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**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**

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**1. CONTEXT**

The recent financial crisis stressed the need for a more robust financial system, given the cost of financial instability for the real economy. In addition, there are several key challenges in the areas of development, resource efficiency and climate change with significant budgetary implications. Against this background, could supplementary taxes on the financial sector be a potential revenue-generating solution?

The European Council concluded on 17 June 2010, in preparation for the G-20 Toronto Summit, that '[t]he EU should lead efforts to set a global approach for introducing systems for levies and taxes on financial institutions with a view to maintaining a world-wide level playing field and will strongly defend this position with its G-20 partners. The introduction of a global financial transaction tax should be explored and developed further in that context.'

The European Parliament has also been debating issues related to the financial sector and taxation. In particular its Resolution of 10 March 2010 asks the Commission and Council to look at how a financial transaction tax could be used to finance development cooperation, help developing countries to combat climate change and contribute to the EU budget. Some Member States have already taken measures with regard to bank taxation.

Such debates are not limited to the European Union. These are indeed issues reflecting the global and systemic nature of the financial crisis and its consequences. There have been discussions in the G-20 on new forms of taxation. However, there is no global consensus on additional tax instruments.<sup>1</sup> Most recently, the issue of taxing financial transactions has been prominently discussed during the UN High Level Plenary Meeting on the Millennium Development Goals. Moreover, the High Level Advisory Group on Climate Change Financing established by the UN Secretary General has also looked at the revenue-raising potential of key sectors active at the global scale, including the financial sector but also international air and maritime transport.

This Communication contributes to the debate by covering two instruments, a Financial Transactions Tax (FTT) and a Financial Activities Tax (FAT).

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<sup>1</sup> The conclusions of the G-20 Toronto Summit say: '*We agreed the financial sector should make a fair and substantial contribution towards paying for any burdens associated with government interventions, where they occur, to repair the financial system or fund resolution, and reduce risks from the financial system. We recognized that there are a range of policy approaches to this end. Some countries are pursuing a financial levy. Other countries are pursuing different approaches.*'

## 2. OBJECTIVES AND RATIONALE FOR ADDITIONAL TAXES ON THE FINANCIAL SECTOR

Regardless of the tax instrument considered, is there a rationale for adapting the tax system to make the financial sector contribute in a fair and substantial way to public budgets? The Commission sees three main arguments for this.

First, to complement the extensive financial sector reforms underway, taxes could contribute to enhancing the efficiency and stability of financial markets and reducing their volatility as well as the harmful effects of excessive risk-taking. In particular, the financial sector might take too much risk due to a range of factors, from actual or expected state support (resulting in moral hazard) and information asymmetries to remuneration structures which together with macroeconomic developments contributed to the recent crisis. Hence, the behaviour of the financial sector creates negative externalities for the rest of the economy. There is thus a case for a corrective tax to internalise such externalities, provided it can be specified to achieve this objective.

The financial and economic crisis has highlighted a number of misaligned incentives in the financial sector as well as weaknesses in the regulatory and supervisory framework for the financial system. As a result, significant regulatory reforms have been adopted or are in the pipeline.<sup>2</sup> There is a broad consensus that regulatory and supervisory reforms are essential in order to enhance the resilience and the stability of the financial system.

The Commission has proposed new crisis management arrangements aimed at improving the capacity of public authorities to manage failures arising within the banking sector.<sup>3</sup> This would include the implementation of a network of national resolution funds financed by a bank levy. The Commission has set out its opinion on this issue in a recent Communication (COM(2010) 254 final) and will provide further detail on its proposals in the near future.

Additional taxes could indirectly and in addition to regulation contribute to the goal of improving the stability of the financial sector by dissuading it from carrying out certain risky activities and be a revenue source at the same time.

Second, the financial sector is seen to bear an important responsibility for the occurrence and scale of the crisis and its negative effects on government debt levels worldwide. Additional taxes could also be justified by the fact that some governments provided substantial support to the sector during the crisis and it should hence make a fair contribution in return. By contributing to fiscal consolidation and auxiliary resources as well as economic efficiency, new financial sector taxes could help to create the conditions for more sustainable growth, as envisaged in the Europe 2020 strategy.

Third, most financial services are exempt from value added taxation in the EU. The reason is that the major part of financial services' income is margin based and therefore not easily taxable under current VAT.

There are therefore arguments that the financial sector could make a fairer and more substantial contribution to government finances. This debate takes place in a general context of fiscal consolidation in the EU and elsewhere and when the world faces at least two urgent global policy challenges with significant budgetary implications. The EU has made

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<sup>2</sup> The Commission set out initiatives in its Communication COM(2010) 301 final.

<sup>3</sup> COM(2009) 561 final.

substantial pledges to climate protection and development.<sup>4</sup> To meet the commitments new revenue sources should be explored further.<sup>5</sup>

EU Member States are starting to put in place national tax instruments to respond to these challenges. It is important that such developments take place in a coordinated framework. If not, different national systems levied on diverging tax bases could create incentives for tax arbitrage and result in allocation distortions between financial markets in the EU. The emergence of uncoordinated national solutions could also lead to double taxation and fragmentation of the financial sector, hampering the proper functioning of the Single Market.

Any possible tax measures must also be seen put into a broader context of current efforts on regulatory reform of the financial sector, in particular with likely higher capital requirements, and discussions on a possible introduction of bank levies. The cumulative impact of such measures must be borne in mind (especially if they are not carefully coordinated and phased in), so that a viable financial sector, able to properly and efficiently finance the broader economy, is not put at risk.

### **3. FINANCIAL TRANSACTIONS TAX (FTT)**

The FTT is designed to tax the value of single transactions. For a wide coverage, it should be applied to a broad range of financial instruments (i.e. equities, bonds, currencies and derivatives), even if some current proposals envisage limiting the scope to a subset (e.g. currency transaction levy).<sup>6</sup>

#### **3.1. Revenue aspects**

The revenue potential and the intensity of the economic impact of an FTT vary considerably with its product scope and coverage (global, EU-wide or national) and the size of trading in a given jurisdiction. In the absence of international consensus on applying such a tax, revenue would depend on relocation of mobile trading activities. It is also affected by possibilities to circumvent by re-engineering of financial products and the tax rate chosen.

Globally, estimated tax revenues would have been around EUR 60 billion for 2006 for stocks and bonds transactions assuming a tax rate of 0.1%. Some studies find ten times this amount if derivatives are included. However, there are technical problems for derivatives such as determining tax bases<sup>7</sup> as well as doubts about the accuracy of revenue estimates. Past

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<sup>4</sup> Developed countries also agreed in the Copenhagen Accord to a goal of mobilising jointly USD 100 billion a year by 2020 to address the needs of developing countries in fighting climate change. To reach the Millennium Development Goals, the EU pledged to increase its official development aid (ODA) to 0.7% of its Gross National Income by 2015, which could entail a doubling of the EU's ODA from almost EUR 50 billion in 2008 to an estimated EUR 100 billion in 2015.

<sup>5</sup> The Commission issued a Staff Working Paper (SWD) on 'Innovative financing at a global level' (SEC(2010) 409 final), which assesses the potential of innovative financing at a global level for raising revenues to address the challenges identified above.

<sup>6</sup> The SWD discusses the currency levy briefly. For the purpose of the present Communication, the broad based FTT covers bond and derivative transactions on exchanges as well as over-the-counter (OTC) traded instruments which include derivative transaction as well as foreign exchange spot transactions.

<sup>7</sup> For a general FTT, collection should be relatively easy for exchange traded products. For over-the-counter traded products, tax administration would be more complex but feasible given the trend towards increased registration obligations and the proposal by the Commission for the Regulation on OTC derivatives, central counterparties and trade repositories COM (2010) 484/5.

experiences have shown a substantial gap between expected and realised revenues. There are also open issues with currency transactions if levied only nationally.<sup>8</sup> Including only exchange traded equity and bonds in the tax base would give about EUR 20 billion in the EU-27.<sup>9</sup> If derivative products are included, revenue estimates would be much higher, up to EUR 150 billion according to some calculations. For a narrow currency transaction levy a tax rate of 0.005% on the world's most traded currencies based on data from 2007 could yield EUR 24 billion annually.

The revenue generated would be largely collected in a limited number of countries where trading activities are concentrated. This uneven distribution would be even greater when derivatives are included. On the one hand, this could make an agreement on a tax more difficult given that all countries would have to implement the tax while only a few gain the revenue. On the other hand, one can argue that investors from all over the world use the central market places. Therefore, all users contribute to the tax revenue, giving it a global dimension. For this reason the FTT is potentially a good revenue raiser at the global level.

It is, however, important to consider the economic burden of the tax. In general, taxes on the financial sector are likely to involve some income redistribution from bank shareholders, managers or market participants to the general population. The tax burden is likely to be partly rolled over to clients and average customers, but it depends on the ability of taxpayers to avoid the tax. Indirectly, the tax would also increase the cost of capital for governments and companies. There is no available empirical evidence on the real incidence.

### **3.2. Effects on market efficiency and economic stability**

One argument put forward in favour of the FTT is that it could implement the ‘polluter pays’ principle and therefore would also help internalise potential negative externalities of financial sector activity. It has been argued that the broad-based FTT could help stabilise financial markets by reducing short-term speculative trading by penalising undesirable financial market transactions, mainly high frequency trading.

Several aspects need to be taken into account. First, efficiency gains are uncertain as the tax may increase price volatility by reducing liquidity, e.g. in markets that are used for risk hedging. Second, while the value to the economy of high-speed trading is questionable, the extent to which this activity was a main driver of negative externalities in the crisis has still to be studied. Third, the FTT taxes gross transaction values. Since the FTT is levied on transactions rather than on value added it is cumulative. More frequently traded products will face a higher tax burden.

Ideally, to improve efficiency, the FTT should be levied on ‘harmful’ or highly speculative transactions. It is in practice not possible to distinguish those from ‘normal’ transactions. Hence, the FTT would have to be levied on the broadest possible base to reach its efficiency goal. A narrow based FTT could lessen the risk of geographical relocation if designed properly.<sup>10</sup> But if only some transactions are taxed, the tax would distort financial

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<sup>8</sup> Experts to the Leading Group’s Task force on International Financial Transactions and Development recommended for a number of reasons the global application of a currency transaction levy. <http://www.leadinggroup.org/article668.html>.

<sup>9</sup> The assumptions are a cut in trade volumes of 30 % for bonds and 20 % for shares.

<sup>10</sup> The design will depend on the exact base. Examples could be currency transactions, or stocks and bonds.

intermediation by favouring some activities which would not be subject to an FTT. Furthermore, depending on the design of the FTT it could create options for avoidance due to reengineering and substitution.

To effectively reduce activities with a potential negative externality at global level and to avoid relocation of trading, the tax should be applied in all financial centres. These global centres are widely interconnected and companies face low costs when shifting trade between them. In addition, many financial companies operate with worldwide subsidiaries. Therefore, the fact that the FTT needs a broad base to reach its efficiency and revenue goals also implies that it would need a considerable amount of global coordination to reduce the risk of relocation and avoidance.

### **3.3. Assessment**

Globally, an FTT could be an appropriate option as a revenue raiser in particular to provide financing for global policy goals. For it to work effectively and fairly, participating countries should try to come to an agreement on global financing tools that can be acceptable to all. The Commission is committed to continuing to work with its international partners, in particular in the G20, to reach such an agreement.

A financial transaction tax could be considered at the EU level only. However, it must be borne in mind that the financial industry is a global and interconnected one. Financial activities are concentrated in a small number of financial centres both inside and outside the EU which compete on the world stage. Finance is also a complex and evolving area and the main players have a developed capacity to seek out new and innovative ways of doing business and of structuring financial transactions.

## **4. FINANCIAL ACTIVITIES TAX**

Another potential instrument to improve taxation of the financial sector and reduce potential negative externalities is the Financial Activities Tax (FAT) as proposed by the IMF. In its most extensive form (addition-method FAT), the FAT falls on total profit and wages. It can also be designed to specifically target economic rents and/or risk.<sup>11</sup> In contrast to an FTT, whereby each financial market participant is taxed according to his transactions, the FAT taxes corporations. The focus here is on the addition-method FAT.

### **4.1. Revenue aspects**

For the 22 developed economies considered in the IMF report to the G-20, a 5% rate of the addition-method FAT would create revenue corresponding to the average of 0.28% of GDP.<sup>12</sup> Using the country-level estimates for the share in GDP to calculate absolute figures, this would translate into total revenue for the 22 countries of roughly EUR 75 billion for the addition-method FAT. For the EU-27, the addition-method FAT could raise up to EUR 25 billion.

The geographical distribution of revenues would by and large reflect the actual distribution of the financial sector in the EU. However, the revenue is not as concentrated as in the case of an

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<sup>11</sup> The latter two versions are discussed in detail in the accompanying SWD.

<sup>12</sup> IMF (2010) Financial Sector taxation — The IMF's Report to the G-20 and background material.

FTT. The reason is that the base is not trading activity, which takes place mainly in a few financial centres, but rather remuneration and profit, which is more evenly spread. In this sense the FAT would be better suited to raising revenue for national consolidation, which is an urgent task in many Member States.

As regards economic burden, the effects depend on the concrete design of the tax. In practice there is no available empirical evidence on the real incidence of a FAT. If the tax were to be shifted to the customer, and given that there is no deduction for business consumers, the tax burden could also partly fall on users of financial services.

#### **4.2. Effects on market efficiency and economic stability**

The effects on financial activities depend on the design of the tax. An addition-method FAT would not directly alter the structures of markets where financial institutions are active since it taxes income independently of how it is generated. In this sense, it does not discriminate between different products nor does it depend on the level of turnover. This is an interesting concept for the EU level since it has revenue potential and addresses some currently unsolved issues with the taxation of financial services.

The FAT taxes the total gains from the business activity of financial institutions. In this sense it is levied on all activities, not only trading. It does not change the prices of financial instruments, thereby leaving the market structure as such unaffected. This means also that it does not directly affect the existence of high-speed trading.

A FAT could add to the existing incentives for profit shifting via relocating income or remunerations out of the EU. Nevertheless, given the nature of the tax base and the need for financial companies generally to operate for their basic activities where consumers reside, incentives for relocation could be mitigated. This has to be balanced by the fact that technical developments may increase the mobility of the financial sector. Finally, the introduction of a FAT by some Member States in isolation could potentially create distortions in the Internal Market which could be incompatible with the need to secure a level playing field between the Member States.

#### **4.3. Assessment**

The addition-method FAT can be interpreted as a tax on a proxy for total value added generated by a financial sector company.<sup>13</sup> However, if designed as a complement to the current VAT, a number of technical issues must be resolved in order to align both taxes. The Commission believes that the FAT option is worth exploring in the EU context. This should include an assessment of its possible competitive implications and whether these are offset by possible disincentives for companies to relocate.

### **5. OVERALL CONCLUSIONS AND WAY FORWARD**

The world is facing major challenges at a time when government budgets are under increasing pressure throughout the EU. These challenges are many and varied. They include the need to

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<sup>13</sup> Since it falls on wages and remuneration, a proxy for value added it could be a potential solution to VAT exemption of the financial sector. However, several caveats have to be addressed to make it compatible with the existing VAT system.

improve the stability and functioning of the financial sector in order to reduce negative externalities for the rest of the economy, the need to consolidate public finance that have suffered from the financial crisis, whilst respecting commitments towards developing countries and to combat climate change and global resource scarcity.

To address the above challenges, there are arguments for revisiting the taxation of financial sector activities. The sector should make a fair and substantial contribution to public budgets and there is a case for saying that this contribution should be higher than it currently is. The reasons are the special position the sector takes in the economy, which became so evident in the financial crisis, and the fact that some of its services are VAT exempt.

In any future action on the taxation of the financial sector the Commission will take into account the need to create the conditions for a fair and balanced taxation of the financial sector by contributing to a more level playing field for the financial sector in the internal market, both vis-à-vis non-financial sectors as well as internally, to contribute to minimise current distortions due to the VAT exemption of financial services and to reduce possible cross border double taxation. It will also promote better regulation principles and contribute to a more streamlined and simplified tax environment for financial services, on the basis of a comprehensive analysis of existing and developing national frameworks and their consequences for the functioning of the Internal Market. In addition, the Commission will take into account the cumulative impact of the overall regulatory reform of this sector.

Innovative financing mechanisms in general and new financial sector taxes in particular could be an important element in responding to the current global and European challenges. As concluded above, the FTT is an instrument that is best suited to raising revenues at the global level. The challenge is to design a global financial transactions tax that would generate sufficient revenue while minimising its adverse economic effects. The Commission will support further exploration and development of the FTT and its variants at G-20 level and will work to promote an agreement with the most relevant international partners. In the light of the analysis undertaken to date, FTT appears less suitable for unilateral introduction at EU-level since the risks of relocation are high and would undermine the ability to generate revenue.

At this stage the Commission considers that there is greater potential for a Financial Activities Tax at EU-level. This option could deal with the current VAT exemption of the financial sector and raise substantial revenues. Given the innovative nature of this tax there is a need for further technical work on how it might be implemented.

In the light of the conclusions above, the Commission will therefore without delay launch a comprehensive impact assessment, which will further examine each of these options, in order to be in a position to make appropriate proposals on policy actions by summer 2011.