CHASM | Centre on Household Assets and Savings Management

Briefing Paper

Bank Taxation: FTT or VAT?

An IMF report [1] in 2010 argued that there may be reasons to consider tax measures on banks in addition to a special bank levy. This is because the large fiscal, economic, and social costs of financial crises suggest a contribution by the financial sector to general revenues beyond covering the fiscal costs of direct support. To that aim, the European Commission has proposed a Financial Transaction Tax (FTT) in EU member states, while holding Value Added Tax (VAT) in abeyance. However, whilst both the FTT and VAT could make a valuable contribution at a time of fiscal consolidation in the member states, I would recommend VAT rather than the FTT.

The European Commission has, however, already proposed a FTT[2] rate of 0.1% on stock and bond trades and 0.01% on derivatives on any transaction involving one financial institution with its headquarters in the tax area, or trading on behalf of a client based in the tax area. The UK opposes the proposal and yet already has a Stamp Duty of 0.5% on the value of shares and property sold. The UK Stamp Duty is different from the FTT because it is applicable on buying and selling of UK-registered shares only once, however, the FTT is applied on the gross value at each stage of the settlement chain of a financial transaction. While the proposed FTT rate may not seem high, its cumulative effect of charging each agent in a multi-step execution process could be substantial. Furthermore, the FTT may seem like a tax on banks, but it is highly likely that its costs would be passed on to the end investors.

The EU FTT would be applicable to other non-participating member countries and to the third countries if they are counterparty to a financial instrument trading in a FTT zone jurisdiction. For example, if a UK share is purchased in an FTT member country, it would be subject to both the UK Stamp Duty and the EU FTT, and hence to double taxation.

[1] http://www.imf.org/external/np/seminars/eng/2010/paris/pdf/090110.pdf
[2] FTT in France was introduced on 1 August 2012 and in Italy on 1 March 2013.

The empirical literature on FTT involving a fixed levy on the value of a currency or a financial asset (e.g., shares) traded, finds that it can be distortionary; as a result of reducing market trading volume and liquidity, and increasing market volatility and the cost of capital for firms. Moreover, the 'Mirrlees Review' of the UK tax system (http://www.birmingham.ac.uk/Documents/college-social-sciences/social-policy/CHASM/briefing-papers/taxing-banks-fairly.pdf) and the 'Henry review' of the Australian tax system both warn against the distortionary effects of transactions taxes.

Financial services are currently 'exempt' from VAT charges to consumers in the EU, including the UK. Hence, unlike non-exempt businesses, banks cannot reclaim VAT paid on their input purchases. This non-recoverable VAT is one of the most significant taxes paid by banks and puts them at disadvantage; which might lead them to take excessive risk in search of profits and even engage in illegal activities, such as the mis-selling of Payment Protection Insurance (PPI) and manipulation of LIBOR. The elimination of exemption of VAT on financial services is desirable. It would increase the revenue for the government; but consumers would have to pay additional tax on the use of financial services. This might increase efficiency because it would discourage wasteful use of financial services (http://www.birmingham.ac.uk/Documents/college-social-sciences/social-policy/CHASM/briefing-papers/2012/briefing-paper-free-banking-may12.pdf). Given the operational difficulties linked to the removal of exemption of VAT for margin-based services, the "Truncated Cash-Flow Method with Tax Collection Account" proposed by Poddar and English (1997)[3] is recommended. To avoid distortions, VAT should be applied to all financial services, including complex ones such as derivatives. VAT might reduce bank lending because of higher costs for customers, but arguably there was over borrowing prior to the financial crisis. Because VAT is less distortionary than FTT, it is to be preferred.

[3] Poddar, S. and English, M. (1997). Taxation of financial services under a value-added tax: Applying the cash-flow approach. *National Tax Journal* 50(1): 89-111.

Sajid Mukhtar Chaudhry

FinCris Research Fellow, Department of Accounting and Finance

University of Birmingham

April 2013