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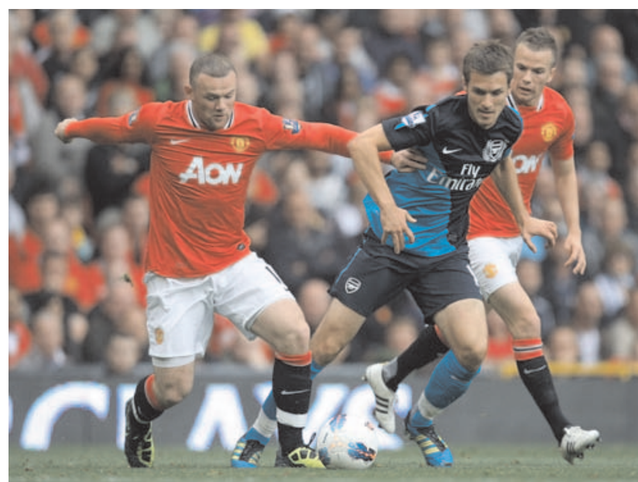
NEWS ANALYSIS

The Argument for Financial Transactions Taxes

by Lee A. Sheppard

Even casual observers of Manchester United home matches may have noticed a plethora of green and yellow scarves in the stands at Old Trafford. These are not stray Celtic supporters. Rather, they are fans protesting the club's American owners, the Glazer family, who loaded the club's balance sheet with nearly $1 billion of debt.

The Glazers will be taking the club public in October in an initial public offering estimated to be worth $1 billion. They plan to list Manchester United Ltd in Singapore, which will allow them to sell nonvoting shares. Hong Kong refused to waive its prohibition on dual classes of shares. Singapore requires that at least 12 percent of voting shares a listed company must be floated (*The Wall Street Journal*, Aug. 20, 2011).



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Manchester United's Wayne Rooney on the ball. Public shareholders won't have a say, but there are worse things going on in the securities markets, which a financial transactions tax might ameliorate.

Investors will be offered packages of voting and nonvoting shares. So the green and yellow scarf crowd may have the satisfaction of partial ownership, but no more say in the club's affairs than they have currently. In the United States, where the Glazers own the Tampa Bay Buccaneers, one designated owner is supposed to be responsible for the management of a team.

That may be cold comfort, but there are worse things going on in the securities markets. Individual investors who might buy Man U shares are at the mercy of more powerful forces than the Glazers. High-frequency traders and bank proprietary trading operations have superior access to information and use sophisticated computer programs to make buying and selling decisions. Markets are unsafe for little investors.

Oddly enough, the financial meltdown may produce ideas for restricting the predations of these aggressive investors. European governments are thinking seriously about a financial transactions tax (FTT). The point is to slow down the market churning that sees high-frequency trading and other unproductive practices dominating the world's financial markets.

Oh, but wouldn't an FTT interfere with free markets? Free market finance is a dangerous myth. This myth, propounded by financiers, their academic acolytes, their captured regulators, their suborned international institutions, and their pet think tanks, got us in the trouble we're in.

Enabling the myth of unfettered freedom to trade financial assets and lend on onerous terms has been a recipe for disaster from the start. The most recent disaster began in 2007 and has not been fully worked through. The recapitalization of the big investment houses (some with banks attached) merely papered over the problem.

In 2010 the IMF proposed two different types of bank levies — a financial activities tax (FAT) and an FTT — in response to a request from G-20 governments to look into taxing financial intermediaries. As the discussion at the recent International Institute of Public Finance (IIPF) annual conference at the University of Michigan Ross School of Business showed, economists prefer the concept of the FAT.

In March the European Parliament passed a resolution endorsing an FTT (*Doc 2011-4880*, *2011 WTD 46-13*). In August French President Nicolas Sarkozy and German Chancellor Angela Merkel proposed an FTT for European financial markets (*Financial Times*, Aug.

17, 2011). Jose Manuel Barroso, president of the European Commission, stated that the commission would present a plan for an FTT in November (*Doc 2011-13553*, *2011 WTD 120-13*). The United Kingdom is implacably opposed to an FTT (*Tax Notes Int'l*, Aug. 29, 2011, p. 639, *Doc 2011-17798*, *2011 WTD 161-2*).

Wolfgang Schäuble, the German minister of finance, has endorsed an FTT (*Financial Times*, Sept. 6, 2011). Arguing that it would help regulate volatile securities markets, he analogized it to Germany's ban on naked short selling. ''Today I would see the introduction of a financial transaction tax in Europe as another case for such a 'pacemaker-approach' by a few, important pioneers,'' he wrote. (He might have meant pacesetter — to an American, a pacemaker is a device implanted to restart the heart of an ailing patient.)

Here's our bottom line: A FAT, while theoretically appealing, cannot be administered, any more than financial intermediaries can be made to pay a fair amount of income tax. We should really be looking for simpler and more straightforward ways to tax financial intermediaries.

> **An FTT would kill high-frequency trading. High-frequency trading is essentially computer-driven front-running and ought to be killed.**

It is argued that an FTT would reduce speculation and short-term trading, raise revenue, and make the financial sector contribute to the cost of government propping it up. An FTT is easily and cheaply administered and has been in place for years in several countries.

We advocate an FTT because its limited purposes of slowing trading and raising revenue are good. Bank leverage, which the FAT purports to address, is better addressed by regulation.

Here's the big point: An FTT would kill high-frequency trading. High-frequency trading is essentially computer-driven front-running and ought to be killed. Why have a tax? Why can't the SEC and other regulators kill it? Because the SEC is dithering, still cannot explain the flash crash, and doesn't have the political will to kill it. Why won't the exchanges stop it? Because they are for-profit companies getting paid for co-location of computers. Stopping this pernicious practice is the best argument for an FTT.

An FTT could reduce the use of derivatives and repo finance by raising the costs of those forms of borrowing and liability creation. This would be no bad thing, since both contribute mightily to the instability of financial intermediaries. The Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 (DFA), did not put any serious limits on derivatives creation, and the creation of these hidden liabilities is headed right back to where it was before the meltdown.

Like a cigarette tax, an FTT would discourage the activity being taxed. So it should be looked at as only partially a revenue raiser, and primarily as a behavioral device. An FTT would not achieve the desired effect if the financial players carried on as before and kept on creating risks and liabilities.

FAT Chance

The IMF proposed a FAT, calculated as cash profit plus compensation, as a quasi-VAT for financial intermediaries, which are exempt from VAT in Europe because no satisfactory method of including them has been devised. Indeed, an EU FAT would have to be made VAT-compatible. (See IMF staff, ''A Fair and Substantial Contribution of the Financial Sector,'' http://www.imf.org/external/np/seminars/eng/2010/paris/pdf/090110.pdf.)

The FAT formula would be similar to that of the Italian regional production tax (IRAP). The FAT could have a deduction for equity, to encourage equity funding. Otherwise, the broadest version would have no deductions. A FAT could also be drafted to tax only excess profits — the profit in excess of a normal return, which would be the result after subtraction of a capital allowance. A more targeted variant would have further adjustments to get at excess profits, on the view that they are only possible with excessive risk assumption.

The idea is to reduce the size of the financial sector without affecting how it operates. The essential elements of the tax base would be culled from banks' financial statements, specifically the income statements. These are numbers banks have no tax incentive to manipulate, but arguments about the adjustments to them could be just as messy as the income tax. British banks would pay about one-fifth of the total revenue from an EU FAT, the IMF estimated.

Ideally, a FAT would cause the banks to reduce their leverage, but it is not a specific tax on leverage on the bank balance sheet, unlike the financial stability contribution proposed by the Obama administration. A FAT is an imprecise instrument to achieve indirectly what bank regulation or higher interest rates could achieve directly.

As this article was being written, Deutsche Bank chair Josef Ackermann said that many smaller European banks would collapse if they were forced to mark their sovereign debt holdings to market. European banks whose solvency is being questioned are being charged higher rates in the overnight markets. The higher price for short-term capital will do more than

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the prospect of a pesky tax to cause them to reduce their leverage and recognize the losses that are lurking in their balance sheets.

The British and French have taxed excessive salaries at the firm level. Both taxes were enacted immediately after the meltdown and somewhat discouraged wildly excessive compensation while they were in effect.

In the wake of the meltdown, many European countries tax leverage, calculated as liabilities less net equity and deposits. The tax on leverage is levied at a very low rate. Austria, Belgium, Cyprus, Denmark, France, Germany, Hungary, Iceland, Portugal, Switzerland, and the United Kingdom have taxes on leverage. The base of some of these taxes includes the notional value of derivatives.

It is no surprise that economists at the IIPF conference expressed a preference for FATs. None of them has ever run a tax administration. They like a tax that is precisely calibrated to the undesirable behavior — a Pigouvian tax — regardless of how difficult it may be to administer. Some even argue that the only reason for an FTT is revenue — as if that were a bad thing.

Economists also tend to overlook the relationship between bank shareholders, who want as much leverage as possible, and bank bondholders, who don't care because there is an implicit government guarantee. The lack of tension between these two groups means that there is no investor constraint on bank leverage. It is also why bankers resist calls for more capital. In addition, large banks have a cost of funds advantage over smaller ones. (For discussion, see *Tax Notes*, Feb. 21, 2011, p. 857, *Doc 2011-3310*, or *2011 TNT 35-1*.)

A virtue of the FAT is that countries could adopt it unilaterally, whereas an FTT would have to be multijurisdictional. British banks would howl and threaten to move, as Barclays recently did, but they are less mobile than they would like policymakers to believe. The supposed talent (overpaid traders) may not want to decamp to Hong Kong or Singapore, and the bank regulation in those places may not replicate the coddling of the home jurisdiction. It is easier to relocate trades than operations.

Tax is a practical discipline. An FTT is administratively easier. And it would hit financial intermediaries who roll over large chunks of their capital in the overnight markets where they live — on their trading. It is not enough to require that these actors be adequately capitalized — assuming for purposes of argument that it is even possible — if they are allowed to continue the same level of dangerous and destructive financial activities as before.

High-Frequency Trading

The argument against an FTT ultimately rests on the efficient market hypothesis, which the meltdown comprehensively debunked. This theory says that financial markets assign the right price to assets, so there can be no such thing as bubbles or international capital imbalances. So capital allocation decisions should be left to markets, which should have as little regulation as possible. At its extreme, this theory says that markets are self-regulating, so much so that there is no need to worry about fraud (yes, Alan Greenspan really did say that).

Markets are a random walk. Markets are not rational. Markets do not take all risks into account. There is no perfect information, and relevant information is not known to all market participants. Big profits are made by having information no one else has, which is why insider traders get rich.

So efficient market hypothesis supporters are forced to argue that various species of financial market parasites are essential to price discovery in the markets. The European Commission fretted that it may be difficult to distinguish speculators from investors, echoing a similar comment from the IMF staff.

Noise traders have been maligned forever, but free market believers jump to the defense of their more technologically sophisticated cousins. Technical analysts, also known as chartists, look for patterns, which just makes them a better-informed variant of noise trader. High-frequency traders have the ability to see prices early, and use proprietary computer algorithms to predict price movements using this data.

High-frequency trading accounts for at least 50 percent of volume on U.S. equity exchanges and 35 percent on European exchanges. The average holding period of a share is a mere 22 seconds. These traders do not deal in fundamental analysis of the business of the issuers. They essentially buy valuable market data from the exchanges to trade ahead of other participants, and arbitrage prices across trading platforms.

The other day, friendly regulator FINRA asked high-frequency traders for trading data, proprietary computer codes, and algorithm parameters. The SEC has been asking for trading data. It is looking at whether traders manipulated markets, encouraged volatility, or committed fraud (Reuters, Sept. 2, 2011). The International Organization of Securities Commissions is also looking at what is euphemistically described as the impact of technological changes on market integrity.

Exchanges are publicly traded, for-profit companies that are looking for volume, apparent liquidity, and market share. They charge high-frequency traders high fees for co-location — parking their computers right next to the exchange's order-matching computers so that the traders have access to valuable market information microseconds before anyone else does. When a European FTT was proposed, the share prices of NYSE Euronext and Nasdaq OMX Group fell. The share of U.S. trading of the former — the old New York Stock Exchange — has fallen to 24 percent.

How do we know an FTT would kill high-frequency trading? Because the margins in high-frequency trading are so small that even a tiny FTT would eat them up.

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The typical spread for a high-frequency trader is less than one hundredth of 1 percent per transaction (i.e., one basis point). (For coverage, see *The Wall Street Journal*, Sept. 3, 2011, p. B1.)

A group of economists has expressed support for an FTT on the ground that it would raise trading costs and reduce volumes, while raising revenue (*Doc 2009-26555*, *2009 TNT 231-35*).

Oh, but we can't ban anything that free markets do! We have been conducting an experiment with unregulated securities markets for at least a decade, if not two. The results have not been pretty. The securities markets are completely unsafe for individual investors — a class of participants that the SEC is supposed to protect. The prices of shares have become unhinged from the fundamentals of the issuers. The securities market has become a high-tech arms race among sophisticated participants.

Even the unregulated United States has an FTT in the form of the SEC section 31(b) fee on all share transactions, which finances the agency (15 U.S.C. section 78ee(b)). The level of the fee is set administratively, as a function of projected trading volume. The Investor and Capital Markets Fee Relief Act of 2001, P.L. 107-123, capped the rate at 0.05 percent. (See http://www.sec.gov/rules/other/2011/34-64373.pdf.)

An FTT, like the SEC fee or a brokerage commission, is a transaction cost. Lowering transaction costs reduces spreads, because traders have to make spreads that exceed their costs. Various European countries have had FTTs for years, and the trend has been toward lowering them as financiers exerted their influence on politicians.

Liquidity

Oh, but high-frequency traders bring liquidity and price discovery to markets! No, they don't bring either, as the flash crash demonstrated. What they bring is volume and the illusion of liquidity.

High-frequency traders can insert bids and disappear — ''toxic quotes'' in the vernacular. When high-frequency traders suddenly withdraw, liquidity goes with them, the result being more volatility as the market thins. Indeed, some observers view withdrawal as a strategic trading method.

High-frequency traders are not market makers, but they sometimes register with exchanges as such to get privileged access to market data. They are not regulated. They have no reporting requirements. They are not required to put customer orders ahead of their own, maintain competitive quotes, or keep inventories. They essentially have the privileges of market makers without the responsibilities.

Moreover, the old-school market makers were not all they were cracked up to be. Before the FBI was completely rerouted to chasing terrorists, it used to investigate market makers, who had a bad habit of front-running their clients. The old market makers also had an annoying habit of disappearing in down markets when they were supposed to be buying to support prices — this responsibility being the quid pro quo for the privilege of seeing prices before anyone else.

Does trading produce liquidity? Up to a point. In a July speech to the International Economic Association, Andrew Haldane of the Bank of England discussed the flash crash. He argued that the data showed that high-frequency trading increased liquidity problems in stressful periods in markets. He argued that market makers should be required to provide liquidity and that exchanges should reinstitute circuit-breakers (http://www.bankofengland.co.uk/publications/speeches/2011/speech509.pdf).

''HFT liquidity, evident in sharply lower peacetime bid-asked spreads, may be illusory. In wartime, it disappears. This disappearing act, and the resulting liquidity void, is widely believed to have amplified the price discontinuities during the flash crash,'' Haldane said, likening the flash crash to the program-driven 1987 crash.

Would an FTT reduce liquidity? Economists think that anything that reduces trading volume also reduces liquidity, but high-frequency trading shows that the converse is not true.

Volatility

Do we really care about volatility? Only if we think that shares and other financial assets have some intrinsic value that diverges from what buyers say they are willing to pay. Lower bid-asked spreads are regarded as a good thing. Asset price bubbles are caused by leverage, not volatility. An FTT does not address leverage.

Should we blame high-frequency traders for volatility? Plenty of investors place blame here, including large pension funds. When high-frequency traders withdraw and liquidity vanishes, then bid-asked spreads widen — the definition of volatility.

The Commodity Futures Trading Commission studied the flash crash and concluded that high-frequency traders exacerbated volatility. They move in the direction of price changes, rather than opposite them, as market makers are supposed to do. Volatile markets get worse when these traders run to the exits. (See Kirilenko et al., ''The Flash Crash: The Impact of High-Frequency Trading on an Electronic Market,'' CFTC working paper, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1686004.)

How then could an FTT that clips the wings of these actors increase volatility? The theory is that sellers may have difficulty locating bids, so that market thinning would increase price swings.

In past debates, economists frequently assumed that an FTT would reduce volatility. More trading means more volatility. Anything that reduces trading should also reduce volatility. If a government action increases

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or decreases the cost of trading, it primarily affects volume, not necessarily volatility of prices. Volume shot up after May 1975, when commissions were deregulated.

In an IMF working paper, IMF economist Thornton Matheson noted that research has found volatility effects all over the map. There is a study for any result that is desired. An FTT may produce more short-term volatility as markets adjust to its presence. It may also reduce the prices of frequently traded financial assets (Matheson, ''Taxing Financial Transactions: Issues and Evidence,'' IMF working paper 11/54 (2011), http://www.imf.org/external/pubs/ft/wp/2011/wp1154.pdf).

Economist Joseph Stiglitz of Columbia University advocated an FTT in 1989, when derivatives were in their infancy. He argued that it would discourage private overinvestment in information with no social value — that is, the private return from gathering information to respond to market changes is higher than the social return. He wanted to reduce rent-seeking and price volatility, assuming the latter would be decreased (Stiglitz, ''Using Tax Policy to Curb Speculative Short-Term Trading,'' 3 *Journal of Financial Services Research*, (1989), pp. 101-115).

Likewise, information asymmetry drives derivatives profits. Derivatives dealers fought tooth and nail against derivatives regulation and exchange trading because profits in derivatives depend absolutely on the dealer having information that is not available to the customer or the public. Profits on interest rate swaps, which are standardized and often cleared or exchange traded, have fallen. Dealers are clinging to their hefty profits on over-the-counter derivatives, which would remain uncleared even under the DFA.

That argues for two adjustments to an FTT, broached by Matheson. These adjustments would be taxing derivatives at a higher rate, and taxing OTC transactions at a higher rate than transactions that are cleared or exchange traded. The point of taxing OTC transactions at a higher rate would be to encourage participants to move them onto clearinghouses or exchanges.

The point of taxing derivatives at a higher rate, Matheson noted, would be to raise transaction costs in proportion to the hidden leverage derivatives engender. In addition to discouraging some derivatives, an FTT could also put a dent in dealer profits. As it happens, applying a flat rate FTT to the notional value of a derivative would be a way of taxing it at a higher rate. This method would also be administratively easier, since derivatives pose base measurement issues.

Revenue

It is accepted that the rate of an FTT should be low. Nonetheless, the Europeans think considerable revenue is to be had, since they are considering an FTT to reduce direct member contributions to a planned €3 trillion bank resolution fund.

There are disagreements about whether an FTT should be viewed as a revenue raiser or a behavioral device. That is, if it really does lower trading volume, it would not produce huge amounts of revenue. It might also reduce asset prices, which is regarded as undesirable even if they have been inflated by frequent trading or ill-advised monetary policy.

The European Commission concluded that an EU FTT of one-tenth of 1 percent (10 basis points) could produce revenue of €20 billion per annum. Roughly 90 percent of the revenue from an EU FTT imposed on all types of financial assets would come from taxing derivatives on their notional values. Roughly 71 percent of the revenue in a European base would be in the United Kingdom, even assuming a reduction in trading volumes (http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_25_en.pdf).

The IMF suggested that the burden of an FTT might fall on users of financial services rather than on financial intermediaries. That would make sense if the financial intermediaries with big proprietary trading books were interacting with clients. It is said of the firms that run themselves as giant hedge funds that they have no clients, only counterparties. It is not as though the pricing of an OTC derivative would be more reasonable if no FTT were levied on it.

Indeed, Matheson noted that the incidence of a FTT could be progressive if it lowered the profits of banks engaged in short-term proprietary trading, causing them to employ fewer traders or pay less compensation to the ones they have. Who knows, the financial sector might even shrink and all that brainpower might migrate to socially productive activities.

Matheson raised the question whether to tax interdealer transactions. The British stamp tax has an exception for dealer trading that is so broad that it excuses bank proprietary trading. Since, as the DFA recognized, prop trading by government-backstopped banks is a big part of the problem, there should be no dealer exemption. It is difficult to differentiate dealer activity from prop trading, as the Volcker rule demonstrated (12 U.S.C. section 13).

No dealer exemption would mean that an FTT would cascade when a financial asset is frequently transferred. The European Commission fretted about the need for a hedging exception or reduction for end-users.

What to Tax

An FTT is usually envisioned as a tax on secondary market trading of financial assets, but it could also be imposed on issuance as well. There would be howls that it would affect capital raising if it were imposed on equity issuance. The British stamp duty is imposed on issuance of shares, as well as secondary market transactions. A problem with this tax is that it does not apply to substitutes for shares, like derivatives.

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IMF researcher John Brondolo wrote a brilliant working paper on FTT feasibility. He concluded that the FTT base should be as broad as possible and the collection points as few as possible — preferably exchanges or clearinghouses (Brondolo, ''Taxing Financial Transactions: An Assessment of Administrative Feasibility,'' IMF working paper 11/185 (2011), http://www.imf.org/external/pubs/ft/wp/2011/wp11185.pdf).

The German and French governments recently demanded that an EU FTT cover equities, bonds, currency transactions, and derivatives, both on exchanges and OTC. The finance ministers of both countries recommended that the rate be as low as possible (*Financial Times*, Sept. 10, 2011, p. 7).

The base of an FTT is the transactional amount and not income, so it is more readily measured. The base could be consideration, strike price, or option premium (there aren't very many physically settled futures contracts to worry about). Brondolo suggested an accrual rule for deferred contracts.

The FTT would need a price on which to base accrual, which could be the spot price of the underlying asset. An accrual rule for taxation of long-dated swaps, forwards, options, and other contracts would encourage parties to shorten the terms of these contracts. That would be good because they often have embedded loans and are used to avoid lending restrictions or disguise debt exposure on the balance sheet.

Should an FTT statute list the products taxed? The DFA has a comprehensive swap definition (7 U.S.C. section 1a(47)(A)). But the law could just say any financial contract, not limited to the contracts enumerated in the DFA definition. (For discussion, see *Tax Notes*, Aug. 16, 2010, p. 693, *Doc 2010-17962*, or *2010 TNT 157-4*.)

The IMF defines financial transaction as ''the purchase or sale of a financial instrument, an agreement that establishes the right or obligation to purchase or sell a financial instrument, or an exchange of payments based on a financial instrument, rate, index or event.'' The EU, IMF, and U.N. use this definition for national accounts.

Moreover, the banking and securities laws could be changed to say no swap or other financial contract is legally enforceable without tax having been paid. This is how the British government collects stamp duty.

British stamp tax is imposed on futures contracts because they call for delivery of shares. But it is avoided by contracts for difference (CFDs), which are primitive cash-settled derivatives that do not involve delivery of shares. CFDs are essentially bets on share price movements, and they account for a large chunk of London trading. The lesson of CFDs is that an FTT would have to be imposed on derivatives.

Derivatives use a notional value for pricing, but they usually do not have an intrinsic value as contracts when they are made. They are bets. There is a view that taxing them on notional value would overtax them. Can derivatives be taxed on the basis of gross periodic payments instead? The parties typically net exposures, but tax administrators should not. Again, the aim is to cut down on this activity, not to facilitate it.

What about repos? Repos are a huge part of the shadow banking system. They are the principal way that financial intermediaries fund themselves in the short term. The aim of the administration's proposed financial stability contribution was to reduce the amount of overnight borrowing these players were using. The FTT should also reach repos, which despite being loans, are formally documented as purchase and resale contracts (hence the name).

The Tobin tax was originally aimed at foreign exchange transactions. Should an FTT tax foreign exchange transactions? If it didn't, would people simply evade tax by denominating their instruments in foreign currencies? Taxing them would not be difficult.

Brondolo noted that the foreign exchange market is mostly a dealer market, exempt from regulation under a Treasury decision about the DFA. The CLS Bank (chartered by the Fed and based in New York) settles more than half of these transactions, so it could be required to collect FTT. Central banks could also be required to collect tax on big transactions (it'd serve the Fed right).

Collection Mechanisms

The transactional base of an FTT and the financial sector's record-keeping capacity make the tax relatively easy to administer, according to Brondolo. (Certainly the meltdown called financial record-keeping capacity into question.) The trade reporting system of clearinghouse and settlement is an audit trail. Clearinghouses and settlement banks are regulated, and there are not very many of them.

The British electronic securities settlement system (CREST) collects and remits the stamp tax upon settlement. The stamp tax has very low administrative costs (0.1 percent of revenue collected). HM Revenue & Customs has a department devoted to monitoring CREST, but it works by visits and inquiries.

British stamp tax collection has teeth because a transfer of a security is not legally enforceable until tax has been paid, regardless of whether the transfer occurred on an exchange. It is a stamp tax, after all.

The SEC collects its little exchange fee from the exchanges periodically, not in real time the way the British stamp tax is collected. An exchange is easier for a tax administrator to audit than a lot of investors and dealers. The IRS would want to continuously audit U.S. exchanges, the way it does very large corporations.

If an exchange or a clearinghouse is involved, a financial transaction can be taxed when it is executed.

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That is easy for sales transactions, but options and derivatives would have to be taxed on an accrual basis since payment is delayed.

What if the transaction does not involve an exchange? The problem with taxing OTC transactions is that the brokers would be required to collect and remit the tax. But a variety of record-keeping rules, some new, would facilitate enforcement.

An FTT could be collected from the dealer/sell side of the transaction, with secondary liability on the customer/buy side. The economic burden of the tax is likely to fall on the customer.

The United States has reporting requirements for OTC transactions, which have to be reported to the industry's lapdog regulator, FINRA (which was formerly chaired by the IRS commissioner and the SEC chair). In the United States and most other countries, bonds must be issued in registered form (code section 163(f)). This facilitates collection of tax on transfers.

The Internal Revenue Code has basis reporting for broker-dealers, who are required to keep track of beneficial owners when securities are held in street name (section 6045B). The same mechanism could be used for OTC transactions because they usually involve a dealer on one side. The IRS would have to put big broker-dealers under continuous audit for FTT compliance.

The DFA contains registration and reporting requirements for derivatives dealers and major swap participants (7 U.S.C. section 4s and 15 U.S.C. section 78o). It also has data collection requirements for swaps (even in the absence of clearing or exchange trading). These requirements would enable the tax administrator to at least find the players. The DFA data collection scheme would be very useful and make taxing OTC transactions much less difficult than it otherwise would have been.

Brondolo noted that it would be difficult for Europe to require brokers to collect a tax, since article 49 of the EC Treaty gives them the right to do business in EU member countries without establishing an office or local agent in them. The lack of a local representative might make tax enforcement difficult for member governments. Belgium, which requires brokers to collect its FTT, does not collect tax from nonresident brokers.

The Border Question

Oh, but won't the traders just move offshore if any country imposed an FTT? What would be the source/site of the transaction? Presumably it would be the country whose exchange executes the trade, when the asset is exchange traded. What if the transaction is OTC? Do we allow parties to say they executed their trades in the Caymans?

Offshore, as we have seen, is a mysterious netherworld where there is no tax or financial regulation, but transactions are respected and property is protected by the source country where the actors make their profits. (For discussion, see *Tax Notes*, June 13, 2011, p. 842, *Doc 2011-12283*, or *2011 WTD 113-3*.)

The European Commission therefore proposed a global FTT. The border problem is easily avoided within Europe: The whole EU, plus the satellites that feed off special arrangements with the EU, like Switzerland, would have to participate.

If Europe had a FTT, trading would move to the United States. If the United States also had an FTT, trading would move to Hong Kong or Singapore, both of which have FTTs. Hong Kong's tax applies to proprietary trading. But the reality of where financial intermediaries gather and transactions occur is that a FTT would work fine if only the United Kingdom and the United States imposed it.

This raises the question: Why shouldn't the United Kingdom keep the entire proceeds of a European FTT? European Commission research estimated that roughly 71 percent of an EU FTT would be paid on British transactions. In essence, an EU FTT would be a British subsidy to the other 26 members. Matheson suggested reallocation of revenue.

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Opponents of the FTT love to point to Sweden's disastrous experiment, which saw 50 percent of trades in Swedish shares being executed in London, since the tax only applied to transactions executed by Swedish brokers. Other traders used foreign brokers to buy Swedish shares on behalf of offshore entities.

Sweden's tax rate was one half of 1 percent, which is regarded as very high for an FTT, and twice that rate on options, with the exercise being taxed again as a sale. So participants had a hefty incentive to avoid the tax, which was raised in the second and fifth years it was in effect.

The impetus for the Swedish tax was the view that the financial sector was parasitic and contributing to income inequality. The tax is thought to have caused share price declines by more than the amount of the round-trip tax.

The British stamp tax was formerly collected on foreign transactions when the shares were entered into a

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foreign clearing service or registered as depositary receipts, like a license. The upfront tax on foreign transactions substituted for uncollectible tax on foreign secondary-market transactions.

This so-called season ticket, imposed at three times the regular rate, seemed like a good idea from an administrative standpoint. But not to the European Court of Justice.

In *HSBC Holdings* (C-569/07), *Doc 2009-21722*, *2009 WTD 189-13*, the Court held that it violated the EU directive 69/335/EC prohibiting indirect taxes on raising capital. The Court viewed a tax on entry of newly created shares issued to a foreign clearing service as tantamount to an indirect tax on issuance.

The ECJ quibbles with a lot of tools that are good for tax adminstration but arguably bad for capital mobility, like withholding at the border. So a European FTT would have to take the form of an EU directive, to limit the number of inevitable court challenges.

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Greece Imposes New Property Tax to Meet Bailout Target

by Randall Jackson

The Greek government on September 11 announced a new property tax designed to generate €2 billion (about 1 percent of GDP) to cover a 2011 shortfall that is jeopardizing Greece's bailout agreement with the European Union, IMF, and European Central Bank. (For prior coverage of the Greek bailout and austerity measures, see *Tax Notes Int'l*, Aug. 1, 2011, p. 325, *Doc 2011-15921*, or *2011 WTD 141-2*.)

Predicting that the coming months will be ''hellish,'' Finance Minister Evangelos Venizelos announced the new property tax at a press conference in Thessaloniki after a heated extraordinary Cabinet meeting called to address the growing fear that Greece will default in the coming weeks.

The tax, which will be collected through monthly electricity bills and will be in place through 2013, is set at an average of €4 per square meter and will affect about €400 billion worth of real estate. The actual range, depending on the neighborhood where it is assessed, is €0.50 to €10.

''We need about €2 billion and a bit for us to cover our [2011] goals. We have to find something that is fair, something that will be accepted by the community . . . something that can be implemented quickly, that will produce results immediately. The only measure that has all those characteristics, that can be universally applied, but which is just with social characteristics, is a special property tax,'' Venizelos told reporters.

''We know that these measures are unbearable. But once more, we all have to rally together in a national effort,'' he added.

Some Greeks aren't accepting austerity quietly. On September 10 about 21,000 Greek workers, students, and others took part in angry protests in Thessaloniki. In Athens, youths reportedly firebombed a police bus in retaliation for the arrests of demonstrators in Thessaloniki. The measures have taken a toll on the ruling Panhellenic Socialist Movement. The party has slipped well below the opposition conservative New Democracy Party in recent polls.

''These new measures are a total disgrace. Rather than go after the bloated public sector, the government has saddled homeowners with more property taxes, for the umpteenth time,'' Stefanos Manos, a former New Democracy Finance Minister, said in a September 11 report on latimes.com.

The government may also have trouble collecting the new tax. After Venizelos announced the new scheme, including the plan to tack the tax onto taxpayers' electricity bills, workers at the electric power utility PPC vowed to block the tax.

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