Financial Activities Tax (FAT). Whilst we note that this model may hold certain advantages in comparison to a Financial Transaction Tax, notably making it more difficult for financial institutions to pass on the tax burden, it may also hold drawbacks, for instance in taxing all financial institutions' activities regardless of how beneficial they are. Whilst there may be a case for further exploration of the case for an FAT, in the current economic climate there is a need for caution before introducing any new taxation of the financial sector that might impair economic growth. (paragraph 145)

184. We note the growing interest amongst other Member States in adopting a model of financial sector taxation similar to the UK Stamp Duty. The Commission continues to stress the case, as it sees it, for an FTT, yet given the manifest weakness of the Commission's FTT proposal and the tentative moves being made in other Member States, led by President Sarkozy, it appears that a tax on the Stamp Duty model is more likely to be introduced. If it is accepted that a robust case for the introduction of a new tax on the financial sector can be made, then this proposal may bear further exploration. Yet whether the support for such a measure spreads beyond France to other Member States, whether there is any prospect of an EU-wide basis for such a tax, what the base and rate of the tax would be, and what the potential impact of such developments would be on the UK and its own Stamp Duty regime, remain uncertain. In this context we strongly urge the Government to continue their dialogue with EU partners and other Member States as they seek to determine whether the UK Stamp Duty model would be a more appropriate basis for taxation of the financial sector at the EU level. (paragraph 155)

APPENDIX 1: EU SUB-COMMITTEE ON ECONOMIC AND FINANCIAL AFFAIRS AND INTERNATIONAL TRADE

The members of the Sub-Committee who conducted this inquiry were:

Lord Flight
Lord Hamilton of Epsom
Lord Harrison (Chairman)
Lord Haskins
Baroness Hooper
Lord Jordan
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford
Lord Moser
Lord Vallance of Tummel
Lord Woolmer of Leeds

Declaration of Interests

Lord Flight
Chairman, Flight & Partners Limited (Manager, private equity fund)
Director, Investec Asset Management Limited (Investment Manager)
Chairman, CIM Investment Management Limited (Investment Manager)
Chairman, Loudwater Trust Limited (Venture Capital Investment Trust)
Chairman, Downing Structured Opportunities VCT1 plc (venture capital trust)
Director, Metro Bank plc (retail bank)
Chairman, Arden Partners plc (Stockbroker)
Marechale Capital (Corporate Advisor)
Aurora Investment Trust Plc (and trading subsidiary AIT Trading ltd)
Edge Performance VCT

Lord Hamilton of Epsom
Director Jupiter Dividend & Growth Trust (Investment Trust)
Split Capital Investment Trust
Director IREF Global Holdings (Bermuda) Ltd (Property Fund)
Director IREF Australian Holdings (Bermuda) Ltd (Property Fund)

Lord Harrison
None relevant

Lord Haskins
Various personal interests in equities and bonds

Baroness Hooper
None relevant

Lord Jordan
Chairman, Homes and Communities Agency Pension Scheme
President, ROSPA
Governor, Ashridge Management College

Lord Kerr of Kinlochard
Director, Scottish Power Ltd
Deputy Chairman, Royal Dutch Shell plc
Director, Rio Tinto plc
Director, Scottish American Investment Company Ltd

Member, Advisory Board, Edinburgh Partners
Chairman, Centre for European Reform

Baroness Maddock
None relevant

Lord Marlesford
None relevant

Lord Moser
None relevant

Lord Vallance of Tummel
Member Supervisory Board Siemens AG,
Member International Advisory Board, Allianz SE

Lord Woolmer of Leeds
None relevant

The following Members of the European Union Committee attended the meeting at which the report was approved:

Lord Bowness
Lord Carter of Coles
Lord Dear
Lord Dykes
Lord Foulkes of Cumnock
Lord Hannay of Chiswick
Lord Harrison
Baroness Howarth of Breckland
Lord Jopling
Lord Richard
Lord Roper (Chairman)
The Earl of Sandwich
Lord Teverson
Lord Tomlinson
Baroness Young of Hornsey

During consideration of the report, Lord Carter of Coles declared an interest as:

Director, Primary Insurance Group Ltd (Insurance Broking and Underwriting)
Advisor, Warburg Pincus (Private Equity)

A full list of registered interests of Members of the House of Lords can be found at http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/

APPENDIX 2: LIST OF WITNESSES

Evidence is published online at http://www.parliament.uk/hleua and available for inspection at the Parliamentary Archives (020 7219 5314)

Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. Those witnesses marked with * gave both oral evidence and written evidence. Those marked with ** gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

Oral evidence in chronological order

*	(QQ 1–28)	Confederation of British Industry (CBI)
*		Trades Union Congress (TUC)
*	(QQ 29–56)	John Chown, Chown Dewhurst LLP
*		John Vella, Senior Research Fellow, Oxford University Centre for Business Taxation
*		David Hillman, Director, Stamp Out Poverty
**		Richard Gower, Senior Policy Advisor, Oxfam
*	(QQ 57–86)	International Swaps and Derivatives Association (ISDA)
*		BlackRock
**	(QQ 87–96)	Sony Kapoor, Managing Director, Re-Define
*	(QQ 97–120)	Mark Hoban MP, Financial Secretary to the Treasury
*	(QQ 121–144)	Algirdas Šemeta, EU Commissioner for Taxation and Customs Union, Audit and Anti-Fraud

Alphabetical list of all witnesses

	The Alternate Investment Management Association Limited (AIMA)
	Association of British Insurers (ABI)
	The Association of Corporate Treasurers (ACT)
	Association for Financial Markets in Europe (AFME)
	The Association of Private Client Investment Managers and Stockbrokers (APCIMS)
	AVIVA PLC
*	BlackRock (QQ 57–86)
	British Bankers' Association
	The British Land Company
	British Property Federation (BPF)
	The Charity Tax Group
	John Chapman
*	John Chown, Chown Dewhurst LLP (QQ 29–56)
	City of London Corporation

* Confederation of British Industry (CBI) (QQ 1–28)

Frank Cranmer

Sylvie Goulard MEP

** Richard Gower, Senior Policy Advisor, Oxfam (QQ 29–56)

* Mark Hoban MP, Financial Secretary to the Treasury (QQ 97–120)

Institute of Economic Affairs (IEA)

* International Swaps and Derivatives Association (ISDA) (QQ 57–86)

Investment Management Association (IMA)

** Sony Kapoor, Managing Director, Re-Define (QQ 87–96)

Lloyds

Mayor of London

Arlene McCarthy MEP

NAPF

New City Initiative

* Algirdas Šemeta, EU Commissioner for Taxation and Customs Union, Audit and Anti-Fraud (QQ 121–144)

Peter Sinclair

* Stamp Out Poverty (QQ 29–56)

* Trades Union Congress (TUC) (QQ 1–28)

Unite the Union

Bart Van Vooren

* John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr, Oxford University Centre for Business Taxation (QQ 29–56)

Wellcome Trust

APPENDIX 3: CALL FOR EVIDENCE

The House of Lords EU Economic and Financial Affairs and International Trade Sub-Committee, chaired by Lord Harrison, is launching an inquiry into a Financial Transaction Tax and its implications for the UK. We invite you to contribute evidence to this inquiry.

The financial crisis, and its associated impact on Government finances, has intensified debate about the use of taxation either as a way to correct the effects of excessive risk-taking on financial institutions or as an instrument to ensure that the financial sector makes a substantial contribution to public finances.

On 28 September the Commission published its proposal for a Directive on a common system of Financial Transaction Tax (FTT). France and Germany are expected to bring forward their own proposal in the near future. The French Presidency of the G20 has made discussions over a financial transaction tax one of its priorities.

From a UK perspective it is inevitable that the proposition of a tax on the financial sector will attract attention given London's status as Europe's largest financial centre. The UK Government have expressed concerns about introducing such a tax unless it is done on a global basis.

The purpose of the inquiry is to investigate the rationale behind the introduction of a financial sector tax, and will focus primarily on the Commission's proposal for an FTT. It will consider the potential risks, benefits and shortcomings of an FTT and its significance for the City of London. It will assess whether an FTT could plausibly be implemented at an EU level, or whether it will only work effectively if implemented globally.

The inquiry will not consider the debate on an FTT as a possible revenue stream for the EU budget. It will nevertheless welcome views on any other possible uses of revenues arising from an FTT.

Particular questions raised to which we invite you to respond are as follows (there is no need for individual submissions to deal with all of the issues):

PART I General questions on financial sector taxation

(1) Is there a case for the introduction of a tax on financial transactions? Does the current exemption from VAT for most financial and insurance services lead to a tax advantage for the financial sector?

(2) What would be the most appropriate form for a taxation of the financial sector? Would a Financial Activities Tax (FAT) be a preferable means of taxing the financial sector? Would other variations (e.g. a currency transaction tax, a securities transaction tax or a financial tax on derivatives) be a more desirable form of taxation?

(3) What lessons can be learnt from the experience of other countries (such as the transaction levy introduced in Sweden in 1984 and abolished in 1991) in relation to a financial sector taxation scheme?

PART II Specific questions on the Commission's proposal for an FTT

Rationale for an FTT and scope

(4) What is your assessment of the Commission's objectives as contained in its proposal for an FTT? Are they fair and appropriate?

(5) Does the Commission proposal for an FTT reflect the most desirable design for an FTT?

(6) On which transactions should the FTT be levied? Is it appropriate for the FTT to be levied on shares, bonds, derivatives and structured financial products as suggested by the Commission? What should be the rate of the FTT?

(7) Is it appropriate for the FTT to be applied on the basis of the residence principle as proposed by the Commission? How likely is the residence principle to work in practice?

(8) How significant is the potential for the FTT to raise significant revenues? How reliable would it be as a revenue stream? Where would the true incidence of the FTT fall? Should the revenues arising from the FTT be used to finance the deficits of Member States?

Impact and effectiveness

(9) Would the Commission's proposal for an FTT be effective in addressing short term volatility and curbing harmful speculation? Would it reduce excessive risk taking?

(10) What would be the impact of the FTT on market liquidity? What effect would the FTT have on speculation in sovereign debt markets?

(11) How easily could the FTT tax be circumvented by market operators?

Impact of the FTT in the UK

(12) What impact would the FTT have on the UK's financial services sector and the City of London, as well as the UK economy more broadly? If a significant proportion of any transaction tax accrued in London, would the burden necessarily fall on British citizens?

(13) How would you assess the likelihood that the FTT would cause financial services to relocate outside the EU, or contribute to a migration of financial transactions towards less regulated parts of the financial sector? Does the UK experience with the stamp duty demonstrate that a modest FTT is not inconsistent with maintaining a successful stock exchange?

(14) Will the FTT duplicate existing taxes in countries which have already implemented a bank levy, such as the UK?

Implementation

(15) Could such an FTT be plausibly introduced at an EU level, or would an FTT only be effective if introduced globally? Should an FTT be introduced at EU level regardless of whether it is introduced at a global level? In the event that an FTT is not introduced at EU level, would there be a case for its implementation by euro area countries alone?

Those responding to this call for evidence are not necessarily expected to address all these points but instead to focus on those issues on which they have special expertise or about which they are particularly concerned.

The deadline for written evidence is Monday 7 November 2011.

APPENDIX 4: GLOSSARY[222]

ABI	Association of British Insurers.
ACT	The Association of Corporate Treasurers.
AFME	Association for Financial Markets in Europe.
AIMA	The Alternative Investment Management Association.
APCIMS	The Association of Private Client Investment Managers and Stockbrokers.
BBA	British Bankers' Association.
Bond	Essentially, a tradable IOU. Governments, companies and other organisations issue bonds to raise money; in doing so, they have an obligation to repay the bondholder according to specific terms.
BPF	British Property Federation.
CBI	Confederation of British Industry.
CDO	Collateralised Debt Obligations.
CDS	Credit Default Swaps.
CFD	Contracts for Difference. This is essentially a contract between an investor and an investment bank or a spread-betting firm. At the end of the contract, the parties exchange the difference between the opening and closing prices of a specified financial instrument, including shares or commodities.
Derivative	A financial instrument whose value is based on the performance of underlying assets such as stocks, bonds currency exchange rates, real estate. The main categories of derivatives are futures, options and swaps.
ECB	European Central Bank.
ECOFIN	The Economic and Financial Affairs Council. It is composed of the finance ministers of all EU Member States.
Equity	What a shareholder owns in a corporation, entitling him/her to part of that entity's profits (in the form of dividends) and a measure of control (through shareholder voting rights). The markets where equity (stocks/shares are also called equities) is traded are called the equity markets (the same as stock markets).
EU	European Union.
FAT	Financial Activities Tax.
First mover advantage	The edge that a company gains by entering a particular market before any competitors.[223]
FTT	Financial Transaction Tax.
FX	Foreign Exchange market.
GDP	Gross Domestic Product.

222 With thanks to http://lexicon.ft.com/ for definitions, except where otherwise stated.

223 http://www.investorwords.com/1977/first_mover_advantage.html

HFT	High-Frequency Trading. The use of computers to implement various highly active trading strategies to trade at exchanges where automated electronic systems arrange trades.
IEA	Institute of Economic Affairs.
IMA	Investment Management Association.
ISDA	International Swaps and Derivatives Association.
Joint and several liability	When a number of parties make a joint commitment under a contract and agree to be liable as a group as well as individually (jointly and severally) for that obligation to be fulfilled.
Liquidity	How easy it is to perform a transaction in a particular security or instrument.
MAR	Market Abuse Regulation.
Market maker	An entity that, ordinarily as part of their business, deals as principal in equities, options or derivatives (whether OTC or exchange-traded) a) to fulfil orders received from clients, in response to a client's request to trade or to hedge positions arising out of those dealings; and/or b) in a way that ordinarily has the effect of providing liquidity on a regular basis to the market on both bid and offer sides of the market in comparable size.[224]
MBS	Mortgage Backed Securities.
MEP	Member of the European Parliament.
MiFID	Markets in Financial Instruments Directive.
NAPF	National Association of Pension Funds.
OTC derivatives	Over-the-counter derivatives.
SDRT	Stamp Duty Reserve Tax.
Spot currency transaction	The purchase of one currency against the sale of another at an agreed price for delivery on a value date which is usually the trade date plus two working days, the traditional 'spot value'.[225]
TFEU	Treaty on the Functioning of the European Union.
TUC	Trades Union Congress.
VAT	Value Added Tax.

224 http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/stock-exchange-notices/2008/n2108pdf.pdf

225 http://www.icap.com/markets/foreign-exchange/spot-fx.aspx