

**Adoption of a Financial Transaction Tax in Europe Through  
Flexible Integration**

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Submitted in Accordance with the Requirements for the Degree of  
Doctor of Philosophy

The University of Leeds  
School of Law

February 2019

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## **Acknowledgements**

I would like to thank the staff at the University of Leeds for helping to create a research culture within which it is possible to complete a PhD. I am indebted to the William Harrison Research Scholarship afforded to me by the University. Particular mention should be made of Professor Michael Cardwell's willingness to help with aspects of chapter 4. Beyond the University of Leeds, I also owe great debts to Dr Jo Hunt of Cardiff University and Professor Nicole Busby and Therese O'Donnell of the University of Strathclyde.

I would like to thank my two supervisors, Professor Andy Campbell and Dr Jen Hendry. This thesis has presented many challenges for each of us, and I am extremely grateful to them for their guidance in various forms. I would also like to thank, Professor Rita de la Feria and Dr John Snape for their constructive comments, which have helped this become a more rounded and comprehensive assessment of the research question.

On a personal note, I owe much to the continuing support of my friends and research colleagues. There are far too many people to name, but special mention must go to Diana, Hedydd and Ian for their patience and reassurance they have provided throughout.

Finally, it would be remiss of me not to thank my family. I have been incredibly lucky to have their constant support throughout the course of my studies. Put simply, I would not have completed this work without them.

## **Abstract**

The scale of the financial crisis of 2008 shocked the world and had a negative impact on millions of people, leading to calls for increased regulation to protect consumers and to prevent a repeat of these difficulties. This PhD thesis addresses one of the forms of regulation debated post-crisis, namely the European Commission's 2011 Proposal to introduce a Financial Transaction Tax.

The thesis explains the economic rationale for the tax and the obstacles the proposal has faced, both political and legal. Particular emphasis is placed on Article 113 TFEU, which requires unanimity for an indirect tax to be adopted at EU level. The main content of the thesis addresses more flexible forms of legal integration in other areas of EU competence, multi-speed Europe, a la carte and variable geometry. It also contains a discussion of the Treaty mechanism of Enhanced Cooperation.

Whilst the thesis favours the introduction of a Financial Transaction Tax relative to other forms of tax regulation, such as bank levies and VAT charged on financial services, it does recognise that there are alternative measures and criticises the 2011 Proposal for being too ambitious and being framed in terms of fairness and fundraising. Ultimately, it argues that in an era where European Union membership has increased beyond the founding six Member States, more flexible forms of integration need to be used for matters which can be considered to be public goods. The argument is made that in order to introduce a common Financial Transaction Tax, the European Commission should have adopted a more graduated approach than the one followed, which allowed for a minimum standard commonly agreed to provide a public good, and to provide incentives for Member States to opt in to additional protocols.

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## Introduction

In the tale of Robin Hood, the portrayal of the title character is of a noble anti-establishment champion, redressing perceived social harm attributable to the Sheriff of Nottingham's actions by stealing or reclaiming funds from the rich and redistributing them to the poor. The story has been adapted several times into various forms of media and literature where the titular character is presented as a virtuous hero to cure society's ills. Robin Hood is a man of the people, acting for a righteous cause, with his actions, whilst ultimately criminal, representing a fairness for everyday citizens against the perceived prejudice of economic inequality. It is a universal tale, which is retold, rebooted and reimagined. It forms part of the public consciousness. The themes raised by the story have to engage with a modern day audience to justify the re-telling of the tale.

The narrative is such that these themes can be applied beyond works of fiction, and can be adapted and applied to current affairs case studies, in order to exacerbate or heighten the perceived inequality. To this end, the same underlying concepts are used by the Robin Hood Tax group, following the effects of the 2008 financial crisis, to argue that financial institutions, as a result of the wider economic impact attributable to the crisis, should be obliged to recompense those in society hit hardest by the scale of the crisis, triggered by the effect that speculative trading in relation to the US subprime mortgage market had upon financial markets, by advocating a flat tax rate of 0.05 per cent to be charged across financial investments upon completion of speculative trades. The causes of the crisis were not a work of fiction. The rapid realisation that investments in seemingly low risk products, predominantly on the American subprime mortgage market, were in fact highly toxic meant that millions of people were mistreated and suffered the emotional distress of losing their homes through repossessions or financial distress by losing their jobs.

The financial sector, viewed as being too big to be allowed to fail, received widespread support from governments across the world, often referred to as 'bail-outs'. Dragomir highlights the scope of methods of government support provided:

“Government interventions for rescuing individual institutions have occurred on a massive scale, although the forms and details of the measures vary widely, ranging from complete bail-outs to various forms of recapitalisation, different guarantees, orchestration of takeovers or mergers, specific funding lines etc.”<sup>1</sup>

Although the crisis was truly global in nature, its impact was particularly felt in Europe, with many national governments, particularly in the Euro area, seeking financial assistance at high profile European Council meetings. At its peak, the crisis cost the States of the European Union €4.6 trillion<sup>2</sup>, the equivalent of €8000 per EU citizen, not per taxpayer.<sup>3</sup> The average is much higher, however in Member States with a larger financial sector, such as the UK. According to the National Audit Office the cost of providing support to the sector at its peak was £1,162 billion<sup>4</sup>, costing £18,400 per citizen<sup>5</sup>, three times higher than the EU-27 average.<sup>6</sup>

By extension, these government interventions were funded by central taxpayer contributions. There was a transfer of private debt to the public domain, placing strain on

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<sup>1</sup> L Dragomir, *European Prudential Banking Regulation and Supervision. The Legal Dimension* (Routledge 2010) 10

<sup>2</sup> J Barroso, 'European Renewal – State of the Union Address' (*Europa*, 28 September 2011) <[http://europa.eu/rapid/press-release\\_SPEECH-11-607\\_en.htm](http://europa.eu/rapid/press-release_SPEECH-11-607_en.htm)> Accessed 5 April 2018

<sup>3</sup> Calculation based on a reported EU population of 500 Million citizens

<sup>4</sup> National Audit Office, 'Taxpayer Support for UK Banks: FAQs' (*National Audit Office*) <<https://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/>> Accessed 5 April 2018

<sup>5</sup> Calculation based on a reported UK population of 63 Million citizens

<sup>6</sup> Croatia acceded to the European Union in 2013

public finances and an era of austerity, particularly within Europe. In effect, private citizens, who paid taxes for public services and whose conduct did not cause the financial crisis, were burdened with paying for the mistakes of the financial sector at the expense of government expenditure on public services. Austerity as a result of the financial crisis has had a negative impact on everyone in one form or another, ranging from unemployment for individuals, freezing wages relative to the cost of inflation and the cost of living to cuts in public services. However, not every State adopted this approach. For example, Australia introduced a series of stimulus packages which committed the government to spending on infrastructure projects to support the economy in line with the principles of Keynesian economics. The impact of this is discussed in chapter 1.

Furthermore, there is also a strong sentiment that the financial services sector received more favourable treatment than other sectors. Comparisons were made between the UK government's actions regarding the financial sector during the last Labour government's tenure and the actions of the subsequent Conservative government in relation to the steel industry. Many advocated that the steel industry should be similarly nationalised or receive similar levels of capital investment, which was projected to cost £1.5 Billion<sup>7</sup>, equivalent to approximately £23.50 per UK resident.<sup>8</sup> Beyond day to day business operations, there were also concerns regarding the pension arrangements of steel workers. By electing to intervene to provide public investment to the financial sector, but failing to adopt the same strategy in relation to steel, there is a perception that the stereotypically rich banker, working in a few square miles of central London and who has lost someone else's money, is being treated more favourably relative to a stereotypically working class steelworker in

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<sup>7</sup> See A Simpson, 'If The Banks Were Too Big to Fail, Why Isn't the British Steel Industry?' (*The Conversation UK*, 31 March 2016) <<https://theconversation.com/if-the-banks-were-too-big-to-fail-why-isnt-the-british-steel-industry-57071>> Accessed 5 April 2018

<sup>8</sup> Based current exchange rates at time of submission and on a 2016 UK population of 64 million

Port Talbot, South Wales. Yet this perception does need to be qualified. It was estimated that 40,000 jobs were attributable to the steel industry, including Port Talbot.<sup>9</sup> The financial services industry across the UK in 2015 was responsible for 2.2 Million jobs. Although London is the UK's largest financial sector (responsible for 751,000 jobs<sup>10</sup>), there are other financial centres across the UK, including Wales, where 56,000 people are employed.<sup>11</sup> The City of London may have benefitted to a greater extent from financial assistance, but the potential impact of a failure to act means that support provided by the UK government in 2008 was not confined to the capital, extending further afield. However, the nationalisation of the UK steel industry would have been required to comply with EU state aid provisions.<sup>12</sup> The post-financial crisis bail outs met the standard required for the non-application of state aid rules.<sup>13</sup> This does indicate that although there are variances between sectors regarding levels of employment, these case studies demonstrate that, in terms of an economic need to provide support through public expenditure, the financial sector is perceived as being more necessary to protect than manufacturing.

It is clear that citizens had fundamentally been let down by the financial misconduct of not simply a handful of individuals, but a whole sector, whose culture was characterised by short-termism and responding to risky incentives. At the very least, the scale of the crisis

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<sup>9</sup> Supra n.7

<sup>10</sup> The City UK, 'London' (*TheCityUK*) <<https://www.thecityuk.com/about-us/uk-work-programme/new-u-k-interactive-map-page/london/>> Accessed 9 April 2018. The City UK statistics were cited by the UK government in its Brexit White Paper (HM Government Report: The United Kingdom's Exit From and New Partnership With the European Union (February 2017))

<sup>11</sup> The City UK, 'Wales' (*TheCityUK*) <<https://www.thecityuk.com/about-us/uk-work-programme/new-u-k-interactive-map-page/wales/>> Accessed 9 April 2018

<sup>12</sup> Article 107 TFEU

<sup>13</sup> For more on the link between State Aid rules and the financial crisis, see P Weismann, 'Banking Crisis and Banks in Crisis: From State Aid to Bank Resolution' (2016) 37(9) *European Competition Law Review* 384

can be attributed to a lack of oversight and regulation across the world. Public reaction following the crisis since then has been hostile, with widespread ‘bank bashing’<sup>14</sup> of the actions of bankers. Continued preservation of the financial sector to the detriment of public finances and provision of public services has become a difficult political issue (see chapter 1). There is a balancing act between, on the one hand, rebuilding the financial sector, and on the other hand, appeasing the disillusioned electorate, to demonstrate that action will be taken to prevent recurrence of the crisis and that taxpayer outlay would provide an adequate return. For example, the UK Government in 2008/9 purchased 83 per cent of Royal Bank of Scotland (RBS) shares at 500p per share, costing the taxpayer £46 Billion alone.<sup>15</sup> In August 2015 the government and began selling off its stake in the company. These shares were sold at 330p per share, representing a loss to the taxpayer of over £1 Billion.<sup>16</sup> On a wider scale, many European Union States have suffered from sovereign debt crises post-2008, with Portugal, Ireland, Italy, Greece and Spain all requiring financial assistance in order to meet debt obligations.

Although not the first crisis to hit financial markets, the scale and speed of the 2008 crisis was unprecedented. Between the 1960s and the 1980s, a process of deregulation accelerated the drive towards transforming economies from manufacturing based industries to competitive service based economies relying heavily on financial services. Legislative action has followed smaller scale financial crises, but the law is fulfilling a reactive, rather than proactive response to financial pressures. This is understandable, since whilst it is possible for regulation to support a financial sector, too much regulation

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<sup>14</sup> See for example H Lethaby, ‘Tax and the City – Financial Transaction Tax’ (2011) 1097 *Tax Journal* 11

<sup>15</sup> National Audit Office, ‘Taxpayer Support for UK Banks: FAQs’ (*National Audit Office*) <<https://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/>> Accessed 1 February 2016

<sup>16</sup> See for example G Parker and M Arnold, ‘Osborne Poised to Start Unloading RBS Stake at a Loss to the Taxpayer’ *The Financial Times* (London 11 June 2015) 1

can lead to a regulatory burden, which makes the financial sector less efficient than is ultimately possible. This discussion of potential is included in discussions concerning 'learning organisations' in chapter 4 of this dissertation. Yet the 2008 crisis demonstrates that it would be incredibly naïve to do nothing and mere expansion of existing regulation is not sufficient. It is a form of folly for governments and international organisations to repeat past failures and expect a different result. It is clear that the framework within which the financial sector operated historically needs to change.

Consequently, the fallout from the crisis has led many to consider different means and forms of regulation, taking into account political considerations as to the level of governmental intervention required. These can broadly be split into two categories – those which seek recompense for the taxpayer and those which seek to alter the business practices of financial institutions. However, there can be an overlap between the two and when this occurs, proposals can suffer from a form of 'identity crisis' in which it is not clear what the primary aim is. This thesis addresses one of these debated measures, the European Commission's 2011 Proposal to introduce a common Financial Transaction Tax. Although there are other international organisations which can address standards in financial regulation (for example the Basel Banking Committee, the G20 and the OECD), the European Union provides a unique platform to achieve inter-state consensus and collaboration for the interest of businesses and EU citizens, but there needs to be clarity in secure policy goals in order to be effective. This thesis maintains that the 2011 Proposal should have been treated and presented principally as a form of financial regulation, recognising the macroeconomic principles of John Maynard Keynes and James Tobin, as outlined in chapter 1 of this thesis. One of the arguments that this thesis makes is that there is an identity crisis and instead, the 2011 Proposal can be considered primarily as a taxation measure, designed to raise revenue, as opposed to modifying investment behaviour and strategies in financial markets to reinforce stability and decrease volatility.

Nevertheless, it does acknowledge that these two perceptions can overlap, therefore chapter 2 contains discussion of other forms of financial regulation measures and alternative tax taxation provisions. The final recommendations of this dissertation, that a Common Finance Policy should be introduced, depends on this overlap being recognised and a clear explanation as to why common Financial Transaction Taxes, such as the 2011 Proposal, should be considered principally as financial regulation provisions.

At the time of writing, the Proposal has not been adopted and has been subject to a myriad of political and legislative obstacles. This thesis addresses why this is the case. The foundation of these obstacles lies in the required legislative basis for adoption of new forms of indirect taxation at EU level, namely Article 113 TFEU, which requires unanimity among EU Member States. If one Member State opposes the introduction of the tax, this creates a legal problem. Appendix A contains a map based on data collated by KPMG demonstrating the level of Member State support for the 2011 Proposal. The primary arguments for and against the introduction of this tax are contained in chapter 1. However, it is clear from this map and a later action for annulment, launched by the UK government (see chapter 3), that the UK fundamentally opposes the introduction of the tax. Therefore, much of the anti-transaction tax literature in this thesis reflects the UK position. This may seem counter-intuitive, given the UK is set to leave the EU in 2019 following the 23<sup>rd</sup> June 2016 referendum. However, the KPMG map highlights that other States continued to have reservations regarding the introduction of the 2011 Proposal. The UK objections represent the most extreme opposition to the tax, but the intent of this thesis is to also provide a blueprint for the future, in the event that a common tax is not adopted. Therefore, if revisited, these reservations inform future discussions for the remaining EU-27 States. This debate is outlined in chapter 4 of the thesis.

This thesis is written from the viewpoint that introduction of a form of taxation on speculative transactions to dissuade from risk is beneficial, but does recognise that there

are legitimate concerns regarding the potential effects of such a tax. It is of the opinion that some form of integration is preferable to no integration at all, and as a result, this thesis looks at flexible forms of integration, which would allow groups of Member States to proceed to introduce some form of taxation, particularly in light of the EU's expansion in membership. It adopts a doctrinal theoretical approach involving documentary analysis of legislative proposals and inter-disciplinary academic commentary to make its assessments as opposed to a quantitative analysis of tax policy. Specifically, chapter 3 addresses the treaty-based mechanism of Enhanced Cooperation, which permits a collection of Member States to continue to adopt common policies. Subsequently, these legally binding provisions do not form part of the *aquis communautaire* of the EU, meaning that non-participating states and states which accede to the Union are not required to adopt them as a condition of EU membership. A sub-group of eleven (now ten) Member States have elected to use the Enhanced Cooperation process to work on a common form of Financial Transaction Tax as explained in greater detail in chapter 3. Chapter 3 also discusses classical theories of differentiated integration, namely multi-speed Europe, *à la carte* integration and variable geometry.

Yet the obstacles that the 2011 Proposal has faced go beyond legal difficulties. By its nature, a variety of different disciplines have an interest in the potential impact of a common Financial Transaction Tax. For example, the 2011 Proposal is of interest to tax lawyers, financial and banking regulation academics, company lawyers, economists and political scientists to name only a handful of disciplines. This thesis attempts to include these perspectives where possible, but the inter-disciplinary nature can lead to inconsistencies in presenting the tax, which thereby creates a narrative in which it is difficult to understand the aims and underlying rationale for the 2011 Proposal. This volume of 'noise' causes problems for the tax – is it primarily a financial regulation matter, which focuses on modifying the behaviour of financial institutions to change the over-

speculative culture which led to the 2008 crisis, or is it a fundraising tool penalising speculative investments in order to raise funds for government? These debates are not new, with similar questions raised by the introduction of green taxes in relation to environmental protection measures (environmental law examples are presented in chapter 4 of this thesis as case studies to demonstrate public good theory in action).<sup>17</sup>

As a result, the Proposal suffers from a form of 'identity crisis'. Often the terms 'Robin Hood Tax', 'Tobin Tax' and 'Financial Transaction Tax' are used interchangeably. However, as the table in Appendix A demonstrates, this is a mistake due to differences in rates, scope of application and rationale for introduction. This table summarises an argument in chapters 1 and 2 of this thesis regarding the need for specific, consistent terminology to be used when discussing transaction taxes. These differences are highlighted by presenting the rates, scope and rationale for different forms of named financial transaction tax at domestic and international level. This thesis includes discussion of the foundational principles of Keynesian economics upon which the 2011 Proposal is built. In doing so, it argues that the underlying intentions, furthered by the work of James Tobin, are primarily based on behaviour modification, not fundraising. Consequently, although social advocacy groups, such as the Robin Hood Tax group discussed in this thesis, help to raise awareness of the underlying principles, they can distort the original intention to present a more punitive tax to accrue funds for philanthropic causes. To an extent, the 2011 Proposal also fell into this trap, by including reference to repaying the costs of the crisis and historical exemption of financial services from VAT due to the difficulties in calculating margin based transactions (chapter 2). Further evidence that the discussion concerning the 2011 Proposal has moved away from the James Tobin

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<sup>17</sup> For further discussion specifically regarding the application of green taxes in the EU, see P Mastellone, 'The Emergence of Green Taxes in the European Union: Part 1' (2014) 54(11) *European Taxation* 478 and 'The Emergence of Green Taxes in the European Union: Part 2' (2014) 54(12) *European Taxation* 545

behaviour modification aspect of a 'Tobin Tax' towards a more fundraising based tax, framed in fairness as opposed to a tax policy provides an inherent public good, is presented by an excerpt from a speech by Pierre Moscovici, European Commissioner for Economic and Financial Affairs, Taxation and Customs at a conference in June 2017:

“Secondly, as some of you may already be aware, a group of Member States have engaged in an enhanced cooperation to ensure that the financial sector makes a fair and substantial contribution to public finances, through the Financial Transaction Tax, the famous FTT. These 10 Member States, and it includes the four largest economies of the Eurozone, Germany, France, Italy and Spain, and the Commission believe that *it is fair that the financial sector pays back* part of what the European tax payers have pre-financed in the context of the bank rescue operations. I really feel and believe that we must reach agreement on FTT. *It is not again about sanctioning a sector.* It is just for fairness. It is also about financing development, about financing the fight against climate change, it is about showing reinforced cooperation can work at the Member States' level when unanimity blocks important reforms. We must spend now some energy and finalise that. It is possible. It is near, but we must go through the last steps of the discussion on the FTT.”<sup>18</sup> [Emphasis Added]

From an outside perspective, it is easy for the financial sector to be criticised for its ills, with institutions deemed to be subject to punitive measures, in order to raise funds for national treasuries. It is possible to advocate for the introduction of a transaction tax, but also to recognise the possibilities and opportunities which financial markets can provide for individuals and businesses, whether providing greater returns on investments for pension funds, or greater access to credit and investment to develop businesses. Financial institutions were not the only culprits in creating a system that collapsed in 2008. By way of example, the supervision of institutions was flawed. To an extent, this appears to have

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<sup>18</sup> P Moscovici, ‘Speech by Commissioner Pierre Moscovici at the Commission's Tax Fairness Conference’ (*EU FairTax Conference*, Brussels 28 June 2017) <[http://europa.eu/rapid/press-release\\_SPEECH-17-1828\\_en.htm](http://europa.eu/rapid/press-release_SPEECH-17-1828_en.htm)> Accessed 14 February 2018

been addressed through the adoption of the European Banking Union (chapter 2), with oversight for banks in the euro area falling under the remit of the European Central Bank. In addition, credit rating agencies, although arguing that their ratings are not binding, gave inaccurate assessments of financial products that investors thought were safe, causing panic when it later transpired that the ratings were incorrect.<sup>19</sup>

Furthermore, a well-functioning financial sector, in addition to providing benefits to private citizens and businesses, can also contribute considerably to tax receipts for national treasuries for government expenditure. For example, a 2016 PWC report indicates that the financial sector contributes £32.4 Billion in tax revenues p.a. to the UK Treasury.<sup>20</sup> This tax revenue enables governments to provide public goods, such as socialised healthcare systems and state education. In addition, sustainable credit provision assists both businesses and individuals to gain access to financial services and investment opportunities. An argument in favour of a transaction tax on speculative trading should not therefore be presented in an anti-growth manner. Sustainability should be key to the design of any proposed tax rather than punishment or fundraising.

To an extent, Member States of the EU have already adopted measures designed to reduce systemic risk, for example, chapter 2 contains discussion of bank levies. There are variances in design between national forms of bank levy (for example, the UK bank levy differs in design from the French bank levy), but these are predominantly calculated on an institution's balance sheet, with a larger balance sheet indicating a greater number of assets and exposure to risk. Yet in order for a transaction tax to change investment cultures and be truly effective, due to the interconnected nature of financial markets in a

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<sup>19</sup> For a greater discussion of the role Credit Ratings Agencies played in the 2008 crisis and the difficulties in regulating them, see P Yeoh, 'Self-Regulation, Regulation, Co-Regulation: The Credit Rating Industry Case' (2013) 2 *Journal of Business Law* 186

<sup>20</sup> PWC: 2016 Total Tax Contribution of the UK Banking Sector (November 2016)

form of economic pluralism (chapter 4), there needs to be a common approach across a substantial number of States. In this regard, the institutional structure of the European Union offers an ideal platform for cooperation. The same conclusion can be reached with regard to the adoption of bank levies, financial activities taxes and extension of VAT to financial services. This thesis is not opposed to their introduction, but its primary focus concerns decreasing volatility by disincentivising speculative trading, with the spectre of technological innovation and the prevalence of algorithmic and High Frequency Trading adding urgency to the research.

Therefore, the ambition of this thesis is to reinforce the economic rationale behind the 2011 Proposal, presenting arguments in favour and opposing the tax and demonstrating its genesis, in order to create a narrative regarding sustainability to increase the likelihood of Member State participation in financial regulation. It therefore seeks to assess how different methods of flexible integration could allow or encourage Member States to elect to adopt a common form of tax on speculative trading. It considers how the noise created by social advocacy groups and inconsistent application of these founding principles have moved the obstacles beyond the legal problems of unanimity, to including political economy obstacles about the role of government in financial markets, masking the true nature of the tax. It acknowledges that the 2011 Proposal is not perfect for two key reasons. Firstly, the 2011 Proposal did not present itself as providing a public good in itself in decreasing volatility to protect the wider economy. Instead, it has been presented as a fundraising tax. Secondly, the Proposal, whilst ambitious, was too radical to be palatable to Member States. This antagonistic approach has had an impact on the participation of Member States in the process, limiting its potential efficacy. The thesis concludes with an assessment of the impact of the approaches taken. This does involve the benefit of hindsight, but it is hoped that Member States can learn from the experience in the future to avoid repetition of mistakes.

The assessments presented in this thesis are informed by conducting documentary analysis of policy documents and academic discussion in journal articles and literature, with supplementary information from other sources where appropriate. In making its assessments, this thesis is not only dependent on the view that the tax is beneficial to citizens and financial institutions, but is also dependent on legal integration in the form of hard law being a positive force. It recognises that there is a problem of a lack of regulation in a particular area, which needs to be addressed and that introduction of new provisions via the European Union, in its capacity to provide a forum for multi-State cooperation, is an effective way to address the problem. In other words the European Union should provide a platform to benefit those who have been burdened by the financial sector.

The thesis does not view the 2011 Proposal as the perfect solution, however. The justification is that the 2011 Proposal is a proactive form of taxation designed to curb speculative risk in financial markets from spreading to the wider economy. The increase in financial technology, in particular the increased speed of transactions through algorithmic and high frequency trading, provides the necessary impetus to reassess the application of Keynesian economics principles to a modern day setting. This is distinct from both other forms of financial regulation, such as the Basel Banking Accords as discussed, and other forms of taxation, such as the application of VAT to financial services, both of which are discussed in greater detail in chapter 2.

## **Structure of the Thesis**

At its core, this thesis agrees with the core aims of the 2011 Proposal. It is founded in the belief that the 2008 financial crisis demonstrates that reform of financial markets is essential, principally in order to achieve a long-term, stable financial sector, which can provide positive economic benefits. Principally, technological developments and innovations have led to speculative trading offering an excessive level of risk, meaning

that financial markets in their current form are not sustainable and that ultimately, it is in the wider public interest to dissuade from this risk.

However, this thesis is critical overall of the approach taken with regard to presenting the 2011 Proposal and the impact that this has had regarding the ability to work towards cooperation at EU level. The thesis ultimately argues that the original intent of the founding economic arguments have been lost and that the narrative has instead focused on arbitrary concepts of fairness, as opposed to presenting the 2011 Proposal solely as a means by which to achieve financial stability.

With this in mind, chapter 1 seeks to present a coherent timeline regarding the conclusion on the part of the European Commission to draft and publish the 2011 Proposal. It presents the particular debate concerning the decision to propose a common Financial Transaction Tax as opposed to a Financial Activities Tax, an alternative which is presented in greater detail in chapter 2. Chapter 1 then seeks to clarify the specifics of the 2011 Proposal, presenting its stated aims, its scope of application and the practical considerations regarding when the tax is chargeable and collection. The rationale is to present what the 2011 Proposal includes and, in addition, what is not included. This classification is supported by content in Appendix A, which seeks to present different forms of Financial Transaction Tax, in order to demonstrate the 2011 Proposal's distinct characteristics.

A central argument in this thesis is that the underlying economic principles and arguments in support of a more general form of Financial Transaction Tax (i.e. beyond the 2011 Proposal) have been distorted, and that ultimately this has damaged the prospects of cooperation between Member States at EU level. Sections three and four of chapter 1 therefore outline the macroeconomic arguments of John Maynard Keynes and James Tobin in particular, in order to explain the economic rationale which ultimately can be determined to underpin the 2011 Proposal. Although a great debt is owed to Tobin's work in particular, the aim is to provide further clarification to distinguish the 'Tobin Tax' from

the 2011 Proposal and to ultimately distinguish arguments concerning the philanthropic nature of tax receipt expenditure, to emphasising the behaviour modification aspect of a hypothetical common Financial Transaction Tax. This clarification enhanced the discussion in section five regarding arguments for and against a common Financial Transaction Tax, with further Keynes inspired economic work informing arguments in favour of a tax on speculative trading. This section also contains a discussion concerning the increasing threat that technological innovation in algorithmic trading has on financial markets, indicating that key concepts from 1936 retain a modern day relevance.

Due to the legislative approach adopted by the European Commission, and as a result of the distortion of the rationale of a common Financial Transaction Tax towards one framed in fairness and providing philanthropic benefits, the 2011 Proposal failed to receive unanimous support from EU Member States. Section six indicates the legal obstacles that this poses, which consequently informs the flexible integration content in chapter three. Section seven also recognises the political obstacles concerning the introduction of a common Financial Transaction Tax which may also influence a state's opposition to the tax.

Chapter 2 follows on from an argument presented in chapter 1, section five, which details that opposition to a common form of Financial Transaction Tax can be based not on the core concept, but on the understanding that there are other forms of taxation of financial services, which may provide alternative benefits relative to those stated for the 2011 Proposal. The initial content of this chapter details the complexities in designing financial regulation matters in general and why distinctive solutions are required, which builds into consideration of stamp duty, taxes on bank bonuses, bank levies, the extension of VAT on financial services and the Financial Activities Tax alluded to in chapter 1. The aim in presenting these alternatives is primarily to distinguish and highlight potential advantages of the 2011 Proposal in order to provide greater support for this thesis' belief that not only

is a common Financial Transaction Tax a necessary means by which to seek to enhance financial stability, it is also an appropriate means by which to reform financial markets. This does not, however, preclude legislators from adopting multiple forms of tax to address financial stability (i.e. a common Financial Transaction Tax and a bank levy are not mutually exclusive and can operate in tandem). Therefore, the aim is also to stress the advantages of each of these alternative forms of tax policy relative to a common Financial Transaction Tax.

Although this thesis has strong support for a common Financial Transaction Tax, it does not view any hypothetical tax as a panacea which on its own can provide the necessary level of financial stability post-2008 financial crisis. It also recognises that there has been international collaboration since 2008 which concerns, for example, capital adequacy requirements as a result of the Basel Banking Accords principles, and a redesigned mechanism of supervision, oversight and crisis management in relation to European banks with the creation of European Banking Union. These two case studies also demonstrate that it is possible to achieve international consensus regarding the introduction of provisions designed to reinforce financial stability, but they do not provide the same advantages compared to a common Financial Transaction Tax.

Chapter 3 builds upon the initial presentation of the legal and political obstacles discussed in chapter 1. This thesis argues that the nature of post-2008 reform is such that in the absence of unanimity, flexible forms of integration must be explored in order to introduce as comprehensive a tax policy to provide financial stability as possible. Firstly, it presents a discussion as to whether the same benefits could be provided by a soft law mechanism, presenting the example of transfer pricing guidelines as an example of international cooperation in matters of taxation. This discussion is complemented by considering the assurances provided in relation to corporation tax by hard law, with specific regard to avoiding a 'race to the bottom' in the operation of a common Financial Transaction Tax.

Consequently, the chapter presents a consideration of the legitimacy of measures adopted at EU level through flexible forms of integration, before examining the Treaty based mechanism of Enhanced Cooperation in relation to the 2011 Proposal. The debate is supported by addressing the UK government's action for annulment regarding the Council's decision to authorise Enhanced Cooperation in this area. This debate is followed in sections eight and nine by examining 'traditional' theories of integration, using case studies to demonstrate the operation of multi-speed Europe, *à la carte* and variable geometry integration in order to inform discussion in the conclusion concerning the most appropriate means by which to seek to achieve cooperation in this area.

With chapters 1-3 clarifying the nature of the tax, the arguments in favour of its introduction and the means by which to proceed at EU level without unanimity, the final chapter, chapter 4, is more reflective. It argues that fundamental mistakes were made by the Commission in its presentation of the 2011 Proposal, specifically in relation to allowing the economic rationale to be distorted by concepts of fairness, and by presenting a Proposal which was too ambitious in scope. With regard to the first criticism, the chapter looks to explain and examine the concept of public goods, arguing that this should inform the debate concerning not only a common Financial Transaction Tax, but also financial regulation in general. This discussion is subsequently supported by presenting arguments of economic pluralism, stressing the importance of inter-linking economies for legislative action, and regulatory pluralism, i.e. that a blend of legislative instruments should be used to achieve a particular policy goal, to provide further justification for legislative action at EU level. In relation to the second criticism, the chapter re-casts the parable of the boiling frog (renamed 'temporal slowness') in a positive manner and presents a case study in relation to the Common Consolidated Corporate Tax Base (CCCTB). The CCCTB is an example of an overly ambitious initial Proposal being redrafted and separated into a Proposal for two directives, echoing a regulatory pluralistic approach. As a result, this chapter

concludes by arguing that if a long-term graduated approach to integration is followed, framed not in terms of fairness, but in terms of providing a public good of financial stability, then it may be possible to incorporate elements of the 2011 Proposal into a form of Common Finance Policy, which builds upon the flexible forms of integration and economic arguments proffered in the previous chapters.

The conclusion then seeks to address what lawmakers and policymakers would consider to be a 'successful' result, regarding the introduction of the principles of a common Financial Transaction Tax being adopted at EU level. It presents a series of options, but ultimately recommends that the approach taken by the Commission regarding the 2011 Proposal has posed a question as to whether to start anew or to persist. If a new approach were adopted, this thesis argues and advocates for, moves towards a Common Finance Policy.

## **Chapter 1 – The 2011 Proposal: Justifications and Obstacles**

The immediate response of many governments across the EU to the 2008 financial crisis focused primarily on recapitalising banks, principally those considered ‘too big to fail’. Although there was a level of international financial regulation in place, such as the Basel Accords (discussed in chapter 2), the impact and scale of the financial crisis left little doubt as to the need to refine the legal framework within which banks operated, with reviews of financial instruments, corporate governance, supervisory oversight and resolution mechanisms. The primary question therefore for legislators was to identify areas of susceptibility to instability across the financial sector and to seek to introduce new means by which to address these flaws. As highlighted in the introduction, there was strong pressure from the public for politicians and legislators to react visibly, the crisis having led to wider social awareness of financial malpractice.

However, there is an incredibly difficult balancing act that draftsmen face. On the one hand, the financial sector can contribute greatly to a State’s economy. States have benefitted in more prosperous times in a variety of forms, from both direct and indirect job creation to tax receipts volumes, such as corporation tax. Yet the underlying potential success of the financial sector is dependent on the inherent risk, which is necessary in conducting trades for profit and loss. If the response is deemed to be of a draconian nature, this economic activity may be stifled, with many of the benefits no longer being provided. On the other hand, if the response is deemed too modest, there are two branches of criticism. On a practical level the perceived ‘casino-esque’ culture of finance may remain. On a political level, the clamour for action may not be met. Allied to this second criticism, legislators may consult with economists as to the appropriate policies to adopt, but are required to comply

with legal requirements, in addition to negotiating political obstacles regarding the role of government.

There is a multitude of different areas for reform. For example regulators may elect to introduce measures with the intent of preventing or limiting the scale of potential financial crises ranging from ensuring effective accountability for poor corporate governance practices, to bank levies based on an institution's exposure to risk. This thesis focuses on the nature of reform through the means of taxation, discussing not only the proposed EU Financial Transaction Tax, but also alternatives such as bank levies. Yet it would be naïve to overlook measures which have been introduced post-2008 which are designed to better prepare banks for losses incurred, principally in the form of ensuring a minimum amount of reserve capital under the international standards set by the Basel III agreement, discussed in chapter 2.

The current chapter however outlines the discussions at EU level which have led to the position where a common form of taxation on financial transactions has been proposed. Not only does it explain the timeline of progress made, it also explains the mechanics of the specific EU-27 Proposal itself, distinguishing it from other forms of taxation of financial transactions. Furthermore, the chapter explains the underlying Keynesian macroeconomic rationale for this form of taxation, before explaining in detail the specific legal problems that such a Proposal encounters in the EU legal framework. In understanding its development, this thesis is able to identify the economic, legal and political obstacles faced and to determine mistakes in the development of a common system of Financial Transaction Tax at EU level.

## **1. Moves Towards An EU-27 Common Financial Tax: Build Up to the 2011 Proposal**

### **1.1. The European Parliament's Resolution and International Discussion**

It would be reductionist in the extreme to state that, following the financial crisis, individual states failed to adopt any form of regulation of the financial sector at a domestic level. However, due to the global nature of the crisis, there was widespread recognition that real reform needed to take place at an international level, using forums such as the Basel Committee on Banking Supervision, the G20 and the EU in order to limit the effects of contagion across borders. By way of example, following the crisis, the leverage ratio and capital requirement principles of Basel II were updated. Basel III was agreed following the crisis, and is discussed in greater detail in chapter 2.

At EU level, preliminary debates took place in 2010, with a European Parliament Resolution instructing the Commission and Council to investigate exactly how a Financial Transaction Tax could be introduced specifically to finance development cooperation.<sup>1</sup> This Resolution highlights that similar consideration had taken place previously at G-20 level.<sup>2</sup>

With regard to individual EU Member State standing within the G-20, some EU Member States, such as the UK and France represent themselves individually, whereas others are represented collectively as a result of their membership of the EU. In light of this continuing

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<sup>1</sup> European Parliament Resolution of 10 March 2010 on Financial Transaction Taxes – Making Them Work at point 7

<sup>2</sup> Ibid. See for example point A with regard to the September 2009 Pittsburgh Summit

global discourse, the European Council concluded on the 17 June 2010, prior to the G-20 summit in Toronto that it sought to act as trendsetters to actively pursue a system of taxation, stating:

“[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.”<sup>3</sup>

While a consensus was reached that some form of penalty for the financial sector was to be pursued, the conclusions from the summit indicate that there was disagreement as to the most appropriate method of achieving this. The resulting Leaders’ Declaration explained the summit’s outcomes. With regard to tax and the financial sector, it stated:

“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.”<sup>4</sup>

This thesis ultimately argues that the underlying economic rationale for introducing a Financial Transaction Tax has been misrepresented, with a fundamental shift from behaviour modification, designed to discourage excessive speculation, towards

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3 European Commission, ‘Conseil Européen – Bruxelles 17 Juin 2010 Conclusions de la Présidence’ (*Europa*, 17 June 2010) <[http://europa.eu/rapid/press-release\\_DOC-10-2\\_en.htm](http://europa.eu/rapid/press-release_DOC-10-2_en.htm)> Accessed 29 January 2016

<sup>4</sup> G20 Toronto Summit Declaration 27 June 2010

fundraising objectives. Ultimately, this declaration indicates that, for the G-20 in 2010, revenue should be raised from the financial sector on the political justification of the use taxpayer funding to limit the fallout from the financial crisis. The intent of regulations has gone beyond the existing capital buffers in the Basel Banking Accords and supervisory principles, to a form of financial reprisal for the events of the crisis. This thesis argues that this is a mistake and that ultimately the rationale should be that of providing a public good of stability in the financial sector.

## **1.2. The European Commission's 2010 Communication**

On the 7<sup>th</sup> October 2010, the European Commission published a Communication concerning taxation of the financial sector.<sup>5</sup> This acted in effect as the Commission's opening salvo. It is worth noting at this juncture the significance of the title of the Communication. The title of the final Financial Transaction Tax Proposal published by the Commission uses the term 'common system of Financial Transaction Tax'. The original Communication however gives further credence to the notion that the target of the final Proposal is the financial sector, rather than individual transactions. This highlights from the outset that the issue of taxation, particularly of the financial sector, has an extremely political nature, with contrasting views of the role of government as either facilitating the free market, with limited interventions beyond that which is absolutely necessary, or a larger, more interventionist government which distorts markets. Ultimately governments are accountable to the electorate and design policies to appeal to both a core base and 'swing voters', which reflect these contrasting views. Political obstacles are discussed in greater detail later in this chapter. In the Communication, the Commission indicated that

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<sup>5</sup> Communication from the Commission to the European Parliament, The Council, The European Economic and Social Commission and the Commission of the Regions – Taxation of the Financial Sector Com (2010) 549 Final 7<sup>th</sup> October 2009

the focus of their debate concerned two types of financial instrument, a Financial Transactions Tax and a Financial Activities Tax (an amended version of VAT), indicating that in principle the Commission were not committed to a Financial Transaction Tax as their only option.

In the Communication, the Commission gives three main arguments for altering the tax system to make the financial sector contribute more (although the term used is 'fair'). These are, firstly, to complement the existing reform of the financial sector to encourage efficiency by dissuading risk-taking and subsequently reducing volatility.<sup>6</sup> Secondly, the Communication states that the financial sector is seen as being predominantly responsible for not only causing the crisis, but causing the scale of the crisis, too, with many national governments forced to increase their debt by offering financial aid.<sup>7</sup> The final justification made is that most financial services have been exempt from paying VAT in the EU since most income is margin-based, making VAT calculations extremely difficult.<sup>8</sup> A discussion of the application of VAT to financial services is outlined in the next chapter.

The use of language indicates again that, from the early stages of its considerations, the European Commission's intent was at least partially to raise funds from the financial sector as opposed to modifying behaviour. Chapter 4 presents a detailed critique concerning the Commission's mistake in not framing the final Proposal in the context of the public good of financial stability, since this creates a perception of punishment rather than correction. This language indicates the mistake is evident in the Commission's approach to consultation as opposed to being a mistake in the drafting of the 2011 Proposal itself.

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<sup>6</sup> Ibid at 4.1

<sup>7</sup> Ibid at 3.1

<sup>8</sup> Ibid at 6

### 1.3. Moves Towards a Financial Transaction Tax

With regard to the Financial Transaction Tax, the Communication stated that it is a form of taxation designed to impact on *individual* transactions. It acknowledged that the revenue potential for the tax varies on its scope of application:

“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.”<sup>9</sup>

The mechanics of a Financial Transaction Tax mean that the burden of taxation should primarily fall on those entities which conduct the greatest number of transactions. If the prevailing view is that each individual transaction is a toxic risk to the wider economy then this form of taxation supports the ‘polluter pays’ principle.<sup>10</sup> This principle is discussed in greater detail later in this thesis, but reflects many of the arguments presented in relation to the introduction of green taxes for environmental protection measures. The term’s origins lie in a 1972 Organisation for Economic Co-operation and Development recommendation in relation to environmental practise.<sup>11</sup> This refers to the ideal whereby those who contribute the most to pollution are charged a greater amount to encourage more efficient use of environmental resources.

The underlying logic of this principle depends on the transaction being of a speculative nature and determining if as a consequence the tax is ‘toxic’. In terms of design, it is difficult to distinguish between ‘speculative’ and ‘normal’ transactions at the time the transaction

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<sup>9</sup> Ibid

<sup>10</sup> D Smits, ‘The Financial Transaction Tax and the TFEU Freedoms’ in D Weber and O Marres (Eds), *Taxing the Financial Sector* (IBFD 2012) 122

<sup>11</sup> OECD Recommendation of the Council on Guiding Principles Concerning International Economic Aspects of Environmental Policies of 26 May 1972

is complete. Therefore, in order to be effective, the tax needed to have a relatively wide remit. This could have a knock-on cascading effect for customers in the sense that the cost of the tax would be passed onto them by financial institutions indirectly by, for example, increased costs from pension funds. Ultimately a business cannot bear the final burden of a tax. Instead, the ultimate incidence must fall to an individual in some form. For example, although a 'pension fund' may be nominally subject to a tax, it is the individuals whose contributions comprise the fund which will bear the economic cost of the tax, not an arbitrary organisation.

At this stage, the Commission appeared to favour the Financial Activity Tax. However, the Commission conducted an Impact Assessment, which included a public consultation in order to establish its preferred method for a Proposal. The summary report indicated the following:

“In general, the opinions of the respondents to the public consultation mentioned above are strongly polarised depending on the group and subgroup to which they belong. Nevertheless, it must be pointed out that there is one general agreement among the vast majority of respondents – that patchwork measures introduced by Member States pose a problem.”<sup>12</sup>

In effect, the key is the consensus that a series of individually applied measures would be ineffective and therefore the only way to achieve an effective solution was an inter-State approach through the forum provided by the EU legal framework. Consequently, on the 29<sup>th</sup> September 2011, the Commission Published its 'Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC'<sup>13</sup>

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<sup>12</sup> Summary Report of Public Consultation 19<sup>th</sup> April 2011

<sup>13</sup> Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC Com (2011 594 Final) of the 28<sup>th</sup> September 2011

(from now on, 'the 2011 Proposal'). Due to difficulties the Proposal has faced the Commission published a 'Proposal for a Council Decision Authorising Enhanced Cooperation in the Area of Financial Transaction Tax'<sup>14</sup> on the 25<sup>th</sup> October 2012 (from now on, 'the 2013 Proposal'). The developments concerning Enhanced Cooperation are addressed in chapter 3 of this thesis.

## 2. Specifics of the 2011 Proposal

The 2011 Proposal itself commences with explaining the rationale for the Proposal: avoidance of fragmentation in the internal market for financial services, 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 regarding taxation and to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets. The Commission's Proposal would have applied from 2014 to financial transactions which take place when at least one of the parties is situated in the EU.<sup>15</sup> The proposed rates are 0.01 per cent for derivatives and 0.1 per cent for other financial transactions (i.e. acquisition of shares and bonds). This would apply to banks and individuals, however due to the volume of transactions carried out by financial institutions, they would be affected more, highlighting the polluter pays principle, as outlined previously in this chapter. Revenue is collected by the tax authority of the Member State in which the party is based.<sup>16</sup> The Commission advocates the revenue raised by the tax (up to €57/£49

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<sup>14</sup> Proposal for a Council Decision Authorising Enhanced Cooperation in the Area of Financial Transaction Tax Com(2012) 631 Final/2 25<sup>th</sup> October 2012

<sup>15</sup> A Goodall, 'Financial Transaction Tax: A Step Forward or a Blunderbuss?' (2012) 1095 *Tax Journal* 7

<sup>16</sup> European Commission, 'Taxation of the Financial Sector' (*Europa*, 27 November 2015) <[http://ec.europa.eu/taxation\\_customs/taxation/other\\_taxes/financial\\_sector/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm)> Accessed 5 April 2018

Billion p.a.<sup>17</sup>) could potentially be used to cover part of the EU budget<sup>18</sup>, subsidise other EU taxes or to repay national budget deficits. It acknowledges in its impact assessment there would be a likely 0.5 per cent decrease in GDP.<sup>19</sup>

It is important to note that the Proposal seeks to introduce a minimum standard. This means that, should a Member State wish to do so, they could charge more than the 0.1 per cent and 0.01 per cent rates, if the Member State considers them to be too low, with an explanation in the 2011 Proposal that “the minimum tax rates (above which there is room of manoeuvre for national policies) are proposed to be set at a level sufficiently high for the harmonisation objective of this Directive to be achieved. At the same time, the proposed rates are situated low enough, so that delocalisation risks are minimised.”<sup>20</sup> This is a fine balancing act. If the rate of taxation is too high, it could mean greater relocation. In the public consultation, the Commission outlined that a potential problem with a Financial Transaction Tax is relocation of financial services, leading to the predicted 0.5 per cent reduction in GDP.<sup>21</sup> It has sought, however, to design the Financial Transaction Tax Proposal in such a manner as to mitigate the potential impact of relocations. This is a frequent criticism of any proposed Financial Transaction Tax, with many critics citing the experience in Sweden as a case study warning against the imposition of a wide ranging

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<sup>17</sup> Ibid. See also European Scrutiny Committee, ‘4 Taxation: a Financial Transaction Tax’ (*Parliament UK*, 26 October 2011) <<http://www.publications.parliament.uk/pa/cm201012/cmselect/cmeuleg/428-xxxix/42806.htm>> Accessed 29 January 2016. These figures are based on 2011 Euro/GBP Sterling conversion rates

<sup>18</sup> European Commission, ‘Investing Today For Growth Tomorrow’ (*Europa*, 29 June 2011) <<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/799&format=HTML&aged=0&language=en&guiLanguage=en>> Accessed 29 January 2016

<sup>19</sup> At 2.2 2011 Proposal

<sup>20</sup> *Supra* n.13 at 3.3.2. Explanatory Memorandum

<sup>21</sup> *Ibid* at 2.2. Explanatory Memorandum

tax.<sup>22</sup> In a 2011 interview Manfred Bergmann, Director for Indirect Taxation and Tax Administration of the European Union, stated that the Proposal differed from other attempts, such as Sweden's attempt to tax the financial sector, by applying to all transactions in all markets across all Member States in a 'AAA approach'.<sup>23</sup> Page 4 of the explanatory notes for the 2011 Proposal outline the proposed means by which to mitigate potential relocations in the design of a common Financial Transaction Tax. These means include drafting a broadly defined tax scope in relation to products, transactions, types of trade and financial actors subject to the tax. In addition, the 2011 Proposal sought to apply the 'residence principle'<sup>24</sup> and to set tax rates at an appropriate level to minimise eventual impacts on the cost of capital for non-financial investment purposes. The Proposal also discusses exclusions from the tax, for example, excluding transactions on primary markets for securities and currencies from taxation, so as not to undermine the raising of capital by governments and companies, ring-fencing the lending and borrowing activities of private households, enterprises or financial institutions (i.e. private loans and mortgages), ring-fencing the day to day lending activities corporate lending is unaffected which is particularly key for Small and Medium Enterprises (SMEs) who would only pay the tax provided that they did not actively invest in financial markets<sup>25</sup> and excluding financial

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<sup>22</sup> For more on Sweden's version of a Financial Transaction Tax, see for example S Umlauf, 'Transaction Taxes and the Behaviour of the Swedish Stock Market' (1993) 33 *Journal of Finance Economics* 227

<sup>23</sup> The 'AAA Approach' is 'all markets, all transactions, all financial institutions' European Commission 'Further Background Information' (*Europa Taxation and Customs*, 15 January 2016) <[http://ec.europa.eu/taxation\\_customs/taxation/other\\_taxes/financial\\_sector/ft\\_background\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/ft_background_en.htm)> Accessed 5 April 2018

<sup>24</sup> "Taxation in a Member State of establishment of financial actors, independent from the location of the transactions." 2011 Proposal at 2.2. Explanatory Memorandum. This includes non-EU financial institutions involved in financial transactions with a party within the EU, and in case one of its branches in the EU is involved in a financial transaction.

<sup>25</sup> J Vella, C Fuest and T Schmidt-Eisenlohr, 'The EU Commission's Proposal for a Financial Transaction Tax' (2011) 6 *British Tax Review* 607

transactions with the European Central Bank (ECB) and national central banks, from the scope of the Financial Transaction Tax, so as not to affect refinancing opportunities.

## **2.1. Collection of Revenue**

The proposed tax is payable at the moment when the transaction occurs. With technological progression facilitating electronic transfers, transactions have increased, and therefore, the tax can be collected in a much quicker timeframe than even in 2008. Technological innovation is discussed in greater depth later in this chapter. However, the 2011 Proposal foresees potential difficulties. For certain financial instruments, it is normal for a price or other consideration to be determined, i.e. the taxable amount. Yet, in order to avoid market distortions, the tax needs to be designed for instances when the consideration is lower than the market value of the instrument. To prevent market distortions, the tax needs to be designed for instances when the consideration is lower than the market price or for transactions taking place between entities of a group for which the notions of 'purchase' and 'sale' are inapplicable. In these cases, the taxable amount is calculated as the market price, determined on the open market price at the time the Financial Transaction Tax becomes chargeable. Therefore, there is value in investors allocating a greater amount of resources to predicting the behaviour of other investors, in order to pre-empt the market, completing a transaction at a comparatively lower price, before selling at a higher price for a proportionately greater return on investment. This position is reflected later in this dissertation when presenting macroeconomic arguments, in particular highlighting Joseph Stiglitz's rationale for a securities exchange tax.

In addition, the taxable amount with regard to derivative agreements in the 2011 Proposal is the taxable amount at the time of the purchase, sale, conclusion or modification of such an agreement. The rationales for this position are simplicity of application, low administrative and compliance costs and increased difficulty to artificially reduce the tax burden as a result of the design of a derivative contract. Since the focus shifts from the

lifetime of a derivative agreement to single events (i.e. purchase, modification, conclusion and sale) this means that there are more instances in which the tax is applicable. In order to reduce relocation possibilities, the Commission has decided to tax appropriately. It is for this reason that the 2011 Proposal advocates that derivative transactions are charged at 0.01 per cent as opposed to 0.1 per cent for other transactions. This demonstrates the level of design present in the 2011 Proposal, demonstrating a consideration of behavioural consequences of a tax. However, this thesis ultimately argues that the design of the 2011 Proposal does not fully represent the underlying economic rationale for a tax on speculative trading. The following section therefore seeks to explain this in further detail and informs the discussion in chapter 4.

### **3. The Economic Rationale of the Financial Transaction Tax**

The economics of the Commission's proposed Financial Transaction Tax are rooted within the field of macroeconomics. This field assesses the economic climate by looking at the wider effect of economic policies as a whole. There are different fields within macroeconomics, but fundamentally it seeks to achieve two primary objectives: to explain short-term fluctuations in national income (both in terms of the causes of the fluctuations and the effect of the fluctuations) and to attempt to achieve long-term economic growth. Macroeconomists seek to achieve these objectives by proposing theories to explain previous instances of economic recession or growth and to use these theories within the context of the current economy to forecast future economic prospects, so that appropriate measures can be taken to ensure stable growth.

It therefore follows that post-2008 macroeconomic models were applied to determine the causes of the crises and to inform policies which would ensure long-term, stable growth. The 2011 Proposal has a macroeconomic base, specifically Keynesian economists, elaborated in more detail in this section. Several high profile Keynesian economics, such

as Joseph Stiglitz and Paul Krugman, have indicated that one of the primary reasons for the scale of the 2008 crisis was the degree of algorithmic and high frequency trading (HFT) which occurred. This is acknowledged in the summary of the Impact Assessment of the 2011 Proposal, in which it states that amendments would need to be made to HFT algorithms to trigger fewer transactions, but with a higher margin.

### **3.1. Keynesian Economics**

John Maynard Keynes was a pioneer of macroeconomics, lending his name to the 'Keynesian' macroeconomic scholarship which underpins the 2011 Proposal. Keynes sought to achieve 'full employment', with many of his theories tied in to labour. A knock-on effect was to increase government borrowing in order to fund the policies to create a stimulus in the economy at a calculable cost to inflation, the idea of spending out of recession. In 1929 the US stock market collapsed, with severe economic consequences. This 'Great Depression' spread beyond the confines of the US economy throughout the 1930s, with millions left unemployed. Recovery started in 1933, but by the end of the decade, although GDP was returning to 1929 levels, the rate of unemployment remained high. This effect was global in nature, with many states, including the UK, still recovering from the economic effects of the First World War. Consequently, governments had to adopt a more interventionist approach in order to lower the rate of unemployment. Therefore, Keynes' economic models were attractive to governments whose priority was to mitigate levels of employment, rather than manage inflation.

The majority of Keynes' ideas are present in the '*General Theory of Employment, Interest and Money*'<sup>26</sup>, better known as simply the '*General Theory*', first published in 1936. Split into five books, the underlying argument is that contrary to the pre-established belief of

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<sup>26</sup> J M Keynes, *General Theory of Employment, Interest Rates and Money* (First Published 1936 MacMillan & Co Ltd 1960)

neoclassical economists, the level of employment is not dependent on the cost of labour but the cost of spending is. *The General Theory* was at the time a revelation, seen as providing hope in an era where hope was in short supply. It summed up the ideas and fears of the era and advocated a radical new approach that challenged pre-existing standards as a means of resolution. The 2008 financial crisis has led to some to draw parallels between its aftermath and that of the Great Depression, bringing Keynesian economics to the fore again.<sup>27</sup>

### **3.2. Keynes' Legacy in Relation to Financial Regulation**

Of particular pertinence to this thesis is an excerpt from the *General Theory* in which Keynes views financial markets as unregulated casinos, which, in the public interest, should be made more expensive to access through the introduction of a new form of taxation. The ultimate argument in this thesis, as outlined in greater detail chapter 4, is that a stable financial sector provides a public good and that a Financial Transaction Tax is a means by which to achieve this aim:

“It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of stock exchanges. That the sins of the London Stock Exchange are less than those of Wall Street may be due, not so much to differences in national character, as to the fact that to the average Englishman Throgmorton Street is, compared with Wall Street to the average American, inaccessible and very expensive. The jobber's ‘turn’, the high brokerage charges and the heavy transfer tax payable to the Exchequer, which attend dealings on the London Stock Exchange, sufficiently diminish the liquidity of the market (although the practice of fortnightly accounts operates the other way) to rule out a large proportion of the transactions characteristic of Wall Street. The introduction of a substantial government transfer tax on all transactions might prove

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<sup>27</sup> For example see P Krugman, *The Return of Depression Economics and the Crisis of 2008* (Penguin 2008) and R Skidelsky, *Keynes The Return of the Master* (Penguin Books 2010)

the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States.”<sup>28</sup>

Keynes’ work has subsequently inspired a number of economists, who have expanded upon and developed these basic theories into finding solutions to financial instability. With regard to a Financial Transaction Tax, James Tobin’s subsequent work is instrumental in leading the global discussion on financial taxes which led to the 2011 Proposal. Tobin’s work is outlined later in this chapter.

### **3.2.1. Keynes Down Under: A Keynesian Response to the Financial Crisis in Australia**

As Hill notes, whilst not entirely immune to the effects of the crisis “at first sight, at least, Australia appears to have withstood the crisis remarkably well”<sup>29</sup> and acts as a case study to demonstrate the efficacy of Keynesian policies post-2008. This is further supported by the OECD, which stated that the Australian economy had been “one of the most resilient in the OECD during the global economic and financial crisis”<sup>30</sup> and that the Australian economy did not go into recession. However, there was some significant impact felt. For example “by 2009...Australia’s stock market capitalization had fallen by over A\$771 Billion, constituting 65 per cent of Australia’s 2008 Gross Domestic Product.”<sup>31</sup> There were also business closures and bank mergers.

Although a tax on individual speculative financial transactions has not been introduced, Australia does serve as a post-2008 case study for the efficacy of Keynesian policies in

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<sup>28</sup> Supra n.26 at 159

<sup>29</sup> J Hill, ‘Why Did Australia Fare so Well in the Global Financial Crisis?’ in E Ferran et al (eds) *The Regulatory Aftermath of the Financial Crisis* (Cambridge University Press 2012) 203

<sup>30</sup> OECD Economic Surveys: Australia, November 2010 Overview

<sup>31</sup> Supra n.29 213

financial crises. Hill states that there are two techniques governments can use in order to address financial crises. The first option is fiscal austerity i.e. cutting government spending on public services to reduce expenditure. This was adopted in the 1990s regarding the East Asian Crisis and post-2008 in the Euro area, however the efficacy of these policies is a matter for further debate beyond the scope of this thesis. This is the opposite of the Keynesian rationale outline previously.

The second option is to increase social expenditure to create a stimulus to the economy. This is the approach that the Australian government undertook. A series of targeted stimulus packages were introduced between October 2008 and February 2009 for various infrastructure projects and grants<sup>32</sup>, comprising of the A\$10.4 Billion Economic Security Strategy, a A\$15.2 Billion funding package for housing, hospitals and education, a A\$4.7 Billion Nation Building package for infrastructure projects and a A\$42 Billion Nation Building and Jobs plan. Overall, the Australian government committed to a discretionary spend of A\$90 Billion over a four year period.<sup>33</sup> Australia was one of only five OECD countries<sup>34</sup> to adopt a fiscal stimulus package over four percent of 2008 GDP.

Keynesian policies were effective in Australia, but did not exclusively protect it from the worst effects of the financial crisis. Australia also adopts a supervisory model of financial services referred to as the 'twin peaks' approach in which the Australian Prudential Regulation Authority assumes responsibility for regulating financial institutions, whereas the Australian Securities and Investments Commission assumes responsibility for business conduct and consumer protection. Furthermore, the government mitigated fears of runs on Australian banks by providing confidence to savers that deposits would be

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<sup>32</sup> Ibid at 234

<sup>33</sup> Ibid at 235

<sup>34</sup> Ibid at 236 along with Canada, South Korea, New Zealand and the USA

protected. This was to include support with regard to residential mortgage-backed securities. Although government backed deposit protection schemes are often criticised as introducing moral hazard into financial markets, this meant that capital was not withdrawn from banks which may have been susceptible to the shocks of the financial crisis en masse. In addition to wide scale public investment and financial commitments, Australia's mining industry had a willing trading partner in China to purchase coal. The increase in global coal and iron ore consumption meant that in 2010 Australia's two-way trade amounted to A\$552.4 Billion, with resource commodities, including iron ore and coal, comprising 47.5 percent of all Australian exports.<sup>35</sup>

The Australian example demonstrates the underlying merits of Keynesian theorems and their practical applicability in the late 2000s as opposed to the 1930s/40s, highlighting that measures inspired by Keynesian economics, such as a Financial Transaction Tax, can have a practical impact. However, the Australian case study also demonstrates that there is not one single policy which can act as a panacea – a combination of federal deposit protection, effective supervision, trading in natural resources and a targeted financial stimulus package were required. Although this thesis argues that Australia demonstrates the potential for Keynesian policies post-2008, it does acknowledge that the 2011 Proposal would be insufficient in isolation to achieve this aim. Nonetheless, it could form part of an overall wider-ranging package of financial regulation measures designed to curb excessive risk-taking in financial markets, with the aim of providing a public good of financial stability.

### **3.3. General Criticism of Keynesian Economics**

The following section in this chapter details James Tobin's advancement and application of Keynes' macroeconomic models to a proposed form of transaction tax. However,

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<sup>35</sup> Ibid at 277

Keynesian macroeconomics is not without its doubters, and due consideration must be given to this critique in order to present a balanced argument.<sup>36</sup> Whilst his work is undoubtedly influential and continues to inspire both national governments and academic literature, it would be naïve in the extreme to state that the work is flawless. In November 1949, just over three years after Keynes' death, Arthur Cecil Pigou, a welfare economist, gave two lectures at King's College, Cambridge, presenting a retrospective assessment of Keynes' work. The lectures were later published in 1950.<sup>37</sup> Pigou's work is also of relevance to this thesis, specifically the concept of a 'Pigouvian tax' as a form of corrective taxation. Pigou's critique is particularly interesting, since Financial Transaction Taxes, such as the 2011 Proposal, are often described as Pigouvian in nature whilst having an underlying Keynesian rationale. A greater discussion of the 2011 Proposal as a Pigouvian tax is presented later in this thesis.

Throughout the lectures, Pigou outlines Keynes' basic principles and definitions, such as his understanding of capital and savings. However, Pigou highlights that there are gaps in Keynes' work, providing further elaboration to develop the basic point Keynes has made. Some of these points are relatively minor, but Pigou's main level of concern appears to be that Keynes' models are presented as fact. Yet the factors which Keynes relied upon are, to Pigou's mind, susceptible to relatively rapid change, meaning that the *General Theory* is in practice untested and focuses on the short-term over the longer term. This does not mean that Pigou does not recognise the *General Theory's* merit, noting:

“These are very serious limitations – limitations of which it is specially proper to remind ourselves when attempts are made to apply Keynes's apparatus directly to

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<sup>36</sup> This thesis presents some select examples of critique, however a more detailed discussion of this is beyond the scope of the thesis. For a more in depth review of Keynes' work and its impact, see W Allan (Ed), *A Critique of Keynesian Economics* (Springer 2016)

<sup>37</sup> A Pigou, *Keynes's 'General Theory' A Retrospective View* (MacMillan & Co. Ltd 1950)

the solution of practical problems. This is in no sense to 'attack' Keynes or to decry his achievement. When a man has devised a new way of tackling an unclimbed mountain, we may, indeed, regret that this way has not led him to the top. But for the effort which has advanced him towards the top nothing is due but praise...Whatever imperfections there may be in his working out of the fundamental conception embodied there, the conception itself is an extremely fruitful germinal idea."<sup>38</sup>

Pigou's assessment may have been different following the Australian case study presented some 68 years later. However, if Pigou's critique was an early warning of the untested nature of Keynes' theories, the 1970s were more problematic for Keynesian economics. Steadily its popularity declined, due to two main factors. The first factor was the momentum gained by academic criticism of Keynes' work, notably by Milton Friedman, a free market economist whose theories were in opposition to Keynes' 'cost-push inflation' model in which product costs rise as a result of increases in wage and raw material costs.<sup>39</sup> Friedman argued, for example, that state intervention merely inhibited private expenditure. The *General Theory* contains relatively few formulae or mathematical models. Subsequent Keynesian economists therefore drafted such models, including the 'Phillips curve'. Originally presented in a 1958 Article by William Phillips, this predicts an inverse relationship between unemployment and inflation.<sup>40</sup> It implies that unemployment can be diminished by stimulus from the government with a calculable cost to inflation. Friedman refuted this, publishing an article in 1968 in which he claimed that no such relationship existed, arguing that continued pursuance of Keynesian policies would in fact lead to

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<sup>38</sup> Ibid at 64 and 65

<sup>39</sup> See for example M Friedman, *Inflation Causes and Consequences* (Asian Publishing House 1963)

<sup>40</sup> W Phillips, 'The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861 – 1957' (1958) 25(100) *Economica* 283

unemployment and inflation rising at the same time, known as “stagflation”.<sup>41</sup> This combined with, and lent support for, a second factor, the economic recession of the 1970s. Stagflation occurred in the UK and USA, as Friedman had predicted. This was worsened by the 1973 oil crisis. The steady decline reached its inevitable end in 1979 when the British government officially renounced the Keynesian economics model it had previously employed. In 1976 at the Labour Party conference, the British Prime Minister, James Callaghan, stated that:

“The option of ‘spending our way out of recession no longer existed’ and in the past had only worked by ‘injecting bigger and bigger doses of inflation into the economy.’”<sup>42</sup>

The focus had shifted from the full employment model that Keynesian economics sought to achieve to price stability. Nevertheless, this does not mean that Keynesian economics had been forgotten. There was a plethora of publications in the area of Keynesian economics published during this period of ‘decline’.<sup>43</sup> Following on from this continued discussion of Keynes’ work, since 2008, there has been a resurrection in the popularity of Keynesian economics as a theory. The winner of the 2008 Nobel Prize in economics, Paul Krugman, for example, has argued that the 2008 economic conditions replicated those of the 1930s Great Depression, meaning that Keynesian economics is more relevant than

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<sup>41</sup> M Friedman, ‘The Role of Monetary Policy’ (1968) 58(1) *American Economic Review* 1

<sup>42</sup> As reported in R Skidelsky, *Keynes – A Very Short Introduction* (OUP 2010) 124. A full transcript of the speech is available at James Callaghan, ‘Leader’s Speech’ (Labour Party Conference, Blackpool, 28 September 1976) <<http://www.britishpoliticalspeech.org/speech-archive.htm?speech=174>> accessed 17 January 2019

<sup>43</sup> For example see L Pasinetti and B Schefold, *The Impact of Keynes on Economics in the 20<sup>th</sup> Century* (Elgar Publishing 1999), M Hayes, *The Economics of Keynes* (Elgar Publishing 2006) and R Blackhouse (ed), *Keynes: Contemporary Responses to the General Theory* (Thoemmes Press 1999)

during the 1970s.<sup>44</sup> Discussion of Keynesian economic literature post-Tobin is presented later in this chapter.

#### 4. James Tobin

The economic rationale for the 2011 Proposal, while inspired by Keynes, owes a greater debt to James Tobin. Tobin was a self-confessed “disciple of Keynes”<sup>45</sup> and a strong proponent of his principles during the 1970s and 1980s in particular, authoring works including ‘How Dead is Keynes?’<sup>46</sup> In 1981 he was awarded the Nobel Memorial Prize in Economic Sciences.<sup>47</sup> In relation to this thesis, Tobin’s ‘Proposal for International Monetary Reform’<sup>48</sup>, better known as the ‘Tobin Tax’, acts as the foundation stone upon which subsequent proposals for common systems of taxing speculative individual transactions is built. Tobin first presented this idea in 1972 in his Janeway Lectures at Princeton, but reiterated it in 1978.<sup>49</sup> Although different from the 2011 Proposal in terms of its scope, Tobin’s Proposal must be addressed in order to present a full consideration of the economic foundations of the 2011 Proposal.

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<sup>44</sup> Supra n.27

<sup>45</sup> Jubilee, ‘James Tobin : “The Anti-Globalisation Movement has Hijacked my Name”’ (*Jubilee*, 3 September 2001) <[http://web.archive.org/web/20050306201839/http://www.jubilee2000uk.org/worldnews/lamerica/james\\_tobin\\_030901\\_english.htm](http://web.archive.org/web/20050306201839/http://www.jubilee2000uk.org/worldnews/lamerica/james_tobin_030901_english.htm)> Accessed 5 April 2018 (Originally in Der Spiegel)

<sup>46</sup> J Tobin, ‘How Dead is Keynes?’ (1977) 15(2) *Cowles Foundation Paper* 456 <<https://cowles.yale.edu/sites/default/files/files/pub/d04/d0458.pdf>> Accessed 5 April 2018

<sup>47</sup> Although the Nobel Memorial Prize in Economic Sciences is not officially a Nobel Prize setup by the will of Alfred Nobel in 1895 it is highly regarded and often awarded at the Nobel Prize ceremony. The Nobel Prize for Economics was first awarded in 1969 and does not accept posthumous nominations, therefore Keynes could not have won the prize.

<sup>48</sup> J Tobin, ‘Proposal for International Monetary Reform’ (1978) 4(3-4) *Eastern Economic Journal* 153

<sup>49</sup> Ibid

The Proposal for International Monetary Reform was a reaction to the collapse of the Bretton Woods Agreement in the 1970s. This original agreement was the result of the 1944 United Nations Monetary and Financial Conference. While the Second World War continued, allied nations met to plan their economic recovery, by creating an international monetary system governed by rules and institutions to facilitate recovery. Keynes was one of the British representatives sent to the negotiations. The result of the agreement included two major developments. The first was an obligation for each of the signatories to adopt a monetary policy which tied its currency to the US dollar in order to maintain an exchange rate. The second was the creation of the International Monetary Fund (IMF), which was able to bridge temporary imbalances. It was the collapse of this Agreement which led Tobin to propose a tax to curb currency speculation, which has ultimately been cited in general discussions about the 2011 Proposal.

Tobin was referring to the problem of currency speculation following President Nixon's declaration in 1971 that the US Dollar could not be converted to gold due to insufficient gold reserves to back dollars invested in banks overseas. The announcement, and its economic effects, are commonly referred to as the 'Nixon Shock'.<sup>50</sup> If this declaration were not made, there was a possibility of a run on the banks, if it were decided to exchange the dollars for gold reserves. The collapse of the Agreement also signalled the change from fixed exchange rates to floating exchange rates, meaning that the value of currencies varied was no longer tied to the value of gold or the US Dollar, but could fluctuate.

Advances in technology made currency conversion increasingly simple, meaning that, as soon as investors had doubts about investing in a particular currency, they could withdraw and convert their investment into another. This would be detrimental to the government of

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<sup>50</sup> For more discussion regarding the Nixon Shock and the subsequent collapse of the Bretton Woods Agreement, see M Bordo and B Eichengreen, *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform* (University of Chicago Press 1993)

the original currency, since states would need to adopt policies which were attractive to international investors. However, whilst the myriad of possibilities created an international buyer's market, the policies that national governments adopted in order to attract international investment were not always designed entirely in the interests of its citizens. The case studies of Latin America between 1970 and 2000<sup>51</sup> and the East Asian<sup>52</sup> currency crisis of the 1990s, indicate that, if investors suddenly withdraw investments from a national economy, there are severe repercussions for the state. The collapse of the Bretton Woods Agreement in 1971 generated a period of uncertainty and instability. Tobin's proposed solution was to introduce a new tax policy in order to make this convertibility between currencies more difficult, explaining that his aim was to "throw some sand in the well-greased wheels"<sup>53</sup>, i.e., to slow down the process of converting investments from one currency to another by shifting the focus from the volatility of short-term investment in currencies, towards a long-term stable approach towards investment. Tobin used similar analogous terms throughout his career, re-stating his Proposals in 1984<sup>54</sup>, 1995<sup>55</sup> and 1996.<sup>56</sup>

Tobin's primary concern in the 1978 Proposal was that the volume of transactions was set to increase with floating exchange rates and that that advances in technology were making it far easier for speculation to occur. As acknowledged throughout this thesis, one of the

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<sup>51</sup> See M Damill et al, 'Financial and Currency Crises in Latin America' in M Wolfson and G Epstein (Eds) *The Handbook of the Political Economy of Financial Crises* (OUP 2013)

<sup>52</sup> S Griffith-Jones and S Pfaffenzeller, 'A Survey on the Debate on its Causes and Possible Solutions' Institute of Development Studies, October 1998

<sup>53</sup> Supra n.48 at 158

<sup>54</sup> J Tobin, 'On The Efficiency of the Financial System' (1984) 153 *Lloyds Bank Review* 1

<sup>55</sup> B Eichengreen, J Tobin and C Wyplosz, 'Two Cases for Sand in the Wheels of International Finance' (1995) 105(428) *Economic Journal* 162

<sup>56</sup> J Tobin, 'A Currency Transactions Tax, Why and How' (1996) 7(1) *Supplement Open Economies Review* 493

accelerants for the 2008 crisis was the degree of automated algorithmic and high frequency trading. It is arguable therefore that this underlying concern carries far greater weight than it did in the 1970s. Tobin summarised his basic idea in 1978 as follows:

“The proposal is an internationally uniform tax on all spot conversions of one currency into another, proportional to the size of the transaction. The tax would particularly deter short-term financial round-trip excursions into another currency.”<sup>57</sup>

In other words, the Tobin Tax was a tax on currency conversions, designed to limit speculative short-term investments in currencies. It was designed as a disincentive measure, a behaviour modification tool, designed to encourage more responsible conversions from investors. The rationale is comparable to taxation on drinks with a high sugar and caffeine content to encourage more responsible consumption by consumers, since these are seen as socially harmful commodities to consume.<sup>58</sup> Alcohol taxes are often cited as classic examples of Pigouvian taxes. Importantly the Tobin Tax was not a fully restrictive measure, such as a ban on fishing at certain times of year to avoid depletion of resources. Nevertheless, the payment of a tax would discourage investors from looking at short-term gains, reducing volatility and encouraging longer-term stable gains. A fuller discussion of the economic impact of a tax, such as the 2011 Proposal, on volatility, is included later in this chapter, however, in short, the frequency of a transaction has an impact on the cost of the transaction itself.

Tobin’s Proposal is simply a basic idea, which Tobin acknowledged, stating “doubtless there would be difficulties of administration and enforcement. Doubtless there would be

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<sup>57</sup> *Supra* n.48 at 155

<sup>58</sup> For example see M Sharma, ‘Taxation on Alcohol: Implications for Health Promotion’ (2009) 53(2) *Journal of Drug & Alcohol Education* 3

ingenious patters of evasion.”<sup>59</sup> Yet Tobin did provide some information as to how he saw such a tax working in practice. He explained that, in terms of scope, his proposal was for an “internationally uniform tax.”<sup>60</sup> Nonetheless, he also explained “the tax would apply to all purchases of financial instruments denominated in another currency.”<sup>61</sup> Tobin acknowledged, therefore, that this should be a measure that is a truly global approach, a concept reflected in the 2010 G-20 Toronto Summit Declaration outlined previously. Secondly, he explained the administration side of the tax, stating that it would have been “administered by each government over its own jurisdiction”<sup>62</sup> regardless of whether or not the currency is that of the state in which the conversion takes place. Thirdly, he addressed the question of the application of the proceeds of the tax, stating that “the tax proceeds could appropriately be paid to the International Monetary Fund or World Bank.”<sup>63</sup> It is this third point that differs from other socially activist proposals, such as the Robin Hood Tax, as proposed by the Robin Hood Tax group, which, unlike the 2011 Proposal, advocates a flat tax of 0.05 per cent on transactions for philanthropic causes. Tobin appeared to back the IMF having a role in the operational side of the tax, stating that “countries could, possibly subject to *IMF consent*, form currency areas within which the tax would not apply.”<sup>64</sup> [Emphasis Added]

One key area in which Tobin was not forthcoming was that of the rates of taxation. In his initial 1978 Proposal, he stated examples of 1 per cent and 2 per cent, which were not

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<sup>59</sup> *Supra* n.48 at 159

<sup>60</sup> *Ibid* at 155

<sup>61</sup> *Ibid* at 159

<sup>62</sup> *Ibid* at 158

<sup>63</sup> *Ibid* at 159

<sup>64</sup> *Ibid*

concrete figures. In addition, he did not calculate what he thought the tax might generate. In 2001. He was interviewed by *Der Spiegel* and explained his original 1978 Proposal as follows:

“I had proposed that the revenue be put at the disposal of the World Bank...The tax on foreign exchange transactions was devised to cushion exchange rate fluctuations. The idea is very simple: at each exchange of a currency into another a small tax would be levied – let’s say, 0.5% of the volume of the transaction.”<sup>65</sup>

Tobin appeared nonchalant with regard to an exact figure for the percentage rate of taxation. What mattered to him more was the disincentive rationale behind the tax, not its fundraising possibilities, discussed in more detail in the following section. However, Tobin’s position appeared to be inconsistent, with emphasis on the World Bank’s perceived capacity to act as the administrator of the tax, rather than indicating an organisation which outlined specific expenditure plans for any revenue raised by the tax. Tobin’s 1978 Proposal stated that any money levied by the tax could be payable to either the IMF or the World Bank, but he referred to “IMF consent” as a controlling mechanism, appearing at the time to favour the IMF. In the later *Der Spiegel* interview he states World Bank in isolation and makes no reference to the IMF. The World Bank and the IMF have different remits, therefore Tobin appears to potentially have altered his view regarding the operation of the tax from 1978. Explaining how Tobin viewed the purposes of the proceeds is important in order to further differentiate the Tobin tax from the European Commission’s 2011 Proposal and from other terms used in discourse, such as the ‘Robin Hood Tax’.

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<sup>65</sup> *Supra* n.48

#### 4.1. Purpose of the Money Raised – Tobin the Philanthropist?

Social advocacy groups, such as the Robin Hood Tax group and ATTAC in France have adapted Tobin's basic idea of a tax on speculative trading, with a primary aim of achieving societal improvements by spending estimated funds raised by such a tax on philanthropic and socially beneficial projects. This thesis argues that whilst these groups do serve a purpose in raising a wider public awareness of the basic ideas of Tobin's work, it is questionable whether Tobin himself viewed the tax as having a truly philanthropic aim. It is sometimes the case that, when citing Tobin's work, the basic idea of curbing speculation is replaced by a philanthropic rationale to the original tax. Therefore, is it possible to be more specific about Tobin's ideas for the proceeds of his tax? This assessment is made exclusively on the merits of Tobin's work on currency taxation, excluding his contributions to other areas of financial regulation, since they are beyond the scope of this thesis.

In order to understand the significance of any changes in language, it is firstly necessary to determine the roles of the IMF and the World Bank. This indicates how indicating that one institution should administer and collect the tax has an impact on the perceived functions of a tax, due to the remit of each of these institutions. The IMF and World Bank are separate entities with differing aims. Both were created at the Bretton Woods Conference of 1944 and both are situated in Washington D.C. In order to accede to the World Bank a state must first be a member of the IMF. The IMF is predominantly focused on global cooperation and financial stability and according to Williams the IMF was:

“Established to provide a mechanism to maintain an orderly system of currency payments between international States by lending currency to members facing balance of payments deficits.”<sup>66</sup>

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<sup>66</sup> P Williams, 'State Succession and the International Financial Institutions: Political Criteria v Protection of Outstanding Financial Obligations' (1994) 43(4) *International And Comparative Law Quarterly* 776

It is tailor-made as a macroeconomic entity, reacting to requests from national governments for loans and financial assistance in economic crisis, for example Latvia<sup>67</sup> and Greece.<sup>68</sup> On its official website it described itself and its objectives:

“The International Monetary Fund (IMF) is an organization of 189 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.”<sup>69</sup>

This definition is rather short and lacking in detail. Exactly how does it seek to achieve “sustainable economic growth” in order to achieve the previously stated goals? In 1990 Hautot stated that:

“Monetary cooperation and stability of currencies are the two main purposes of the IMF and these objectives may be considered as having been fulfilled until 1968-1969...Another purpose of the IMF was and is to reduce the disproportions in balances of payments. With this end in view, the Fund helps States, in case of a temporary disequilibrium and it can use for this purpose important resources of its own, i.e. a common pool of currencies made up of States subscriptions.”<sup>70</sup>

The IMF aims to reduce poverty by providing conditional financial assistance to national governments in an attempt to prevent defaulting on payments. The World Bank, on the other hand, has more of a philanthropic cause relative to the IMF, by financing infrastructure projects in order to support citizens. Within the context of this thesis,

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<sup>67</sup> See for example S Dahan, ‘The EU/IMF Financial Stabilisation Process in Latvia and its Implications for Labour Law and Social Policy’ (2012) 41(3) *Industrial Law Journal* 305

<sup>68</sup> See for example A Koukiadaki and L Kretsos, ‘Opening Pandora’s Box: The Sovereign Debt Crisis and Labour Market Regulation in Greece’ (2012) 41(3) *Industrial Law Journal* 276

<sup>69</sup> IMF, ‘About the IMF’ (*IMF*, 8 July 2015) <<https://www.imf.org/external/about.htm>> Accessed 20 June 2016

<sup>70</sup> I Hautot, ‘The Excessive Indebtedness of Developing Countries and the Conversion of Debts’ (1990) 2 *International Business Law Journal* 253

'philanthropic' is presented as seeking to promote welfare gains. The World Bank funds private projects globally with a wide remit, ranging from establishing defences against natural disasters in Romania<sup>71</sup> to training and providing greater access to the justice system in Honduras<sup>72</sup> to name but a few examples. It appears to be more focused on the specific project than the IMF, which appears to be focused on aiding an ailing economy in line with macroeconomic principles.

Many proponents of variants of a financial transaction tax advocate that revenue raised by the tax should be allocated to philanthropic causes. This builds on the narrative of redirecting private funds from seemingly wealthy financial actors to often vulnerable members of society. If Tobin favoured funds being allocated to the World Bank, this would indicate a more philanthropic rationale, whereas if the proposed funds were allocated to the IMF, this would be an outcome focused more on national financial stability. The previous section indicates that, in the 1978 paper, Tobin mentioned both the IMF and the World Bank as possible recipients of the funds raised, however there appeared to be a preference towards the IMF on the initial wording. In 1996 Tobin re-stated his proposal for the tax and seemed to acknowledge, that while the 1978 paper did specifically mention the World Bank, it was the IMF which was best placed to introduce a tax, stating that the "IMF is in a good position to develop ways in which a transactions tax could work."<sup>73</sup>

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<sup>71</sup> World Bank, 'Mitigating the Risk of Natural Disasters in Romania' (*World Bank*, 18 September 2012) <<http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:23274535~menuPK:141310~pagePK:34370~piPK:34424~theSitePK:4607,00.html>> Accessed 5 April 2018

<sup>72</sup> World Bank, 'Strengthening the Justice Sector in Honduras' (*World Bank*, 10 May 2012) <<http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:23193451~menuPK:141310~pagePK:34370~piPK:34424~theSitePK:4607,00.html>> Accessed 5 April 2018

<sup>73</sup> J Tobin, 'A Currency Transactions Tax, Why and How' (1996) 7(1) *Supplement Open Economies Review* 493

However, he did explain the tension between revenue raising goals and its behaviour modification effects:

“In my 1978 article, I advocated channeling the monies collected by the tax to international purposes. I mentioned in particular the World Bank, thinking of subsidizing loans to poor developing countries. Now, however, there is a growing constituency of advocates of the tax for its revenue-raising potential, not its incentive effects. There is always a tradeoff between these two goals. The more the tax succeeds in the economic objectives that primarily motivated me, and the handful of economists who agree with me, the less revenues it collects for worldwide good works. In this case, however, there's plenty for both. Certainly the needs for resources for international purposes have exploded, as multilateral peacemaking and peacekeeping forces are in great demand, and refugees are suffering all over the world.”<sup>74</sup>

From these excerpts, it can be concluded that, although Tobin was aware of the need for increased resources for the IMF and the World Bank, the function of the money raised was not determinant on which institution he favoured. Instead, the primary aim was on the basic idea of behaviour modification. When advocating which institution should receive the funds, the emphasis seems to be on administrative capacity as opposed to the use of the funds raised. Whilst Tobin was aware of the potential and need for funds allocated for the public interest, behaviour modification was the main goal.

Keynes' and Tobin's work informs the development of the 2011 Proposal, but the arguments in favour of or opposing these policies have developed since both the publication of the *General Theory* in 1936 and 1978 Tobin Tax article. There remains further economic discussion linked to price volatility outlined in greater detail later in this

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<sup>74</sup> Ibid at 496-497

chapter. However, there are more general arguments regarding the 2011 Proposal which are discussed in the following section.

## **5. Arguments for and Against a Common Financial Transaction**

### **Tax**

If Tobin's original rationale is followed strictly, the primary justification for the 2011 Proposal is to reduce the amount of High Frequency Trading which helped to trigger, or at least accelerate, the scale of the 2008 crisis. The 2011 Proposal therefore encourages more efficient trading: institutions need to be certain that there will be a benefit to their consumers. As a consequence, there will be lower projected risk and lower volatility in the marketplace. A counter argument to this is that price stability in turn is affected; the greater the frequency of transactions, the more stable the cost of the product. Yet research from the Institute for Development Studies argued that price fluctuations due to volatility would be unlikely to increase if a Financial Transaction Tax were to be introduced. The report shows that, if implemented, there would be no negative effect, volatility would not increase, and stability would neither increase nor decrease.<sup>75</sup> Volatility is discussed in greater detail later in this chapter.

The second reason cited in favour of the 2011 Proposal is to act as a source of revenue for national treasuries. Since the revenue is collected by the national treasury, it is up to the Member State to decide how to utilise the money levied, which is particularly pertinent in states with sovereign debt crises or those with larger financial sectors who contributed a greater amount to financial stability measures. The argument therefore is that the greater

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<sup>75</sup> N McCulloch and G Pacillo, 'The Tobin Tax: A Review of the Evidence' (Institute of Development Studies Research Report 2011)

the number of transactions which take place within a particular Member State, the greater amount is raised and the greater the fiscal benefit. Opponents argue that overall the tax will be detrimental to national economies due to the acknowledged likely drop of at least 0.5 per cent in GDP owing to relocation. In support of this argument, opponents cite the experience of Sweden in the mid-late 1980s.<sup>76</sup>

“Following the introduction of an FTT, the trading in futures on bonds fell by 98 per cent within the first week of the application of the tax. In the light of this experience and the fear that the tax base could largely disappear the particular figures chosen might be seen as not being large enough. If the Swedish experience is indeed to be taken seriously and 98 per cent instead of 70 per cent or 90 per cent of the tax base is lost, this should reduce predicted tax revenue 15 or 5-fold respectively.”<sup>77</sup>

According to Manfred Bergmann the ‘AAA approach’ (All institutions, All markets and All instruments) of the Commission’s 2011 Proposal differs<sup>78</sup> from that of the Swedish tax. Furthermore, the Proposal also includes a review clause in Article 16 including an obligation to monitor the imposition of financial transaction taxes globally outside of the EU institutional structure.

“Every five years...the Commission shall submit to the Council a report on the application of this Directive and, where appropriate, a proposal for its modification.

In that report the Commission shall, at least, examine the impact of the FTT on the proper functioning of the internal market, the financial markets and the real

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<sup>76</sup> See S Umlauf, ‘Transaction Taxes and the Behaviour of the Swedish Stock Market’ (1993) 33 *Journal of Finance Economics* 227

<sup>77</sup> *Supra* n.22 at 617

<sup>78</sup> European Commission ‘Further Background Information’ (*Europa Taxation and Customs*, 15 January 2016) <[http://ec.europa.eu/taxation\\_customs/taxation/other\\_taxes/financial\\_sector/ftt\\_background\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/ftt_background_en.htm)> Accessed 29 January 2016

economy and it shall take into account the progress in taxation of the financial sector in the international context.”<sup>79</sup>

Nevertheless, there are understandable reservations. Assessing the design of the 2011 Proposal further, it is also clear the tax supports the ‘polluter pays’ principle, ensuring that the institutions that complete the most transactions ultimately pay more overall. Opponents argue that in fact ultimately there will be a cascading effect, whereby consumers will bear the burden of the tax when applicable, as opposed to a bank or financial institution. For example, pension funds which individuals pay into, but which are managed on their behalf, would be subject to the tax when buying shares, meaning that the cost of a transaction may be offset to individuals, as opposed to being absorbed by a large financial entity. There is also an argument that traders will simply change the type of transactions that they complete in order to pay the lower rate of tax in a form of arbitrage.

Opponents of the tax also cite difficulties in collection of the tax, particularly over the counter, or when collecting 0.01 per cent of a relatively small transaction. The opposite argument is that, since the majority of transactions which take place are now via electronic transfer as opposed to an over the counter, physical act, the tax would be far easier to collect than in previous years i.e. when the Tobin Tax on currency conversions was first presented.<sup>80</sup>

Furthermore, some argue that they are not necessarily opposed in principle to a form of Financial Transaction Tax. Their opposition is subject to further conditions, such as a commitment from the G-20 to implement the same tax and have a global rather than a regional, inter-state version of a tax. Contrary to this it is arguable that the EU should act

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<sup>79</sup> Article 16 2011 Proposal

<sup>80</sup> For an outline of technological developments in the shift from physical payments to debit cards and e-money, see F Dehghan and A Haghighi, ‘E-Money Regulation for Consumer Protection’ (2015) 57(6) *International Journal of Law & Management* 610

as a trendsetter in this area. In addition, others reason that there may be more effective alternatives, discussed in the following chapter.

## **5.1. Further Economic Literature Beyond Tobin Re Volatility and Accuracy of Information**

Keynesian economic literature beyond Tobin's currency transaction tax should be highlighted in order to provide further evidence for the economic underpinnings of the 2011 Proposal. This literature demonstrates that calls for taxation on speculative trading in an increasingly efficient and innovative financial marketplace, such as those made by the 2011 Proposal's supporters, are by no means new. These versions of taxes proposed by economists are analogous to the 2011 Proposal, therefore the underlying arguments are similar to the post-2011 debate. However the specific design differs in scope from the 2011 Proposal.

Summers and Summers<sup>81</sup> echo the concerns later expressed in Thomas Lin's article on algorithmic finance and High Frequency Trading regarding technological innovations:

“Technological and institutional innovations have radically transformed financial markets in the United States and around the world. These changes have permitted and encouraged spectacular increases in the volume of trade in securities of all kinds. In 1960, 766 million shares were traded on the New York Stock Exchange; by 1987, more than 900 million shares changed hands in the average week. More shares were traded on the lowest-volume day in 1987 than in any month in 1960. And more shares changed hands in the first 15 minutes of trading on October 19 and 20, 1987, than in any week in 1960.”<sup>82</sup>

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<sup>81</sup> L Summers and V Summers, ‘When Financial Markets Work Too Well: A Cautious Case for a Securities Transaction Tax’ (1989) 3 *Journal of Financial Services Research* 261

<sup>82</sup> *Ibid* at 261

They argue financial markets in the United States in 1989 had become too efficient; that it was far easier for companies to drastically change their investment portfolios more quickly and with an increasingly lower administrative cost whilst new derivatives markets were being created, with a large volume of trading.

Using Tobin's language, Summers and Summers state that financial innovators and ultimately free market economists view measures which throw 'sand into gears' as an inefficiency. This also ties in to the social utility of financial markets, asking how well spread risk is in an overly efficient financial market:

"The difficult question about our financial markets, however, concerns how well they perform their ultimate social functions of spreading risks, guiding the investment of scarce capital, and processing and disseminating the information possessed by diverse traders. Financial innovators and their academic champions argue that the facilitation of trading necessarily contributes to economic efficiency. They therefore see innovations that reduce trading costs as clearly beneficial and regard as badly misguided proposals, such as those of Keynes and Tobin, to throw "sand into the gears" of financial markets."<sup>83</sup>

Throughout the piece, while advocating a Securities Transaction Excise Tax (STET), Summers and Summers highlight the examples of Japan and Britain in particular to highlight that, administratively, such taxes are possible and that furthermore, if the United States were to introduce a STET, its overall competitiveness in financial markets would remain protected because of taxes being charged in other markets. This creates a link with two other points made in this thesis. Firstly, it highlights that stamp duty on shares in the UK is a form of a Financial Transaction Tax, supporting the argument that misuse of terms conflates wider understanding of the aims of the tax (i.e. stamp duty charged on share transactions differs in design from the Tobin tax, which differs from the 2011 Proposal as

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<sup>83</sup> Ibid at 263

detailed in Appendix A). Secondly, the article discusses the “significant” amount of revenue raised by STETs around the world. This thesis argues that there is an over-reliance on potential revenues raised by the tax. Rather, the primary aim should be to achieve the public good of financial stability. It therefore appears that even among academic literature, there is a tendency to fall into focusing on revenue over policies to achieve a public good of financial stability.

If Summers and Summers’ arguments are founded in the revenue raising potential of a STET, Stiglitz’s support is based more in terms of the curbing of speculative short-term trading and is therefore more aligned to this thesis’ argument that financial stability should take precedence over fundraising potential when assessing taxes on speculative trading. In making his assessment, Stiglitz reviews the effects of a tax at “a relatively low rate, say .5 percent to 1 percent of the value of the transaction.”<sup>84</sup> This is considerably higher than the rates proposed in the 2011 Proposal.

Firstly, Stiglitz explains the four conditions under which he considers governments introduce selective taxes, such as taxes on financial transactions. In addition to this, he presents examples of taxes on alcohol and Pigouvian taxes to demonstrate these four conditions in practice:

“(1) the commodity being taxed has a highly inelastic demand, so that the tax has little distortionary effect; (2) the commodity being taxed is a luxury good, consumed largely by the very rich, and not much weight is accordingly attached to the reduction in its consumption (perfume falls into this category); (3) the commodity being taxed is associated with certain benefits provided by the government (a benefit tax) – gasoline and airport taxes fall within this category; and (4) the commodity being taxed has some socially undesirable characteristics, such as giving rise to a negative externality. Alcohol and cigarette taxes in spite of their

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84 J Stiglitz, ‘Using Tax Policy to Curb Speculative Short-Term Trading’ (1989) 3 *Journal of Financial Services Research* 101

regressive nature are justified on the grounds of their inelastic demand and the negative social attributes of these commodities. Where gambling is legalized, it is almost always heavily taxed. *Corrective* (or Pigovian) taxes are designed to ameliorate some externality, where there is a deviation between private and social costs and benefits.”<sup>85</sup>

These four categories help to inform the overall discussion in this thesis, in particularly that governments tax commodities to socially undesirable characteristics. Many supporters of a common form of Financial Transaction Tax would argue that the fourth criterion identified by Stiglitz provides the impetus for common action. Stiglitz’s analogy with gambling indicates the Keynesian influence in this article:

“Americans love to gamble, and the stock market – while it serves other important social functions – is our largest gambling casino. It is such a popular gambling casino precisely because the winners can tell stories of their insights and theories, theories which, when subjected to the test of scientific verification (can they be used in a predictive manner?) inevitably fail. Of course, gamblers...tell stories of their "feel for the dice," their intuition for how things were going to turn out; but somehow, those stories connecting winning with the individual's own merits have a more hollow ring than the claims put forward by the successful stock speculator.”<sup>86</sup>

Stiglitz argues that the financial markets are a different beast from other sectors of the economy, however, and that certain functions within these markets would be improved by the introduction of a tax designed to discourage short-term speculative trading. Therefore, following from Summers and Summers’ argument that financial markets are too ‘efficient’, it is perhaps preferable, when discussing arguments in favour of a common Financial Transaction Tax, to avoid discussion of efficiency and instead use the language of

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<sup>85</sup> Ibid at 101

<sup>86</sup> Ibid at 107

encouraging transactions that support the ‘functioning’ of financial markets. However, the word ‘functioning’ appears in Article 113 TFEU, the legal basis for the 2011 Proposal. As discussed later in this chapter, determining what helps the ‘functioning’ of the internal market is difficult and whilst a change in language from efficiency to functioning may assist in economic discussions, it is not a panacea.

Stiglitz’s analysis is highly dependent on his characterisation of how financial markets work, in that individuals and institutions for one reason or another believe that they are at a relative advantage compared to others operating in the same system:

“Most of the short-term trading in the stock market is motivated by quite different considerations: individuals believe that they can beat the market, either because they are privy to insider information, or at least information that is not widely available, or because they believe that they are better able to interpret the world around them, and thus make predictions concerning the performance of various securities, than are other investors.”<sup>87</sup>

Stiglitz states that financial markets have three primary functions: exchange (i.e. allowing trading of financial instruments); information (i.e. the aggregation of data upon which to make decisions); and capital fundraising. With regard to the exchange function, Stiglitz further groups traders into one of four categories, the uninformed, the informed (i.e. there is some inside knowledge that gives an advantage), noise traders (i.e. people who think they know how markets work) and those in between, referred to as “partially informed” (who for example study the decisions noise traders make. Stiglitz appraises within the context of loss of welfare, the likely effect on each of these traders. This classification would still apply within the context of the 2011 Proposal.

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<sup>87</sup> Ibid at 102

With regard to uninformed traders, Stiglitz argues that they would be largely unaffected by a securities tax, since they have a diverse portfolio and are content therefore to match the market instead of trying to beat it. Informed traders would similarly not be impacted, since they base their investment allocations on specific pieces of information which do give them an advantage as opposed to noise traders who think they can (mistakenly) outsmart the market. Therefore, the tax would, according to Stiglitz, only have a real impact on noise traders and those who base their investment decisions based on noise traders, which he ultimately argues would lead to less volatile markets:

“The turnover tax primarily affects short-term speculators, those who buy and sell within the trading day, and within days or weeks. For these, such a tax may represent a significant fraction of the returns they hope to achieve on each transaction. These short-term traders consist of two groups: noise traders and those who live off them.”<sup>88</sup>

Most of Stiglitz’s more convincing arguments in favour of a securities tax however focus on the second function, collection of data. For each of the different classes of traders, decisions need to be based on available data to conduct their trades in order to ‘beat the market’. Therefore, there is a large incentive for individuals and financial groups to gather information and be able to analyse it quicker than competitors. Because of this, costs increase for institutions and, as a result, a tax to slow down speculative short-term trading, allied with moves to moderate financial innovations, would reduce these costs, since there is a greater emphasis placed on longer-term investments. Stiglitz refers on a previous article to tie this reduce in costs to the social return gained by the information acquired:

“Stiglitz and Weiss (1988) have shown that not only is the social return to this kind of information gathering – getting information slightly earlier than other investors – less than the private return, but this is even true of many of the financial innovations

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<sup>88</sup> Ibid at 105-6

(like more rapid recording of transactions) that have occurred in the past decade. More precisely, they show that such financial innovations – to the extent that there are any costs associated with them – actually lead the economy to a Pareto inferior equilibrium.<sup>89</sup> Barring these innovations (were this possible) could actually make everyone better off.”<sup>90</sup>

Stiglitz’s reasoning regarding the information aspect of finance extends beyond costs to the reliability of the information upon which decisions are made. Specifically, Stiglitz focuses on the reliability of share prices being an indicator of a company’s corporate health. Stiglitz states that Tobin’s theories were dependent on stock prices playing a central role in investment decisions and that “when stock prices are high, firms know to invest more.”<sup>91</sup> However, previous empirical work conducted by Greenwald and Stiglitz argued that prices in the stock market play no basic informational role in the economy. The price reflects the confidence in the marketplace between traders as to the value of the share. Although, ultimately, Stiglitz concludes that share prices still do have some value when making investment decisions, they cannot be 100 per cent accurate because of the distance between investors who do not have full information on the operation of a company and the directors of companies making decisions with non-public information:

“The fundamental question can be put simply: does one really believe that the managers of GM or Ford base their decisions about whether or how to invest on the prices that they see on the stock market? Do they think that those prices--reflecting judgments of the dentists in Peoria and the retired insurance salesmen in Florida--have much, if anything, to add to the analysis of their own market research departments and the reports from their engineers concerning costs of various projects? Any manager who argued that *because* the price of his stock was

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<sup>89</sup> Pareto equilibrium means that one party’s cannot be improved without making another party’s situation worse

<sup>90</sup> Ibid at 103

<sup>91</sup> Ibid at 107

high it was therefore a good idea to invest more would, I suspect, quickly find himself looking for another job.”<sup>92</sup>

In short-term speculative trading extending beyond the shares themselves to derivative agreements based on a future value of a share at a specific point in time, there is an incentive to act on information quickly, information which is therefore not 100 per cent reliable. The only time in which a decision can be made with 100 per cent accuracy concerns insider trading.

Stiglitz’s overall conclusions regarding the information function of financial markets can be summarised as follows, indicating again that the work is framed in the context of welfare economics by discussing social returns:

“The large deviation between social and private returns means that there are excessive expenditures on gathering information and on financial innovation. Individuals invest to the point where their marginal private return equals the return they could obtain elsewhere, and since their private return is more than the social return, this means that the net marginal social return is negative.

A turnover tax represents a tax on this kind of activity, and thus will serve to promote economic efficiency by discouraging the excessive expenditures on this form of "rent seeking." It can thus be viewed as a special and potentially important case of a Pigovian corrective tax, a tax that improves economic efficiency at the same time that it raises revenues.”<sup>93</sup>

Stiglitz’s hypothesis is that if volatility were to be reduced by reducing the activity of noise traders, there would be a positive impact on the final function of financial markets, raising of capital:

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<sup>92</sup> Ibid at 107

<sup>93</sup> Ibid at 103

“Of the three functions, it is only this last function to which I attach some limited importance. I do not think it would be greatly impeded by a small transfer tax; to some extent, I think it would be enhanced...I see a distinct advantage arising from a reduction in volatility. For, to the extent that volatility would be reduced, the buyer of the security bears less risk concerning the price he or she will receive when he or she sells it. Thus, reducing the volatility will make it easier for firms to raise equity capital.”<sup>94</sup>

While this thesis does agree with Stiglitz’s argument, it should be borne in mind that this paper states an economic case for a tax and is not in itself a detailed proposal, at least not to the same extent as the 2011 Proposal.

Both Summers and Summers and Stiglitz were published in 1989. However, studies which pre-date these papers also sought to discuss volatility and instability in financial markets. For example, Wojinlower also used the casino/gambling analogy when discussing credit crunches, highlighting the wider real economy social impact that financial markets have relative to casinos:

“The freeing of financial markets to pursue their casino instincts heightens the odds of such crises. With few bounds left on short-run price change, floating rates in the key banking sector, new futures markets, large international crowds of participants- and with a much more un-stable "outside" world providing continual reminders of the futility of longer-range plans-bizarre financial behavior is to be expected. Because, unlike a casino, the financial markets are inextricably interlinked with the world outside, the real economy pays the price.”<sup>95</sup>

In addition, French and Roll provide a form of empirical evidence which demonstrates that a speculative tax can significantly reduce volatility in financial markets. The overall aim of

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<sup>94</sup> Ibid at 108

<sup>95</sup> A Wojinlower, ‘Central Role of Credit Crunches in Recent Financial History’ (1980) 2 *Brookings Papers on Economic Activity* 277 at 326

the 2011 Proposal is to curb speculative short-term trading. The most extreme form of regulation would be to prohibit trading altogether. French and Roll provide an assessment of financial markets in 1968.<sup>96</sup> In making their assessment French and Roll examined variability between different time periods, for example under standard market conditions, it was observed that the difference between prices between the closure on Mondays and closure on Tuesdays was three times as great as the variability between the closure of markets on a Friday to closure on a Monday. However, due to a high volume of trading, for a period of time in 1968 markets closed on Wednesdays for administrative purposes to clear the backlog.

French and Roll's review discovered that the volatility between the close of markets on Tuesday and Thursday was halved when markets were closed on the Wednesday. The price reflected on different days of the week were to an extent dependent on the release of different news having an impact on the marketplace, however these results indicated that Wednesday trading was in itself a source of volatility.

On this assessment, the 2011 Proposal would reduce volatility. Admittedly, it is difficult to make direct comparisons in the structure of financial markets in 1968 with 2008, and by extension, to modern markets. However, the amount of information available which has a detrimental impact on financial markets, spreads far more quickly. Furthermore, the volume of trading is considerably higher, although the administrative procedures in place to cope have also developed since 1968.

Although this thesis agrees with the economic assessment presented in this section, it would be remiss to fail to present some more sceptical economic literature. By no means is there full economic consensus concerning Financial Transaction Taxes: Free market

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<sup>96</sup> K French and R Roll, 'Stock Return Variances: The Arrival of Information and the Reaction of Traders' (1986) 17(1) *Journal of Financial Economics* 5

economists would view them as an inefficiency, whereas social welfare economists, such as Keynes, Tobin and Stiglitz view financial markets as dangerous and raising the cost of accessing them is in the public interest. Schwert and Sequin reflect this confusion, concluding that there are too many questions remaining about the introduction of taxes on speculative trading that that more data is needed.<sup>97</sup> This is more than understandable and it reflects Pigou's concerns regarding Keynes' theories about a lack of available data upon which to conclusively state his theories as fact.

Further critique concerns the language used by Tobin and Stiglitz. For example, whilst the language used is a useful way of explaining Tobin's rationale, there is some critique of phrases such as 'throw some sand in the wheels' and classification of certain investors as 'noise traders'. For example, Dooley, specifically referencing Tobin's collaborative 1995 paper, states:

"Proposals to throw sand in the wheels of international capital movement are often linked to the view that short-term speculative movements of hot money are least likely to reflect fundamentals... Formal models of this idea assume the existence of 'noise traders' that induce variability in exchange rates unrelated to fundamentals. A transactions tax falls most heavily on such traders because each transaction incurs a new tax. In contrast, 'long-term' investments are taxed very little since a one time tax is spread over the life of the investment."<sup>98</sup>

Furthermore, Subrahmanyam<sup>99</sup> published findings from an empirical study of modelled Financial Transaction Taxes, indicating mixed results. On the one hand, the study is

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<sup>97</sup> G Schwert and P Sequin, 'Securities Transaction Taxes: An Overview of Costs, Benefits and Unresolved Questions' (1993) 49(5) *Financial Analysts Journal* 27

<sup>98</sup> M Dooley, 'Capital Controls and Emerging Markets' (1996) 1(3) *International Journal of Finance Economics* 197 at 199

<sup>99</sup> A Subrahmanyam, 'Transaction Taxes and Financial Market Equilibrium' (1998) 71(1) *Journal of International Business* 81

positive. It provides empirical legitimacy for Stiglitz's discussion of the information function of financial markets, stating that introducing a Financial Transaction Tax to reduce the emphasis on agents to race, in order to acquire information, would be a reasonable policy goal:

"Transaction taxes can reduce short-term information acquisition and increase traders' incentives to acquire long-term information, thereby enhancing long-term price informativeness and overall firm values. My analysis thus outlines some possible benefits of a transaction tax that are especially likely to prevail in large, competitive markets, while the potential costs are likely to be important in thin, relatively less developed financial markets, in which strategic behavior by informed investors is more likely to be an important issue."<sup>100</sup>

However, Subrahmanyam does highlight that a transaction tax can cause problems for market liquidity. He uses Stiglitz's language regarding the different types of trader in order to consider the impact of taxes on uninformed and informed traders:

"We find that the introduction of a small transaction tax increases market liquidity in the case of a monopolist-informed trader but decreases it in the case of multiple informed traders...Without a transaction tax, since the informed agents are Cournot competitors<sup>101</sup>, they end up trading "too much" in equilibrium, that is, in a dissipative fashion such that their profits decrease in the total number of informed agents in the market, leading to greater market liquidity. A transaction tax causes them to scale back their trading to the extent that, while their profits net of the transaction tax are decreasing in the tax, the profits gross of the transaction tax are increasing in the tax. This causes the transaction tax to have a perverse effect: it reduces market liquidity (and increases the adverse price impact faced by informationless traders), but it also reduces informed trader profits."<sup>102</sup>

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<sup>100</sup> Ibid at 107-108

<sup>101</sup> Cournot competitors compete independently of each other re their degree of output

<sup>102</sup> Supra n.104 at 82

These two distinct findings demonstrate a tension that the 2011 Proposal faces. On the one hand, there can be a legitimate policy aim in improving the quality of the information available and in reducing costs for agents to actively find information to act upon quickly. On the other hand, it is possible to characterise the 'credit crunch' experienced post-2008 as a liquidity crisis.<sup>103</sup> It would therefore seem to be detrimental, post-bail out, for a government to adopt provisions which, whilst seeking to reinforce stability in financial markets, reduce efficiency of financial markets. As detailed previously in this chapter, a well-functioning financial sector will provide several benefits for investors, for employees of financial institutions and for national governments in the form of greater tax receipts. Nevertheless, this thesis argues that the ultimate long-term policy goal of a common Financial Transaction Tax should be in ensuring financial stability by curbing speculative trading in financial markets, to reduce volatility and investments based on longer term, reliable information is in the public interest.

## **5.2. The Impact of Algorithmic and High Frequency Trading**

Tobin's original tax proposal was motivated by two factors. The volume of trading was set to increase due to the ending of fixed exchange rates and improvements in computing technology meant that electronic transfers were more rapid and easier to complete. These concerns were expressed again by Wojinlower, Summers and Summers and by Stiglitz. However, whilst these articles are aware of the increase in trading, they do not in themselves provide a full explanation of the more recent trend towards algorithmic and high frequency trading. Understanding these risks is crucial in explaining the intended aims of taxes, such as the 2011 Proposal.

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<sup>103</sup> See, for example, references to a liquidity crisis in A Campbell and R Lastra, 'Revisiting the Lender of Last Resort – The Role of the Bank of England' in I MacNeil and J.O'Brien (eds) *The Future of Financial Regulation* (Hart 2010)

Two articles by Thomas Lin explain the opportunities and pitfalls of increasing technological advances in financial markets. Using the term “cyborg finance”, Lin explains that financial markets are designed to work for the ‘reasonable investor’. However, computers have fundamentally changed the nature of who can be considered to be an investor. Lin’s ‘New Investor’ starts with an explanation of increasing recourse towards computers and smartphones in everyday life, in a drive towards being more productive, and time efficient. Lin states “Modern finance is cyborg finance, an industry in which the key players are part human and part machine.”<sup>104</sup> The focus of the article is primarily on the functioning of financial markets in the United States, with reference being made to the Securities and Exchange Commission encouraging technological innovation to be incorporated into financial decision making in the 1990s. These reforms have led to “a new form of finance in which complex mathematical models processed by computers at warp speed played critical roles in the most important decisions concerning capital allocation and risk assessment.”<sup>105</sup> As a consequence, ‘black box’ trading models (investment strategies comprising of decisions made by mathematical models) has increased, with algorithmic and high frequency trading being prominent forms of black box trading practice.

According to Lin:

“Algorithmic trading utilizes preset formulas to buy, sell and hold positions in various financial instruments...Computers are programmed to ‘automatically capture and read market data in real-time, transmit thousands of order messages

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<sup>104</sup> T Lin, ‘The New Investor’ (2013) 60(3) *UCLA Law Review* 678 at 687

<sup>105</sup> *Ibid* at 689

per second to an exchange, and execute, cancel or replace orders based on new information on prices or demand’.”<sup>106</sup>

As a result, news items have a much faster impact on financial markets and investment decisions than they even in 2008. On the one hand, this is a positive, since data sets can be assessed in fractions of a second and trades executed to protect the investor’s position. This is reliant on the mathematical model being correct and the information upon which these decisions are made being accurate. Stiglitz’s work demonstrates that this is a legitimate policy goal of a securities exchange tax, and therefore a legitimate policy goal in relation to the 2011 Proposal. However, the economists presented thus far (Keynes, Tobin, Stiglitz and Summers and Summers in particular) have made their arguments in an era where the risk of cyber security and ‘fake news’ could conceivably cause shockwaves in an economy in a very short period of time.

High Frequency Trading “refers to trading that uses computerized platforms to execute a large number of trades at super speeds. The velocity of high-frequency trading is measured not in minutes but in seconds and milliseconds.”<sup>107</sup> This can be a positive and increase liquidity in the marketplace. However, during periods of uncertainty, such as the 2008 crisis, volatility is increased. Lin’s article demonstrates that there has been a significant increase in HFT in the 2000s, with daily trading on the New York Stock Exchange from 2005-10 increasing by 164 percent. By extension, similar increases in the volume of trading have also been experienced in Europe and developing financial markets.

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<sup>106</sup> Ibid

<sup>107</sup> Ibid at 691

Lin discusses the different ways in which investors can be categorised, building on this further in a subsequent 2015 article.<sup>108</sup> He states that the regulation of financial markets is designed for the reasonable investor, a long-term trader who is assumed to understand neoclassical economics in operation. This does however tie in with Stiglitz's aversion to noise traders increasing volatility in marketplaces – these are short-term traders and therefore by extension can be considered unreasonable investors. Lin states “financial regulation is, therefore, structured to equip investors with the requisite information and tools so that ‘investors can protect themselves against corporate abuses and mismanagement’ in relatively efficient markets.”<sup>109</sup> The difficulty is, however, that real individuals are, at times, foolish and therefore in designing mathematical investment models, there is irrationality in the system. Lin's New Investor is better informed than Stiglitz's noise traders. The New Investor has easier access to information, the transfer of information is faster and their decision making can, as a result, be more rational by comparison with Stiglitz's noise traders and capable of better diversification.

Lin's characterisation of the new investor is part human and part computer, meaning in theory anyone with a computer or a smart phone is capable of being an investor. As Lin states “because we are all cyborgs, we all hold the promise and potential of becoming a better investor – of becoming the new investor.”<sup>110</sup> Keynes' advice from 1936, that speculative financial markets should be made expensive to access is therefore being tested, because technologically is making it easier to access these markets and become a noise trader. If that is the case, then the 2011 Proposal may be a Keynesian reaction to the increase in noise traders which Stiglitz identified.

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<sup>108</sup> T Lin, ‘Reasonable Investors’ (2015) 95(2) *Boston University Law Review* 461

<sup>109</sup> *Supra* n.109 at 695

<sup>110</sup> *Ibid* at 703

Lin presents a series of case studies concerning flash crashes, but gives two main consequences of the negatives of black box trading. Firstly, Lin says that systemic risks have become “too fast to save.”<sup>111</sup> This does not mean that an individual cannot cause problems for financial markets. However, it does mean that, by the time a systemic risk, such as those in 2008, has been spotted, the reaction is too late to prevent the risk from spreading. While there have been regulatory developments in financial supervision post-2008 with the agreement of the Basel III principles and the introduction of the Single Supervisory Mechanism in the EU, technology means simple oversight is not sufficient to save all banks. Secondly, Lin says that modern finance is “too linked to fail.”<sup>112</sup> This is an interesting take on the too-big-to-fail argument concerning the size of one institution being so great that government intervention is necessary to keep it in operation. This reclassification indicates the impact of the links between investors and the wider economy as demonstrated by the 2008 financial crisis.

Provisions such as the 2011 Proposal are designed to slow speculative financial transactions down, however at the time of writing, nearly eight years have passed since its release, without a common tax being introduced. In 1965, Gordon Moore, the founder of Intel, wrote an article<sup>113</sup> in which he predicted that “the number of components on integrated circuits would increase exponentially about every two years and costs would fall correspondingly, leading to incredible progressions in computing power and electronic processing capacity.”<sup>114</sup> Referred to as ‘Moore’s Law’, put simply, this meant that computing capacity would double every two years up to 1975. This rate of growth has

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<sup>111</sup> Ibid at 711

<sup>112</sup> Ibid

<sup>113</sup> G Moore, ‘Cramming More Components Onto Integrated Circuits’ (1965) 38(8) *Electronics* 114

<sup>114</sup> *Supra* n.109 at 683

largely continued to be accurate since the publication of the article in 1965 and this means that in the ten years since the financial crisis and the near seven years since the 2011 Proposal computing capacity has quintupled and trebled respectively. If Tobin's Proposal concerns the advent of technology changing investment behaviour, Moore's law indicates that the Proposal remains relevant in the modern day, with the 2011 Proposal acting as a post-2008 version of Tobin's proposed solution.

### **5.3. A Think Tank Perspective – Institute for Economic Affairs**

The partisan nature of a tax on speculative trading is perhaps best demonstrated by presenting the conclusions of a report by Tim Worstall, a fellow of the Adam Smith Institute, for the Institute of Economic Affairs, on the 2011 Proposal.<sup>115</sup> The Adam Smith Institute aims to promote Smith's economic principles, focusing on low, simple taxes and promotion of free market economics objectives in order to amend and inform public policy. The structure of the assessment centres on answering key questions regarding the 2011 Proposal. Much of this discussion reflects the concerns highlighted previously in this thesis. Whilst the report acknowledges that the 2011 Proposal is feasible, it concludes that there would be a net loss overall due to the loss of other tax receipts:

“A reasonable estimate of the marginal rate of taxation for EU countries is 40-50% of any increase in GDP. That is, that from all of the various taxes levied, 40-50% of any increase in GDP ends up as tax revenues to the respective governments. Thus if we have a fall of 1.76% in GDP we have a fall in tax revenues of 0.7-0.9% of GDP. The proposed FTT is a tax which collects 0.1% of GDP while other tax collections fall by 0.7-0.9% of GDP. It is very difficult indeed to describe this as an increase in tax revenue.”<sup>116</sup>

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<sup>115</sup> T Worstall, 'The Case Against a Financial Transactions Tax' (Institute of Economic Affairs Current Controversies Paper No.33, November 2011)

<sup>116</sup> Ibid at 6

Worstell's report also makes an assessment regarding who will ultimately bear the economic burden of the tax. The 2011 Proposal and social advocacy groups, such as the Robin Hood Tax group, argue that the tax will fall on financial institutions. However, Worstell disagrees. He states that the tax cannot fall on banks since corporations cannot in themselves bear the burden of a tax. Instead, a human being ultimately bears the final tax. Worstell tracks the incidence of stamp duty based on another IFS report in order to determine the incidence of the tax, arguing that users and workers will ultimately bear the cost:

“The incidence of stamp duty is dual: some part of it falls upon capital, making raising capital more expensive. This, in turn, just as with the corporation tax, will affect the workers' wages: more expensive capital leads to less of it being employed and thus lower average wages. Note that this does not mean that it is bankers earning less: it is the workers who earn less as a result of less capital being employed. The second part is the incidence upon the users of the financial markets: a fairly obvious result of a transactions tax. The IFS found that pensions achieved lower returns, partly as a result of lower share values as a result of the tax and partly as a result of paying the tax itself when changing which shares were owned in the pension fund. So part of the incidence of the FTT will be upon all users of any financial instrument, for all financial instruments are to be taxed.”<sup>117</sup>

Worstell also recognises that the 2011 Proposal would make financial markets smaller, but he argues that in itself this is insufficient to justify pro-Financial Transaction Tax arguments. He does state that more complex arguments in favour of a Financial Transaction Tax focus on excessive speculation increasing volatility, and non-excessive speculation reducing it, making reference to theories, such as Stiglitz's work, on noise traders. However, he contests that increases in volatility are linked to high transaction

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<sup>117</sup> Ibid at 7-8

costs. Thus a tax charged on financial products, in increasing the cost, would increase volatility, not decrease it.

Worstell is also sceptical as to whether the tax would make another financial crisis less likely. He attributes much of the 2008 crisis to Forex trading, arguing that the 2011 Proposal targets markets which did not fail and that certain economists, such as Robert Shiller, have argued that a lack of options in the futures markets in housing “failed to prick the US housing bubble before it blew.”<sup>118</sup>

Yet Worstell’s main critique appears to be focused on the politics of the Proposal. This thesis disputes some of this criticism. Discussing why the Commission might wish to introduce the 2011 Proposal, he states:

“There are, however, bureaucratic reasons why the European Commission might still suggest such a tax move. The revenues from the FTT would be designated as the EU’s ‘own resources’, that is, money which comes to the centre to be spent as of right; not, as with the current system, money begrudgingly handed over by national governments. The EU bureaucracy therefore has a strong interest in promoting such a change. What’s in it for the rest of society is harder to spot.”<sup>119</sup>

He frames some of the critique as a bureaucratic means by which the Commission can self-finance. However the following section contains a discussion of the ‘own resources’ claim. An assessment of the 2011 Proposal indicates that it is for national treasuries to collect the tax. They would keep the revenues for national government, meaning that although the EU budget could be indirectly financed through tax receipts received as a result of a common Financial Transaction Tax, they are not direct. Whilst the design of the

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<sup>118</sup> Ibid at 10

<sup>119</sup> Ibid at 6

2011 Proposal is not perfect, this is a clear mischaracterisation of the Proposal and contributes to the political economy obstacles discussed in this chapter.

#### **5.4. Extension of a Financial Transaction Tax to the United States**

One of the primary objections to the European Commission's Common Financial Transaction tax is that it is inter-state in nature and that in order to be effective, it needs to be applied globally i.e. beyond Europe. In order to be truly effective, there is an argument that the largest financial sector in the world, in the United States, should also be subject to a form of tax too. The 2008 crisis is attributable to the securitization of US sub-prime mortgages, therefore there is a logic in stating that, to avoid a repeat, the real cause needs to be addressed. Consequently, there have been multiple attempts in both the United States Congress and Senate to introduce a form of Financial Transaction Tax. The vast majority of these include the tax as a means by which to fund a particular cause. The most significant attempt to date has been a co-sponsored Bill, proposed by Representative Pete Defazio and Senator Tom Harkin.<sup>120</sup> The Bill sought to amend the Internal Revenue Code to impose a 0.03 per cent excise tax (3 cents on a \$100 trade) on security purchases if the trading facility or the purchaser/seller is in the United States. The Joint Committee on Taxation projected that the tax would raise \$352 billion over the course of 10 years.<sup>121</sup> Like the 2011 European Commission Proposal, certain transactions were considered exempt, however these exemptions differed significantly from the Commission's Proposal by including timeframes and not including refinancing and central bank transactions.

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<sup>120</sup> H.R. 3313 (112<sup>th</sup>) Wall Street Trading and Speculators Tax Act (2011)

<sup>121</sup> G Zornick, 'Financial Transactions Tax Introduced Again – Can it Pass This Time?' (*The Nation*, 28 February 2013) <<https://www.thenation.com/article/financial-transactions-tax-introduced-again-can-it-pass-time/>> Accessed 5 April 2018

The Bill was not enacted in spite of reintroduction in 2013.<sup>122</sup> More recently however there was a renewed impetus given to introducing a Financial Transaction Tax by Democratic Party candidates in the 2016 Presidential Election. Both Bernie Sanders and Hillary Clinton indicated support for a version of a Financial Transaction Tax. Hillary Clinton indicated support on her campaign website, but did not provide specifics in terms of rate, scope and purpose of money levied by imposing a tax. The phrasing of the commitment indicates that Clinton viewed such a tax as more of a behaviour modification tool:

“The growth of high-frequency trading has unnecessarily placed stress on our markets, created instability, and enabled unfair and abusive trading strategies. Hillary would impose a tax on harmful high-frequency trading and reform rules to make our stock markets fairer, more open, and transparent.”<sup>123</sup>

The other major Democratic Party nominee, Senator Bernie Sanders, sought to introduce a version of a financial transaction tax on several occasions. In 2011 Sanders proposed a tax of 0.02 per cent on credit default swaps to provide every US resident with healthcare services.<sup>124</sup> This included exceptions for initial issues and retirement accounts but did not include refinancing opportunities. In 2012, Sanders proposed a 0.25 per cent tax on securities to fund dental care reform.<sup>125</sup> Most recently, in May 2015, Sanders proposed an altered version of a Financial Transaction Tax to fund tuition free higher education<sup>126</sup>:

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<sup>122</sup> H.R. 880 (113<sup>th</sup>) Wall Street Trading and Speculators Tax Act (2013)

<sup>123</sup> Hillary Clinton Campaign ‘Wall Street Must Work for Main Street’ (*HillaryClinton.com*, July 2015) <<https://www.hillaryclinton.com/issues/wall-street/>> Accessed 5 April 2018

<sup>124</sup> S.915 American Health Security Act (2011)

<sup>125</sup> S. 3272 (112<sup>th</sup>) Comprehensive Dental Reform Act (2012)

<sup>126</sup> College for All Act (2015)

Sanders therefore appeared to view the imposition of the tax as a fundraising opportunity more in line with a Robin Hood Tax group ideology. Indeed, the summary of the Act expressly uses the term 'Robin Hood Tax'.<sup>127</sup> Both the Clinton and Sanders versions differ substantially from the 2011 Proposal, but all three have an underlying thread; taxing speculative trading. It is not inconceivable therefore that a similar-style tax will reappear in the future election pledges of democratic presidential nominees.

## **6. 2011 Proposal: Legal Obstacles**

In spite of the stated economic background and explanation of the mechanics of the 2011 Proposal, it has faced fierce opposition for various reasons. The main obstacles within the context of this thesis, that the Proposal faces are legal. The legal impediments need to be addressed in order to determine if it possible for a collection of Member States to proceed to adopt a form of regulation which they deem to be beneficial to their long-term financial stability in a Union which has now expanded to 28 Member States at the time of writing.

### **6.1. Article 113 TFEU: Unanimity and Advancing the Internal Market**

The primary legal hurdle that the 2011 Proposal faced was with regard to the chosen legal basis in the Treaties. Traditionally most legislative proposals use a *lex generalis* legal base, either Article 114 TFEU or Article 115 TFEU. Article 114 TFEU provides a process by which decisions can be made by Qualified Majority Voting (QMV) as opposed to unanimity, however Article 114(2) TFEU precludes fiscal matters, such as the proposed Financial Transaction Tax, from being adopted in this manner.

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<sup>127</sup> Bernie Sanders, 'Summary of Sen.Sanders' College for All Act' (*Bernie Sanders*, 19 May 2015) <<http://www.sanders.senate.gov/download/collegeforallsummary/?inline=file>> Accessed 30 January 2016

As a result, the Commission was required to examine other potential legal bases for the 2011 Proposal. The remaining options all require a unanimous decision in order to proceed. This creates two problems. The logistical problem concerns the numbers required to vote in favour of the 2011 Proposal in a then 27-State European Union. One side-effect of EU enlargement is that more voices are active in the decision making process. More parties to negotiations means that there is a greater chance of disagreement. This has in part led to a requirement to use QMV more frequently in order to complete a legislative programme. Article 114 TFEU is now the Ordinary Legislative Procedure, meaning that the use of QMV is now standard in EU law-making, unless the proposed legislation requires another specific *lex specialis* legal basis requiring unanimity. With regard to the 2011 Proposal, Appendix A contains a colour coded map of the then 27 EU Member States from January 2012, indicating their degree of support for the Financial Transaction Tax Proposal as calculated by KPMG.<sup>128</sup>

The second problem concerns the phrasing of the chosen alternative legal basis, Article 113 TFEU. Article 113 TFEU, states that the introduction of new forms of indirect taxation is permissible “to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.”<sup>129</sup> Therefore, in order to fall within the scope of the EU’s legislative competence, the 2011 Proposal is required to ensure the establishment and functioning of the EU’s internal market. A similar phrasing is used in Article 114 TFEU, which means that this would also have been a requirement under the QMV process, but the TFEU does explain how to determine if a Proposal in effect advances the internal market, in part due to a lack of precision in the definition of the EU’s internal market itself. Certain EU Member

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<sup>128</sup> S Lane, ‘Reviewing Member State Support For The FTT’ (2012) 1111 *Tax Journal* 16

<sup>129</sup> Article 113 TFEU

States have a domestic internal market (e.g. the UK market is an amalgamation of English, Welsh, Scottish and Northern Irish markets), but there are no questions regarding the competency to create these markets across borders as stated in Article 26(1) TFEU, which specifies the Union's aim to establish a common market.

This is a bizarre state of affairs, given that the concept of a common market has been present since the formation of the European Economic Community. Following the ratification of the Single European Act in 1987, there was a concretisation of the internal market at the core of the European integration project. A greater mandate has now been accorded to the concept of the internal market in the modern day EU. However it is not always easy to determine what the internal market is. For example, the EU has adopted provisions beyond the facilitation of free movement of goods to include more socially charged provisions, such as labour protection rights. De la Feria and Fuest identify the controversy as follows:

“The fundamental issue is whether, rather than conferring competence upon the Union as regards the internal market, that article [114 TFEU] actually imposes an obligation upon the Union to approve legislation with a view to establishing or improving the functioning of the internal market.”<sup>130</sup>

This frustration is built upon whether Article 26(1) TFEU, which states that the Union will seek to establish an internal market, merely determines a political aim, without providing a form of constitutional authority, a view advocated by Gulmann<sup>131</sup>, or provides a concrete legal basis for legislative action, as advocated by Schermers.<sup>132</sup> If it is held that Article 26(1)

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<sup>130</sup> R De la Feria and C Fuest, ‘The Economic Effects of EU Tax Jurisprudence’ (2016) 41(1) *European Law Review* 44 at 47

<sup>131</sup> C Gulmann, ‘The Single European Act: Some Remarks from a Danish Perspective’ (1987) 24(1) *Common Market Law Review* 31

<sup>132</sup> H Schermers, ‘The Effect of the Date 31 December 1992’ (1991) 28(2) *Common Market Law Review* 275

TFEU establishes a compulsory aim, a definition of the internal market must be provided. Article 26(2) TFEU states that the internal market comprises of “an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties.”<sup>133</sup> The concept can be broken down into removal of internal frontiers and free movement. Nevertheless, this breakdown provides terms which are rather general in nature, leaving scope for confusion and debate, in particular regarding the effect of “an area without internal frontiers” being included due to its potentially broad scope. In the absence of a clear definition in the Treaties, it has fallen to the CJEU to expand on the concept of the internal market, but this ultimately can create a series of inconsistent judgments. As Weatherill states:

“The legitimacy of the Court’s rulings is of enduring importance, since it amounts to the continued willingness of other actors to comply even when that does not correspond with their immediate self-interest...This is especially significant and sensitive given that the Court has famously, notoriously – a track record in delivering rulings that strain the outer edges of EU law.”<sup>134</sup>

De la Feria and Fuest highlight that in the *‘Titanium Dioxide’* case, the court stated that, “in order to give effect to the fundamental freedoms in [art.26 TFEU], harmonising measures are necessary to deal with disparities between the laws of the Member States in areas where such disparities are liable to create or maintain distorted conditions of competition.”<sup>135</sup> However, a more measured approach was taken by the CJEU in the later case of *Germany v Parliament and Council (2000)*,<sup>136</sup> better known as the *‘Tobacco*

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<sup>133</sup> Article 26 (2) TFEU

<sup>134</sup> S Weatherill, ‘The Court’s Case Law on Internal Market: ‘a Circumloquacious Statement of the Result Rather Than a Reason for Arriving at it’?’ in M Adams et al (eds) *Judging Europe’s Judges: The Legitimacy of the Case Law of the European Court of Justice Examined* (Hart Publishing 2013)

<sup>135</sup> Commission v Council (C-300/89) [1991] E.C.R. I-2867

<sup>136</sup> Case C-376/98 Germany v Parliament and Council [2000] ECR I-8419

*Advertising*’ case, which concerned a measure adopted under Article 114 TFEU to ban tobacco advertising. The measure covered mobile media, sponsorship and static advertising, such as billboards. The benefit of selecting Article 114 over Article 115 is the use of QMV as opposed to unanimity. The German government launched an Article 263 TFEU action for annulment on the grounds of incorrect legal basis for the provision. The action was ultimately successful, but the CJEU provided qualifications to the concept of measures establishing the internal market. Although eliminating distortions between States is within its scope, the Court determined that the measure must have a genuine objective of advancing the internal market, rather than removing disparities. This was affirmed subsequently in *Tobacco Advertising II*<sup>137</sup> concerning the revised Tobacco Advertising Directive – this included prohibitions on press and radio advertising as well as sponsorship. The CJEU held this was valid “since there were disparities between the national laws on advertising and sponsorship of tobacco products, which could affect competition and inter-state trade.”<sup>138</sup>

In a retrospective assessment of the case, Weatherill highlights that “momentous decision was heralded as an important assertion of the Court’s constitutional role in controlling political infidelity to the principle that the EU’s scope for action is limited to that mandated by the founding Treaties, which are now the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU).”<sup>139</sup> On the one hand, the transfer of interpretation of the “internal market” from the political sphere to the judiciary creates a degree of legal authority, and can therefore be viewed as a positive. On the other hand,

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<sup>137</sup> Case C-380/03 *Germany v Parliament and Council* [2006] ECR I-11573

<sup>138</sup> *Ibid*

<sup>139</sup> S Weatherill, ‘The Limits of Legislative Harmonization Ten Years After Tobacco Advertising: How the Court’s Case Law has Become a “Drafting Guide”’ (2011) 12(3) *German Law Journal* 827

there remains imprecision in the CJEU's classification. Weatherill argues in other work that inclusion of phrases used by the CJEU, including "appreciable" and "considerable" prompts many other questions and he is critical of the high constitutional weighting placed on these abstract concepts:

"So, if the divergent national measures subject to harmonisation cause an appreciable distortion of competition, the matter falls in principle within the scope of Article 114 TFEU and legislative harmonisation by the EU is permitted. If the distortion of competition is not appreciable, the matter escapes the scope of Article 114 TFEU...The adjective appreciable carries heavy constitutional weight."<sup>140</sup>

In selecting a legal basis which relies on the requirement of advancing the internal market, the 2011 Proposal encounters difficulties, since neither the Treaties, nor the CJEU's jurisprudence provide a definitive means by which to determine if proposals advance it, due to the use of abstract terms. If the 2011 Proposal does advance the internal market, a legal obstacle is avoidable. If it does not, then in theory, the Proposal is susceptible to legal challenge on these grounds. The question is, how can this be determined?

One method is to review the original 2011 Proposal for references to the internal market, in order to determine how the Commission interprets how the proposed tax assists its functioning. Principal references to the internal market are throughout the document and are framed in line with the arguments of avoiding fragmentation and preventing distortions in competition thanks to divergent measures being adopted at a domestic level. These arguments are framed principally to satisfy the Treaty requirements of compliance with the principles of proportionality and subsidiarity. The 2011 Proposal is clearly aware of the need to demonstrate that the proposed tax will assist the functioning of the internal market,

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<sup>140</sup> *Supra* n.139 at 102

but compliance with proportionality and subsidiarity does not automatically mean that the measure is necessary for the functioning of the internal market.

It is highly unlikely, though, that, if, the 2011 Proposal were challenged on this basis the CJEU would dismiss the objection. Weatherill's conclusion in the retrospective *Tobacco Advertising* piece is that the CJEU's reliance on vague terms has enabled the EU legislature to 'court proof' provisions. If they are challenged before the CJEU based on failing to advance the internal market, the "slippery" nature of the existing jurisprudence means that measures can fall within the classification of the internal market.<sup>141</sup> This is hardly a ringing endorsement of the 2011 Proposal, but it does appear to satisfy the requirements of Article 113 TFEU, and, by extension, opens the door for Enhanced Cooperation to be used. In addition, there are political differences which appear to cause the greatest problems for the 2011 Proposal.

## **6.2. The Own Resources Issue**

One potential further legal obstacle to the 2011 Proposal concerns the Treaty provisions concerning funding the EU. Part of the rationale for introducing the Financial Transaction Tax, as acknowledged in the Manfred Bergmann 'AAA' interview, as discussed previously in this chapter, was to allow EU Member States to use tax receipts attributable to the 2011 Proposal to contribute towards their contributions to the EU budget (i.e. financing the EU indirectly through Member State contributions), since the EU institutions themselves would not collect the tax. The previous section concerning the Institute for Economic Affairs' perspective, presents one view that the aim of the tax is to act as a "money grab" for the European Union institutions. This however, is a misnomer. Although the EU seeks to

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<sup>141</sup> *Supra* n.144

benefit from the tax revenue, it would be relying on the national treasury in each Member State to collect the tax on their behalf, using the money levied to contribute towards their existing financing obligations for the EU. As a result, the proposed tax it is arguably a new revenue stream for the Union. This creates a potential difficulty, since Article 311 TFEU states that the Union's budget should be financed wholly from its own resources. This is a more nuanced presentation of the IEA's arguments than the IEA itself offers.

Reassessing the operational side of the tax leads to the question as of whether the domestic tax authorities in each Member State can be considered as a resource of the EU. At first glance, the nature of a domestic tax authority is that it is a resource of the national government. This in turn leads to the question of whether or not the Member States can be considered as a resource of the EU for the purposes of its budget. If so, can the domestic tax authority indirectly be considered as a resource of the EU? Categorising the Member States as being a resource of the EU implies a subservient role for Member States.

However, upon closer inspection there is a solution to be found. Article 311 TFEU continues:

“The Council, acting in accordance with a special legislative procedure, shall unanimously and after consulting the European Parliament adopt a decision laying down the provisions relating to the system of own resources of the Union. In this context it may establish new categories of own resources or abolish an existing category.”<sup>142</sup>

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<sup>142</sup> Article 311 TFEU

There are two key parts to this paragraph. The first phrase is that there is a method by which it is possible to “establish new categories of own resources.” Returning to the Commission’s 2011 Proposal, which states:

“The subsequent Proposal for a Council Decision on the system of own resources of the European Union of 29 June 2011<sup>143</sup> identified a FTT as a new own resource to be entered in the budget of the EU. Consequently, this proposal will be complemented by separate own resource proposals setting out how the Commission proposes that the FTT will serve as a source for the EU budget.”<sup>144</sup>

This indicates that the Commission was aware of the problem of “own resources”. Essentially, the solution proffered by the Commission is to introduce separate proposals to ensure the Financial Transaction Tax as a new revenue stream is its “own resource” under the procedure in Article 311 TFEU. Reading the European Commission’s Proposal for a Council Decision on the System of Own Resources highlights that the Financial Transaction Tax is not seen as the panacea to the EU’s financing problems. It is seen as a key sub-part in a three pronged approach to reform, since, as the Proposal phrases it, “the EU Financing System is Outdated.”<sup>145</sup> The Own Resources Proposal explains the three pronged approach in greater detail, but in brief the approach includes simplifying Member State contributions, introducing new forms of ‘own resources’ (with both a Financial Transaction Tax and a new VAT resource system proposed) and reforming ‘correction mechanisms’ (a set of principles concluded at the 1984 Fontainebleau European Summit).

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<sup>143</sup> Commission Proposal for a Council Decision on the system of own resources of the European Union of 29 June 2011 (COM(2011) 510)

<sup>144</sup> 2011 Proposal

<sup>145</sup> Ibid

Article 311(3) TFEU indicates that not only must the EU recognise when a new resource is required, Member States must also consent. All 28 Member States could be deemed to support the 2011 Proposal as a new resource if adopted under Article 113 TFEU unless the Enhanced Cooperation process is required as discussed in chapter 3. Financing the EU remains a contentious issue, since Member States need to consent to how the EU is funded. As part of their accountability to the electorate, Member State governments need to present that contributions to the EU budget by the national treasury, funded, in part, via income tax contributions, represents value for money, in order to justify continued membership of the European Union. Regardless, this thesis advocates, particularly in chapter 4 that the true value received from participation in a common system of Financial Transaction Tax, is in a public good of financial stability through behaviour modification as opposed to fundraising.

## **7. Political Economy Obstacles**

The nature of taxation of the financial sector means that in addition to the differing economics argument and legal obstacles presented in this thesis, the 2011 Proposal also faces inherent political obstacles. These ramifications extend to the discussion in this thesis even when presenting economic arguments in favour of and opposing the introduction of a Financial Transaction Tax. Although there is an aim to remain neutral and present a representative critique of the process, this thesis does fundamentally favour the introduction of a Financial Transaction Tax on the strength of the Keynesian economics arguments.

More modern day scholarship in the field of economics owes a debt to the pioneering work of Adam Smith in the 1700s, in particular his *magnum opus*, '*The Wealth of Nations*'.<sup>146</sup> Smith argued that individuals were directed to pursue their own self-interest by the invisible hand<sup>147</sup>, which in turn cumulatively encourages a collective of individuals to pursue the national interest. In Smith's classification, it is citizens as opposed to governments, who are best placed to serve the general public interest. Chapter 4 of this thesis advances this concept in its discussion of 'public goods'. In this regard, the functions of government were superseded by automatic corrections in the marketplace, meaning that the role of government could be smaller and less interventionist. Smith's work represents an economic liberalism perspective of law in society, whereby individuals are free to engage in economic activity without or with limited restrictions whilst the State ensured that others did not interfere with those freedoms. As a consequence, Smith's work is reflected in the politics of libertarianism and small government conservatism and furthermore in economics literature through free market economics. This means that, under this interpretation, the 2011 Proposal acts against the general public interest. In not adopting Smith's doctrine and instead favouring Keynesianism, this is an automatic political preference for a more interventionist, but enabling, government. Therefore, this thesis subscribes to a more social liberal view, that individuals may need assistance in order to exercise their freedoms, such as financial investments.

Keynes adopted an approach to welfare which focused on investing in order to create a stimulus in the economy and to ultimately obtain 'full employment'. This is clearly a different approach from Smith, since Keynes' work is grounded upon the government playing an

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<sup>146</sup> A Smith, *Wealth of Nations* (First published 1776, Wordsworth 2012)

<sup>147</sup> Ibid at 445. The concept had appeared previously in Part IV Chapter 1 A Smith, *The Theory of Moral Sentiments* (First published 1759)

active role to create opportunities for the market. The case study of Australia presented previously has demonstrated the applicability of Keynes' theorems post-2008 and provides credibility for new Keynesian economists.

The move towards allocation to the individual and the concepts of welfare economics are also characterised by Pigouvian taxes; corrective taxes charged to deter behaviour which produces negative externalities. This thesis has previously referred to Pigou's critique of Keynes' *General Theory* and seeks to expand upon the previous outline of Pigouvian taxes, as detailed in Pigou's '*The Economics of Welfare*', first published in 1920.<sup>148</sup> The concept is designed to correct inefficiencies in the marketplace, or when extended by policymakers, to wider society for the long-term. Pigouvian taxes are particularly demonstrated by environmental taxes, such as introducing a tax on cars which produce a greater amount of CO<sub>2</sub> per km whilst removing other cars from taxation altogether. Long-term, the aim is to encourage drivers to modify their behaviour to reduce the negative externality by increasing the cost of access. This does not in itself prescribe a purpose for the funds raised from green taxes, yet they do appeal to policymakers and can be utilised in order to proffer policies to the electorate to highlight regulatory action against perceived negative consequences. Whilst this thesis does acknowledge that the 2011 Proposal represents a Pigouvian tax, there are some complexities and a juxtaposition to overcome. Pigouvian taxes are designed to encourage efficient markets, but Tobin's original proposal, as built upon by Summers and Summers, are framed in markets being too efficient, seeking instead to introduce taxes to make economic activity deliberately less efficient. If taxes such as the 2011 Proposal are truly Pigouvian, they should make a market more efficient in terms of its externalities. Ultimately, this classification centres upon the

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<sup>148</sup> A Pigou, *The Economics of Welfare* (First published 1920, 4<sup>th</sup> Edn 1938 R & R Clark)

interpretation of 'efficiency' and 'speed'. On the one hand, when describing markets as being too efficient, one could argue that this relates purely to the speed of conversion. The 2011 Proposal would not be Pigouvian in this context, since it creates a deficiency in speed. On the other hand efficiency could have a similar definition to efficacy. Consequently, the 2011 Proposal would be Pigouvian, because the negative externality (the volume of negative speculative trading and investments in non-performing products) is reduced, with the aim of increasing the quality of each individual transaction, which is efficient.

These considerations do lead to a practical difficulty. It is far easier to announce a contested policy in opposition than it is to attempt to introduce it in government i.e. it is easier to support the 2011 Proposal as an opposing party compared to a governing party. Castanheira et al<sup>149</sup> assessed empirical data with regard to the "political economy" obstacles that tax reforms face. They recognised that political constraints and conversely political incentives are the genuine driver of tax reforms, since "in democratic societies, policies are made by political parties who must win elections."<sup>150</sup> Proposed changes in tax policy, such as the introduction of a new form of financial transaction tax in isolation, create a more pronounced system of constraints and incentives, therefore a "status quo bias emerges in tax reforms: improving a tax system means starting from an existing situation and convincing politicians and voters to support a reform of the system."<sup>151</sup> Reforms generate uncertainty; ultimately most of the contested arguments against the 2011 Proposal concern uncertainty as to its effects as moving away from the status quo bias.

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<sup>149</sup> M Castanheira et al, 'On the Political Economics of Tax Reforms: Survey and Empirical Assessment' (2012) 19(4) *International Tax Public Finance* 598

<sup>150</sup> *Ibid* at 599

<sup>151</sup> *Ibid*

This thesis argues that there is evidence of a minimum standard for regulating financial services overall and that, when introducing proposals akin to the 2011 Proposal, these common standards should be the foundation stone.

Castanheira et al state that “the government can tailor its reform strategy to try and circumvent this opposition. One strategy is to pursue gradual reforms, which amounts to splitting the reform in different chunks, for instance, to target different groups at different moments in time.”<sup>152</sup> Therefore, if there is to be a significant move away from the status quo bias, regardless of the economic merits of the policy, step by step reform is a calculated political decision. This thesis is critical of the absence of a stated timeline for a phased introduction of the tax in the 2011 Proposal and recommends a gradual approach should be adopted in the final chapter of this thesis. A similar argument can be made concerning the Common Consolidated Corporate Tax Base discussions at EU level, also discussed in the final chapter.

When drafting a set of tax provisions, a political classification would indicate that rather than drafting the most economically sound policy, policies should instead appeal to the widest part of the electorate. In 1957, Downs wrote of the concept of the “median voter” in which political parties proffer policies preferred by the median voter.<sup>153</sup> Yet, this is a simplistic view of determining policy, since it assumes all actors can be placed on a single, traceable line to make identification of the median voter straightforward. Castanheira et al determine that the model cannot be maintained when applied to empirical data, since taxation is not a single dimension linear conundrum. The median voter can therefore develop an incentive to increase tax rates above efficient levels, with certain studies

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<sup>152</sup> Ibid

<sup>153</sup> A Downs, ‘An Economic Theory of Political Action in a Democracy’ (1957) 65(2) *Journal of Political Economy* 135

presenting directly contrasting results. Instead, the individual voter will support the policies which they believe will best serve their own interests, since there will be a direct impact on their welfare. It is therefore more politically well informed to draft policies which appeal to swing voters to encourage them to maximise their own interest independently of Tobin's original Proposal for International Monetary Reform, published in 1978. These characteristics are reflected in individual States either supporting or rejecting legislative processes which impact their welfare. The Enhanced Cooperation process, in theory, provides the opportunity for Member States who believe that participating in a legislative action promotes their own welfare, with non-participating States reflecting their perceived welfare gains by non-involvement. However, if a proposal drifts too far from the status quo bias, such as the 2011 Proposal, which has a potentially greater impact in the UK, Enhanced Cooperation can be challenged as indicated by the UK's unsuccessful Article 263 TFEU action for annulment discussed in chapter 3.

Castanheira et al's study appears to focus on national political economy considerations, as opposed to political economy considerations, in inter-governmental/supranational organisations, such as the EU. In addition to the concerns listed previously, legislation in the area of taxation also influences concerns about individual Member States' national sovereignty in tax affairs. By advancing so far from the status quo bias in the 2011 Proposal, Member States are more reticent to cede sovereignty to a common cause. Nation state and European Union political apprehensions are therefore reflected in the legislative process, complicating regulatory progress.

Proposals also require the cooperation of Member States with the legislative process in order to be adopted. Since the publication of the 2011 Proposal until the time of writing, there have been significant changes in the formation of national governments. For example Nicolas Sarkozy, a right-of-centre candidate, was the President of France at the time of initial publication. Sarkozy was succeeded by François Hollande, a socialist

candidate, who did not seek re-election in 2017. The current President, Emmanuel Macron is a centrist politician. France's government has therefore adopted three very different approaches with regard to preferred economic policies. These changes in domestic political structures have had a detrimental impact on policies including the 2011 Proposal. A lack of political consistency and certainty, as is the nature of politics, fundamentally alters negotiating positions. In addition to inherent obstacles in the EU legal framework, legislators have had to contend with an ever-changing landscape during these discussions. Adopting a more gradual approach, closer to the status quo bias, which introduces provisions in stages is far more politically attainable than an overly ambitious legislative agenda as seen in the 2011 Proposal.

The current chapter demonstrates the design of the 2011 Proposal and presents how this ultimately differs from the core macroeconomic principles in line with the work of Keynes and Tobin in particular. It also presents the inherent legal and political obstacles which have ultimately hindered progress towards the introduction of a common Financial Transaction Tax at EU level. However, in order to build upon this thesis' support for a common Financial Transaction Tax, the following chapter seeks to outline the importance of financial markets to the wider economy, their distinctive characteristics and ultimately presents a range of alternative forms of taxation and financial regulation to specify the role that a common Financial Transaction Tax would fulfil in seeking to achieve increased financial stability.

## **Chapter 2 – The Complexities of Financial Regulation: Adopted Measures and Alternatives**

### **1. The Importance of the Financial Sector To The Economy**

This thesis argues that the 2008 financial crisis demonstrated that the legal framework that was in operation to regulate financial markets was inadequate. In particular, its design failed to protect the wider economy from the economic effects of the crisis. The effects of the crisis were so severe that, in order to avoid a repeat experience, new forms of regulation are required. This thesis argues that the 2011 Proposal is part of a wider range of necessary reforms to either prevent a recurrence, or to limit the impact of any subsequent crises in financial markets, and that subsequently, this comparative financial stability provides a public good. Chapter 4 contains a fuller discussion of classifying regulatory intervention in this area as providing a public good. However, as the 'political obstacles' section in the previous chapter demonstrates, there is an opposing view to this main argument of the thesis. This is a more libertarian perspective, which would argue that markets are self-correcting and that government intervention distorts this natural balance. This argument is also developed further in chapter 4.

Therefore, the discussion in chapter 4 is preceded in this chapter by demonstrating the importance of the financial sector to the wider economy and the particular difficulties that financial regulation poses for legislators, i.e. why bespoke regulation is required. This chapter therefore outlines, using financial intermediation theory and economic theory, that specialist regulation in financial markets is required, relative to other sectors of the economy.

In addition, this thesis, whilst critical of financial institutions, seeks to present a balanced view of their potential merit, as opposed to engaging with a narrative which is more 'bank bashing' in nature. In fact, as some of the discussion in the previous chapter demonstrates, a stable financial sector provides opportunities for growth and can contribute to the economy. Therefore, this chapter seeks to present a more forthright argument in favour of financial regulation by presenting case studies in relation to financial regulation and taxation. Specifically, this chapter will present the examples of stamp duty (in relation to financial transactions), taxes on bank bonuses, bank levies, the extension of VAT to financial services and a Financial Activities Tax, alluded to in the previous chapter. This chapter also contains discussion of two key post-2008 financial regulation provisions, the international Basel III banking principles and the European Banking Union, in order to present examples of legislative action which have received support among states. These examples, whilst positive, indicate that whilst increased supervision and capital adequacy requirements for individual institutions demonstrate a consensus between states, they do not possess the same characteristics as tax provisions. Therefore, applying the principles of regulatory pluralism, discussed in chapter 4, truly effective reform would consist of a blend of these provisions.

Chapter 1 stated that one of the arguments opposing the 2011 Proposal is that other forms of financial regulation through taxation were more appropriate. This thesis is supportive of the introduction of a tax akin to the 2011 Proposal, however, it does not argue that these options for financial regulation are mutually exclusive, i.e. that if the 2011 Proposal were to be introduced, that VAT could not be extended to apply to financial services. It does argue that the 2011 Proposal presents significant advantages in comparison to these other forms of taxation, but other forms of taxation can provide complementary benefits. Yet in order to make this case, it is necessary to present the respective merits of alternatives. Chapter 3 outlines various options for introducing provisions by means of flexible

integration. Therefore, if the aims of individual tax provisions can be identified and presented as a means by which to achieve financial stability, in combination with other forms of financial regulation, such as Basel III and European Banking Union, then it may be possible to introduce a more wide-ranging and ambitious Common Finance Policy, in accordance with the principles discussed in chapter 4.

### **1.1. The Distinctive Functions of Banks and Financial Institutions**

The wider economy is based upon transactions which form part of wider society. For retail customers, high street banks, building societies and credit unions are the face of the financial sector. They are their first port of call for accessing financial services, whether opening an account, depositing and withdrawing money from an account, applying for a loan or mortgage or providing credit for businesses. These institutions promote financial inclusion, offering credit and, potentially, a range of investment opportunities which otherwise would not be available for businesses and individuals. These institutions provide a private source of capital to grow the national economy. In good times, borrowing and the cost of credit are relatively cheap. In times of economic uncertainty however, it is difficult for credit to be provided to customers. Banks and building societies comprise multiple sectors, which, in addition to retail banking, includes investment banking. Yet the intention of the 2011 Proposal is not to increase the cost of access to retail banking services. Instead, the emphasis is on individuals and collectives (i.e. hedge funds and brokers) who trade in speculative financial markets. The profitability of a financial agreement is also linked to the relative risk incurred: low risk, low reward and high risk, high reward. A good investor will have a spread portfolio with a range of investments. Thomas Lin's article, discussed in the previous chapter, indicates that a good investor is also a 'new' investor, able to access and process data in record time. One of the primary issues with the 2008 financial crisis was the volume of portfolios which were dependent on the American sub-prime mortgage market, which were mistakenly deemed safe, secure investments with low

risk. The lack of transparency in these markets, and the fear of investors who did not know their full exposure to losses, triggered the events of the 2008 financial crisis. With governmental intervention, the mislabelled risk ensured that private debt became public debt.

Tobin's original 1978 Proposal expressed concerns about financial innovation in currency exchange markets. Often, the developments of financial services can progress at a much faster pace than the law and regulation. Business entities and individuals who were not previously investors have now entered the marketplace, which in turn increases the number of 'noise traders' identified by Joseph Stiglitz as outlined in the previous chapter. Dragomir argues the distinction between banks and other parts of the financial sector has become increasingly narrowed:

“Banks and banking are changing: banks tend to be financial services firms, whereas other financial institutions are increasingly offering retail banking services and there are ever more alternative financial products that meet the demands of traditional bank products.”<sup>1</sup>

On the one hand, this is a positive. More actors in financial markets means that there is a greater amount of capital available for investments, which can provide social benefits. On the other hand, new investors, with less experience, can raise corporate governance concerns. MiFID introduced a 'know your customer' requirement<sup>2</sup>, which focused on understanding the individual client's expertise and providing advice accordingly. Yet there remain tensions in the structure of banks and financial services, which new investors may

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<sup>1</sup> L Dragomir, *European Prudential Banking Regulation and Supervision. The Legal Dimension* (Routledge 2010) 18

<sup>2</sup> For more on MiFID and Conduct of Business Regulation, see A Hudson, *The Law of Finance* (2nd Edn Sweet and Maxwell 2013) 291-315

be unaware of. Mullineux<sup>3</sup> states that banks are special within the financial sector, since managers have a fiduciary duty to both risk averse depositors and risk prone shareholders, banks are the most important source of external finance, especially for small and medium enterprises (SMEs) in all economies<sup>4</sup> and they are at the core of payments systems. Firms and households rely on banks for these services, meaning systemic crises are very costly. The key from this categorisation is that the emphasis when determining the justifications for legislative intervention should be determined by its functions. Banks provide additional challenges to regulators though, due to their unique nature. Dewatripont and Tirole define a bank as a:

“Financial intermediary that participates in the payment system and finances entities in financial deficit (typically the public sector, non-financial firms and some households) using the funds of entities in financial surplus (typically households).”<sup>5</sup>

Financial intermediation theory, outlined in the following section, further highlights why the role of banks is distinctive and, therefore, why specialist intervention is required to protect their functions relative to other sectors in the wider economy. Mullineux highlights the importance that banks have on firms and households with regard to financing and providing payment systems.<sup>6</sup> In the event of a crisis, the financial sector acts as the first domino in a series. Consequently, this has a knock-on effect on consumer spending and confidence in institutions to be able to meet their debt obligations. Subsequently,

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<sup>3</sup> A Mullineux, ‘The Corporate Governance of Banks’ (2006) 14(4) *Journal of Financial Regulation and Compliance* 375

<sup>4</sup> There is an argument that Peer to Peer lending is becoming an increasingly important source of financing. See for example R Lenz, ‘Peer to Peer Lending: Opportunities and Risks’ (2016) 7(4) *European Journal of Risk Regulation* 688

<sup>5</sup> M Dewatripont and J Tirole, *The Prudential Regulation of Banks* (MIT Press 1994) 13

<sup>6</sup> *Supra* n.3

businesses may react by cutting operating costs. This could mean freezing wage increases in line with inflation and the cost of living, cutting contracted hours, or offering redundancy packages to reduce operating costs and avoid going into liquidation. If unemployment increases, this also places an additional strain on the out-of-work welfare system, putting increased costs and strain on public finances. Many arguments advanced by social activist groups, such as the Robin Hood Tax group argue that these public funds could instead have been allocated differently had the 2008 financial crisis not happened, to infrastructure projects, as was the case in Australia, or to more socially beneficial areas of public expenditure, such as healthcare or education services, which chapter 4 explains, are considered to be public goods. Whilst this thesis acknowledges this argument, it argues that the design of the 2011 Proposal should have been centred on providing a public good in itself by modifying behaviour in a proactive manner before another financial crisis as opposed to raising funds for the treasury to provide public goods. However, this thesis is also cognisant of the particular difficulties which are raised by seeking to introduce new forms of financial regulation, meaning that, particularly in relation to tax, specialist regulation is required in order to be truly effective.

## **2. The Need for Specialist Regulation of Banks**

Given the impact on the wider economy, in times of severe economic crisis, this thesis takes the position that new forms of specific regulation are essential for long-term stability in financial markets. Yet the previous section, while outlining the functions of the financial sector in being able to provide services to consumers, does not in itself explain theoretically why specific types of regulation are required for the financial sector relative to other sectors. How is it possible to demonstrate this is the case?

## 2.1. Financial Intermediary Theory

Financial Intermediation Theory primarily explains the role that financial institutions fulfil in the wider economy, by examining the specific functions that they satisfy for their clients. It argues that banks and companies offering financial services act as financial intermediaries to ensure that one financial asset is transformed into another financial asset, which requires specific expertise. Depositors can be individuals or companies beyond banks entrusting intermediaries with capital. If a situation such as the American subprime mortgage crisis arises, whereby the investment enterprise fails to gain a return after transforming savings into investment opportunities, capital is permanently lost, which has a knock-on effect to the saver and to the wider economy due to a lack of available credit provided by the financial sector, curbing wider spending.

Financial intermediary theory also assumes that, in order for a financial system to be efficient five primary tasks must be continue to be fulfilled.<sup>7</sup> Firstly, an efficient financial system enables and guarantees the operation of the payments system. Secondly, it facilitates the allocation and transfer of resources over time between sectors or geographical areas. Thirdly, it offers a system of guarantees that reduces the uncertainty regarding the true value of money. Fourthly, an efficient financial system makes it possible to issue financial products (debt or capital) in order to invest into real investment projects. Finally, an efficient financial system provides information on the price of financial assets.

As identified in the previous chapter, Stiglitz argues, with empirical support, that introducing a Securities Transaction Exchange Tax, a form of Financial Transaction Tax similar to the 2011 Proposal, has a legitimate policy aim of improving the quality of information on the price of financial assets. No other sector performs all five of these

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<sup>7</sup> J Canals, *Universal Banking: International Comparisons and Theoretical Perspectives* (Clarendon Press 1997) 28

particular tasks and therefore regulation that may be effective for institutions in these wider sectors cannot be easily transposed. Whilst it is true that there is potential to over-regulate, there is a strong argument that it is for governments to ensure that, at a minimum, regulation preserves these five tasks as opposed to self-policing by the financial sector. Policies designed to fulfil these five tasks should provide a benefit to all (i.e. no one is excluded), meaning that preservation in line with financial intermediary theory provides a public good.

There is a divergence within this theory, providing two different perspectives to assess the degree to which these five tasks are fulfilled and consequently whether governments are required to act. The 'institutional approach'<sup>8</sup> favours an evaluation of the institutions that form financial markets, focusing on their ability to adapt to changes in the relevant sector and markets, effectively pre-empting regulation in a quasi-micro approach, since it focuses on the individual institution as opposed to the wider market economy. In the context of the 2008 financial crisis, this can be described as 'victim blaming' i.e. that the individual institution adopted poor investment strategies, which is not the fault of the market. The 'functional approach'<sup>9</sup> instead focuses on the ensuing functions that wider society expects from both the financial system and also financial intermediaries. This is a more 'macro' approach, since it focuses on consumer demands on the wider economy to guide legislative intervention as opposed to institutional practice. It assesses activities undertaken by financial intermediaries from the viewpoint of their ability to respond to the functions assigned to them. This thesis argues that, when applying the financial intermediation theory, the public reaction to the financial crisis indicates that a functional approach is preferable. The 2011 Proposal is ambitious in attempting to change the market

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<sup>8</sup> D Llewellyn, *Regulation and Supervision of Financial Institutions* (Chartered Institute of Bankers 1986)

<sup>9</sup> Supra n.7

culture from short-term excessive speculation, to a more long-term sustainable approach, as opposed to regulating specific institutions. The demands on the financial sector have changed and, as a result policy intervention in the form of increased scrutiny or increased taxation in the form of the 2011 Proposal, gain a greater degree of support despite institutional reservations.

Financial intermediaries (i.e. financial institutions) can be considered to act as agents for their clients. Capital is reallocated by their actions from those who have a surplus, to those who require funds.<sup>10</sup> Transaction costs arise because markets are imperfect due to divergences in knowledge between parties in the financial system. As a result, these information asymmetries are difficult to overcome for investors without the existence of agents, making the existence of financial intermediaries a prudent solution.<sup>11</sup>

In contrast, it is arguable that there is an overly negative perception of agents. Investment Capital's paper on Financial Transaction Taxes<sup>12</sup> argues that a large cost of transactions at present is taken up with agency fees and commission. In isolation, this appears to indicate that financial intermediaries only elevate transaction costs. However, Benston and Smith<sup>13</sup> and Matthews and Thompson<sup>14</sup> state that financial intermediaries have the ability of lowering various transaction costs, such as search, verification, monitoring and enforcement costs. It is therefore too simplistic to group all financial intermediaries together, and better to acknowledge that there are both general actors and specialist

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<sup>10</sup> F Mishkin, *The Economics of Money, Banking and Financial Markets* (7<sup>th</sup> Edn, Pearson 2006)

<sup>11</sup> See for example F Allen and A Santomero, 'What do Financial Intermediaries Do?' (1997) 25(2) *Journal of Banking and Finance* 271

<sup>12</sup> A Persaud, 'Improving Resilience, Increasing Revenue: The Case for Modernising the UK's Stamp Duty on Shares' (Intelligence Capital May 2017)

<sup>13</sup> G Benston and C Smith, 'A Transactions Cost Approach to the Theory of Financial Intermediation' (1976) 31(2) *The Journal of Finance* 215

<sup>14</sup> K Matthews and J Thompson, *The Economics of Banking* (2<sup>nd</sup> Edn John Wiley & Sons 2008)

brokers in financial markets. Agents can facilitate the changing of positions from high risk to low risk, based on market indicators, such as credit ratings. However, it is the quality of the information that all financial intermediaries act upon which at the very least needs to be improved. For example, the trigger to the 2008 crisis was securities backed by the subprime mortgage market in America, which was mistakenly believed to be stable. As indicated in the previous chapter, information which is relevant to financial market values now spreads far quicker than ever before. Policies such as the 2011 Proposal can improve this information gap for financial intermediaries and be beneficial to investors, but a macro approach is required across financial markets.

## 2.2. Economic Theory

Financial intermediation theory focuses on the preservation of five main tasks, but does not explain the role that financial actors play in risk creation and management. Economic theory, like financial intermediary theory is split into two branches, with one branch being more 'macro' in nature than the other. Unlike financial intermediation theory, the division in branches in economic theory is due to differing chronology. As a result, older theories<sup>15</sup> provide an explanation of the functions that banks perform in transforming risk, but do not label banks as financial intermediaries and do not refer to five tasks fulfilled, merely that banks transform and consolidate risk:

“The ‘old theories’...assume the existence of banks in the economy and apply standard micro-economic theory to explain the transformation and consolidation of risks, as well as the broker function performed by banks.”<sup>16</sup>

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<sup>15</sup> For example see J Gurley and E Shaw, *Money in the Theory of Finance* (Brookings Institution 1960)

<sup>16</sup> *Supra* n.1 at 15

Post-1980 'new' theories present a differing view. The older theories focus on the role that banks play in shaping the wider marketplace. Newer theories<sup>17</sup> instead focus on how pre-existing market imperfections have shaped how banks operate and the resulting functions that they perform. This thesis adopts the more modern view of economic theory, arguing that the 2008 crisis demonstrated clear imperfections, with new regulation being required accordingly.

Because of market imperfections, the modern view of economic theory provides three key reasons why banks should be considered as specialist entities requiring unique regulation and supervision. Firstly, as a consequence of managing customer accounts, the financial institutions are privy to masses of private and sometimes sensitive information, which puts them at a competitive advantage. There is an expectation that banks will safeguard this data but this comes at a cost, with the burden of keeping private information confidential from the open market. In effect, the profitability of a financial institution depends upon how effectively they use this information. Secondly, from a functional perspective, which to an extent reflects financial intermediary theory, banks take deposits and lend:

“The distinctive feature of banks stems primarily from their role in transforming liquid short-term liabilities (deposits that can be easily withdrawn) into illiquid long-term assets (commercial loans for which traditionally there is no market for liquid assets.”<sup>18</sup>

If this feature is 'distinctive', then only banks can benefit from this position, yet the burden of it is that, since deposits can be easily withdrawn, there can be a run on a bank, for

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<sup>17</sup> See for example G Benston and C Smith, 'A Transaction Cost Approach to the Theory of Financial Intermediation' (1976) 31(2) *Journal of Financial Research* 215 and D Diamond, 'Financial Intermediation and Delegated Monitoring' (1984) 51(3) *Review of Economic Studies* 393

<sup>18</sup> *Supra* n.1 at 18

example Northern Rock in the UK.<sup>19</sup> This is not so for other financial institutions, such as insurance companies, affecting a bank's ability to transform deposits into assets. It is for this reason that some authors have argued that there was a liquidity crisis as opposed to a credit crisis in financial services.

The final reason is that banks incur special risks which are distinct from these in other sectors. One particular risk is contagion. Systemic problems in one bank may spread to another in the same system, with two types of contagion, the 'real channel' and the 'information channel'. The real channel results from explicit financial links between banks as a result of exposure to another bank's failure (i.e. a domino effect). A good example of this is concerns the collapse of the three major Icelandic banks in 2008. In spite of operating individually, once one collapsed, the others followed.<sup>20</sup> The information channel, on the other hand, refers to imperfect information about a failure or a perceived failure of one bank, causing customers to withdraw deposits from other banks.<sup>21</sup> The information channel, given the development in technological innovation towards algorithmic financing, will likely become increasingly relevant. As the importance of cyber security grows, the need to have accurate information also grows. A misleading or 'fake' news story can be planted, which can trigger severe economic panic. New mechanisms are required in order to mitigate the impact of calculated attempts to cause financial panic. Therefore if proposals, such as the 2011 Proposal are adopted, which slow the volume of trading to

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<sup>19</sup> For an outline of the events of the run on Northern Rock, see R. Tomasic, 'Corporate Rescue, Governance and Risk-Taking in Northern Rock: Parts I & II' (2008) 29(10) *Company Lawyer* 297 and (2008) 29(11) *Company Lawyer* 330

<sup>20</sup> For an outline of the Icelandic crisis and explanation of Iceland's Regulatory response see E Gunnarson, 'The Icelandic Regulatory Responses to the Financial Crisis' (2011) 12(1) *European Business Organisation Review* 1

<sup>21</sup> For more information on the spread of contagion globally see M King and S Wadhvani, 'Transmission of Volatility Between Stock Markets' (1990) 3(1) *Review of Financial Studies* 5

limit its effects, the information channel aspect of the more modern classification of economic theory provides greater justification.

The 2011 Proposal clearly is a specific form of regulation. It is not the extension of an existing tax, although as the next section outlines, many states have a version of a financial transaction tax in following the 'stamp duty model'. However, as discussed in the previous chapter, one of the argument opposing the 2011 Proposal is that there are alternative forms of tax policy and financial regulation which are more appropriate to introduce.

### **3. Major Alternatives to the Proposed Financial Transaction Tax**

This thesis supports the introduction of a form of common financial transaction tax, but this is not at the expense of other forms of taxation on financial services. It is important to acknowledge some alternatives and outline their strengths relative to, for example, the 2011 Proposal. The use of the word 'alternative' does not in this context mean one or the other (i.e. only one tax can exclusively be adopted). Instead, in acknowledging that the 2011 Proposal is imperfect, these other forms of taxation are additional Proposals. Nevertheless, one of the factors that explains some of reticence towards the Commission's FTT is simply that there are alternatives forms of taxation, with some of these alternatives being more appealing to some states and organisations than others. This section focuses primarily on stamp duty, bank levies, bank bonus taxes, extension of VAT to financial services, the Financial Activities Tax, bank levies and a corporation tax surcharge.

#### **3.1. Stamp Duty Model**

Although the UK is in theory opposed to the Commission's Financial Transaction Tax, there is a variation of it employed in the City of London. In its most basic form the term 'Financial Transaction Tax' means any form of taxation charged on an individual financial transaction, with the 2011 Proposal including share transactions. Stamp Duty is a tax

payable on share transactions in UK incorporated companies and so the UK already has a Financial Transaction Tax. It was first introduced in 1974 as a 'Stamp Duty Reserve Tax' at a rate of 2 per cent before being lowered in 1984 to 1 per cent and again in 1986 to 0.5 per cent<sup>22</sup>, on share transactions, rates far higher than those outlined in the 2011 Proposal of 0.1 per cent. The tax, it can be argued, is an inefficiency, which at times has led to certain transactions being less competitive relative to other financial sectors.<sup>23</sup> Yet Stamp Duty on share transactions in the UK did raise £3.5 Billion in 2017-18 for the Treasury.<sup>24</sup> The Investment Capital report referred to previously in this chapter<sup>25</sup> bases its support for a wider Financial Transaction Tax on modernising and extending the existing Stamp Duty provisions to cover a broader scope of transactions. This is a logical argument, due to the technological innovations in financial markets since 1974, that as a minimum reform is required for share transactions.

The previous chapter, in its outline of the timeline towards the 2011 Proposal, presented discussion at the House of Lords' European Union Commission, with its report concerning alternatives to a Financial Transaction Tax being published in 2012. The House of Lords Commission report provides a useful explanation of the benefits of a Stamp Duty based model. The model was weighed against the proposed Financial Transaction Tax:

“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

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<sup>22</sup> See original ss 86-99 Finance Act (1986)

<sup>23</sup> For example, Stamp Duty was removed on AIM shares to encourage investment and provision of liquidity. See Company Lawyer, 'London Stock Exchange Applauds Decision to Abolish Stamp Duty on AIM Shares' (2013) 34(6) *Company Lawyer* 194

<sup>24</sup> HM Treasury UK Budget 2018 at Table C.5: Current Receipts

<sup>25</sup> A Persaud, 'Improving Resilience, Increasing Revenue: The Case for Modernising the UK's Stamp Duty on Shares' (Intelligence Capital May 2017)

rate of 0.5% of the value of purchases of UK listed companies. By contrast, the FTT has a broader scope and is 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.”<sup>26</sup>

This quote does reflect concerns regarding relocation of financial services, however a direct comparison can be argued to be impossible, since the 2011 Proposal seeks to extend taxation to the derivatives markets, to which stamp duty is not currently charged.

There are many examples of domestic smaller scale financial transaction taxes across Europe similar to stamp duty, such as in France<sup>27</sup> and Italy<sup>28</sup>, indicating that Member States are more open and willing to accept them as a form of taxation relative to the 2011 Proposal and the Financial Activities Tax. However they are limited in scope, offering a lower projected tax receipts and often not applying to the areas in which the most damaging speculation occurs. In the UK the roots of stamp duty lie in raising funds as opposed to behaviour modification as Tobin envisioned. If stamp duty is viewed as a fundraising tax i.e. a form of corporation tax for the financial sector, then it does not accurately reflect macroeconomic principles of long-term stability in the same manner as

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<sup>26</sup> House of Lords European Union Commission – Twenty Ninth Report, ‘Chapter 5: Alternatives to a Financial Transaction Tax’ (*Parliament UK*, 28 March 2012) <<http://www.publications.parliament.uk/pa/ld201012/ldselect/lducom/287/28708.htm>> Accessed 30 January 2016 at para 144

<sup>27</sup> See S Taieb and A Louvigne, ‘France: Recent Changes to Transfer Duties’ (2013) 11(3) *Tax Planning International Indirect Taxes* 7

<sup>28</sup> See V Wisenhoff, ‘Italy: Update on Financial Transaction Tax’ (2013) 15(6) *Derivatives and Financial Instruments* 179

a wider scope inter-state Financial Transaction Tax as envisaged in the 2011 Proposal. In addition, from a UK perspective, stamp duty on share transactions was charged before 2008. This indicates that the scope of domestic financial transaction taxes can be too narrow to prevent future recurrence of future crises on their own.

Hemmelgarn and Nicodème<sup>29</sup> note in their discussion concerning the adoption of the 2011 Proposal that there are two case studies of transfer taxes operating outside the EU framework, which are financial transaction taxes broader in scope than the standard Stamp Duty model. The first example cited is Switzerland's '*Umsatzabgabe*', a transfer tax, which is levied on the transfer of domestic or foreign securities, where one of the parties is a Swiss security broker. Specifically, "companies that own taxable securities of a book value in excess of CHF10 million qualify as security brokers."<sup>30</sup> The prescribed rates for the transfer tax are 0.15 per cent for domestic securities and 0.3 per cent for foreign securities. However there are some exemptions including Eurobonds. In 2007 the tax raised CHF1.9 Billion.<sup>31</sup> The second case study mentioned is Taiwan's Securities Transaction Tax. This is levied on the gross sales price of securities transferred, with chargeable rates of 0.3 per cent for share certificates issued by companies and 0.1 per cent for corporate bonds or any securities offered to the public that have been duly approved by the government. Taiwan also charges a stock index futures transaction tax on both parties to the transaction based on the contracted amount. Charged on individual transactions, the rates are 0.01 per cent and not more than 0.06 per cent, based on the value of the futures contract. In 2009 this raised €2.4 billion.<sup>32</sup> These case studies

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<sup>29</sup> T Hemmelgarn and G Nicodème, 'Can Tax Policy Help to Prevent Financial Crisis?' in J Alworth and G Arachi (eds) *Taxation and the Financial Crisis* (Oxford University Press 2012)

<sup>30</sup> Ibid at 144

<sup>31</sup> Ibid

<sup>32</sup> Ibid at 145

demonstrate that a broader version of Stamp Duty is administratively possible. This is the underlying argument from Investment Capital's policy paper. It is arguable that the 2011 Proposal is an extension of these existing taxes in line with, in particular, the Taiwanese model. The arguments made previously concerning the 2011 Proposal's interaction with financial intermediation theory and economic theory apply to Stamp Duty.

### **3.2. Tax on Bank Bonuses**

The underlying principle of taxing bank bonuses concerns the disconnect between the perceived reward for short-term overly risky performance, which is out of line with other forms of work in other sectors. This has been fuelled by a marked shift in the nature of awarding bank bonuses within the culture of the financial sector. Perhaps one of the highest profile examples of this controversy concerns Fred Goodwin, the former CEO of Royal Bank of Scotland who presided over the period of boom and bust which led to nationalisation. Goodwin's practices were heavily criticised.<sup>33</sup> There are indications that these discussions are unlikely to dissipate without major corporate reform. For example, in the United States similar questions were raised with regard to the Wells Fargo scandal and the retirement package for the Senior Vice President of Community Banking, Carrie Tolstedt, which initially comprised \$125 million before the implementation of clawback processes.<sup>34</sup>

Whilst this thesis does agree with reinforcing pay for performance in financial markets, it does not on a basic level agree that an automatic tax on bank bonuses is the best means

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<sup>33</sup> For more discussion concerning Goodwin's practices, see P Ashton, 'How "Fred the Shred" Got Away With It: Loud Calls For Company Reform' (2013) 1(1) *Birkbeck Law Review* 187. For discussion and a breakdown of the reported pension awarded, see K Weber, 'The Bank Boss and His Pension: Legal Implications' (2009) 20(3) *PLC Magazine* 7

<sup>34</sup> See M Fox and A Black, 'Wells Fargo, Corporate Wrongdoing and Clawback Provisions' (2017) 32(9) *Journal of International Banking Law and Regulation* 377

by which to achieve this. There should be a distinction made between bank bonus taxes and pay for performance measures, such as deferral (i.e. a proportion of remuneration is paid initially, with the remainder being paid at a later date), malus (i.e. deduction of remuneration before payment based on performance) and clawback (i.e. claims to repay remuneration issued for poor performance after employment). Under an automatic bank bonus tax, all 'bankers' are tarred with the same brush, whereas the existing thresholds for in particular malus and clawback provisions, both referred to in Article 94 of the Capital Rights Directive<sup>35</sup>, are of a sufficiently punitive nature to enhance pay for performance.

The public discontent with bank bonuses may stem from a lack of understanding as to how the bonus system has developed. Many banks were originally partnerships with lending risk held on the balance sheet, however with increasing international trade and increasing investment opportunities, banks started to increase capital bases by floating on the stock market. This enabled bankers to enter into profit-sharing bargains with new shareholders, creating the first system of bank bonuses. Therefore, bankers who were no longer tied to a particular employer could work for whichever bank offered the most generous bonus system. Additionally there has been an increasing prevalence of stock-based remuneration since the 1980s, designed under the principle of shareholder primacy to align the interests of shareholders and directors/senior management. Bankers were driven to take excessive risks for higher returns to inflate the price in the short-term and exposing the bank to more long-term risks. Hitting bonus performance targets outweighed long-term prosperity for the bank. As a result of the credit revolution, opportunities for greater bonuses also materialised, with risk being sold on to other investors with bonuses continuing to be paid. Once the risk materialised in the financial crisis, bonuses had already been paid and money had been taken out of the system. Payment deferral,

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<sup>35</sup> Capital Rights Directive 2013/36/EU

clawback and malus now address this system sufficiently in tying pay to performance targets. Furthermore, bank bonus taxes do not help to fulfil the five functions listed in financial intermediary theory outlined previously in this chapter.

### 3.2.1. Taxing Bank Bonuses in the UK

Nevertheless, in an attempt to curb this culture, in 2009, the Labour Chancellor, Alistair Darling, introduced a one-off bank bonus tax of 50 per cent, raising £2 Billion for the Treasury.<sup>36</sup> The tax appeared to have little effect on bank behaviour in terms of remuneration, with banks raising bonus payments paid by 25 per cent on 2008/09 levels.<sup>37</sup> In the absence of any tangible alteration in bonus payments taxing bank bonuses therefore only appears to have a financial strand. Support for taxing bank bonuses is provided by an investigation by Bell and Van Reenen which highlighted wage inequality in the economy has increased with bankers accounting for “somewhere between two-thirds and three-quarters of the overall increase in the share of wages taken by those in the top percentile.”<sup>38</sup> They concluded the crisis was little more than a blip for bankers’ remuneration. If a similar trend were to continue and a more permanent version of a tax on bank bonuses were to be introduced, it could both be viewed as a corrective tax for wage inequality as a social positive or viewed as a punishment for bonus payments being made to executives. The policy reappeared in both the Labour and SNP 2015 UK general

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<sup>36</sup> A Wilson, ‘Bankers’ Bonus Tax Failed, Admits Alistair Darling’ (*The Telegraph*, 2 September 2010) <<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7976575/Bankers-bonus-tax-failed-admits-Alistair-Darling.html>> Accessed 30 January 2016

<sup>37</sup> S Bowers et al, ‘Bonuses : The Essential Guide’ (*The Guardian*, 28 February 2013) <<http://www.theguardian.com/business/2013/feb/28/bonuses-the-essential-guide>> Accessed 30 January 2016

<sup>38</sup> B Bell and J Van Reenan, ‘Bankers and Their Bonuses’ (2013) 124(574) *Economic Journal* F1 at F2

election manifestos, with Labour's manifesto seeking to use the funds to create a job guarantee for unemployed youths<sup>39</sup>, which supports the former view.

However, as a policy, this tax on bank bonuses was flawed for two reasons. Firstly, it may not have generated as much revenue as Labour and the SNP envisaged. In 2011 the European Commission proposed legislation to implement global standards developed by the Basel Committee on Banking Supervision. Article 94(1)(g) of Directive 2013/36/EU<sup>40</sup> includes provisions indexing variable remuneration to fixed remuneration with respect to individuals whose professional activities impact on the risk profile of credit institutions and investment firms. Article 94(1)(g)(i) of the Directive specifies the variable component of remuneration shall not exceed 100 per cent of the fixed component of total remuneration for individuals, but does permit shareholders to raise this to up to 200 per cent of fixed remuneration in certain circumstances.

Many have stated that this is a 'cap' on bank bonuses. As a result, the UK government brought an unsuccessful action for annulment under Article 263 TFEU to the Court of Justice of the European Union.<sup>41</sup> The UK's primary argument of the incorrect legal basis being used to introduce the Directive was dismissed by the Advocate General on the grounds that, rather than fixing the rate of pay, the ratio itself does not dictate the level of pay. Rather, the financial institution does, which leads to negotiation between staff and banks. There is, therefore, effectively no 'cap' on variable remuneration as such since

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<sup>39</sup> 2015 Labour Party General Election Manifesto at pg32

<sup>40</sup> Directive 2013/36/EU on Access to the Activity of Credit Institutions and the Prudential supervision of Credit Institutions and Investment Firms, Amending Directive 2002/87/EC and Repealing Directives 2006/48/EC and 2006/49/EC

<sup>41</sup> Case C-507/13 United Kingdom v Parliament and Council

there is only an indirect link with pay. Following the publication of the Advocate General's Opinion the UK elected to withdraw its legal challenge.<sup>42</sup>

In addition, in March 2015 the European Banking Authority published draft remuneration guidelines outlining the governance process for implementing sound remuneration policies across the EU.<sup>43</sup> They also specify the criteria for mapping all remuneration components into either fixed or variable pay and complement the European Banking Authority Opinion on allowances issued in October 2014.<sup>44</sup> The guidelines seek to remove national waivers used to exempt some companies from rules introduced to reform banker pay.<sup>45</sup> The Financial Conduct Authority has previously granted waivers for standalone asset management companies and personnel at small banks, meaning the scope of ratios may be extended beyond senior management. The move was subject to a three month consultation period, with the rules to come into force by the end of 2015. The new EBA regulations are not guaranteed to come into force and could still be challenged by national authorities. For example, a joint statement by the UK's Prudential Regulation Authority and Financial Conduct Authority accepted all guidelines bar limiting variable remuneration to 100 per cent of fixed remuneration, or 200 per cent with shareholder approval, to all firms subject to the Capital Requirements Directive (CRD).<sup>46</sup>

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<sup>42</sup> See M Randall and L Lu, 'Capping of Bankers' Bonuses? Case C-507/13 UK v Parliament and Council' (2015) 42(4) *Legal Issues of Economic Integration* 383

<sup>43</sup> EBA Consultation Paper 4 March 2015, Draft Guidelines on Sound remuneration Policies Under Article 74(3) and 75(2) of Directive 2013/36/EU and Disclosures Under Article 450 of Regulation (EU) No 575/2013

<sup>44</sup> EBA, 'EBA Reviews Guidelines on Remuneration Policies' (EBA, 4 March 2015) <<https://www.eba.europa.eu/-/eba-reviews-guidelines-on-remuneration-policies>> Accessed 30 January 2016

<sup>45</sup> L Noonan and C Binham, 'Brussels Seeks Bonus Caps for Smaller Lenders' *The Financial Times* (London, 5 March 2015) 19

<sup>46</sup> PRA and FCA Statement of Compliance With the EBA Guidelines on Sound Remuneration Policies of 29<sup>th</sup> February 2016

Secondly, the City maintains a competitive advantage globally in financial services. In order to maintain its status, firms require top talent which usually costs a lot of money to retain and, to prevent relocation to other financial sectors. Following the CJEU case, it was argued that, in order to be retain the advantageous position as attractive employers, either a higher fixed rate of remuneration would need to be offered in order to facilitate a greater amount received as variable remuneration in line with the ratio or offer new methods of remuneration, such as share offerings to offset the effect of any cap.<sup>47</sup> In addition, although the maximum ratio between fixed pay and bonus is designed to reduce short-term risk-taking and align bankers' behaviour with the long-term interest of banks, it may have the reverse effect. A tax on the variable remuneration aspect of bankers' pay may again lead to banks raising fixed salaries to compensate for this, meaning that any policy aspect of a bank bonus tax of not incentivising risk is undermined. Raising fixed pay may firstly increase the fixed costs for banks, whereas the 2011 Proposal would be charged on individual transactions, which are a variable cost. In addition, if pay is fixed, remuneration will not vary in line with a bank's performance. In guaranteeing fixed pay, bankers may in fact take more risky decisions, which can lead to short-term, high reward gains for the financial institution, which may attract new investors. However, this could have a snowball effect in the long run, encouraging higher basic salary payments to retain staff whilst risk continues to develop as before, putting the bank in a dangerous situation, whereby the fixed costs offer limited degrees of flexibility in managing financial difficulties within an institution.

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<sup>47</sup> For example see M Seiler and D Fischer, "'Bonus Bonds' For Bankers: A New Type of Debt-Based Remuneration in the Financial Industry' (2015) 12(3) *European Company and Financial Law Review* 425 and L Lu, 'The End of Bankers' Cap: How Will the UK Regulate Bankers' (2016) 27(7) *European Business Law Review* 1091

Thirdly, the framing of a bank bonus tax appears to be punitive in nature, relocating funds from a profession deemed to have caused widespread social harm to those affected by its conduct but targeting the wrong individuals and institutions. The proposal to tax bank bonuses supposes, firstly, that banks and individuals were equally culpable for the financial crisis and, secondly, that the individuals still work for these companies or in the financial sector at all i.e. that the 'bad apples' have not been rooted out of the company. This has a knock-on effect of those not responsible effectively subsidising the misconduct of others. A bank bonus tax does not therefore change the culture of pursuance of excessive speculative gains and is a more micro approach to a problem requiring a macro solution.

### **3.3. Bank Levies**

One of the major macro solutions to changing the culture of financial investments through taxation is to tax an institution as a whole dependent on its size. The design of bank levies indicates that the larger the bank as determined by the size of its balance sheet, the larger the potential risk to the wider economy and the more problems they are likely to cause should they encounter financial difficulty. This thesis is underpinned by the argument that the regulatory requirements in the financial sector prior to the financial crisis were insufficient and that ultimately insufficient progress has been made in introducing policies designed to curb speculative trading. This does not mean however, that this thesis overlooks the fact that legislative steps have been taken to introduce bank levies in the UK and beyond in order to modify bankers' behaviour. Many bank levies have been introduced post-2008. In order to understand why there have been legislative successes in this area unlike with the 2011 Proposal, it is necessary to explain timelines and outcomes, both in the UK and beyond, to demonstrate the importance of the design of a bank levy in order for it to be effective. This thesis supports the introduction of bank levies, however it does argue that the 2011 Proposal can function in tandem to enhance the overall policy of

curbing speculative trading, with bank levies being calculated and payable only at certain times of the year, and a financial transaction tax fulfilling a nanosecond by nanosecond role to reduce speculation. With regard to the interaction between bank levies and financial intermediation theory, in order to calculate the amount payable, a detailed assessment of the balance sheet needs to take place. Provided the assessment is accurate, this provides information to investors about exposure to risk, which improves the information and uncertainty requirements in the five factors listed previously. Bank levies are also a more macro approach – although calculated on an individual institution by institution basis, the overlaps in financial markets mean that in theory exposure to risk is limited across borders.

### **3.3.1. Bank Levies in the UK**

In the Finance Act (2011)<sup>48</sup>, the UK adopted a bank levy. Prior to the introduction of this levy, HM Treasury published a consultation in October 2010. Its executive summary outlined that the levy would be designed with two functions, namely raising revenue from banks, in order to reflect their potential risk factor, and to modify funding activities to achieve stability:

“The design of the Levy is based on the proposal in the International Monetary Fund Report to the G20, ‘A Fair and Substantial Contribution by the Financial Sector’, for a broad balance sheet charge. It has been designed to encourage less risky funding and complements the wider agenda to improve regulatory standards and enhance financial stability.”<sup>49</sup>

Furthermore, the consultation recognised the wide-ranging impact of the financial crisis on the wider economy, stating that “The Government believes that banks should make a full

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<sup>48</sup> Clause 72 Schedule 19 Finance Act (2011)

<sup>49</sup> HM Treasury Bank Levy: Consultation Response (October 2010) at 5

and fair contribution in respect of the potential risks they pose on the wider economy.”<sup>50</sup> This echoes a criticism which is elaborated upon in greater depth in chapter 4, in that in framing the proposed reform in terms of ‘fairness’, there can be a potential to dilute the macroeconomic arguments underpinning a policy, meaning that their design can be distorted and open to greater levels of critique.

The UK bank levy was first introduced on 1<sup>st</sup> January 2011, with an introductory rate of 0.05 per cent for 2011, with an increase to 0.075 per cent from 2012. At the time of its introduction, Mark Hoban, Financial Secretary to the Treasury, stated that:

“The levy which comes into force today means that banks will now make a full and fair contribution in respect of the potential risks they pose to the wider economy. This measure will also encourage banks to reduce their dependence on the riskier, short-term funding that was one of the main causes of the financial crisis. Once fully in place, the bank levy is set to raise £2.5bn per annum.”<sup>51</sup>

It is clear that at least at the outset the bank levy's aim was to encourage changes to banks' funding models, while also consistently raising £2.5bn. The levy was charged according to where a bank was domiciled.<sup>52</sup> Banks located in the UK were charged on an assessment of their global balance sheet, whereas international banks were charged based on their UK balance sheets. However prior to 2014/15 the £2.5 billion target was not met: in 2011/12 the levy raised £1.8 billion, with £1.6 billion raised in 2012/13<sup>53</sup> and £2.3 billion in

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<sup>50</sup> Ibid at 7

<sup>51</sup> R. Milnes, ‘Lessons From the Bank Levy’ (2014) 1208 *Tax Journal* 8 at 8

<sup>52</sup> Full operation and calculation of the Bank Levy was detailed in Schedule 19 of the Finance Act (2011). Part 3 addresses ‘Groups Covered by the Bank Levy’

<sup>53</sup> See for example S Slater (*Reuters*), UK Raises Bank Tax for a Sixth Time as Proceeds Fall Short, (5 December 2013), available at <<http://uk.reuters.com/article/2013/12/05/uk-britain-budget-banks-tax-idUKBRE9B40QJ20131205>> Accessed 23 March 2015

2013/14.<sup>54</sup> A series of increases in the rate ensued, reaching 0.21 per cent, commencing on 1<sup>st</sup> April 2015.<sup>55</sup> This appeared to be a clear shift in the purpose of the bank levy from reducing exposure to risk and providing a target of £2.5 billion per annum, to being seen purely as a means by which to raise revenue.

While the design of the bank levy is such that it taxes institutions at the same rate, this does mean that larger institutions, or ones which have not taken steps to reduce the size of their balance sheet, appear to pay a proportionately higher amount than others. For example, the UK's largest bank is HSBC. Writing in the Financial Times, Patrick Jenkins explained that HSBC in having a large global balance sheet already paid over one third of the overall levy<sup>56</sup>, so in 2013-14 HSBC paid at least £759 Million alone. Jenkins also noted at the 2015 increase that a "back of the envelope calculation suggests it may jump by £200 Million to £300 Million."<sup>57</sup> By contrast, rivals and state backed banks that had reduced their overall balance sheet and therefore market exposure should be lower, negating the raise in the basic rate to a certain extent.

Following the increase in the rate of the bank levy prior to the 2015 UK General Election, Anthony Browne, Chief Executive of the British Bankers' Association, raised concerns related to deterrence of investment in UK markets and wider competitiveness. In addition to stating that UK banks pay £40 Billion p.a. in taxes, the Chief Executive stated:

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<sup>54</sup> Budget 2015 at Table C.3: Current Receipts: OBR Forecast

<sup>55</sup> Budget 2015 at para 2.131

<sup>56</sup> P Jenkins, 'Poetic Justice as Tax Assault Delivers Another Bloody Nose to HSBC' *The Financial Times* (London, March 19 2015) 3

<sup>57</sup> Ibid

"The bank levy imposes a significant cost on banking businesses in the UK, which is making many banks move work and jobs to other parts of the world, and is deterring international banks from investing in the UK.

This major increase in the bank levy is likely to accelerate that process and damage the competitiveness of the UK economy.

This will also further disadvantage UK headquartered banks by increasing tax on their overseas activities, while their competitors in those markets do not pay this tax at all."<sup>58</sup>

The main concern therefore appeared to be that in having a different application for UK based banks relative to global banks with operations in the UK, a raise in the levy would make them proportionately less competitive and be ultimately detrimental for the City in terms of discouraging foreign investment in acting as a potential hindrance to accessing a marketplace.

### **3.3.2. UK Change in Bank Levy Tax Base Post-2015: A Move Towards Corporation Tax Surcharge**

Following the 2015 UK General election, the Chancellor announced an about face in the Summer Budget 2015. The rate of the levy would be subject to a phased reduction and in addition the scope of application was narrowed. To compensate for this offset in revenue the Chancellor announced a new tax on bank profits:

“• the introduction of a new tax on banking sector profit from 1 January 2016, set at a permanent rate of 8%.

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<sup>58</sup> British Banker's Association, 'BBA Response to Bank Levy Increase in the Budget' (*British Bankers Association*, 18 March 2015) <<https://www.bba.org.uk/news/press-releases/bba-response-to-bank-levy-increase-in-the-budget/#.VQ9iAeFWW3Y>> Accessed 30 January 2016

- a phased reduction of the bank levy rate, from the existing rate of 0.21% to 0.18% from January 2016, 0.17% from January 2017, 0.16% from January 2018, 0.15% from January 2019, 0.14% from January 2020 and 0.10% from January 2021.
- a change in the bank levy's scope from 1 January 2021, meaning that UK headquartered banks are levied on their UK balance sheet liabilities.”<sup>59</sup>

The change in reducing the scope and rate of the bank levy over the course of the following Parliament and compensating for this was undeniably good news for larger banks such as HSBC and RBS whose share prices rose following the news.<sup>60</sup> Antony Browne stated in response:

“We welcome the Chancellor’s decision to amend the Bank Levy to reduce the damage it does to Britain’s biggest export industry.

But introducing yet another new bank-specific tax will reinforce fears that Britain is becoming a less attractive place for banks to do business. This is the fifth new bank-specific tax measure in as many years following fast on the heels of the big rise in March and will increase banks’ tax burden by nearly £2 billion. We believe these moves will also undermine competition in the industry by making it harder for smaller players to break through and challenge larger banks.”<sup>61</sup>

Under the new corporation tax surcharge, the threshold is lower, meaning that many smaller banks will be affected disproportionately relative to larger banks. The 2011 Proposal supported the polluter pays principle, however by way of example in contrast to

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<sup>59</sup> Summer Budget 2015 at para 1.201

<sup>60</sup> See BBC News, ‘Budget 2015: Bank Levy to be Reduced’ (*BBC News*, 8 July 2015) <<http://www.bbc.co.uk/news/business-33444127>> Accessed 6 April 2018

<sup>61</sup> *Ibid*

HSBC and RBS' share price rise the changes were estimated to have reduced the value of Clydesdale Bank, a far smaller institution by up to £200 million.<sup>62</sup>

Nevertheless overall, it was argued that the changes would be more acceptable for the financial sector. Anna Anthony, Head of Financial Services Tax at Ernst and Young, stated:

“A reduction in the rate and scope of the bank levy will be very welcome news for the sector...The introduction of an 8% surcharge sounds high, but is likely to be more acceptable than the levy because it at least has a direct link to the profitability of an institution. In addition, the fact that overall corporation tax is going to go down also helps ease the pain for banks of the surcharge.”<sup>63</sup>

A corporation tax surcharge differs greatly from the 2011 Proposal in terms of its underlying justification. Corporation tax paid on profit is a primarily fundraising tax as opposed to a primarily behaviour-modifying tax. Changing the emphasis from risk to profit could be considered dangerous. In effect, this is a change away from taxing the potential exposure to risk, to taxing hypothetical profits. This thesis argues that one of the central advantages of a Financial Transaction Tax is that taxes the risk, not the reward. The 2008 Financial Crisis was caused, ultimately, but investments in the American sub-prime mortgage market, investments which many inaccurately thought carried little to no risk, with high returns. If the rate of the bank levy is reduced and offset with corporation tax surcharges, the dissuasive nature of the bank levy is diminished in favour of a revenue raising tax on hypothetical profits. The bank levy is not being withdrawn completely at this stage in the

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<sup>62</sup> See BBC News, ‘Budget Announcement is Blow to Clydesdale Bank Sale’ (*BBC News*, 10 July 2015) <<http://www.bbc.co.uk/news/uk-scotland-33486420>> Accessed 6 April 2018

<sup>63</sup> Ernst & Young, ‘Budget 2015: Bank Levy Comment: The Introduction of an 8% Surcharge Sounds High, but is Likely to be More Acceptable Than the Levy’ (*Ernst & Young*, 8 July 2015) <<http://www.ey.com/UK/en/Newsroom/News-releases/15-07-08---Budget-2015---Bank-Levy-comment---The-introduction-of-an-8pc-surcharge-is-likely-to-be-more-acceptable-than-the-levy>> Accessed 29 January 2016

UK, though this thesis argues that it needs to be set at a level that the UK banks notice in order to continue to be effective.

### 3.3.3. The Efficacy of Bank Levies Across Europe

The UK is not the only EU Member State to introduce a form of a bank levy. This is of little surprise, since in 2011 there were clear indications that both France and Germany were also making plans to introduce similar provisions.<sup>64</sup> As of October 2013 14 Member States had adopted some form of a bank levy.<sup>65</sup> Yet there remained divergence in how levies have been calculated and applied. According to Chris Sanger in 2011, Global Head of Tax Policy at Ernst and Young:

“While the overall goal of [bank levies being introduced in a number of countries] is largely consistent, the application can vary considerably. In France, for example, the bank levy uses assets as the tax base, whereas in the UK, it uses liabilities.”<sup>66</sup>

It therefore appears to be the case that a significantly growing number of Member States view bank levies as a means by which to either raise revenues or alter bank institutional behaviour. Due to the interconnected nature of financial markets in Europe, an EU-wide bank levy was set to come into effect on 1<sup>st</sup> January 2016 as part of forming a European Banking Union (EBU), discussed in greater detail in the following section of this chapter. Its Single Resolution Mechanism is set to be funded by the Single Resolution Fund, consisting of contributions from a common bank levy compulsorily among all euro area States and others on a voluntary basis, to avoid recourse to taxpayer money in resolution

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<sup>64</sup> For example see K Cummings, ‘The Bank Levy: Draft Legislation’ (2011) 1 *British Tax Review* 24

<sup>65</sup> Said Business School, Bank Levy Information (2013), available at <[http://www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Docs/Publications/Working\\_Papers/Series\\_13/BankLevydata.pdf](http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_13/BankLevydata.pdf)> Accessed 25 January 2016

<sup>66</sup> C Sanger, ‘Overseas Policy Trends’ (2011) 1076 *Tax Journal* 9

of financial crises. Article 2 of Regulation 806/2014 states that the entities liable to contribute to the Single Resolution Fund are:

“(a) Credit institutions established in a participating Member State;

(b) Parent undertakings, including financial holding companies and mixed financial holding companies, established in a participating Member State, where they are subject to consolidated supervision carried out by the ECB in accordance with Article 4(1)(g) of Regulation (EU) No 1024/2013;

(c) Investment firms and financial institutions established in a participating Member State, where they are covered by the consolidated supervision of the parent undertaking carried out by the ECB in accordance with Article 4(1)(g) of Regulation (EU) No 1024/2013.”<sup>67</sup>

The amount of money that an entity is required to contribute is calculated by the Single Resolution Board<sup>68</sup>, which determines *ex ante* contributions in accordance with Article 70(2) of Regulation 806/2014. This is a flat contribution, determined on the basis of an institution's liabilities excluding own funds and covered deposits and a risk-adjusted contribution depending on the risk profile of that institution. Therefore, the higher the risk that an entity poses, the greater the amount it is required to contribute to the fund. Therefore even when taking into account the change in scope of application this design is similar to that of the UK bank levy in the sense that the larger the bank, the greater its exposure to contagion in the marketplace and the greater the incentive to alter behaviour to become more stable in order to reduce its tax liabilities. The target is to develop a fund of €55 Billion over eight years.<sup>69</sup>

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<sup>67</sup> Article 2 Regulation 806/2014

<sup>68</sup> Whose composition is outlined in Article 5 Regulation 806/2014

<sup>69</sup> European Commission, ‘Finalising the Banking Union: European Parliament backs Commission’s proposals (Single Resolution Mechanism, Bank Recovery and Resolution Directive, and Deposit Guarantee

There is overlap in the approaches that the UK and EU adopt. Like the UK, the EU also frames its current financial proposals and policies in the frame term of ‘fairness’. In part, this is because alternatives, such as the Financial Activities Tax, are thought of as more unpalatable. At this stage, it is too early to determine how successful the EU-wide bank levy will be in terms of meeting its target amount and its impact on banks reducing the size of balance sheets. However, there is some data from a 2013 study by Devereux et al of how domestic versions of bank levies across Europe had impacted the actual behaviour of banks.<sup>70</sup> The paper demonstrated that levies are associated with considerable reductions in banks’ funding risk, but at the cost of an increase in regulatory risk-weights for the “average bank.” The data suggested therefore that the impact of the levies has been to shift risk from the liability side to the asset side of the balance sheet, with the net effect of levies being to reduce total risk.

In addition, the Devereaux et al paper refers to ‘safe banks’ and ‘risky banks’. Safe banks were determined to have a high initial regulatory capital ratio and were found to have increased their equity-asset ratio most as a response to the levies. However, risky banks, determined to have a low initial regulatory capital ratio, were found to have increased the risk of their assets so that whilst overall safe banks experienced a reduction in total risk, this was not the case for risky banks. It can be presumed that risky banks pose the greater risk to financial stability and that it was these banks which caused the initial 2008 crisis.

A conclusion that can be drawn from the paper therefore is that bank levies can cause riskier banks to continue to be risky whilst safer banks overall become less risky. At first

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Schemes Directive)’ (*Europa*, 15 April 2014) <[http://europa.eu/rapid/press-release\\_STATEMENT-14-119\\_en.htm](http://europa.eu/rapid/press-release_STATEMENT-14-119_en.htm)> Accessed 25 January 2016

<sup>70</sup> M Devereux, N Johannesen and J Vella, ‘Can Taxes Tame the Banks? Evidence from the European Bank Levies’ (Niels Johannesen, 9 December 2013) <[http://www.nielsjohannesen.net/wp-content/uploads/2013/12/Can-taxes-tame-the-banks\\_SUBMISSION.pdf](http://www.nielsjohannesen.net/wp-content/uploads/2013/12/Can-taxes-tame-the-banks_SUBMISSION.pdf)> Accessed 30 January 2016 [Working Paper]

glance this appears rather ominous for the EU bank levy, since the SRF can potentially be seen by riskier banks as a safety net to counter potentially risky activities which could have a detrimental impact on the real economy, i.e. introduce a greater element of moral hazard into financial markets. One of the issues that the paper highlights is that levy rates varied substantially across individual Member States and are therefore highly fragmented. In establishing in line with the principle of subsidiarity that a common system at EU level is necessary this issue is avoided in having the Board determine the amount that a bank is required to contribute to the SRF.

### **3.3.4. The Importance of the Design of Bank Levies**

As with the other tax policy options presented in this chapter, the efficacy of bank levies is dependent on their design. Are they principally designed to raise funds from financial institutions or are they designed to mitigate risk? Writing in March 2014, prior to the UK change towards a corporation tax surcharge, Richard Milnes was critical of the design of the bank levy, stating that in identifying a set amount to be raised by the tax before its entry into force, the government has been hamstrung once the stated £2.5 Billion target had not been reached in the following years. In order to demonstrate its “folly” Milnes drew a mocking comparison with reducing his children’s pocket money:

“I told my three children that for every day they didn’t keep their rooms tidy, I would take 11.9p out of their pocket money. Maximum untidiness would give me £2.50 a week. They responded to the incentive — they tidied their rooms four days a week. But I still quite fancied the £2.50, so I changed the rules to take 27.8p out of their pocket money for each untidy day. My children hate me and want to leave home.”<sup>71</sup>

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<sup>71</sup> R Milnes, ‘Lessons From the Bank Levy’ (2014) 1208 *Tax Journal* 8

By extension, this critique can be extended to the EU bank levy. If the target fund is not reached and banks modify their investment strategies to reduce exposure to risk, what happens next? Does the rate increase in an attempt to reach the target, or is the scope more broad?

Milnes did recognise that the UK levy had forced banks to alter their funding models to less risky, long-term stable methods. He concluded that the levy had therefore fulfilled its behavioural objective in reducing exposure to risk by reducing balance sheets in line with macroeconomic principles, but had failed to fulfil its taxation objective, due to set targets. He concluded that the policy should be revised in order to allow bank levy revenues to 'free float' in order to reduce rates to a level that ensures stability, whilst not deterring growth in UK balance sheets. Milnes' assessment supports this thesis' most basic point, that the behavioural objectives of the 2011 Proposal should be considered for taxation measures, with ascribed monetary values proving a secondary concern.

One further criticism of the UK bank levy is that it by nature is charged to institutions, not necessarily the noise traders identified by Stiglitz. The financial sector comprises of more than banks. There are hedge funds, pension funds and investment portfolios which may fall below the threshold of taxation. Collectively, these smaller financial actors would represent a significant percentage of the overall financial investment sector and the 2011 Proposal would ensure that these actors also conform to greater corporate responsibility.

An alternative view is to approach bank levies as having a punitive dimension, which seeks to punish financial institutions after the fact. In the United States for example, President Obama, in January 2010, advocated a 'Financial Crisis Responsibility Fee', which Cummings and Gall described the fee as a "“mega levy” of US\$90 billion over 10 years”<sup>72</sup>

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<sup>72</sup> K Cummings and G Gall, 'Finance Act 2011 Notes: Section 73 and Schedule 19 – The Bank Levy' (2011) 4 *British Tax Review* 454

which would apply to only large firms. If a firm reached the threshold of \$50 billion in assets then they would be affected by the fee.<sup>73</sup> The President said:

“We want our money back, and we’re going to get it. And that’s why I’m proposing a Financial Crisis Responsibility Fee to be imposed on major financial firms until the American people are fully compensated for the extraordinary assistance they provided to Wall Street. If these companies are in good enough shape to afford massive bonuses, they are surely in good enough shape to afford paying back every penny to taxpayers.”<sup>74</sup>

The United States enacted wide-ranging financial regulation reform following the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, however, the financial crisis responsibility fee was not included and, to date, has not been introduced in the United States. Politically speaking, the fee sounded appealing, although in reality its introduction would have been impractical and in directly tying the fee to the financial crisis, is tantamount to a fine. In addition, in linking justifications for the fee to bonus payments, this is far closer to a bank bonus tax than the European bank levy models. Whilst comparable to European bank levies in being calculated on the size of assets, it does not prescribe as great an incentive for financial institutions to lower the size of balance sheets or achieve greater stable economic growth in line with macroeconomic principles. Its primary focus was fundraising, as opposed to modifying conduct.

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<sup>73</sup> J Lee, ‘The President to Wall Street “We Want Our Money Back, and We’re Going to Get It”’ (*The White House*, 14 January 2010) <<https://obamawhitehouse.archives.gov/blog/2010/01/14/president-wall-street-we-want-our-money-back-and-were-going-get-it>> Accessed 30 June 2017

<sup>74</sup> Ibid

### 3.4. Extension of VAT to Financial Services

The 2011 Proposal and bank levies are new forms of taxation designed post-2008. Yet one of the justifications cited in the 2011 Proposal is that financial services have historically not been subject to VAT, a tax long pre-dating the 2008 crisis. Therefore, it may appear to be more logical to extend the existing VAT principles at EU level to financial services if possible, and indeed these discussions have taken place as outlined in this section.

The vast majority of financial and insurance services which operate within the EU are classed as being exempt in accordance with Article 135(1)(a) to (g) of the VAT Directive.<sup>75</sup> Auerbach and Gordon have previously stated that the action of exempting financial services from VAT should be viewed as being contrary to the underlying principle of VAT as a general consumption tax on goods and services.<sup>76</sup> According to De la Feria and Lockwood<sup>77</sup> “it is now widely accepted amongst economists that on efficiency grounds, financial services should be subject to VAT.”<sup>78</sup> Therefore, in order to determine the possibility of extending VAT to financial services, it is necessary to determine the basic principles of the VAT system, its stated fairness, and examine why the exemption is in place.

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<sup>75</sup> Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax

<sup>76</sup> A Auerbach and R Gordon, ‘Taxation of Financial Services Under a VAT’ (2002) 92 *American Economic Review* 411

<sup>77</sup> R De la Feria and B Lockwood, ‘Opting for Opting-In? An Evaluation of the European Commission’s Proposals for Reforming VAT on Financial Services’ (2010) 31(2) *Fiscal Studies* 171

<sup>78</sup> Ibid at 175. For more on VAT on financial services see also R De la Feria and M Walpole, ‘Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared’ (2009) 58(4) *International and Comparative Law Quarterly* 897

As De la Feria notes, “The EU VAT system is founded on two basic principles, namely the principle of VAT as a general consumption tax, and the principle of fiscal neutrality.”<sup>79</sup> However, the overall aim was to build on the system of existing turnover taxes in EU Member States prior to the formation of the EEC, to build a common framework. The founding six Member States of the European Economic Community previously used differing forms of indirect taxation on consumption, with the majority being multi-stage cascade taxes levied on the actual value of output at each stage of the production process, making it impossible to determine the real amount of tax actually included in the final price of a particular product. One potential side effect of this was Member States subsidising their exports by overestimating the taxes refundable on exportation. As a result, in order to achieve an efficient single market, a neutral and more transparent form of tax was required in order to calculate the exact amount of tax to be rebated following export.

The founding concept of VAT was to act as a ‘general’ Consumption Tax, “yet whilst as a general tax on consumption VAT should apply to all consumption, the decision was made in the 1960s by the EU legislator to exclude certain consumption from the tax base”<sup>80</sup> replicating some existing exclusions at national level under the turnover tax systems. VAT should be paid by the final consumer to the seller, who pays subsequent VAT liability to the national treasury. Output VAT consists of the amount of money raised through purchases (i.e. paid by other businesses and consumers), with sellers calculating the amount of added value to attribute to its good or service. Input VAT concerns the value

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<sup>79</sup> R De la Feria, ‘EU VAT Principles as Interpretative Aids to EU VAT Rules: The Inherent Paradox’ Oxford University Centre for Business Taxation WP 16/03 <[https://www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Docs/Publications/Working\\_Papers/Series-16/WP1603.pdf](https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series-16/WP1603.pdf)> Accessed 9 April 2018 at 2

<sup>80</sup> Ibid at 3

added to the price when purchasing goods or services which are liable to VAT (i.e. the supplier pays VAT on its own purchases).

These exemptions and reduced rates of VAT ultimately reflect difficult-to-tax services, such as margin based financial transactions. Exemptions are also based upon the principles of vertical equity (i.e. exemptions to essential household items if the tax is to have a greater impact on more impoverished households), to increase employment or to produce 'positive externalities' (i.e. provide some form of merit, such as cultural events and books). The initial exemption for VAT in financial services appears to have been based in the perceived complexity of applying such a system. As VAT developed at Union level, a far more rapid expansion was occurring in financial markets, with the City of London providing a competitive, innovative service based economy with financial services as its central pillar. Financial markets developed more rapidly than the legislation. Yet this classification does not preclude VAT from being charged on financial services. One of the early justifications for the exemption from the consumption principle is if the good or activity produces a positive externality if an exemption or a reduced rate is granted. If, as this thesis argues, speculative markets produce the inverse, negative externalities, if administrative difficulties can be overcome, financial services should not be VAT exempt. Furthermore, this classifying of financial services within the scope of VAT is not a Pigouvian tax, due to the second principle, neutrality.<sup>81</sup>

Neutral taxes are ones which do "not influence commercial decisions"<sup>82</sup> i.e. their application is so neutral as to not alter business practices. The design of neutral taxes should eliminate potential for distortion of competition, so that each State has similar goods taxed at a

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<sup>81</sup> For a greater outline of the principle of neutrality, see G Loutzenhiser, *Tiley's Revenue Law* (Hart 2016) 11-12

<sup>82</sup> *Supra* n.79 at 4

similar burden. This basic principle is to an extent argued by the Robin Hood Tax rhetoric in the UK, by referring to a global 'tiny tax' on transactions. However, the very purpose of Tobin's original tax was to modify business behaviour. In its design, the 2011 Proposal is therefore not a neutral tax, strengthening its classification as a Pigouvian tax.

The basic problem in the application of VAT to financial services is the determination of the specific value added by margin based transactions. Certain services can be calculated for VAT purposes in the usual way. As De la Feria and Lockwood state, "if a financial services company is providing a product that can be priced via the charging of fees and commissions (consultancy services, commissions charged by brokers on acquisitions and disposals of securities, etc.), this can be made subject to VAT in the normal way."<sup>83</sup> Other services, such as bank lending, insurance products and other intermediation services fall outside of this scope.

There is a distinction though between the classification of consumers and businesses for VAT liability. De la Feria and Lockwood give the following example to demonstrate the complexity of determining VAT liability:

"In the first period, a depositor deposits £100, which the bank lends on to a borrower. In the second period, the borrower repays the principal plus interest at 15 per cent and the bank repays the principal plus 7 per cent interest to the depositor. In this case, the value of intermediation services is  $£15 - 7 = 8$ , and VAT should be paid on this value added. The simplest situation is where both the depositor and borrower are consumers, i.e. not liable for VAT. In this case, the value added could be taxed simply by requiring the bank to pay VAT on the whole margin of £8.

But in the case where either the borrower or the depositor is a business, a complication arises. Suppose, for example, that the borrower is a business liable

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<sup>83</sup> *Supra* n.77 at 175

for VAT. In this case, if the bank charges VAT, the value of intermediation services supplied only to the borrower must be identified, so that the borrower can claim back VAT paid on the intermediation services supplied to it by the bank.”<sup>84</sup>

Hoffman, Poddar and Whalley<sup>85</sup> consequently proposed a ‘cash-flow VAT’ to resolve this problem. All inflows to banks are treated as being taxable supplies, with all outflows treated as inputs as a credit against VAT. Referring to the previous example, De la Feria and Lockwood highlight the problems with the original cash-flow VAT approach, stating that in the first period, the bank would be liable for a tax of £10 on the deposit, considered a cash inflow, while also receiving a tax credit equal to the £100 loan, meaning no tax is paid. However, “in the second period, the cash flows of the repayment of the loan by the borrower to the bank and of the deposit to the household by the bank, again cancel out, except for the margin of £8, and so the bank’s tax liability in the second period is 80p.”<sup>86</sup> For a commercial borrower, the cash inflow is £100, so has a VAT liability of £10. In the second period, the cash outflow is £115, leading to a tax credit of £11.50. Under this system, it would be possible for the consumer to receive a tax period in the second period without having paid any tax in the first period.

Poddar and English<sup>87</sup> proposed a refined version, a Tax Calculation Account (TCA). Tax which would be payable or creditable is instead debited or credited to the TCA and carried forward to the period during which the capital transaction is reversed, thereby deferring the tax subject to interest charges at the government borrowing rate. However, this does

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<sup>84</sup> Ibid at 176

<sup>85</sup> L Hoffman et al, ‘Taxation of Banking Services Under a Consumption Type, Destination Basis VAT’ (1987) 40(4) *National Tax Journal* 547

<sup>86</sup> *Supra* n.77 at 192

<sup>87</sup> S Poddar and M English, ‘Taxation of Financial Services Under a Value-Added Tax: Applying the Cash-Flow Approach’ (1997) 50(1) *National Tax Journal* 89

create administrative complexity and requires the choice of a government borrowing rate in order to be effective.

There have been attempts to amend the legislation at EU level in order to introduce at least some form of VAT calculable on financial services. In 2007, the European Commission published proposals to amend the VAT treatment of financial and insurance services, with the underlying rationale of enhancing the functioning of capital markets whilst also increasing the competitiveness of European financial institutions.<sup>88</sup> There were two primary aims of the Proposals in order to achieve this: increasing legal certainty and reducing the impact of non-recoverable VAT for financial institutions.

The Proposals consisted of three pillars. These pillars consisted of clarification of the rules governing exemption, introduction of cost-sharing groups and the introduction of a compulsory option to tax. Pillar 1 seeks to introduce a form of clarity, by defining the exemptions. At present, the CJEU plays a vital role in defining exemptions for financial services through cases referred to it, however there is often a lack of consistency and distortion through this process, which undermines the VAT system and exacerbates any uncertainty. Pillar 2 regulates pooled investments, which would allow firms to redistribute the cost of investments without being subject to VAT. Yet whilst all three pillars are discussed in De la Feria and Lockwood, particular emphasis is placed on the third pillar.

The option to tax relates to financial institutions volunteering to participate in a new VAT system. It would be compulsory for Member States to introduce the *option* to tax, but with an opt-in system for financial institutions. Under their assessment, different institutions

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<sup>88</sup> Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services, COM(2007) 747 final, 28 November 2007 and Proposal for a Council Regulation laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services, COM(2007) 746 final, 28 November 2007

would derive different benefits from opting in dependent on their corporate awareness and the nature of the transaction i.e. if business to business (B2B) or business to consumer (B2C). If financial institutions do not coordinate their behaviour effectively, opting to tax is profitable for the firm only if the transaction is a B2B transaction, since opting-in eliminates the disadvantage in terms of costs that EU financial service firms face when competing with others. However, if the institution is able to coordinate its business practices, there is no advantage to opting in as demonstrated by the following table.<sup>89</sup>

	Opt Out	Opt in, B2C	Opt in, B2B	Zero-Rating
Price of Input (excl. VAT)	100	100	100	100
VAT on Input	10	10	10	10
Price of Output (incl. VAT)	200	200	220	200
Price of Output (excl. VAT)	200	181.8	200	200
VAT on Output	0	18.2	20	0
VAT Paid by Supplier	0	$18.2 - 10 = 8.2$	$20 - 10 = 10$	0
Profit Per Unit of Supplier	$200 - 110 = 90$	$200 - 110 - 8.2 = 81.8$	$220 - 110 - 10 = 100$	$200 - 100 = 100$

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<sup>89</sup> Supra n.77 at 186

While administratively possible, the Proposals were not adopted. De la Feria and Lockwood note that Pillar 1 was discussed by the Member States, Pillar 2 had been largely overlooked, but that “the third pillar...has also been the subject of lengthy discussions, but most national delegations, including those from the UK and France have reportedly manifested their scepticism as regards any change to the current legal provisions.”<sup>90</sup> The main problem however, is that for many financial services there is often no well-defined price or fee for the service. This reflects the discussion of economic theory and financial intermediation theory previously in this thesis; the financial sector is unique and a more nuanced form of regulation, in this case taxation, is required. Extending VAT would be a macro approach, and there are clear economic advantages to doing so. If a greater amount of revenue can be accrued, funds raised can indirectly be used by national governments to provide and subsidise public goods. The aims of transaction taxes as envisioned by Tobin are targeted at specific areas of speculation. The 2011 Proposal, in including historical VAT exemptions of financial services as a justification for a new form of Common Financial Transaction Tax, indicates that the 2011 Proposal has distanced itself from the economic underpinnings of James Tobin, in that the key should be to stress dissuasion from risk and financial stability, as opposed to historical compensation, which may appear punitive in nature. This thesis argues that it is a mistake to do this, with its primary focus on designing a financial regulation policy, including tax, which in itself provides a public good through behaviour modification, outlined in greater detail in chapter 4.

Yet this does not mean that this thesis opposes the extension of VAT to financial services, and its application cannot be dismissed outright. Administratively, applying VAT may be difficult, however, it is possible. For example, recently China, with a financial market which is less developed than those in Europe and the United States, has elected to replace a

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<sup>90</sup> Ibid at 174

business tax of 5 per cent on financial services with a 6 per cent rate of VAT.<sup>91</sup> This change was due to come into effect by the 1<sup>st</sup> May 2016, an ambitious timeframe. However, there remain several concerns about how VAT will apply, with a KPMG report demonstrating 10 particular areas of concern.<sup>92</sup>

The primary reason as to why China is able to introduce VAT in this way concerns the types of transaction which occur. These transactions are far simpler and less technical in nature than those in Europe in particular. The financial sector in China is an emerging market and already has had a form of taxation charged upon it. In contrast, the European sector is far more developed, far more technical and has had a more limited form of taxation charged historically. If VAT were to be imposed on financial services, relative consumer prices will remain unchanged only if the transactions services are subject to VAT, with credit being given for VAT paid on inputs to the financial services sector. The exact cost of irrecoverable VAT from the financial sector is unknown, though in the UK HMRC estimated that in 2014-15 exemption of VAT to financial and insurance services totalled £5.150 billion<sup>93</sup> with the figure set to rise to £5.3 billion in 2015-16<sup>94</sup> but do acknowledge a wide margin of error. In addition, the appendices to this thesis include a VAT assessment of derivatives as determined from OECD data from 1998, indicating that some derivatives are within the scope of VAT, however this tax treatment is limited relative

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<sup>91</sup> For a greater discussion of Chinese VAT reform, see S Shen and R Krever, 'China's VAT Reform: Experiences and lessons Learned' (2017) 28(2) *International VAT Monitor* 147

<sup>92</sup> KPMG China Tax Alert Issue 7 March 2016, 'China's Value Added Tax Expanded to Fully Replace Business Tax in Major New Announcement'. For a discussion of China's reform process from business taxation to VAT in financial services, see W Cui, 'China's Business-to-Tax-to-VAT Reform: An Interim Assessment' (2014) 5 *British Tax Review* 617

<sup>93</sup> HMRC, 'Main Tax Expenditures and Structural Reliefs' (HMRC, 31 December 2015) <<https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs>> Accessed 31 January 2016

<sup>94</sup> Ibid

to the scope outlined in the 2011 Proposal and does not have the same underlying economic rationale. The ultimate conclusion is that there is no reason why it is not administratively possible to include VAT treatment of derivatives in tandem with a well-designed Financial Transaction Tax, but in stating in the 2011 Proposal that one of the justifications is the historical exemption, the Commission has encouraged the perception that it is an either/or discussion, not a discussion of taxes which complement each other.

De la Feria and Ness in a recent journal article<sup>95</sup> assess the stated arguments in favour of the 2011 Proposal as opposed to the application of VAT on financial services, concluding that the 2011 Proposal will not meet its stated aims and that the discourse regarding extension of VAT should continue. In particular, the discussion appears to focus on other examples of Financial Transaction Taxes falling short of revenue targets, that the 2011 Proposal is a proxy tax, designed to compensate for the difficulties in extending VAT to financial services and that there are legislative difficulties posed regarding advancement of the internal market and the Enhanced Cooperation process, discussed elsewhere in this thesis. Regarding the below expected revenues of other taxes, they identify that:

“Reported experiences with the FTT in both France and Italy provide sober reading: in 2012, the French FTT collected only 44 percent of estimated revenue; and the revenue impact of the Italian FTT was even lower, having collected in 2013 less than 20 percent of the initial estimated revenue.”<sup>96</sup>

Projected revenues have been invariably discussed throughout the legislative process. However, Tobin’s original intentions and this thesis’ focus do not concern the funds raised by the tax. De la Feria and Ness argue that extension of VAT to financial services would

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<sup>95</sup> R De la Feria and R Ness, ‘Policy Forum: The EU Financial Transaction Tax as an Unsuitable and Unnecessary Proxy Tax’ (2016) 64(2) *Canadian Tax Journal* 373

<sup>96</sup> *Ibid* at 383

lead to a steadier and more predictable level of previously irrecoverable VAT being recovered. This thesis' primary focus concerns the volatility discussion in the previous chapter. Yet in seeking to revisit the extension of VAT to financial services, De la Feria and Ness state that there are four factors which indicate a level of optimism that the discussion may be revived. These are the length of time passed since the last full discussion of extending VAT to financial services, technological developments providing impetus for VAT to be introduced in financial markets, current public finance pressures combined with public interest in VAT treatment and that the door has been opened by Enhanced Cooperation, as discussed in the following chapter, for some collaboration between Member States in this area.

### **3.5. Financial Activities Tax**

Due to the perceived complexities of extending VAT to financial services, in its 2010 Communication, outlined in the previous chapter, the Commission stated that, in addition to the Financial Transaction Tax, it was considering a Financial Activities Tax, a more nuanced form of VAT. The Communication acknowledged that this was originally proposed by the IMF, referring to the IMF's Report to the G-20.<sup>97</sup> The report contains a collection of evidence, with chapter 7 concerning a Financial Activities Tax. In the report, Keen et al. define the general concept of an FAT as follows:

“By a FAT is simply meant a tax on the sum of profits and remuneration in the financial sector. Precisely how profits and remuneration are defined for this purpose, however, makes a substantial difference to both the economic impact of a FAT and its revenue yield. The FAT is thus a family of possible taxes, not a single

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<sup>97</sup> Communication from the Commission to the European Parliament, The Council, The European Economic and Social Commission and the Commission of the Regions – Taxation of the Financial Sector Com(2010)549 Final 7<sup>th</sup> October 2009 at p7

tax in itself, with each member better addressed to serving some purposes rather than others.”<sup>98</sup>

The ultimate rationale for an FAT is tied to the difficulties that are faced in applying VAT to certain financial services. Using the term ‘margin based transactions’, the report highlights that although certain financial services, such as those provided on a fee paying basis, are capable of being quantifiable for VAT purposes, transactions which require intermediation services need to be designed in such a way as to attribute a credit to the business as opposed to the final consumer. These conditions inherently create calls for exemptions, which can lead to over taxation for businesses that access financial services, since the ultimate price that financial institutions charge reflects the unrecovered VAT charged on the financial institution’s input VAT. As a consequence the tax cascades i.e. is passed down the turnover chain.

These points echo the complexities presented previously in this chapter with regard to extending VAT to financial services, however the report was presented to the G-20. All members of the G-20 except for the United States have a national VAT system, therefore when seeking to introduce a new form of taxation on financial services, VAT cannot simply be extended in the United States. These circumstances mean that for financial taxation to occur across the G-20, a new form of tax needs to be discussed, hence the discussion of Financial Activities Taxes in addition to VAT discussions.

The report presents various different designs for a Financial Activities Tax in determining the base for margin based transactions. The tax bases can be summarised as follows,

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<sup>98</sup> M Keen et al, ‘The Financial Activities Tax’ in M Keen et al (eds) *Financial Sector Taxation The IMF’s Report to the G-20 Background and Material* September 2010 at 118

with an assessment of the potential application in each of the members of the G20 included in the appendices.<sup>99</sup>

#### FAT1:

An addition method VAT applied to financial services. The tax base consists of the gross sum of profits, minus gross fixed capital outlays **plus** total wage costs. In design terms, this raises questions concerning the definition of profits and credit provision to both financial institutions and purchasers of financial services in line with VAT credits. Of the three methods proposed, this bears the closest design to VAT and therefore the most indirect form of taxation.

#### FAT2:

This uses the same profit component as FAT1, however the wage component assumes 12 percent of wage costs to be surplus. FAT2 therefore is intended as a tax on any returns to capital and labour in the financial sector above the minimum their providers require. This method also creates complexities, particularly in attaching a value to an individual's earnings due to effort or skill.

#### FAT3:

This uses the same wage component as FAT2, however profits relate to the excess of after-tax net income over a benchmark return on equity of 15 percent. In effect, of the three forms of FAT this reflects the behaviour modification rationale of financial taxation. High returns are taxed more heavily than low returns. The primary indicator to dissuade from risk is the higher the return, the greater the exposure to risk.

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<sup>99</sup> When reading the table, the tax bases are explained in columns, for example for FAT 1, the sum reads [4] = [1-2+3]. This means that the FAT1 tax base in the 4<sup>th</sup> column comprises of Profits in column 1 minus Capital Formation in column 2, plus wages in column 3 of the table.

Interestingly, there is a discussion in the report when discussing FAT3 of Pigouvian taxes, with the authors viewing dissuasive taxes on behaviours which produce negative externalities as being Pigouvian in nature:

“Excessive risk-taking that increases the probability that public resources will be needed for the orderly resolution of a failed institution, or which risks triggering a systemic crisis, is in the nature of a harmful economic externality—situations in which the private and social costs and/or benefits diverge. The usual remedy for a harmful externality is a tax on the activity; an appropriately determined tax is referred to as a Pigovian tax. Thus a progressive tax on risktaking can be thought of as a Pigovian tax to remedy a harmful externality.”<sup>100</sup>

In the Communication, the Commission does not use the same terminology as the IMF report, but stated that for the purposes of its consideration it would use the Financial Activities Tax in its most extensive form, referring to the ‘addition-method FAT’. This appears to coincide more with FAT1, however FAT1 does not fall on wages. The Commission’s terminology appears to echo FAT2, stating:

“The FAT falls on total profit and wages. It can also be designed to specifically target economic rents and/or risk. In contrast to an FTT, whereby each financial market participant is taxed according to his transactions, the FAT taxes corporations.”<sup>101</sup>

In other words, the focus shifts from taxing individual transactions to taxing wealth, but the Commission appears to be overlooking the behaviour modification option in favour of FAT2. It is argued that in applying FAT2, the spread of revenue collected would, in fact,

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<sup>100</sup> Ibid at 135

<sup>101</sup> Communication from the Commission to the European Parliament, The Council, The European Economic and Social Commission and the Commission of the Regions – Taxation of the Financial Sector Com(2010)549 Final 7<sup>th</sup> October 2009

be more representative of the financial sector as a whole, since instead of financial sectors being penalised for conducting an amount of transactions, the tax would focus on companies' profits and remuneration, which are more evenly spread throughout Europe. However, this indicates by extension that the Commission were looking at the Financial Transaction Tax for its revenue, not its behaviour modification potential. This Communication does show that revenue objectives played a primary role in the process, indicating that the criticisms detailed in chapter 4 apply not simply to the 2011 Proposal, but the planning and design before its publication.

In terms of the potential revenue levied the Commission used figures from the IMF in a report to the G-20. The Commission stated in the Communication that:

“Using the country-level estimates for the share in GDP to calculate absolute figures...For the EU-27, the addition-method FAT could raise up to EUR 25 billion.”<sup>102</sup>

The Commission does highlight potential problems with a Financial Transaction Tax relative to a Financial Activities Tax. These include the potential for the financial sector to pass the burden of the tax onto users of financial services e.g. charge individual customers more to compensate for the cost of the tax. In addition, there are concerns about the potential for businesses to relocate, technical issues if the Financial Activities Tax is to be incorporated in line with the current VAT system and possible distortion of the internal market if not adopted universally. The Commission states finally that the Financial Activities Tax merits consideration, but that many of these issues would be dependent on the structure of any final Proposal. Ultimately, this is the same conclusion that the IMF report makes.

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<sup>102</sup> Ibid. The Communication was drafted prior to Croatia's accession in 2013.

At the Communication stage the Commission appeared to favour the Financial Activities Tax, yet elected for a Financial Transaction Tax instead. The 2011 Proposal simply states that:

“The impact assessment accompanying the present proposal analyses the impacts of additional taxes on the financial sector with regard to the objectives of (1) ensuring a contribution of the financial sector to public finances, (2) limiting the undesirable market behaviour and thereby stabilising markets and (3) avoiding distortions on the internal market. The impact assessment analysed two basic options: a financial transaction tax (FTT) and a financial activities tax (FAT), as well as the numerous design options related to them, and concluded that an FTT was the preferred option.”<sup>103</sup>

The 2011 Proposal does not elaborate further on the merits of a Financial Transaction Tax over a Financial Activities Tax. The Impact Assessment seems to indicate that the main reasoning after the Communication was the potential to be levied by a Financial Transaction Tax is far greater and more effective at targeting companies which conduct a larger volume of transactions. The following is a statement from Algirdas Šemeta, EU Commissioner for Taxation, Customs, Anti-Fraud and Audit recorded by a House of Lords European Union Commission Report published 28<sup>th</sup> March 2012:

“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.”<sup>104</sup>

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<sup>103</sup> Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC Com (2011 594 Final) of the 28<sup>th</sup> September 2011

<sup>104</sup> House of Lords European Union Committee – Twenty Ninth Report, ‘Chapter 5: Alternatives to a Financial Transaction Tax’ (*Parliament UK*, 28 March 2012)

Insight can also be drawn from the summary report of the public consultation. It reports that the financial sector opposed any form of taxation, however its conclusion in response to NGOs and Trade Unions was that:

“NGOs are largely neutral towards a financial activities tax (FAT) as long as it does not "crowd out" the FTT implementation. Some trade unions are clearly against an FAT, essentially considering it as a tax on labour.”<sup>105</sup>

Furthermore, it concluded that local authorities resulting from representatives as part of the Commission of the Regions were in favour of a broad-based Financial Transaction Tax and finally that citizens favoured a Financial Transaction Tax. Therefore, it appears the Financial Transaction Tax was chosen because it had a greater potential for revenue collection but also because it had wider public support in comparison with the Financial Activities Tax. It was envisioned that the political obstacles faced would be less for the 2011 Proposal relative to a Financial Activities Tax.

Nevertheless, the decision to not pursue a Financial Activity Tax has received a mixed response. Some clearly favoured the introduction of a Financial Activity Tax as highlighted by the following from the European Union Select Committee of the House of Lords:

“John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr argued...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. According to Peter Sinclair, an FAT represented "the best way of taxing the financial sector"<sup>106</sup>

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<<http://www.publications.parliament.uk/pa/ld201012/ldselect/ldcom/287/28708.htm>> Accessed 30 January 2016 at para 144

<sup>105</sup> European Commission, ‘Summary Report of Public Consultation 19<sup>th</sup> April 2011’ (*Europa*, 19 April 2011)  
<[http://ec.europa.eu/taxation\\_customs/resources/documents/common/consultations/tax/financial\\_sector/summary\\_results\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/financial_sector/summary_results_en.pdf)> Accessed 30 January 2016

<sup>106</sup> House of Lords European Union Committee – Twenty Ninth Report, ‘Chapter 5: Alternatives to a Financial Transaction Tax’ (*Parliament UK*, 28 March 2012)

Nigel Fleming conceded that an Financial Activities Tax had some benefits...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.... Peter Sime, Head of Research at 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."<sup>107</sup>

There are clear advantages and disadvantages to each method. Other witnesses with a preference for a Financial Transaction Tax also gave evidence to the House of Lords Committee including, ironically, the British Bankers Association, a staunch opponent of the 2011 Proposal on the grounds that it would target the City of London specifically:

"The BBA [British Bankers' Association] 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.

Sony Kapoor argued that...with Financial Transaction Taxes the primary point of incidence would arise in the shadow banking system.

The TUC [Trades Union Congress] did not consider FATs and FTTs to be mutually contradictory."<sup>108</sup>

To a certain degree it is clear that the Committee was aware of the Financial Activities Tax's advantage with regard to relocation possibilities, since their final Financial Transaction Tax Proposal contains mitigation measures. Yet the Committee's motives are

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<<http://www.publications.parliament.uk/pa/ld201012/ldselect/lddeucom/287/28708.htm>> Accessed 30 January 2016 at para 139

<sup>107</sup> Ibid at paras 139 and 140

<sup>108</sup> Ibid at paras 141–143

clear; take the more ambitious approach to create the greatest amount of behaviour modification in line with macroeconomic principles, whilst also raising a greater amount in revenue for national treasuries.

## **4. Other Post-2008 Reforms: Capital Buffers and European Banking Union**

The alternatives presented in the previous section all refer to regulation through hard law taxation, however this thesis argues that the 2011 Proposal should have been presented as more of a financial regulation policy as opposed to a tax policy, i.e. that the 2011 proposal should fill in gaps in existing general financial regulation standards. Furthermore, chapter 4 contains a discussion of regulatory pluralism, meaning that a range of regulatory and legislative mechanisms should be used in order to introduce a policy effectively. Since this thesis views a common Financial Transaction Tax as, principally, a mechanism by which to contribute to providing financial stability, it is necessary to examine non-taxation means which seek to achieve the same aim. In addition, the remaining discussion in this chapter indicates that, whilst there has been some positive regulatory reform, the focus of these reforms differs from those of the Financial Transaction Tax. If the ethos of these reforms can be combined with a more flexible approach to integration, as discussed in the following chapter, and framed in accordance with providing a public good of financial stability, this may ultimately mean that a common Financial Transaction Tax can form part of a wider Common Finance Policy, as outlined in the conclusion.

### **4.1. The Basel Accords**

The Basel Committee on Banking Supervision is part of the Bank for International Settlements. Now comprising of 60 national central banks, its aim is to promote common standards to support national central banks to achieve financial and monetary stability.

First formed in 1974 by the G10 countries<sup>109</sup>, the Committee has published three sets of guidelines for financial supervisory standards, Basel I (1988), Basel II (2004) and Basel III (2010). In order to understand the impact of these accords in relation to financial regulation, it is necessary to outline the principles agreed pre-2008, and the post-2008 response.

The 1988 Capital Adequacy Accord for credit risk (Basel I) sets minimum capital requirements for internationally active banks, with risk weighted to different categories of bank assets. As part of this determination of the amount of capital reserve for banks to hold, the Accord defined elements to be considered as capital and determined a ratio of capital to hold dependent on the risk weighting of the asset. The total capital reserve was a minimum of eight per cent, broken down into two categories. Tier 1 capital was required to be at a minimum of 4 per cent and comprised of risk-weighted assets (paid up capital and disclosed reserves). Tier 2 capital comprised of undisclosed loans, revaluation, general loan-loss reserves, subordinated debt and hybrid debt, with a recommendation to be fixed to up to 100 per cent of tier 1 capital. Therefore as a minimum, the total capital reserve was eight per cent, of which at least four per cent comprised of Tier 1 capital. The aim of these provisions was to ensure financial institutions were able to withstand runs on banks without recourse to government intervention.

However, in 1990-91, only a few years after the publication of the Accord, there was a credit crisis in the United States. In the years that followed, authors slowly drew a causal link between Basel I and this crisis, implicating the standards in the downturn of financial markets. For example, Syron indicated that the recession was not a standard credit

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<sup>109</sup> Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom and United States

crunch, but a 'capital crunch'.<sup>110</sup> Bernanke and Lown presented that post Basel I, banks tried to meet these requirements by decreasing their lending to boost their capital ratios as a cheaper way to meet the requirements than through raising additional capital.<sup>111</sup> This runs counter to the primary function of a bank, to provide credit to individuals and businesses to function in the marketplace. What is particularly striking about the link between the Basel I standards and the credit crisis is the speed of its development after preliminary introduction. The first official set of regulations was adopted in 1988<sup>112</sup>, with the remainder set in 1989, with a phase in approach lasting from 1991 to full implementation by the end of 1992. Banks respond to regulatory incentives and there is evidence that, after learning of the nature of the Accord, certain institutions started to change their positions in 1987<sup>113</sup>, with many banks having the eight per cent minimum ratio in effect before the 1992 implementation date.<sup>114</sup> Complying with the capital ratio prior to official implementation does provide institutions present a positive impression to the marketplace of financial health, but at the expense of restricting lending. The underlying rationale of creating a capital adequacy ratio is commendable. However, the Accord was further criticised for failing to provide incentives for banks operating in financial markets with high volatility to hold a greater weighting of capital in reserve and for potentially overlooking

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<sup>110</sup> R Syron, 'Are We Experiencing a Credit Crunch?' (1991) July/August *New England Economic Review* 3

<sup>111</sup> B Bernanke and C Lown, 'The Credit Crunch' (1991) 2 *Brookings Papers on Economic Activity* 205

<sup>112</sup> See for example M Flannery and K Rangan, 'What Caused the Bank Capital Build-Up of the 1990s?' (2008) 12 *Review of Finance* 391

<sup>113</sup> See J Hall, 'How Has the Basel Accord Affected Bank Portfolios?' (1993) 7 *Journal of the Japanese and International Economies* 408

<sup>114</sup> See D Hancock and J Wilcox, 'Bank Capital and the Credit Crunch: The Roles of Risk-Weighted and Unweighted Capital Regulations' (1994) 22(1) *Journal of the American Real Estate and Urban Economics Association* 59

other standards of supervision and prudential regulation to encourage financial stability, demonstrating that the Accord required further refinement to be effective.

As a result, Basel II was published in 2004, but did not amend the capital targets. Basel II's main differentiation from Basel I was the creation of a three-pillar system. Pillar 1 contained the capital requirements from Basel I. Pillar 2 contained provisions regarding supervisory review, with the intention of granting greater oversight to regulators in financial institutions. The final pillar contained market discipline provisions, which sought to increase transparency in order for participants in financial markets to gauge the capital adequacy of the institution. The basic overall intent is the same as Basel I in ensuring banks are able to absorb financial shocks through capital buffers, with pillars 2 and 3 addressing some of the previous critique.

Yet it is arguable that there is at least a partially causal link between Basel II and the triggers for the 2008 financial crisis<sup>115</sup>, since it failed to address two key points. The first of these concerns is excessive leverage ratios, i.e. the level of debt to equity. Leverage concerns were outside the scope of the Basel II principles. The second concern was the volume of illiquid assets held, which, being outside the scope of Basel II's concerns, meant that a lack of liquidity in financial markets exacerbated the panic in 2008, as investors lost confidence and sought to close their positions.

There is a debate as to whether or not Basel II was fully implemented and in effect at the time of the 2008 financial crisis, with some arguing that Basel II's final implementation date was deferred to 2011, one year after the endorsement of the Basel III provisions. However, since the basic capital ratios remained unchanged from Basel I, banks' compliance with the minimum capital requirements can be used to determine if there was a mitigating

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<sup>115</sup> See L Cathcart et al, 'Basel II: An Engine Without Brakes' (2017) 18(4) *Journal of Banking Regulation* 359

impact in financial services. In the United States in 2006 average Tier 1 and total capital ratios were 11.3 per cent and 12.8 per cent respectively.<sup>116</sup> In the early stages of the 2008 crisis, the top 25 banks in the US had an average Tier 1 capital ratio of 8.3 per cent and a total capital ratio of 11.4 per cent.<sup>117</sup> This demonstrates that compliance with the ratio did not automatically mean that financial institutions could absorb all shocks, placing greater emphasis on the quality of capital to held and other standards of regulatory oversight. It can be concluded that while capital buffers have a valid aim, the design of other supervisor principles is also fundamental to the stable functioning of financial markets.

The Basel III principles were therefore drafted in the wake of the 2008 financial crisis with an express aim to build upon the pillar structure established by the Basel II framework. Implementation was to start in 2013 to be fully completed by 2019 and contains major reforms to pillar 1, comprising of a higher tier 1 capital ratio of 6 per cent, a new Capital Conservation Buffer of 2.5 per cent and a liquidity standard consisting of a non-risk based ratio of 3 per cent. Consequently, the minimum capital ratio of 8 per cent remains, but with the addition of the Capital Conservation Buffer, the overall standard is a minimum 10.5 per cent. However, none of these provisions addresses the primary rationale of a Financial Transaction Tax as discussed in chapter 1 in mitigating risk. Instead, they reinforce the mechanics for the economic effects of a crisis to be contained to the financial sector, as opposed to preventing exposure to excessive risk and a crisis from occurring in the first instance.

Subsequently, there is an attempt to increase the quality of the overall percentage of capital in increasing the tier 1 requirement and an attempt to address the liquidity problems

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<sup>116</sup> See A Berger et al, 'How Do Large Banking Organizations Manage Their Capital Ratios?' (2008) 34(2) *Journal of Financial Services Research* 123

<sup>117</sup> See R Chami and T Cosimano, 'Monetary Policy With a Touch of Basel' (2010) 62 *Journal of Economics and Business* 161

of the 2008 crisis. Additional measures reinforcing the management, disclosure and transparency requirements of Pillars 2 and 3 were also agreed. This demonstrates that financial crises can foster cooperation at an international level in attempts to address flaws in financial markets, but these reforms are close to the status quo bias, not an overall wholesale reform of financial markets. However, the Basel III requirements are not guaranteed to resolve all ills in financial markets. For example, many of the non-performing financial investments for 2008 were outside of the scope of the Basel II framework. Lee writes that shadow banking practices in less regulated markets will undercut the efficacy of Basel III.<sup>118</sup> Furthermore, Ugeux<sup>119</sup> argues that judged on the updated capital buffer standards alone, Italy presents a positive outlook to investors. However the practical reality is that Italy is suffering a prolonged banking crisis. It is therefore advisable to assess the potential that tax policies can have on limiting exposure to risk alongside well-designed capital adequacy requirements, which provide confidence in the marketplace.

## 4.2. European Banking Union

The Basel banking principles indicate that in addition to capital adequacy requirements, an effective supervisory system is necessary to negate potentially harmful effects of financial markets. With this in mind, although this thesis is of the opinion that further legislative intervention is necessary to protect the wider economy, it is incorrect to state that progress has not been made at EU level, with the European Banking Union (EBU) established following the 2008 financial crisis. It is striking from this example that it is possible to achieve a consensus across the EU with regard to strengthening financial

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<sup>118</sup> E Lee, 'The Shadow Banking System: Why It Will Hamper the Effectiveness of Basel III' (2015) 30(7) *Journal of International Banking Law and Regulation* 373

<sup>119</sup> G Ugeux, 'What Does the Italian Crisis Teach Us on Basel III and the European Banking Union?' (2017) 32(8) *Journal of International Banking Law and Regulation* 341

stability. Therefore, by extension, if the 2011 Proposal were framed as a financial stability measure, this might have given it a greater chance of being adopted.

The EBU's origins lie in the desire of euro area States to strengthen Economic and Monetary Union provisions to ensure a degree of stability for the euro, representing a broad change in banking supervision and a fundamental shift in legislative competences. Ultimately, the process of negotiation towards EBU occurred between June 2012 to July 2014, which Nielsen<sup>120</sup> notes is a "remarkable feat" in EU legislation, particularly due to the nature of the changes negotiated. All banks in the euro area are supervised by the European Central Bank, with a new European agency, the Commission and the Council of Ministers adopting responsibility for the resolution of banks in serious financial turmoil. For example, against the backdrop of these discussions, Spanish banks required recapitalisation of €100 billion.

Although the modifications to financial regulation are radical, the EBU is established mainly based on existing treaty provisions and legislative instruments. The impetus for change came at the height of the euro crisis of 2011-12, with political pressure to reinforce the financial health of the euro in both the short and longer terms. In June 2012 the then President of the European Council, Herman Van Rompuy, published a report which called for a stable and prosperous EMU built on integrated financial, budgetary, economic policy frameworks and ensuring democratic legitimacy for decision making in the EMU. Of these four building blocks, it was the first, an integrated financial framework, which was to become the EBU. This financial framework was to consist of three elements; integrated supervision at EU level, with additional EU deposit insurance and bank resolution schemes.

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<sup>120</sup> B Nielsen, 'Main Features of the European Banking Union' (2015) 26(6) *European Business Law Review* 805

The report received two distinct responses. Euro area Member States provided a positive response, recognising the need to break the link between banks and the sovereign providing loans. The response from the EU27 overall however, was decidedly more mixed, reaffirming the aim to promote a genuine EMU through collaboration between the Commission, the Eurogroup and the ECB. Yet there was a sufficient degree of authority for the Commission to continue towards EBU, publishing a Communication and two Proposals in September 2012, which sought to establish a Single Supervisory Mechanism (SSM).

Not all of the elements envisioned for an integrated financial framework were included in the final EBU. Whilst integrated supervision and bank resolution were incorporated, a joint European deposit guarantee scheme did not proceed. Changes were made to the Directive on Deposit Guarantee Schemes with regard to the breadth of deposits covered, speed of payment and transparency, however overall control of these schemes remained at a national level.

#### **4.2.1. The Composition of European Banking Union**

In addition to demonstrating that economic pressures can foster cooperation between EU Member States in relation to regulation of financial services, it is necessary to assess the result of these negotiations to determine their efficacy, and to outline how a proposed common Financial Transaction Tax would provide a different means of providing financial stability. Furthermore, the formation of the EBU framework reflects a legislative reform programme which adopts a regulatory pluralism approach to law-making, which informs critique in chapter 4 regarding the scale and ambition of the 2011 Proposal.

Ultimately, the EBU framework can be broken down into four strands. The first strand, the formation of the 'single rulebook', a concept that dates back to the de Larosière Group of 2008. The grouping identified a lack of consistent rules as one of the factors leading to

inadequate financial regulation. The group's package of reforms included removal of national exceptions and legislation which did not allow for inconsistencies in transposition. The single rulebook consists of a set of legislative texts that all EU financial institutions are required to comply with. These include the CRD IV package, which seeks to transpose the Basel Accords into the EU legal framework. This consists of a Directive<sup>121</sup>, which regulates the authorisation and supervision of banks, including sanctions and promoting effective corporate governance standards and a Regulation<sup>122</sup>, which determines prudential rules for compliance.

Furthermore, the legislative texts include the Deposit Guarantee Directive<sup>123</sup>, which as stated amended an existing Directive and a new Directive on Bank Recovery and Resolution (BRRD). BRRD sought to provide common tools to national authorities to pre-empt bank crises without recourse to taxpayer losses, including resolution tools and provisions regarding bail-ins, i.e. the writing down of debts owed as opposed to external capital covering debts. BRRD mandated that each Member State must establish a resolution fund of up to one per cent of covered deposits in order to recapitalise banks after losses of more than eight per cent of total liabilities have been covered by bail-ins.

The second strand of EBU is the Single Supervisory Mechanism (SSM). Based on Article 127(6) TFEU, the Council can confer specific tasks to the ECB with regard to the prudential supervision of banks. Agreement was reached in March 2013, with signature and adoption

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<sup>121</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

<sup>122</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

<sup>123</sup> Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes

on amendments to the EBA regulation occurring in October 2013. Comprising the ECB, the supervisory authorities of Member States, the SSM covers all banks in the euro area, plus those outside of the euro area who wish to participate. Non-euro area States are free to participate and withdrawn their support from the SSM to mitigate concerns of a permanent transfer of sovereignty.

The regulation creates a quasi-two tier system of supervision in which overall supervisory authority rests with the ECB, however the ECB will supervise larger banks, whereas national authorities will continue to supervise smaller banks on its behalf. If necessary however, the ECB can manually override national authorities in order to supervise smaller banks. The SSM therefore required a supervisory board in order to eliminate potential conflicts of interest between its objectives of monetary policy and prudential supervision.

The board's operation requires the creation of a common fund to finance its activities, the Single Resolution Fund (SRF). This is in theory to be funded by contributions from banks based on their exposure to risk, in a form of EU wide bank levy as outlined previously in this chapter. However, the original legal basis cited for introducing the SRF was Article 114 TFEU, which raises concerns as to how the measure advances the internal market. The original gambit proved to be too ambitious, therefore in order to resolve the logjam in December 2013 the Council agreed to make an Inter-Governmental Agreement on the transfer of funds to an SRF, with a more graduated approach. This graduated approach includes an eight year transitional period, from the point of contributions to the SRF not being common (i.e. if one State contributes x amount to the fund, that is reserved for their exclusive use unless otherwise necessary) to a period of a common fund. All States signed the IGA bar the UK and Sweden with a target commencement date of January 2016.

The final strand of EBU is the European Stability Mechanism (ESM), which aims to provide financial assistance exclusively to euro area members to safeguard financial stability by providing support directly to governments, not private institutions (i.e. banks). The ESM's

recapitalisation programme is designed to only be used as an absolute last resort, with a bail-in of eight per cent a pre-condition of access to funds and in compliance with state aid rules.

#### **4.2.2. Efficacy Of European Banking Union**

EBU is undoubtedly a step in the right direction to provide a common oversight of financial stability standards across the Union. It indicates that there is political will, in times of severe economic strife, to cooperate and to cede sovereignty to the Union institutions as demonstrated by the establishment of the SSM. Yet they do not go far enough and seem to be reactionary. Ideally, banks and nation States would not be required to use the resources of the SSM and ESM, since they would be stable. The reality is though, in spite of discussions about the speed of recapitalisation, the safety nets in place are of use after the fact. There is an intergovernmental commitment to introducing a levy to fund the SRF, which in theory reduces overall exposure to risk, but these do not in themselves regulate the second by second algorithmic and high frequency trading in the same way that a well-designed financial transaction tax would on speculative trading.

However, there are criticisms of the SSM more generally, which raise concerns over how quickly problems are identified and resolved. For example, in January 2018 the European Court of Auditors conducted an audit of the crisis management aspect of the ECB's mandate post-2014, indicating the following:

“The ECB's operational framework for crisis management has some flaws, and there are signs of inefficient implementation. Guidance for early intervention assessments is underdeveloped and does not define objective criteria or indicators for determining that a bank has entered a crisis situation. There is no guidance on the best use of the ECB's powers or the most appropriate measures to be considered in specific scenarios. We obtained no comprehensive evidence on the actual use of its powers so we cannot conclude on the efficiency of its management

in practice. Guidance on “failing or likely to fail” assessments is also lacking in scope and detail.”<sup>124</sup>

Under this assessment, the SSM is far from perfect and not the panacea that some might view it as. Criticism can also be levelled at the application of capital ratio standards, introduced via the CRD IV package and the BRRD during the Italian banking crisis. Supervisory authorities apply stress tests in order to determine the resilience of financial institutions to economic downturns. These stress tests are applied by the European Banking Authority in the EU under the supervision of the ECB, but do not include sovereign debt. As a result, these tests do not appear to demonstrate the true vulnerability of the banking sector in Europe. This undermines the potential for recognising early intervention to limit the impact of these crises. Ugeux<sup>125</sup> considers these difficulties, using Italy’s oldest bank, Monte dei Paschi di Siena (MPS) as a case study. In 2010 MPS’ Tier 1 capital ratio was assessed by the ECB at 6.8 per cent, however in December 2010 the actual capital ratio was 5.8 per cent. In 2011, it passed the stress test by pledging to raise €1.84 Billion in equity to increase its tier 1 ratio to 6.3 per cent. The ECB focused on banks who failed the test and therefore the EBA did not issue any recommendations to MPS. By June 2012 a €1.7 Billion shortfall was apparent in MPS and, carrying losses on derivative assets, was granted a €4.1 Billion euro state recapitalisation in 2013. In 2014 however, the stress test revealed a further €2.1 Billion shortfall, with MPS failing the stress test again in 2016.

Under these figures, the structural deficiencies of MPS have remained over at least a 7 year period, with warning signs dating back to the 2010 stress test. The stress test does pre-date the EBU discussions, however, it does raise concerns about the ability to identify

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<sup>124</sup> European Court of Auditors, ‘Special Report No 2: The Operational Efficiency of the ECB’s Crisis Management for Banks’ (2018) <[https://www.eca.europa.eu/Lists/ECADocuments/SR18\\_02/SR\\_SSM2\\_EN.pdf](https://www.eca.europa.eu/Lists/ECADocuments/SR18_02/SR_SSM2_EN.pdf)> accessed 9 April 2018

<sup>125</sup> Supra n.119

crises at an early stage, reflecting the later findings of the Court of Auditors. In addition, Ugeux highlights a contradiction in the application of the BRRD. Its application is reserved for institutions that have been identified as either failing or likely to fail and have gone through the bail-in process. However, in order to comply with the restrictive nature of state aid rules, the bank has to be officially put in resolution – if an institution is identified outside of these standards, as MPS was, the resolution mechanism in the BRRD cannot be applied, compounding MPS' situation further.

This is not to criticise the existence of stress tests in themselves, rather this is presented to illustrate that stress testing and capital buffers, combined with a recovery system that is reactive, not proactive, is an insufficient level of protection for the wider economy from financial markets. Capital buffers and supervisory mechanisms alone are not guaranteed to prevent future crises, even if their creation since 2008 establishes a relatively improved degree of safety.

The content presented in this chapter seeks to explain why a distinctive tax policy, such as the 2011 Proposal, is required if one is of the opinion that post-2008, reform of financial markets is necessary. It has sought to outline the alternative forms of taxation available, demonstrating the strengths of a hypothetical common Financial Transaction Tax in terms of dissuading from risk to achieve financial stability, but also to demonstrate the areas where the overall aims of a common Financial Transaction Tax can be supported by other forms of both tax and financial regulation. It has also sought to demonstrate that international consensus post-2008 with regard to financial regulation can be strong, with renewed emphasis on the importance of capital adequacy ratios and supervisory mechanisms. However, this thesis is of the opinion that whilst this reform is positive, it does not offer the same form of necessary protection as a common Financial Transaction Tax would. The first two chapters demonstrate the economic arguments and need for a tax similar to the 2011 Proposal, and explains the obstacles that the tax has faced,

particularly in relation to the requirement of unanimity. The following chapter therefore seeks to explore flexible methods of integration, designed to achieve as much consensus as possible, with regard to the introduction of a Financial Transaction Tax.

### Chapter 3 – Flexible Integration

The previous chapters outline the economic rationale underpinning the 2011 Proposal, the primary alternatives for regulating the financial sector through taxation and most importantly, the legal and political obstacles faced regarding its implementation. At the time of writing, the 2011 Proposal has not been adopted; there is no indication that it will any time soon. The overall argument from this thesis is that a well-designed Financial Transaction Tax will emphasise and create a public good of continued financial stability through behaviour modification in collaboration with other regulatory provisions, which in turn will encourage participation from Member States. This chapter presents an assessment of the different mechanisms by which it may be possible to achieve legislative cooperation in this process in the absence of unanimity as stated in Article 113 TFEU. It outlines three classical theories of differentiated integration, highlighting respective merits of each theory and in addition outlines the legal process of Enhanced Cooperation, which has been used as an attempt to introduce a common Financial Transaction Tax among a smaller cross section of Member States.

One of the problems when assessing theories and mechanisms of flexible integration is what Stubb has referred to as “a severe case of semantic indigestion.”<sup>1</sup> Many authors have used differing terms to refer to what is effectively the same procedure. This problem is further exacerbated by subtle nuances within theories themselves. For example, this chapter highlights that there are major differences in how the *à la carte* theory of integration, which prescribes that Member States are able to ‘pick and choose’ EU level

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<sup>1</sup> A Stubb, ‘A Categorization of Differentiated Integration’ (1996) 34(2) *Journal of Common Market Studies* 283

obligations to adopt, can be interpreted in various forms, contrasting a more positive and inclusive interpretation of the theory, as outlined by Ralf Dahrendorf, with a the interpretation of the UK Conservative party governments of Margaret Thatcher and John Major. Furthermore, examination of theories of integration has attracted academic interest from various different backgrounds, meaning that often legal theorists may use different definitions relative to, for example, political scientists. These theories also invite literature in a variety of languages and by nature it is difficult to directly translate works, which in turn can encourage a greater degree of linguistic, terminological and conceptual differences between authors when assessing a particular theorem. Stubb's article sought to distinguish the main theories and group together differing terms used within certain categories.<sup>2</sup> Whilst this classification of terms is a useful foundation stone, it can be argued that since the Article was first published in 1996 there has been an increased degree of complexity for each theory. In addition to an expanded EU membership, Stubb's article was written prior to the inclusion of the Enhanced Cooperation legal process in the EU legal order as outlined later in this chapter.

The traditional Eurosceptic argument is that unelected and unaccountable bureaucrats in Brussels dictate and impose laws and rules upon national governments of sovereign states. This has forced Member States to consider how they view the Union's authority. An extension of political discussions concerning the role of national governments, there has been a conflict between viewing the Union as a supranational organisation, in which power is located above the nation state, and viewing the Union as an intergovernmental organisation, in which authority for cooperation in the Union is granted by the Member States' will. Whilst progress towards greater degrees and forms of integration is desirable

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<sup>2</sup> Stubb's tables of classification are included in the appendices to this thesis.

in line with the European Union project, it must also be a democratically legitimate form of progress.

The Union faces criticism for a democratic deficit, challenging the overall legitimacy and accountability of the Union's law-making processes. It is the idea of a supranational organisation imposing a tax upon the financial sector which fuels much of the opposition to the 2011 Proposal. Yet when presenting a case for the use of flexible forms of integration to promote a public good, if more flexible methods of adopting legally binding measures are used, they can be viewed purely as a means by which to circumvent unanimity requirements. Certain Member States may consider flexible integration to be a greater affront to their sovereignty relative to more traditional forms of integration, and therefore question the legitimacy of Union measures further. This chapter will highlight that differentiated integration, for the context of this thesis in relation to the adoption of indirect taxes, far from being a simple process to circumvent unanimity, is a further complication, but that if viewed positively can be viewed as a way to providing a greater standard of public good than at present.

## **1. Is 'Hard Law' Necessary to Introduce a Common Financial Transaction Tax?**

### **1.1. Transfer Pricing Guidelines as a Case Study**

Thus far, in focusing on the 2011 Proposal, this thesis' interest has concerned the possibility of adopting a Directive, a hard law measure, in order to attain progress in taxation of the financial sector. However, this overlooks the potential for collaborative soft law approaches to common standards in taxation. Can the aims of the 2011 Proposal therefore be achieved by soft law discussions instead, potentially avoiding the complexities posed by compliance with Article 113 TFEU? The previous chapter included discussion of

the Basel Banking Accords, which demonstrate a soft law approach to financial regulation may be possible. However, this example does not address tax policy. Therefore, it is necessary to consider an example of soft law and taxation. The OECD's transfer pricing guidelines offer an example of commonly agreed international tax standards, which reflect the potential positives that a soft law approach can provide in relation to cooperation in tax policy.

Transfer pricing is linked to the increase in globalised trade through Multi National Enterprises (MNEs) and refers to the "allocation of profits for tax and other purposes between parts of a multinational corporate group."<sup>3</sup> This can lead to complexities in determining profitability of a company. For example, a bicycle manufacturing company in Spain might purchase bicycle saddles from a subsidiary company in Italy. The transfer price relates to how much the parent company pays its subsidiary, therefore it determines how much profit the subsidiary reports to tax its domestic tax authorities. In this example, if the Spanish manufacturers pay below market price for the saddles, the Italian company may appear to be in financial difficulty. Nonetheless, overall the MNE may display a healthy profit margin once the bicycles are sold. The true profit is only reflected in one State, with the Spanish tax authorities claiming the revenue. However, the profit is not reflected in the report to the Italian tax authorities. In contrast, if the two were separate entities and the market price were paid, there would be a profit reflected in both States for tax purposes.

In the interests of both States and businesses, the OECD transfer pricing guidelines seek to clarify these positions by applying the 'at arm's length principle', meaning that the transfer price between two parts of an MNE should be the same as if they were two separate entities on the open market. The aims of the principle involve avoidance of double

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<sup>3</sup> J Neighbour, 'Transfer Pricing: Keeping it at Arm's Length' (*OECD Observer*, 3 July 2008) <[http://oecdobserver.org/news/archivestory.php/aid/670/Transfer\\_pricing:\\_Keeping\\_it\\_at\\_arms\\_length.htm](http://oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.htm) l> Accessed 13 February 2018

taxation and clarity for MNEs with regard to identifying financially sound and the financially vulnerable parts of their business. Furthermore, the OECD guidelines seek to ensure that national tax authorities collect revenue from businesses based on their genuine economic activity which occurs on their territory. This incentive creates a clear overlap with efforts to combat taxable profits being artificially shifted out of a jurisdiction to reduce tax liabilities.

Although there is an argument that a soft law approach to regulating financial markets would be time efficient relative to the protracted timeframe for hard law provisions, both the Basel Banking Accords and the OECD's transfer pricing guidelines have evolved over a significant period of time. For example, the OECD's transfer pricing guidelines reflect the general international consensus of OECD members as to their understanding of the arm's length principle. The gestation period in creating these draft guidelines was relatively long. The first steps towards draft guidelines occurred in 1979, with the publication of an OECD report on transfer pricing.<sup>4</sup> However, the first draft guidelines, which were a revised version of the 1979 report, were published in 1995 and have undergone several revisions since, with the most recent guidelines published in July 2017.<sup>5</sup> The guidelines state that these updates reflect, in particular, Action Points 8-10 and 13 of the OECD's 2015 Base Erosion and Profits Shifting programme (BEPS), a project which Khan Niazi explains in relation to the Common Consolidated Corporate Tax Base discussions in chapter 4, created a renewed impetus for cooperation at EU level. The continuing development of these guidelines indicates a general advantage of soft law matters: that a great degree of flexibility is possible in building upon and refining existing guidelines as opposed to repealing and replacing tax legislation. This creates a sense of fairness in the international community with regard to the definition of the tax base, but in doing so, the efficacy of

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<sup>4</sup> OECD Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979)

<sup>5</sup> OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 2017

provisions may be limited. The following section in this chapter presents a contrasting case study of corporation tax, arguing that flexibility may create a 'race to the bottom' and damage the efficacy of the policy. In relation to taxation of financial markets, in a manner similar to the 2011 Proposal, if a soft law approach were to be appropriate, it must be demonstrated that flexibility is not detrimental to achieving these aims. This same concern is reflected, to an extent, in chapter 4, concerning discussion of the 'weakest link' in relation to providing public goods.

On the face of it, the OECD's transfer pricing guidelines are successful. They reflect an inter-governmental approach beyond the confines of the EU's legal structure, reflecting international consensus. Still, the guidelines are not without their critics. Criticisms range from the definition of the arm's length principle, to the general value of soft law on enforcement grounds and the compatibility of transfer pricing with the aims of the European Commission (specifically with regards to the application of alternative mechanisms to mandate States to claim revenues from companies in spite of their apparent compliance with transfer pricing guidelines).

With regard to the arm's length principle, Luckhaupt et al<sup>6</sup> highlight that its reliance centres on being able to determine an open market price for the item traded. In essence, this price is calculated on the potential cost of a controlled transaction with the value of an uncontrolled transaction. However, this does not reflect realities in the marketplace, that a company may still be at a competitive advantage regardless, due to expertise or investment in, for example, research and development programmes, which is not capable of being traded on the open market. As a result, a large degree of leeway is provided by relying on other data, which can be exploited for relative benefit. They note that the

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<sup>6</sup> H Luckhaupt, M Overesch and U Schreiber, 'The OECD Approach to Transfer Pricing: A Critical Assessment and Proposal' in W Schön and K Konrad (eds) *Fundamentals of International Transfer Pricing in Law and Economics* (Springer 2012)

empirical literature indicates that in spite of these guidelines, MNEs are still able to shift profits to lower tax States to reduce overall tax liabilities.

In addition, the underlying concept of regulating transfer pricing makes several assumptions which overlook practical business conduct. In attempting to encourage MNEs to transact with a subsidiary as if two separate entities, the arm's length principle overlooks that in choosing to complete that transaction, the MNE has excluded the wider market anyway due to some formation of a perceived advantage. Instead, Luckhaupt et al<sup>7</sup> argue for a more simple approach due to the complexities created in attempting to determine an accurate transfer price, instead recommending a transaction-based apportionment method, combining a fixed standard profit margin with apportionment of residual profits. In this regard, the focus is not on the transfer price itself, but the effect of the transfer, which the authors argue can be observed far more easily, reduces compliance and enforcement costs and furthermore reduce double taxation risks.

The second area for critique is enforcement of the transfer pricing guidelines. Whilst soft law can be effective and the BEPS programme demonstrates can have a rejuvenating effect on EU wide CCCTB deliberations (discussed in chapter 4), the guidelines are not binding to the methods to achieve the stated aim. All States have a finite amount of resources which they can attribute to enforcement and collection of taxes, such as transfer pricing rules. Yet some States are more able to allocate a greater proportion of enforcement of these rules than others, creating automatic discrepancies between States, which can create opportunities of MNEs to divert profits to lower tax jurisdictions. Innamorato states more generally that "the value of 'soft law' is widely debated. Scholars only seem certain that 'soft law' should not be considered as a source of international law

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<sup>7</sup> Ibid

because as a non-legally binding instrument it is not found in Art.38 of the Statute of the International Court of Justice.”<sup>8</sup> This relates to the enforceability of provisions. Chapter 4 of this thesis includes an explanation of how public goods can factor in to tax policies, such as the 2011 Proposal, to inform cooperation.

### **1.1.1. Soft Law Interaction With Hard Law**

There may be a common goal stated by these guidelines, however the difference in application creates a weakest link scenario, as reflected in chapter 4. It is agreed that if possible, common action is required for Financial Transaction Taxes to be effective. Yet, while it is possible to have soft law elements in application of global financial standards, such as the Basel Banking Accords outlined in the previous chapter, the efficacy of these principles may be complemented by hard law. For example, many of the Basel III principles are reflected in the European Commission’s CRD IV Package<sup>9</sup>, i.e. a series of hard law measures. Therefore, whilst the principles set are agreed as soft law, international standards, their efficacy in European financial markets is reinforced as a result of the EU’s non-compliance procedures. If a Financial Transaction Tax is to be introduced in the name of reducing speculative trading, its effectiveness is compromised if a State does not enforce it and financial markets are exposed to greater risk accordingly. It runs counter to the aims of the tax.

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<sup>8</sup> C Innamorato, ‘Expeditious Amendments to Double Tax Treaties Based on the OECD Model’ (2008) (36(3) *Intertax* 98 at 106

<sup>9</sup> Consisting of the ‘Capital Requirements Directive’ Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC and the ‘Capital Requirements Regulation’ Regulation 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

One of the benefits of being adopted within the EU's institutional framework is that there is a clear process of debate, adoption and enforcement, particularly if there is a dispute between two participating States. In soft law agreements, it is not guaranteed that all States will be in accordance with each other at all times. This chapter discusses the variable geometry form of flexible integration and presents a proposed solution for a Tobin Tax by Heikki Patomäki, which builds on this by proposing the creation of a new international Tobin Tax Organisation. However, when establishing a new organisation the same difficulties arise with regard to enforcement of the tax, which provides greater impetus for a common tax on speculative trading in financial markets to be established within the EU's institutional framework.

Furthermore, a soft law provision can be undermined by an alternative hard law practice. For example, there have been several high profile cases in recent years concerning the tax affairs of companies including Apple, Starbucks and Fiat in states such as Ireland, the Netherlands and Luxembourg. The justification for many of the European Commission decisions has been that Member States have agreed tax arrangements which are in contrast to the competition law based state aid provisions in the Treaties. It can be viewed that these cases simply seek to determine recovery of taxes from MNEs based on genuine economic activity in these States. However, there is a strong debate as to whether state aid rules should be applied in this manner at all.<sup>10</sup> There is also critique of the international relations impact of these decisions<sup>11</sup>, yet the key to demonstrating that hard law can trump soft law is that, while in line with OECD transfer pricing guidelines, the agreed deals were

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<sup>10</sup> See T Jaeger, 'Tax Concessions for Multinationals: In or Out of the Reach of State Aid Law?' (2017) 8(4) *Journal of European Competition Law and Practice* 221

<sup>11</sup> See E Stuart, 'Whether or Not to Bite the Apple: Some Implications of the August 2016 Commission Decision on Irish Tax Benefits for Apple (2017) 16(2) *European State Aid Quarterly* 209

held to be in breach of EU state aid rules.<sup>12</sup> Regardless of the merits of applying state aid provisions in this area, this does demonstrate that if there is a conflict between a soft law guideline and a hard law provision, that the hard law provision will prevail irrespective of the jurisdiction. Financial Transaction Taxes, such as the 2011 Proposal, are more susceptible to a similar undermining as the transfer pricing guidelines in a soft law agreement as opposed to a hard law piece of adopted legislation.

## **1.2. Avoiding a ‘Race to the Bottom’: The Case Study of Corporation Tax**

The transfer pricing guidelines indicate a successful example of international cooperation to establish commonly agreed principles and standards through a soft law approach to policymaking. The original 2011 Proposal presented a draft Directive (i.e. a hard law provision), but the success of the soft law approach raises the question as to whether the same and or similar results could be achieved by following a more flexible, soft law strategy. This would accordingly mean that each individual Member State would have a greater a degree of flexibility in terms of designing the operation of a tax, providing that they did not operate against the spirit of the tax.

This thesis is of the view, however, that a hard law provision is necessary in order to introduce a tax on speculative trading in financial markets at EU level, the primary rationale being to ensure compliance and, in ensuring a minimum standard in terms of rates of a tax and tax base, limits concerns of a ‘race to the bottom’ from Member States attempting to, in effect, undercut each other. Chapter 1 explained that the 2011 Proposal recognised a potential 0.5% decrease in EU GDP and that the tax was designed to mitigate the impact

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<sup>12</sup> See A Taferner and J Kuipers, ‘Tax Rulings: In Line With OECD Transfer Pricing Guidelines, But Contrary to EU State Aid Rules’ (2016) 56(4) *European Taxation* 134

of any relocation of financial institutions to establish themselves outside of the Financial Transaction Tax area i.e. to jurisdictions that do not apply the tax. If a minimum standard were not set, then a Member State may seek to either apply a lower tax rate or not apply the tax to particular financial products, in order to encourage financial institutions to relocate to these areas. This could initially be presented as a positive, with increased capital and investment in a state supporting the national economy, for example with the provision of job prospects for the local population. However, such an approach would be antithetical to the economic arguments advanced by Keynesian macroeconomics, as outlined in chapter 1. For example, although different in application from the 2011 Proposal, James Tobin's *Proposal for International Monetary Reform*<sup>13</sup> is ineffective if only one state were to introduce a currency conversion tax. Ultimately, speculation in these markets will remain, meaning that real progression and change, which this thesis argues is essential post-2008, would not be achieved. These concerns are reflected in chapter 4 of this thesis, regarding the 'weakest link' assessment of provision of public goods.

For the purpose of this chapter, however, the 'race to the bottom' concern is reflected in the ongoing legislative efforts regarding the operation of corporation/company tax. The tax is charged based upon a business' economic activity within a particular jurisdiction, i.e. as a percentage of the profits attributable to operating within a state. However, as Mugarura states, there is the challenge of "forum shopping, otherwise known as the race to the bottom, which occurs when state parties in the same regulatory market domain (the EU) choose to adopt different regulatory standards. Regulatory arbitrage normally comes about when one country chooses to adopt a rigorous regulatory regime, while another chooses

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<sup>13</sup> J Tobin, 'Proposal for International Monetary Reform' (1978) 4(3-4) *Eastern Economic Journal* 153

to adopt less stringent regimes.”<sup>14</sup> There are clear examples of other areas in financial regulation where harmonisation of law is necessary to prevent the aims of the regulation being undermined. For example, Mugarura gives the example of anti-money laundering legislation at EU level to demonstrate why harmonisation is necessary:

“Drawing on the EU, anti-money laundering/countering financing of terrorism (AML/CFT), for instance, harmonization is achieved through issuance of directive and regulation which states transpose to approximate laws and policies in line with anticipated EU reforms. There was a recognition that member states would not be able to work together without first adopting measures to harmonize their different legal systems, cultures and customs in areas of international trade, financial markets regulation, employment law, environment law and other areas of shared interests.”<sup>15</sup>

Individual states are able to set this tax rate in accordance with national priorities, whether seeking to elevate the rate in an effort to increase tax receipts from companies already established within the state, or decrease the rate in order to attract new investment from companies seeking to reduce their tax burden. Chapter 4 includes the assessment of Murphy and Nagel in *The Myth of Ownership*<sup>16</sup> regarding the philosophical considerations of determining tax policy. From this classification, it is possible to conclude that, because national governments provide the infrastructure and mechanisms for companies to operate and to be profitable, businesses, in theory, have no moral right to retain profits. Corporation tax acts as a vital contributor to a state’s national treasury, for example the UK Budget

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<sup>14</sup> N Mugarura, ‘Can “Harmonization” Antidote Tax Avoidance and Other Financial Crimes Globally?’ (2018) 25(1) *Journal of Financial Crime* 187 at 198

<sup>15</sup> *Ibid* at 190

<sup>16</sup> L Murphy and T Nagel, *The Myth of Ownership* (OUP 2004)

2018 indicates that in the UK in 2017-18, corporation tax receipts totalled £55.9 billion.<sup>17</sup> The budget demonstrates further that only personal income tax (£180.7 billion), national insurance contributions (£132.5 billion) and VAT (£125.3 billion) are the only larger single tax contributors to the national budget.<sup>18</sup> Given Murphy and Nagel's assessment, and in the context of austerity governance, particularly in Europe as a consequence of the 2008 crisis, greater importance is placed upon sources of revenue for governments and, in addition, there is increased pressure on national governments to justify policy decisions regarding rates of taxation, such as corporation tax rates, to the electorate. In other words, if a company is perceived to not be paying the appropriate level of tax, even if they are complying with legal obligations, the efficacy of the tax is questioned.

Consequently, as the previous section made reference to, there have been numerous high profile cases of large multinational corporations being accused of tax avoidance at EU level. For example, Apple<sup>19</sup>, Amazon<sup>20</sup>, Fiat<sup>21</sup>, IKEA<sup>22</sup>, and Starbucks<sup>23</sup> and have all been subject to investigations regarding their effective rate of corporation tax payable on profits. These investigations have, however, been directed under the mandate of the European Commissioner for Competition in relation to the application of state aid rules (i.e. that national governments have distorted competition in offering artificially low effective tax rates in return for establishment in the particular state), not under the mandate of the European Commissioner for Economic Affairs and Financial Affairs, Taxation and

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<sup>17</sup> *UK Budget 2018* at Table C.5. Current Receipts

<sup>18</sup> *Ibid*

<sup>19</sup> State Aid Case 38373 Ireland and Apple

<sup>20</sup> State Aid Case 38944 Luxembourg and Amazon

<sup>21</sup> State Aid Case 38375 Luxembourg and Fiat

<sup>22</sup> State Aid Case 46470 Netherlands and IKEA

<sup>23</sup> State Aid Case 38374 Netherlands and Starbucks

Customs. Consequently, there is a debate as to the legitimacy of these investigations, whereby the specific mechanism adopted in order to determine fines for alleged underpayment of taxes is appropriate. In effect, the result of these investigations is to infringe on a Member State's ability to determine its own corporation tax rates. Therefore, whilst the aims of the Commission may be valid, the mechanism may lack the same legitimacy. To this end, a hard law corporation tax assessment at EU level would not only avoid a race to the bottom, but it would also provide legitimacy to ensuring companies pay the appropriate level of tax. This proposed hard law approach is discussed in greater detail in chapter 4 regarding the Common Consolidated Corporate Tax Base, with evidence of a more graduated approach to introducing tax policy at EU level producing encouraging reform.

This thesis does not, however, seek to present a reduction in corporation tax rates as nefarious. It should therefore be stated that a reduction in corporation tax rates may not be designed to encourage MNEs to establish themselves in a particular state. Instead, the reduction may seek to provide a form of tax relief for national small and medium enterprises (SMEs), which contribute to the national economy. A reduction in corporation tax rates would reduce the tax burden for these companies, with them either being able to reinvest profits in hiring and retaining more staff, paying dividends to shareholders or to offset against other costs, such as local rents and business rates.

It is possible for the same debates and concerns regarding regulatory divergence in the application of corporation tax at national level. At the time of writing, in the UK the standard rate of corporation tax is 19 per cent, set to be cut to 17 per cent by 2020.<sup>24</sup> However, the current standard corporation tax rate in the Republic of Ireland is 12.5 per cent, with the

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<sup>24</sup> *UK Budget 2018* at 3.1

Minister for Finance's 2019 Budget Statement stating that "our longstanding 12.5 per cent rate will not be changing."<sup>25</sup> Therefore, in order to allow for a more competitive rate of taxation across the Irish border in Northern Ireland, the Corporation Tax (Northern Ireland) Act (2015) grants the devolved national assembly in Stormont the authority to determine applicable corporation tax rates in Northern Ireland from 2018, meaning Northern Ireland will have a different applicable rate from the rest of the UK. However, the national assemblies of Scotland<sup>26</sup> and Wales<sup>27</sup> have been granted additional powers in relation to tax policy. It is therefore arguable that with increasingly devolved taxes, that the Scottish Parliament and Welsh Assembly should, similar to Northern Ireland, be able to determine corporation tax rates. If such powers were granted, this would, potentially, lead to the four nations of the United Kingdom seeking to undercut the other's tax rate.

Although not named as such, the race to the bottom concerns prompted James Tobin's *Proposal for International Monetary Reform*. It should be recalled from chapter 1 that part of Tobin's reasoning was to address his concern that the currency conversion markets had developed to such an extent that states may need to adopt monetary policies, in order to attract external investment, which are ultimately detrimental to national aims. For example, he states that "national economies and national governments are not capable of adjusting to massive movements of funds across the foreign exchanges, without real hardship and without significant sacrifice of the objectives of national economic policy with respect to employment, output, and inflation."<sup>28</sup> In the name of competitiveness, Tobin feared that,

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<sup>25</sup> Irish Budget 2019 Statement of the Minister for Finance and Public Expenditure and Reform Mr. Paschal Donohoe T.D. 9th October 2018

<sup>26</sup> See Land and Buildings Transaction Tax (Scotland) Act (2013), Landfill Tax (Scotland) Act (2014) and the Air Departure (Scotland) Act (2017)

<sup>27</sup> See the Wales Act (2014) which devolved stamp duty land tax, landfill tax and income tax (subject to a referendum) to the Welsh Assembly

<sup>28</sup> *Supra* n.13 at 154

without the introduction of his proposed tax, an unsustainable system based on competing lowering of standards and administrative burdens would have a detrimental impact on national economies.

## **2. Balancing Legitimacy of Policies, Flexibility and the Rise of Pragmatism**

The previous section outlined the reasoning for a hard law mechanism to introduce a common Financial Transaction Tax, however, these changing nature of the EU's remit and scope raises concerns surrounding the legitimacy of provisions, and has consequently led to the creation of flexible forms of hard law integration and an increase in pragmatic policymaking, in order to continue to drive the EU's legislative agenda. The modern day EU's legislative output at present concerns 28 Member States as opposed to targeting a single Member State. Nonetheless, as illustrated later in this chapter by UK opposition to 2011 Proposal, there remain occasions where individual Member State governments, elected by their citizens, believe they are being unduly targeted by a particular measure. If a state perceives its interests are being overlooked, the argument for an intergovernmental approach with regard to the EU is reinforced. In order for the Union's measures to be respected by Member States in a more supranational manner, it needs to take steps to address the democratic deficit. If the 2011 Proposal is presented in such a way as to be overly supranational, use of flexible integration may reinforce this democratic deficit. However, if the 2011 Proposal were presented as being necessary to fulfil a global public good, as argued in the following chapter, there is a greater incentive for participation in the interests of citizens. This argument is developed further in chapter 4.

## 2.1. The Requirement for Flexibility in Law Making

Attempts to increase legitimacy and accountability for the EU legislature indicate a concerted effort to address the pressures that the Union's institutional structure place upon legislative output. The pressures become more controversial when more flexible forms of governance and law making develop in order to avoid legislative stagnation. The necessity to incorporate flexibility into the EU's legislative and decision-making processes can be traced back to the phrasing of the Preamble of the Treaty of Rome in 1957. This stated that the six founding members sought an "ever closer union among the peoples of Europe."<sup>29</sup> The Preamble also stated that the goal of ensuring "the economic and social progress of their countries by *common action* to eliminate the barriers which divide Europe."<sup>30</sup> [Emphasis added].

The requirement for flexibility in the EU's legislative process derives from two primary driving forces in order to achieve widening and deepening of the Union, which are more widespread than the specific difficulties that the 2011 Proposal has faced. The first of these forces is the increase in the number of Member States. The probability of achieving uniform consensus on Union policy decreases following each new Member State accession. The second of these forces is the neofunctionalist spill-over effect. Once competence is achieved in one area there is appetite to expand this competence further to other areas. Since the stated aim of the then European Economic Community was to create a common internal market, this means that the interpretation of the internal market, and subsequently measures designed to advance the development of the internal market, also expanded.

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<sup>29</sup> Preamble to 1957 EC Treaty

<sup>30</sup> Ibid

This discussion was reflected previously in this thesis concerning whether the 2011 Proposal advances the internal market.

The CJEU's actions in *Van Gend*<sup>31</sup> and *Costa*<sup>32</sup> placed greater credence on the treaties. Fears of a 'competence creep' were highlighted in particular by the German Constitutional Court<sup>33</sup> in the *Internationale Handelsgesellschaft* case.<sup>34</sup> Following the CJEU's explanation of primacy of EU law over national law in *Costa* the German Constitutional Court clarified its perspective, proffering a counter-theory. Whilst the Court expressly allowed for the transfer of sovereign powers, the transfer was controlled by national constitutional law. Famously the Court introduced its 'So-long' doctrine, leading to the case being referred to as the *Solange* case:

"In the hypothetical case of a conflict between [EU] law and a part of national constitutional law...there arises the question of which system of law takes precedence, that is, ousts the other. In this conflict of norms the guarantee of fundamental rights in the Constitution prevails so long as the competent organs of the [Union] have not removed the conflict of norms in accordance with the Treaty mechanism."<sup>35</sup>

Whilst Member States by way of their continued membership of the Union appear to be supportive of the EU integration project, there have been many instances of legislative stagnation within the EU of the kind illustrated by the 2011 Proposal. In spite of the political

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<sup>31</sup> Case 26/62, *NV Algemene Transporten Expeditie Onderneming van Gend en Loos v Nederlandse Administratie der Belastingen* [1963] ECR I

<sup>32</sup> Case 6/64 *Falminio Costa v ENEL* [1964] ECR 585

<sup>33</sup> Bundesverfassungsgericht

<sup>34</sup> *Solange I - Internationale Handelsgesellschaft von Einfuhr- und Vorratsstelle für Getreide und Futtermittel*, decision of 29 May 1974, BVerfGE 37, 271; *Solange II - Wünsche Handelsgesellschaft* decision of 22 October 1986, BVerfGE 73, 339, case number: 2 BvR 197/83, *Europäische Grundrechte-Zeitschrift*, 1987, 1,

<sup>35</sup> Paras 23 and 24 BVerfGE 37, 271 (*Solange I (Re Internationale Handelsgesellschaft)*). English translation in [1974] 2 *Common Market Law Review* 540

climate of the 1950s leading to a predominantly supranational approach to the European Coal and Steel Community, Member States were unaware of how wide ranging the Union would become and the structures in place.

As an international organisation, the Union is still in its relative infancy. Pescatore stated that the need to develop direct effect is borne of an ‘infant disease’ which could only be remedied with an increased degree of federalism.<sup>36</sup> Structural amendments to the legislative process can only be made by unanimously agreed Treaty amendments among all 28 Member States. If there is a lack of flexibility in the law making process, it is incredibly difficult to amend Treaties to reflect this. For example, the unanimity requirement for Article 113 TFEU can only be changed via a future Treaty Amendment, which in itself would require a unanimous vote from Member States. The constitutional requirements of each individual State of the EU will vary, but the advantage that the EU offers in providing a forum for legislative accords is also its downfall. Although not specifically a constitution, it is arguable that the actions of the CJEU have constitutionalised the Treaties<sup>37</sup>, with the CJEU referring to the TFEU as the “basic constitutional charter” of the Community in the *Les Verts*<sup>38</sup> case. Nevertheless, in order for the Union to be an effective legislative body at all, given the increase in membership, there is a greater requirement for flexible integration. This thesis argues that the public good nature of a common Financial Transaction Tax outlined in the next chapter means that the pursuit of flexible integration to achieve it is justifiable.

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<sup>36</sup> P Pescatore, ‘The Doctrine of “Direct Effect”: An Infant Disease of Community Law’ (1983) 8 *European Law Review* 155

<sup>37</sup> A Boerger and M Rasmussen, ‘Transforming European law: the establishment of the constitutional discourse from 1950 to 1993’ (2014) 10(2) *European Constitutional Law Review* 199.

<sup>38</sup> Case 294/83 Parti Ecologiste ‘Les Verts’ v European Parliament (1086) E.C.R. 1339

## 2.2. Built in Flexibility in Treaties and Directives

Junge states that “European integration was never a ‘uniform process’<sup>39</sup> and accordingly EU institutions have sought to counter the preservation of the status quo approach by adopting more flexible solutions in order to encourage the European integration process. Furthermore, there is clear evidence that through Treaty amendments Member States are recognising that a more flexible approach is required within certain areas. For example, post-Lisbon Article 114 TFEU’s Qualified Majority Voting (QMV) provisions are now the standard legal basis for Proposals as opposed to Article 115 TFEU’s unanimity provisions. In addition, the Treaty of Amsterdam introduced Closer Cooperation, the process which would later be renamed to Enhanced Cooperation and detailed later in this chapter, which permits a group of Member States to continue to adopt legislation in areas requiring unanimity, but excluding Member States that do not wish to participate. Furthermore, the Treaties contain flexibility clauses including Article 352 TFEU, which allow the competences of the Union to be adjusted to the objectives laid out in the Treaties, yet there remains evidence that there are certain policy areas where Member States seek to preserve unanimity requirements, for example Article 114(2) TFEU expressly excludes fiscal matters from QMV, hence the requirement to base the 2011 Proposal on Article 113 TFEU instead.

On paper at least a certain degree of flexibility has been possible since the entry into force of the TFEU in the design of Directives. Directives are normative acts which are addressed to Member States. They impose a deadline by which the Member State is required to give effect to the policy objective of the Directive. This transposition is conducted in accordance with national laws, which in turn allows for a degree of variety, since Article 288(3) TFEU

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<sup>39</sup> K Junge, ‘Differentiated European Integration’ in M Cini (ed), *European Union Politics* (2<sup>nd</sup> Edn OUP 2007) at 392

states that Directives are “binding as to the result to be achieved” whilst leaving the choice of form or method to the national authority. In theory therefore Directives reflect the principles of subsidiarity, in which decision making in the EU should take place as close to individual citizens as possible (i.e. only at EU level if absolutely necessary) and proportionality by only going as far as is necessary to ensure that a policy objective is pursued.

Furthermore, Directives prescribe a minimum standard for States to achieve – it is reasonable to assume that a Member State may wish to adopt more stringent measures. For example, the 2011 Proposal sought a Council Directive as the legal instrument for its introduction. The 2011 proposed rates of 0.1 per cent and 0.01 per cent on transactions were only minimum rates i.e. certain States may wish to go further and charge higher percentages. However, in reality for many Directives, particularly for highly technical policy areas, there is little room for manoeuvre with regard to the form chosen by the Member State. There is little doubt that any legislative instrument for a common Financial Transaction Tax will be highly technical in nature.

This thesis argues that a common FTT is required primarily to mitigate the specific risks posed by speculative High Frequency Trading. In the absence of a soft law agreement, unanimity under Article 113 TFEU and a lack of an alternative Treaty Article acting as the foundation for a Financial Transaction Tax Proposal there must therefore be an assessment of other pragmatic solutions. Flexible forms of governance and law making are borne as a result of frustration concerning legislative and political stalemates. Flexible integration and the classic theories outlined in this chapter are by no means the ideal methods of introducing measures. By nature, flexible integration runs contrary to the Rome Preamble concerning common action. Furthermore, certain theories and approaches may not be universally applicable. For example, as the following sections of this chapter outline,

although multi-speed Europe may be the closest of the classic theories to the Rome Preamble, certain measures may merit an *à la carte* approach.

### 3. Establishing a Working Definition of Flexible Integration

In order to apply theories of flexible integration to the Financial Transaction Tax a working definition must be established. In theory, this should be simple – many authors and textbooks give a definition as to what they consider to be ‘flexible integration’<sup>40</sup>, however there is also discussion of ‘differentiated integration’. For the purposes of this thesis, flexible integration is seen as a wider, all-encompassing term that would include the built in legislative flexibility (i.e. flexibility clauses and Enhanced Cooperation), soft law, forms of governance such as the OMC and theories of differentiated integration. This chapter includes discussion of Enhanced Cooperation and Article 136 TFEU as ‘mechanisms of integration’. The following sample definitions do aid in establishing a definition of differentiated integration, which in turn fall under the umbrella term of flexible integration.

The first definition is taken from the European Commission’s Glossary ‘The Reform of the European Union’, published in 1997. The Glossary formed part of the process of educating the public following the Inter-Governmental Conference on the reform of the European Union in 1996. The Commission’s aim was to provide “non-specialists with signposts through a vocabulary which can sometimes be obscure.”<sup>41</sup> The Commission defined differentiated integration as:

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<sup>40</sup> For example see M Avbelj, ‘Revisiting Flexible Integration in Times of Post-Enlargement and the Lustration of EU Constitutionalism’ (2008) 4 *Croatian Yearbook of European Law and Policy* 132

<sup>41</sup> European Commission ‘Glossary: The Reform of the European Union in 150 Definitions’ <[http://www.ab.gov.tr/files/ardb/evt/1\\_avrupa\\_birligi/1\\_7\\_sozlukler\\_ve\\_kilavuzlar/Glossary\\_The\\_reform\\_of\\_the\\_European\\_Union\\_in\\_150\\_definitions.pdf](http://www.ab.gov.tr/files/ardb/evt/1_avrupa_birligi/1_7_sozlukler_ve_kilavuzlar/Glossary_The_reform_of_the_European_Union_in_150_definitions.pdf)> Accessed 21 November 2014

“A process of integration in which the Member States opt to move forward at different speeds and/or towards different objectives, in contrast to the notion of a monolithic bloc of States pursuing identical objectives at a single speed.”<sup>42</sup>

An alternative textbook definition of differentiated integration is provided by Junge:

“A collective term that covers all methods of European Union (EU) integration that do not require Member States to participate in every integration project, or that allow member countries to implement European policies at their own pace.”<sup>43</sup>

At first glance, these may appear to be similar definitions. Both focus on Member States rather than individual actors and stipulate that Member States wish to adapt at different speeds as opposed to a collective block, cementing a more multi-speed Europe theory of integration as presented later in this chapter. However, Junge’s definition goes further and states that Member States are not required to participate in every integration project. By this definition, differentiated integration also includes a more *à la carte* element and therefore recognises that opt-outs would be considered as a part of differentiated integration.

### 3.1. Theories of Integration Precursor

The three classical theories presented in this chapter rely predominantly on political science literature. Often the areas in which these theories have been applied have encountered many of the political obstacles faced as outlined in chapter 1. This is supported by Přebáň highlighting the distinction between legal and political science understandings of integration within the EU. He states that the EU is functionally differentiated into social subsystems, with its polity being defined by a “process of *social*

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<sup>42</sup> Ibid

<sup>43</sup> Supra n.39 at 392

*differentiation* which is communicated within the political system through the notion of differentiated integration and within the legal system through the equivalent notion of flexibility clauses”<sup>44</sup> such as Article 352 TFEU. This would appear to indicate that differentiated integration is reserved exclusively for political scientists, with flexibility clauses being exclusive to lawyers. However, in order for these political science theories to be implemented the Union has had to adopt various forms of legal instruments to give effect to politically controversial or sensitive measures. Assessing these legal instruments grants lawyers a gateway into the debate concerning differentiated integration. Likewise, it would be naïve to believe that flexibility clauses are the exclusive preserve of lawyers. There is, therefore, an overlap between legal and political science literature.

#### **4. Enhanced Cooperation**

Before considering the classical theories as included in Stubb’s article, it is informative to review the Enhanced Cooperation procedure and its application to the 2011 Proposal to highlight the approach that Member States have practically adopted in this area. Following the June and July ECOFIN meetings of 2012 it became clear that unanimity as required by Article 113 TFEU would not be attainable for the foreseeable future. Consequently, those Member States that were in favour of adopting a common Financial Transaction Tax elected to use the Enhanced Cooperation procedure.

Enhanced Cooperation permits a minimum collective of nine Member States in provided circumstances to collaborate to adopt a legally binding measure among themselves, without creating a legal obligation on those States that do not wish to proceed. In other

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<sup>44</sup> J Příbáň, ‘Legal Flexibility, Governance and Differentiated Integration: On Functional Differentiation of EU Law and Politics’ in K Dyson and A Sepos (eds), *Which Europe? The Politics of Differentiated Integration* (Palgrave 2010) at 24

words, in the absence of unanimity, by using the Union's institutional and legislative framework, subject to certain caveats, Enhanced Cooperation is to be seen as the primary Treaty mechanism with which to try to break legislative stalemates. This, by its very nature, means that in the context of adopting the 2011 Proposal, Member States were naturally inclined to look to use the process.

The process itself is a relatively new creation, which did not appear in the original Treaties of Rome (1957). Although Enhanced Cooperation has rarely been used since its earliest form of introduction at the Treaty of Amsterdam in 1997, it is becoming increasingly apparent that Member States are conscious of its existence, in particular in economic areas.

As part of an attempt to halt the economic crisis in Europe, in particular in the euro area, the EU negotiated the 'Treaty on Stability, Coordination and Governance in the Economic and Monetary Union'.<sup>45</sup> Article 10 of the Treaty made express reference to Member States being prepared to use Enhanced Cooperation more frequently, highlighting that the draftsmen and vast majority of Member States saw great and increasing potential in using the process:

"In accordance with the requirements of the Treaties on which the European Union is founded, the Contracting Parties stand ready to make active use, whenever appropriate and necessary, of measures specific to those Member States whose currency is the euro, as provided for in Article 136 of the Treaty on the Functioning of the European Union, and of *Enhanced Cooperation*, as provided for in Article 20 of the Treaty on European Union and in Articles 326 to 334 of the Treaty on the Functioning of the European Union on matters that are essential for the proper

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<sup>45</sup> The Stability Treaty was infamously signed by 25 of the then 27 States, with the UK exercising its veto and the Czech Republic failing to achieve parliamentary approval

functioning of the euro area, without undermining the internal market.”<sup>46</sup> [Emphasis added]

Although Article 10 refers to Enhanced Cooperation in relation to the Eurozone, Peers has noted, “Article 10 may be relevant as regards the possible use of Enhanced Cooperation to adopt legislation on a financial transactions tax.”<sup>47</sup> In addition, Article 10 also makes reference to Article 136 TFEU. Article 136 permits closer cooperation between euro area Member States and will be discussed later in this chapter.

#### **4.1. The Rationale for Introducing Enhanced Cooperation**

In order to understand the potential application of the Enhanced Cooperation process to the 2011 Proposal, it is necessary to consider the historical development of the concept and its transition from 1997 to the 2010s. Previously known as ‘Closer Cooperation’ following its introduction at the Treaty of Amsterdam, Enhanced Cooperation has since been refined and developed by subsequent Treaty amendments as a legally prescribed means of authorising Member States to cooperate in areas of Union competence using the EU’s institutional framework. The Treaty of Amsterdam introduced a number of general conditions and provisions which needed to be fulfilled before Closer Cooperation could be used, the logic being that any measure adopted should not jeopardise the functioning of the internal market<sup>48</sup> and measures adopted through the process would not form part of

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<sup>46</sup> Article 10 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union February 2012

<sup>47</sup> S Peers, ‘The Stability Treaty: Permanent Austerity or Gesture Politics?’ (2012) 8(3) *European Constitutional Law Review* 404 at 429

<sup>48</sup> This point is also echoed in Article 10 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

the *acquis communautaire*.<sup>49</sup> These conditions were that the measure in question must aim to further the objectives of the Union, protecting and serving its interests and that that the measure must have respected the principles of the Treaties and the single institutional framework of the Union.<sup>50</sup> Furthermore, in order to limit or mitigate fragmentation concerns, Closer Cooperation should only be used as a last resort, comprise at least a majority of Member States, be open to all Member States and, most importantly, not affect the *acquis communautaire* nor the competences, rights, obligations and interests of those Member States which do not participate in it.<sup>51</sup>

#### 4.1.1. The Design of Closer Cooperation

Closer Cooperation was introduced when the three-pillar structure<sup>52</sup> of the EU was still in place and was permitted in fields covered by the Treaties of Rome and in police and judicial cooperation in criminal matters. Whilst the pillar structure is no longer in effect, the division of EU competencies is indicative of the circumstances in which Closer Cooperation was intended to be used, and by extension, to explain the widening of the scope of the process in order to advance the EU's legislative agenda. Consequently, it is possible to build upon these foundations to determine how appropriate the modern form of Enhanced Cooperation is in reference to the 2011 Proposal, as discussed in greater detail later in this chapter.

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<sup>49</sup> The *acquis* is “the body of common rights and obligations which bind all the Member States together within the European Union” Europa Glossary, ‘Community Aquis’ (EUR-Lex) <<http://eur-lex.europa.eu/summary/glossary/acquis.html>> Accessed 6 April 2018

<sup>50</sup> Europa, ‘Closer Cooperation’ (EUR-Lex) <[http://europa.eu/legislation\\_summaries/institutional\\_affairs/treaties/amsterdam\\_treaty/a28000\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/treaties/amsterdam_treaty/a28000_en.htm)> Accessed 6 April 2018

<sup>51</sup> Ibid

<sup>52</sup> Not applicable post-Lisbon

For the first pillar, the Cooperation process must not have concerned areas of exclusive Community competence, Community policies and actions, citizenship of the Union (or discriminate between nationals), remain in Treaty powers and not constitute a restriction of trade between Member States. In the third pillar, the Cooperation was required to respect the powers of the European Community and the objectives laid down by Title VI of the Treaty on European Union and have the aim of enabling the Union to develop more rapidly into an area of freedom, security and justice. Closer Cooperation could not apply to Common Foreign and Security Policy (CFSP) measures since the authors of the Treaty of Amsterdam decided that constructive abstention.<sup>53</sup>

In both the first and third pillars, launching Closer Cooperation depended on a decision taken by a qualified majority of the Council. However, the Member States had a safeguard 'emergency brake' clause allowing any of them to prevent a vote being taken for important reasons of national policy. For example, if, in relation to a common Financial Transaction Tax, the UK may have sought to use the emergency brake to prevent a vote if it were deemed that were for reasons of national policy. The Council, acting by qualified majority, was then able to send the question to the European Council if the decision fell under the third pillar or to the Council via the heads of state or government, if the decision fell under the first pillar. In both cases, referral required a unanimous vote. If such an event occurred, the Court of Justice played an important role in having to decide the degree of importance of the reasons of national policy invoked by a Member State.

#### **4.1.2. From Closer Cooperation to Enhanced Cooperation**

Over time, Closer Cooperation changed to become the more modern version of Enhanced Cooperation that a group of Member States have used in order to try to adopt a version of

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<sup>53</sup> i.e. Abstention was not necessarily a block to the requirement for a unanimous vote was already designed to meet flexibility requirements, and that recourse to Closer Cooperation was therefore unnecessary

the 2011 Proposal. The process was renamed at the Treaty of Nice (2000) and importantly the emergency brake provision was removed due to misgivings about the feasibility of the process. This does not mean that Member States do not have recourse to challenge provisions adopted as a result of Enhanced Cooperation, but this must be on the grounds of incompatibility with the Treaties through an action for annulment as prescribed by Article 263 TFEU as opposed to national policy. As is outlined later in this chapter, the UK government brought a failed Article 263 TFEU action against the Council Decision to authorise Enhanced Cooperation towards a Financial Transaction Tax. If the emergency brake had remained in place, the UK could instead have claimed that due to its large financial sector, introducing a tax through this process would have been an issue of national policy, applying the emergency brake.

The mass accession of Member States in the 2000s and the abolition of the pillar structure have led to two key changes. Recourse to Enhanced Cooperation has been made easier, since there are fewer procedural constraints in dividing the application of Cooperation among policy areas by their standing in the pillar structure. These changes have made Enhanced Cooperation more wide ranging in scope with fewer procedural constraints concerning the legal basis for measures and requiring proportionately fewer Member States following the expansion to 28 Member States. The modern day Enhanced Cooperation Treaty Articles themselves do not exclude any measures from the procedures, although there remain certain special processes for CFSP measures.<sup>54</sup>

Enhanced Cooperation is a two-stage process. Stage 1 grants participating Member States permission to cooperate further among themselves. Stage 2 concludes once participating Member States have unanimously voted to adopt a legally binding provision.

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<sup>54</sup> See Article 329(2) TFEU

Articles 326 – 334 TFEU and Article 20 TEU provide the legal basis for the first stage of Enhanced Cooperation i.e. the process which will lead to authorisation for a smaller group of Member States to cooperate in areas of EU competence. The following negotiation is the second stage. Initially, eleven Member States elected to cooperate to form a common system of Financial Transaction Tax<sup>55</sup> and therefore the first stage has been successfully completed, however there have been difficulties in agreeing a form of Financial Transaction Tax among these States as discussed later in this chapter. Estonia has indicated that it no longer wish to participate in the final version of the tax. De la Feria and Ness state that in theory, this should mean that the remaining ten Member States should seek to complete stage 1 again, since the initial Cooperation was permitted for eleven States, not ten.<sup>56</sup> This situation is unprecedented though and it is far from certain that this is an absolute necessity.

Nevertheless, there remain questions regarding Member States' recourse to Enhanced Cooperation. Ness states that in general "the procedure should be used only when there is disagreement over *whether* to act at Union level, and not when there is disagreement about *how* to act."<sup>57</sup> This assessment is clearly a logical interpretation of the purpose of the creation of the Enhanced Cooperation procedure, expressly acknowledging that the process is designed to act as a last resort when the differentiation between States is whether to act or not. Yet the article is critical regarding the use of the process for the purpose of trying to introduce a common Financial Transaction Tax. This chapter agrees with much of Ness' assessment, however the conclusions differ to a large extent. This

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<sup>55</sup> Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain

<sup>56</sup> R De la Feria and R Ness, 'Policy Forum: The EU Financial Transaction Tax as an Unsuitable and Unnecessary proxy Tax' (2016) 64(2) *Canadian Tax Journal* 373 at 381

<sup>57</sup> R Ness, 'An Analysis of the Financial Transaction Tax in the Context of the EU Enhanced Cooperation Procedure' (2015) 6 *EC Tax Review* 294

thesis is more sympathetic to the Member States' decision to try to use the process in this area. Yet in order to make a full assessment on the suitability of the Enhanced Cooperation process to introduce a Financial Transaction Tax, it is necessary to dissect the nature and operation of Enhanced Cooperation.

## **4.2. Enhanced Cooperation in Action: Stage 1**

The TFEU and TEU offer different characteristics with regard to Enhanced Cooperation. The TFEU contains more of the mechanics of the process, whereas the TEU places Enhanced Cooperation in context, outlining the envisaged ethos of the procedure. Understanding the intent of the Treaties informs the discussion of the decision to authorise Enhanced Cooperation for the 2011 Proposal. The Treaty Articles underpinning Enhanced Cooperation can broadly be split into three different categories; respect for the competences of EU and authority of the EU, an explanation of how the process is triggered and the voting mechanisms and promotion of common action.

### **4.2.1. Respect for Competences and Authority**

Article 20(1) TEU states that in areas of "non-exclusive competence" Member States can pursue Enhanced Cooperation within the TFEU framework in order to advance the Union's objectives as prescribed in the Treaties. As such, fulfilment of the internal market, as required by Article 113 TFEU and stated in the 2011 Proposal fall within these objectives. Additionally Article 326 TFEU seeks to guarantee due process by ensuring compliance with other EU Treaty Articles and obligations, preventing the Union acting *ultra vires*. This means that the appropriate legal basis for the original Proposal must be used throughout when seeking to make use of Enhanced Cooperation. The European Commission was correct in selecting Article 113 TFEU as the legal basis for the 2011 Proposal, which outlined how the policy respects other EU Treaty Articles and competences such as subsidiarity and proportionality as opposed to using Article 114 TFEU. Article 326 also

requires that Member States should be selective about when to use Enhanced Cooperation, stating that although in theory Enhanced Cooperation is not limited in the areas of policy to which it can apply, that any measures adopted following the successful completion of the second stage should not undermine the internal market. Article 326 also stipulates that measures adopted as a result of Enhanced Cooperation apply *solely* to participating states i.e. the competence and autonomy of non-participating States should not be affected by the measures. This is reinforced in Article 327 TFEU. However, there is also an obligation on non-participating Member States to “not impede its implementation by the participating Member States.”<sup>58</sup> Further emphasis on allaying the fears of non-participating Member States is conveyed in Article 332 TFEU, which explains that as a standard rule it is the participating Member States that fund the procedure themselves i.e. costs are confined to participating Member States only. This tension between measures applying solely to participating Member States and the obligation on non-participating States to not impede implementation is reflected in the UK’s decision to launch an unsuccessful action for annulment as detailed later in this chapter.

In addition, Article 20(4) TEU expands respect for State autonomy by preventing any resulting measures from inclusion in the *acquis*, preserving the autonomy of candidate Member States. This does not preclude Member States, candidate or otherwise, from participating at a later date since Article 20(1) TEU states that “such cooperation shall be *open at any time to all Member States*.”<sup>59</sup> [Emphasis added] However, the express protection of non-participating Member States does not preclude non-participating Member States from bringing an action for annulment. In addition to the UK’s challenge in relation to a common financial transaction tax, Spain and Italy previously petitioned for an

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<sup>58</sup> Article 327 TFEU

<sup>59</sup> Article 20(1) TEU

action for annulment regarding the use of Enhanced Cooperation for the unitary patent. The use of Enhanced Cooperation in relation to the 2011 Proposal is contrasted with non-tax examples later in this chapter in order to determine if Enhanced Cooperation was an appropriate legislative mechanism to be used.

#### **4.2.2. Instigation and Voting Procedures**

If the previously mentioned Articles outline the procedural constraints of the Enhanced Cooperation process, then Article 329 TFEU specifies how a minimum group of nine Member States can elect to use Enhanced Cooperation, triggering the first stage. Participating Member States address the request to establish Enhanced Cooperation to the Commission based on a Proposal. At this point, the scope of the Proposal can be altered so that its effects are more appealing to a greater number of Member States i.e. three Member States may wish to adopt a radical measure, whereas six Member States prefer a more moderate approach. This allows for more Member States to negotiate in order to find common ground to agree to Enhanced Cooperation and increase the number of participating Member States.

The Commission must inform the Council and Parliament of the request to authorise Enhanced Cooperation. Subsequently, the Commission has the discretion to draft a second Proposal in conjunction with the Member States' decision to pursue Enhanced Cooperation. If the Commission elects not to draft a second Proposal, it must explain the reasons for this to the Member States. Next, the Proposal needs to be subjected to the scrutiny of and obtain the consent of the European Parliament. Article 329 therefore seeks to introduce a greater degree of democratic legitimacy in allowing MEPs to scrutinise the request by Member States to seek Enhanced Cooperation. Without these express indications of support for the Enhanced Cooperation process by the Commission and the European Parliament, stage 1 of the Cooperation cannot be completed since the Council,

which ultimately authorises Enhanced Cooperation via Qualified Majority Voting, cannot approve further negotiation among participating Member States:

“Authorisation to proceed with the Enhanced Cooperation referred to in the first subparagraph shall be granted by the Council, on a Proposal from the Commission and after obtaining the consent of the European Parliament.”<sup>60</sup>

Article 330 TFEU outlines in greater detail the influence that individual Member States may have in the Council during Enhanced Cooperation. Article 330 seeks to actively include Member States in the Enhanced Cooperation procedure in the sense that every Member State may play an active role in deliberations. However, Articles 330 TFEU and 20(3) TEU state only those Member States wishing to pursue measures via Enhanced Cooperation are able to take part in the final vote to signal the conclusion of stage 2. This does not prohibit a Member State from electing to participate in an Enhanced Cooperation measure at a later date, since Article 331 TFEU provides that States may apply to the Commission to participate. For example, although Estonia has indicated that it no longer wishes to cooperate in this area, if the remaining ten Member States can determine an acceptable version of the tax, Estonia could adopt this version if it ultimately concludes that participation is beneficial. The Commission examines and approves the Member State’s participation. In this case, a Member State would be agreeing to a measure to which it may have been involved with during the discussion phase, but for which it did not actively vote for when concluded by the original participating States. This would mean that if a common system of Financial Transaction Tax were to be agreed between Member States and a non-participating State elected to adopt the measure at a later date it would not have actively approved the version agreed by the ten Member States in the second stage of

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<sup>60</sup> Article 329 TFEU

Enhanced Cooperation. The argument may be slightly different when applied to Estonia, since it has been involved in some of the debate concerning a common form of taxation, yet for the remaining States this raises questions of democratic legitimacy, although ultimately in indicating its willingness to participate, a State would be indicating that in its current form it wishes to adopt the tax on behalf of its citizens.

#### **4.2.3. Promotion of Common Action**

Although by definition Enhanced Cooperation is designed to legally facilitate integration among a smaller number of Member States, the success of the measures adopted relies on the maximum number of Member States possible cooperating. In addition to Article 331 TFEU allowing Member States to participate later, Article 328 TFEU contains several clauses and obligations. It states that Enhanced Cooperation is open to all Member States at any time; a non-exclusionary clause. Secondly, there is a joint obligation on the Commission and Member States to promote Enhanced Cooperation and to encourage participation by as many Member States as possible (an inclusion clause). Finally, there is an obligation on the Commission to inform the Council and the European Parliament of progress throughout the Cooperation process in order to allow for transparency to encourage participation by Member States that may have reservations about the process (a monitoring clause).

These three clauses in Article 328 TFEU are positive in nature, though the rationale behind these clauses is apparent in Article 334 TFEU, which reflects anxieties concerning over usage of Enhanced Cooperation leading to fragmentation. Article 334 demonstrates these anxieties by placing a further monitoring obligation on the Council and Commission to monitor the effect of Enhanced Cooperation. These fears can also be illustrated in the second part of Article 20(2) TEU which states that authorising Cooperation should be considered as a last resort in that no other form of integration is possible, or that the delay in adoption is unreasonable for any particular reason. Yet there is no outline as to the

definition of a 'reasonable period' and this must therefore be treated on a case-by-case basis. Furthermore, Article 20(2) provides that a minimum of nine Member States must participate in order to proceed with the Cooperation to ensure a minimum degree of consistency across Member States using the process. At the time of writing, 10 Member States are participating in the Financial Transaction Tax Enhanced Cooperation process. If another Member State were to withdraw, although the minimum of nine participating States would be met, this would clearly create pressure on the remaining States as to whether or not to continue.

Crucially the potential scope of Enhanced Cooperation is still broad, with limited barriers placed on the policy areas, which the standard procedure can address. The references to promotion of common action and to the process being used as a last resort are designed to ensure that the differentiation has to be on whether to act, not how to act as indicated previously by Ness.<sup>61</sup> There are times where legislative proposals can pass by the wayside or there are strong disagreements, which although difficult are not necessarily irrevocable. These clauses ensure that Enhanced Cooperation will not become the norm, with Kuipers indicating that using the process incorrectly would "push Europe in two directions."<sup>62</sup> This could also be interpreted as creating a two-tier Europe, which is more closely associated with the multi-speed Europe theory of integration outlined later in this chapter. The risk of this is exacerbated further because, as Ness indicates, "there is nothing preventing *another* group of nine States using the procedure to implement their own approach to the same policy, leading to preventable fragmentation."<sup>63</sup> These arguments are strongly rooted

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<sup>61</sup> *Supra* n.57

<sup>62</sup> J Kuipers, 'The Law Applicable to Divorce as Test Ground for Enhanced Cooperation' (2012) 18(2) *European Law Journal* 201 at 213

<sup>63</sup> *Supra* n.57 at 295

in the concern that rather than advancing European integration through a consensus of a sub-group of Member States the process is a means by which to circumvent requirements for unanimity without full debate.

## 5. Enhanced Cooperation and the Financial Transaction Tax

The Enhanced Cooperation procedure has at present been used a handful of times. It was first used in relation to marriage and divorce laws<sup>64</sup>, before being applied to the unitary patent system.<sup>65</sup> Beyond the Financial Transaction Tax, the procedure has also, successfully, been used in relation to property regimes of international couples<sup>66</sup>, creating a European Public Prosecutor<sup>67</sup>, and to introduce permanent structured cooperation in the area of defence and security.<sup>68</sup> At present, the two outstanding uses of the process are in relation to investment in supercomputing infrastructure<sup>69</sup> and the Financial Transaction Tax. While it is important to recognise that there has been a degree of success, particularly with regard to the progress concerning marriage and divorce laws and the unitary patent,

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<sup>64</sup> For a full discussion of the timeline for using Enhanced Cooperation in this area see S Peers, 'Divorce European Style: The First Authorization of Enhanced Cooperation' (2010) 6(3) *European Constitutional Law Review* 339. For a discussion of the practical implications of the adopted provision see D Hodson, 'EU Approves European Divorce Enhanced Co-Operation' (2011) Mar *International Family Law* 65

<sup>65</sup> See E Postoiu, 'Enhanced Cooperation as a Tool to...Enhance Integration? Spain and Italy v Council' (2014) 51(1) *Common Market Law Review* 247

<sup>66</sup> Council Regulation (EU) 2016/1103 of 24 June 2016 Implementing Enhanced Cooperation in the Area of Jurisdiction, Applicable law and the Recognition and Enforcement of Decisions in Matters of Matrimonial Property Regimes

<sup>67</sup> Council Regulation (EU) 2017/1939 of 12 October 2017 Implementing Enhanced Cooperation on the Establishment of the European Public Prosecutor's Office (EPPO)

<sup>68</sup> See Council Decision (CFSP) 2017/2315 of 11 December 2017 Establishing Permanent Structured Cooperation (PESCO) and Determining the List of Participating Member States

<sup>69</sup> A collection of 23 Member States has signed the European Declaration on High Performance Computing. The Cooperation Framework on High Performance Computing was initially signed by seven founding Member States on the 23<sup>rd</sup> March 2017 in Rome

in spite of legal challenges by Spain<sup>70</sup> and Italy<sup>71</sup>, a full discussion is beyond the scope of this chapter. Nevertheless, these examples do influence a wider interpretation of the status of Enhanced Cooperation, yet this section examines in particular how the Enhanced Cooperation method has been applied to the Financial Transaction Tax.

As has been noted previously, it quickly became apparent following the publication of the 2011 Proposal that a stalemate had been reached and the Proposal in its original form would not be adopted. Therefore, on the 22<sup>nd</sup> September 2012 eleven Member States requested authorisation of Enhanced Cooperation. The Commission published its second Proposal<sup>72</sup> (the 2013 Proposal) which contained the substantive part of the original 2011 Proposal, however there was the addition of the 'issuance principle', meaning that financial instruments issued in the eleven Member States will be taxed when traded, even if those trading them are not established within the Financial Transaction Tax zone. This Proposal subsequently obtained the consent of both the European Parliament<sup>73</sup> and Council<sup>74</sup> to authorise Enhanced Cooperation. On the 14<sup>th</sup> February 2013 the European Commission adopted a Proposal for a Council Directive implementing Enhanced Cooperation (the '2013 Proposal').<sup>75</sup> This meant that the first stage of Enhanced Cooperation had been successfully completed and that in theory all that remained was a unanimous vote between the eleven Member States in question on the specifics of the legislation to be adopted.

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<sup>70</sup> Case C-274/11 Spain v Council

<sup>71</sup> Case C-295/11 Italy v Council

<sup>72</sup> Proposal for a Council Decision Authorising Enhanced Cooperation in the Area of Financial Transaction Tax Com (2012) 631 Final/2 25<sup>th</sup> October 2012

<sup>73</sup> 22<sup>nd</sup> December 2012

<sup>74</sup> 22<sup>nd</sup> January 2013

<sup>75</sup> Proposal for a Council Directive Implementing Enhanced Cooperation in the Area of Financial Transaction Tax COM (2013) 71 Final 14<sup>th</sup> February 2013

## 5.1. The 2013 Proposal

### 5.1.1. The Residence Principle

As Ness notes “the residence principle is premised on the notion that financial institutions are harder to relocate than financial transactions.”<sup>76</sup> This principle was also included in the 2011 Proposal, with the effect of stating that entities would be liable to pay the tax if established in one of the Member States where the tax is charged. The original example given in the interview with Manfred Bergmann presented in chapter 1, when asked about the operation of the 2011 Proposal, concerned a Spanish bank and a Finnish pension fund entering into a derivative agreement in the City of London.<sup>77</sup> The Spanish bank would pay the tax to the Spanish Treasury and the Finnish bank would pay the tax to the Finnish Treasury. As a constant in both the 2011 and 2013 Proposals, this is likely to appear in any final agreement made by the participating Member States. On the one hand examples such as this appear to be relatively non-controversial. However there is potential scenario whereby a “US bank that trades stock options in a US corporation with the US brand of a German bank OTC in New York will be liable to pay FTT.”<sup>78</sup>

It is this controversial counterparty principle that drew the attention of the Council’s legal service. Council Legal Service’s Opinion (LSO) published 6 September 2013<sup>79</sup>, released six months prior to the CJEU’s decision. The LSO took particular issue with Article 4(1)

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<sup>76</sup> Supra n.57 at 304

<sup>77</sup> European Commission ‘Further Background Information’ (*Europa Taxation and Customs*, 15 January 2016) <[http://ec.europa.eu/taxation\\_customs/taxation/other\\_taxes/financial\\_sector/ftt\\_background\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/ftt_background_en.htm)> Accessed 5 April 2018

<sup>78</sup> J Englisch et al, ‘The Financial Transaction Tax Proposal under the ECP: Legal and Practical Considerations’ (2013) 2 *British Tax Review* 223 at 236

<sup>79</sup> Document – 13412/13 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT) – Legality of the counterparty-based deemed establishment of financial institutions (Art. 4(1) point f) of the proposal).

point f of the 2013 Proposal due to the counterparty factor resulting in financial institutions based in non-participating Member States being liable to pay the tax. It addressed the customary law argument first, assessing jurisdiction issues, differing treatment of resident and non-resident financial institutions, double taxation and extra-territorial effects of the Proposal before addressing Article 327 TFEU regarding the competences and rights of non-participating Member States. It concluded that, in its present form, the 2013 Proposal would be contrary to the Treaties, providing grounds for CJEU annulment under Article 263 TFEU. However, the LSO is not a legally binding document and does not carry the same authority as that of a CJEU decision. The assessment was also made on a non-finalised version of a common financial transaction tax; any finally agreed tax may be different in design, particularly in light of the LSO's findings.

Ness argues that Article 4(1) of the 2013 Proposal demonstrates that there are strong economic ties between States, which mean that *prima facie* it is possible to justify the residence principle within the confines of international law. This view is particularly supported by the inclusion of Article 4(3), which exempts institutions from paying the tax when able to prove no link between the "economic substance" of the transaction and the territory of the participating Member State. In addition to this caveat, the work of Ernst-Ulrich Petersmann, which argues that there is an economic constitutional pluralism granting legitimacy to legislative measures due to increased economic integration between States, supports this assertion and is discussed in greater detail in the following chapter.

The territorial application of the proposed Financial Transaction Tax and the participating Member States' taxing rights are defined based on the rules laid down in Article 4. This provision refers to the notion of "establishment." In essence, it is based on the "residence principle" supplemented by elements of the issuance principle with a view mainly to strengthen anti-relocation.

### 5.1.2. The Issuance Principle

The primary area of difference between the 2011 and 2013 Proposals is the addition of the 'issuance' principle. While the core concept of the residence principle may have been a constant, the 2013 Proposal indicated that, due to the reduction in the number of participating Member States, the residence principle would require further support, stating that the concept of establishment was "based on the 'residence principle' supplemented by elements of the issuance principle with a view mainly to strengthen anti-relocation."<sup>80</sup>

The rationale for the issuance principle is to mitigate relocation by expanding the scope of taxation beyond the residence of the parties completing the transaction to include the location of where the transaction itself occurs. By way of example, if an American bank and a Chinese bank enter into a contract to trade in shares with one of the participating Member States, such as Germany, they are liable to pay the tax. As Ness indicates, "this is despite neither party setting foot on German...soil, using its infrastructure or receiving the benefits associated with such a presence."<sup>81</sup> In other words there is a disconnect between the territory of a State and the economic reality of the specific transaction itself. However, there is an argument that the success of the investment is still dependent on the performance of the financial product itself, meaning that there is a view that there is still some benefit obtained through ownership of the individual product regardless of physical location. Furthermore, Scott<sup>82</sup> argues that neither the residence nor issuance principles are unprecedented and that the way in which they have been deployed does not warrant the intensity of opposition. She notes that the principles have been included in other financial

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<sup>80</sup> 2013 Proposal

<sup>81</sup> *Supra* n.57 at 306

<sup>82</sup> J Scott, 'The New EU Extraterritoriality' (2014) 51(5) *Common Market Law Review* 1343

regulation provisions, specifically the Markets in Financial Instruments Regulation<sup>83</sup> (MiFIR) and the Market Abuse Regulation<sup>84</sup> (MAR).

While in itself this does not mean that the issuance principle in particular is automatically applicable, this does indicate a dichotomy in how the 2013 Proposal can be viewed. MiFIR and MAR are both primarily viewed as exclusively matters of financial regulation independent of taxation measures. They are designed to improve standards in the interests of consumers by enhancing conduct of business requirements and insider trading. Ness' article later goes on to say that "even the strong moral argument of financial institutions contributing to the costs of the financial crisis borne by their own economies, cannot explain why a US bank should contribute to the coffers of the German State."<sup>85</sup> If the view is adopted, that the 2013 Proposal is seen as a means by which to raise funds from the financial sector, this shifts focus away from consumer protection to a predominantly tax provision. In other words, if the view is taken that the 2013 Proposal is punitive in nature, not an efficiency measure to control risk, it opens an alternative perspective. This thesis argues that the discussion, partly as a result of a mistake by the Commission, has allowed the rhetoric concerning the 2011 and 2013 Proposals to focus on fundraising and quasi-retribution for historical non-payment of VAT. The focus should instead be on emphasising the public good policy implications of the taxes; therefore, this thesis views the Proposals to be more in line with Scott's classification than Ness'.

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83 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012

84 Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC

<sup>85</sup> Supra n.57 at 306

## 5.2. UK Action for Annulment

On the 18<sup>th</sup> April 2013 the UK government, electing not to participate in Enhanced Cooperation, brought an unsuccessful action for annulment before the CJEU.<sup>86</sup> The primary rationale was to protect the City of London from the scope of the tax. The UK requested that the CJEU annul the Council Decision authorising the use of Enhanced Cooperation in the area of Financial Transaction Tax and requested that the Council pay the costs of proceedings. Austria, Belgium, France, Germany, Portugal and the European Parliament and Commission were granted leave to intervene in support of the forms of order sought by the Council.<sup>87</sup> Actions for annulment are by no means uncommon<sup>88</sup>, but this action raises the question whether in cases of Enhanced Cooperation, there is a similar question of circumvention of certain basic rules of the Treaty by opting for a legal basis requiring only QMV in areas of taxation.

### 5.2.2. Arguments of the Parties

#### 5.2.2.1 United Kingdom

The UK challenged the Council decision on three primary points of law. The first of these concerned extra-territorial effects of a Financial Transaction Tax adopted via Enhanced Cooperation on two grounds. Article 327 TFEU aims to prevent extra-territorial infringements of measures adopted via Enhanced Cooperation for non-participating Member States. The UK's argument was grounded in the definitions of 'Establishment' in

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<sup>86</sup> Case C-209/13 UK v Council

<sup>87</sup> For a full outline of the case see M Randall, 'Case C-209/13, UK v. Council: Enhanced Cooperation and the FTT' (2014) 41(4) *Legal Issues of Economic Integration* 407

<sup>88</sup> See for example Cases C-377/98 Netherlands v Parliament and Council; C-393/01 France v Commission, C-239/01 Germany v Commission and Joined Cases C-61/93, C-132/97, C-45/98, C-27/99, C-81/00 and C-22/01 Spain v Council

Article 3(1)(e) of the 2011 Proposal (the ‘counterparty principle’) and in Article 4(1)(g) and (2)(c) of the 2013 Proposal (the ‘issuance principle’). The definition of establishment plays a key role in identifying which institutions and consequently which transactions would be taxable.

Secondly, the EU is required by Article 3(5) TEU to respect customary international law. The UK argued that the Council’s decision to authorise Enhanced Cooperation is unlawful in the sphere of customary international law – i.e. there is no customary justification for allowing the Financial Transaction Tax’s alleged extra-territorial effects. Paragraph 20 of the judgment outlines the UK’s claims that:

“Customary international law permits legislation which produces extraterritorial effects only on the condition that there exists between the facts or subjects at issue and the State exercising its competences thereon a sufficiently close connection to justify an encroachment on the sovereign competences of another State.”<sup>89</sup>

Finally, the UK argued that the decision in question is contrary to Article 332 TFEU, which aims to prevent costs to non-participating states. The UK argued that the nature of an FTT across a section of Member States means:

“That implementation of the FTT will also “be the source of costs for the non-participating Member States, because of the application of Council Directives 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures...and 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation.”<sup>90</sup>

#### 5.2.2.2. Counter Arguments

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<sup>89</sup> Paragraph 20 Case C-209/13 UK v Council

<sup>90</sup> Ibid at Paragraph 22

Paragraphs 25 – 29 explain the counter arguments raised by opposing actors. Paragraphs 26 and 27 highlight that the UK was challenging provisions which were “purely hypothetical components of legislation which is yet to be adopted.”<sup>91</sup> The challenge itself was therefore described as “premature and speculative”<sup>92</sup> and in relation to the costs plea “invites a premature debate on the manner in which the European Union legislature will regulate the question of liability for costs.”<sup>93</sup> In endorsing this position the CJEU were able to effectively avoid the questions of conflicts with Articles 327 and 332 of the TFEU and Article 3(5) TEU, meaning that on paper at least the court has not provided any guidance. In contrast, in a later successful case that the UK brought before the CJEU concerning euro-clearing houses<sup>94</sup>, the court did provide active recommendations as to how to remedy the contested point of law.

Finally, Paragraph 28 continues the disputed element of costs. The Commission, Council, Austria and Portugal argued that the UK had misinterpreted the notion of costs in relation to compliance with other legally prescribed Union obligations, stating Article 332 TFEU:

“Concerns solely operational expenditure to be borne by the European Union budget in relation to measures establishing Enhanced Cooperation and not the

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<sup>91</sup> Ibid at Paragraph 26

<sup>92</sup> Ibid

<sup>93</sup> Ibid at Paragraph 27

<sup>94</sup> Case T-496/11 UK v European Central Bank

expenditure which might be incurred by the Member States under Directives 2010/2495 and 2011/16<sup>96</sup>.”<sup>97</sup>

### **5.3. Outcome of the Action for Annulment: CJEU’s Decision**

The Court dismissed the UK’s arguments on two key points. Paragraphs 36 and 39 treat the extra-territorial aspects of the UK’s case, addressing the counterparty and issuance principles. The Court stated, “The principles of taxation challenged by the United Kingdom are, however, not in any way constituent elements of that decision”<sup>98</sup> since the counterparty principle refers to an element in the 2011 Proposal, not the Council’s Decision to authorise Enhanced Cooperation. Furthermore, the issuance principle first appeared in the 2013 Proposal. In other words: the challenged decision to permit Enhanced Cooperation itself does not regulate the content of the Financial Transaction Tax.

Paragraphs 37 and 38 of the decision addressed the cost issues of Article 332 TFEU. In essence, the Court stated that since there had not been any definitive implementation steps made in respect of the Financial Transaction Tax, it was impossible to calculate likely costs. Paragraph 38 stated:

“The question of the possible effects of the future FTT on the administrative costs of the non-participating Member States cannot be examined for as long as the principles of taxation in respect of that tax have not been definitively established

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<sup>95</sup> Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures

<sup>96</sup> Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/199/EEC

<sup>97</sup> Paragraph 28 Case 209/13 UK v Council

<sup>98</sup> Ibid at paragraph 36

as part of the implementation of the Enhanced Cooperation authorised by the contested decision.”<sup>99</sup>

Prior to the case, the UK was optimistic of a successful challenge. Seemingly, further credence had been given to their cause by the non-legally binding report of the Council Legal Service’s Opinion published 6<sup>th</sup> September 2013.<sup>100</sup> This concerned an assessment of the 2013 Proposal and was released 6 months prior to the CJEU’s decision. It concluded that in its 2013 form the legal effects prescribed in the second draft Proposal would be contrary to the treaties, providing grounds for CJEU annulment under Article 263 TFEU.

### 5.3.1. Effect of the UK Challenge

The main conclusion that can be drawn from the decision given by the CJEU is that the UK government was premature in its challenge. The action can be described as bizarre, since nothing with concrete legal effect was able to be annulled. In paragraph 16 of the final judgment it is stated that:

“While recognising that its action, brought as a precautionary measure, could be considered to be *premature*, the United Kingdom relies on two pleas in law in support of its action.”<sup>101</sup> [Emphasis added]

This clearly indicates that the UK Government should have been aware that the challenge was of a speculative nature. The court’s decision can be criticised to an extent for not addressing the underlying points of the UK’s arguments in a form of quasi *obiter dicta*, but in the first instance the court was required to look for a legally binding agreement that

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<sup>99</sup> Ibid at Paragraph 38

<sup>100</sup> Supra n.79

<sup>101</sup> Paragraph 16 Case 209/13 UK v Council

simply was not present. Therefore, in reality this was the only decision that the CJEU could have made.

For the remaining Enhanced Cooperation states, if it is the case that the UK is unable to bring a second action, this is a positive outcome, since they are able to proceed unimpeded. The final agreement could be wider in scope or alternatively more specifically focussed on mitigating the greatest risk in financial services. Yet these States struggle to find agreement among themselves. In addition, it must be reiterated that the UK itself does not possess the exclusive right to bring Article 263 TFEU actions, particularly post-Brexit. This is afforded to all 27 other Member States, one real danger of decisions such as this is that it will continue to fuel discontent between financial centres across the EU and Brussels, leading to more Article 263 TFEU actions being brought in the future for matters which are primarily concerned with regulating the financial sector. The use of the Enhanced Cooperation process could be perceived as an overly overt way to circumvent unanimity requirements and simply adds another layer of complexity and legal susceptibility to an already intricate legislative process. Case studies, such as the European Banking Union, do indicate that widespread financial regulation across the Union is possible in a relatively short period, however Enhanced Cooperation must not become the *de facto* norm for matters of financial regulation. However, if there is a strong public good outcome which can be demonstrated, greater credence is given to the Enhanced Cooperation process.

### **5.3.2. Effect on Cooperation Between EU-Eleven Financial Transaction Tax States**

Following the decision, the eleven participating Member States released a joint statement which reinforced their commitment to the introduction of a Financial Transaction Tax, but which acknowledged that the States were facing difficulties in reaching an agreement, highlighting the difficulties with the second part of the two-stage process of Enhanced

Cooperation. However, of greater importance was the first indication of a radical rethink in the design of the tax relative to previous incarnations. The statement acknowledged that, in order for any tax to be successful, the Member States would need to agree to a different incremental approach regarding adoption in contrast to the Commission's original 2011 Proposal:

“The work on the introduction of a harmonised financial transaction tax is to be based on a progressive implementation of the tax. The progressive implementation will first focus on the taxation of shares and some derivatives. Our approach is essential to ensure that each step towards full implementation of the financial transaction tax is designed in a manner that takes due consideration of the economic impact.”<sup>102</sup>

The eleven participating Member States had set a deadline of 1 January 2016 by which to confirm a version of a Financial Transaction Tax but there remains disagreement as to the scope of this revised version. The remarks of the Austrian Finance Minister in November 2015 have proven to be particularly telling with talks leading to clear progress but no deal:

“In general, everybody is committed to implement the project, but there are of course conditions to realize such a project...That's why the technical side and the political decision can't be separated. It might sound technical, but in reality it's a political principled decision that has to be taken.”<sup>103</sup>

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<sup>102</sup> Federal Ministry of Finance, ‘Joint Statement on Financial Transaction Tax’ (*Federal Ministry of Finance*, 6 May 2014) <<http://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Taxation/Articles/2014-05-06-joint-statement-financial-transaction-tax.html>> Accessed 27 January 2016

<sup>103</sup> S Bodoni, ‘Schelling Says EU Needs December Decision on Transaction Tax’ (*Bloomberg*, 10 November 2015) <<http://www.bloomberg.com/news/articles/2015-11-10/schelling-says-eu-needs-december-decision-on-transaction-tax>> Accessed 6 April 2018

There appear to be two points of contention. Firstly, Italy is continuing to advocate that the tax should include sovereign debt derivatives, while most other nations have agreed to exclude those derivatives along with government bonds and secondly Slovenia and Estonia want the tax to have a broader cross-border reach to ensure it would raise sufficient revenue to be worthwhile, with Estonia indicating it no longer supports the Proposal<sup>104</sup> due to concerns about the amount of revenue to be accrued, indicating that even participating States still view the purpose of the tax as being fundraising as opposed to reducing risk in a financial sector to achieve stability. These points of contention are difficult due the extra territoriality argument that the UK made in its action for annulment; the fundamental principle of Enhanced Cooperation is that only participating States are affected by or benefit from the adopted measure. There is a real possibility that these negotiations will fail at the second stage.<sup>105</sup> Yet there is no expiry date on the Commission's decision to authorise Enhanced Cooperation, it is a self-imposed deadline that the EU-eleven can amend and return to at a later date if necessary. Politically this may be a negative message to portray about confidence in a common system of Financial Transaction Taxation, but this may be necessary due to the amount of political capital invested in the project.

## 6. Current Standing of Enhanced Cooperation

At first glance, the Enhanced Cooperation appears to mirror the 'multi-speed Europe' theory of integration outlined later in this chapter in express recognition that not all Member

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<sup>104</sup> See for example B Larking, '10 EU Member States Agree on Some Principles for a Financial Transaction Tax; Others Still Under Discussion' (*KPMG*, 9 December 2015) <<https://www.meijburg.com/news/10-eu-member-states-agree-on-some-principles-for-a-financial-transaction-tax-others-still-under-discussion>> Accessed 6 April 2018

<sup>105</sup> The following chapter discusses a proposed alteration to the Financial Transaction Tax Proposals should Enhanced Cooperation fail and the Commission elects to draft a new Proposal

States are either willing or able to cooperate in EU policy at the same time. Yet the differentiation provided for by using multi-speed Europe is dependent primarily on time i.e. common policy goals have been agreed, but require different timescales, whereas the differentiation provided by Enhanced Cooperation is primarily on the grounds of the substance of a Proposal. Enhanced Cooperation therefore appears to be more akin to the *à la carte* theory also presented later in this chapter, yet is far more inclusive due to its emphasis on promoting common action. Therefore, the most logical way to classify Enhanced Cooperation is as a 'mechanism of integration' under the larger umbrella term of 'flexible integration.'

In reclassifying Enhanced Cooperation, multi-speed and *à la carte* as divisions of a wider term. This creates two key advantages. The purpose of each form of integration is more clearly and more accurately defined, which in turn means that in an enlarged EU, in which it is likely that there will be greater recourse to flexible forms of integration will be sought, policymakers and advocates are able to identify the most appropriate method of flexible integration based on the specific point of disagreement.

Since the process itself has been used rarely, it may be too early to draw firm conclusions, yet certain general patterns, trends and important questions are seemingly emerging. Combining the information from the Treaties, successes in predominantly social provisions, such as marriage and divorce laws, can be tempered by application to economic provisions, the 2011 Proposal. By extension, these conclusions consequently lead into consideration of the appropriateness of the process for future proposals, whether banking and financial stability proposals, taxation proposals or otherwise. However, the process continues to be used in new areas, such as defence cooperation and infrastructure for high speed computing, indicating that if a true collective benefit can be presented, it is more likely that Member States will participate in the process.

## 6.1. Legitimacy

Although the Treaty Articles are inclusive in nature, there remains an issue with regard to democratic legitimacy and accountability. A clear principle is that non-participating Member States are able to alter their position and participate or adopt measures resulting from Enhanced Cooperation being authorised. Article 330 TFEU provides that non-participating states are still able to take part in discussions even if they are not part of the final vote. Non-participating Member States may still accede to an agreement that has entered into force at a later date. As a consequence, this means if Member States participate at a later date, provisions which they did not design may be effectively imposed upon them, meaning that the provision lacks legitimacy for that particular Member State. This does not in itself preclude all States from ratifying changes at a later date.

Furthermore, the fact that the CJEU did not consider the UK case in full raises concerns for Member States about what they perceive to be legitimate concerns regarding the effect of subsequent provisions. There is evidence that launching legal proceedings can have an effect on subsequent policies. In addition to challenging the Financial Transaction Tax<sup>106</sup> the UK launched successful legal proceedings in two cases against the ECB on its requirement that euro-denominated business be conducted under the supervision of a Euro system central bank.<sup>107</sup> Even the act of raising a challenge led to an inclusion in the Single Supervisory Mechanism Regulation of an injunction for the ECB not to discriminate based on the place of business. Article 1 states:

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<sup>106</sup> Which the joint statement illustrates is likely to result in a tax which is far narrower in scope than originally envisaged provided negotiations are successful

<sup>107</sup> T-496/11 United Kingdom v. European Central Bank.

“No action, proposal or policy of the ECB shall, directly or indirectly, discriminate against any Member State or group of Member States as a venue for the provision of banking or financial services in any currency.”<sup>108</sup>

Following the CJEU’s decision in the Financial Transaction Tax case, Open Europe drew a comparison with a neighbour building a house to highlight inefficiencies and a perceived lack of fairness with the decision:

“Imagine you had agreed to let your neighbour build a new house based on a certain agreement and set of plans. Halfway through building it becomes clear that he has adopted a new plan which will hamper your view or infringe on your land. You appeal to the council but they rule that it is too soon to tell where the house will end up and that they can only rule when the house is built. Tearing down a house is much messier and more costly than stopping one being built in the first place. Hardly seems efficient or fair, does it?”<sup>109</sup>

The contrasting viewpoint is that having the two-stage Enhanced Cooperation process i.e. consent followed by a substantive act means that invariably in order to assess whether the ‘house’ is truly incompatible it needs to be built before any challenge. This viewpoint does have a variety of potential faults though. It is practical for potentially flawed piece of legislation to be introduced as opposed to preventing it from being introduced in the first place? As has been highlighted throughout this thesis, opposition may be due to the perceived lack of quality of a measure as opposed to the underlying principle. The counter to this is that the role of the CJEU is purely to scrutinise the legality of laws, not the content

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<sup>108</sup> Article 1 of Regulation 1024/2013

<sup>109</sup> Open Europe, ‘ECJ Throws Out UK’s FTT Challenge, Raising Questions About Whether it Can be Trusted to Police the EU treaties’ (*Open Europe*, 30 April 2014) <<http://openeuropeblog.blogspot.co.uk/2014/04/ecj-throws-out-uks-fft-challenge.html>> Accessed 6 April 2018

itself. Furthermore it is clear that the cost of adopting and repealing a measure if necessary far exceeds not adopting the Proposal in the first place.

## 6.2. Increasing Use and Vulnerability to Legal Challenge

By nature, Enhanced Cooperation addresses contentious areas of policymaking and non-participating Member States have brought challenges. Consequently Enhanced Cooperation has had mixed fortunes thus far. The initial momentum gained was due to the success stories of its application to marriage and divorce laws and the unitary patent. Even following the difficulties that the Financial Transaction Tax has faced, recourse to the Enhanced Cooperation process continues as evidenced by the authorisation for the developments in property regimes for international couples.<sup>110</sup> Perhaps the most striking conclusion that can be drawn so far regards the type of provisions to which Enhanced Cooperation may be applicable to improve the efficiency of the process in terms of avoiding costly legal challenges.

A key continuing point from Ness' article is that Enhanced Cooperation does serve a purpose, but that it should be reserved for measures where the disagreement is *whether* to act at all as opposed to *how* to act. This is a plausible assertion, but there is an argument that the lack of consensus between the participating and non-participating Member States was due to whether to regulate as opposed to the method. This thesis argues that there is a form of identity crisis for the Financial Transaction Tax, in that over time the concept has had to contend with being both a financial stability measure and a tax provision. It has lost sight of its Keynesian economics roots and through wider public discussion and the conflation of different variants of Tobin's original tax, its intended purpose has been lost in

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<sup>110</sup> Council Regulation (EU) 2016/1103 of 24 June 2016 implementing enhanced cooperation in the area of jurisdiction, applicable law and the recognition and enforcement of decisions in matters of matrimonial property regimes

translation. This thesis adopts the view that a Financial Transaction Tax on speculative trading should primarily be considered as a financial stability measure. There is clear evidence through the Basel agreements and the creation of the European Banking Union (including a common bank levy), that where there is disagreement regarding financial regulation provisions, the lack of consensus is in how to proceed and negotiation continues until an accord can be reached. If widely viewed as a financial stability measure, there is no reason why the potential for a form of Financial Transaction Tax could not have been included in the EBU drafting process, which would lend itself to a more multi-speed Europe approach to flexible integration. However, if Financial Transaction Tax discussions are founded upon a perception that it falls primarily into the latter category as a fundraising, proxy tax due to the difficulties in adopting VAT, this lends itself to discussions about whether or not to act. Although this thesis is ultimately critical that the underlying purpose of a Financial Transaction Tax has been lost, it is understandable why a selection of Member States resorted to the Enhanced Cooperation process.

Therefore, it may be possible to argue instead that the institutions and the Member States need to be more selective about the policy areas that Enhanced Cooperation should apply to. The process itself is relatively new and has achieved unquestioned success so far in a social provision (e.g. marriage and divorce laws) and is therefore not without merit. Nevertheless, it seems at present fewer potential obstacles are presented for social provisions relative to economic provisions. It is arguable that Enhanced Cooperation should not realistically be used for economic issues, which would indicate that the process is ill suited to negotiations concerning a Financial Transaction Tax. Nevertheless, there may be areas of overlap where protecting consumers from harmful social effects of an economic activity may be intended, for example there has been consideration of using

Enhanced Cooperation to introduce regulations for online gambling within the EU.<sup>111</sup> It should be recalled that Keynes' General Theory included reference to casinos and gambling in relation to taxing speculative financial trading. It is arguable by extension that the use of Enhanced Cooperation in this area is justified.

The viability of Enhanced Cooperation in progressing areas of economic policy is particularly important since Enhanced Cooperation is clearly being increasingly recognised and used. Its standing in Article 10 of Stability Treaty<sup>112</sup> as a procedure which may promote euro area integration is particularly telling. The vast majority of EU Member States were contracting parties to the Treaty, a tacit acceptance that Enhanced Cooperation will be used more frequently. Yet the actions for annulment indicate that the procedure, designed to overcome a legislative stalemate, is not a silver bullet. It should not be seen as a quick fix and furthermore opposition to measures adopted under Enhanced Cooperation should not be seen as sheer stubbornness, they should be treated as a legitimate concern about the quality of proposals. With regard to the Financial Transaction Tax, this could concern, for example, the scope of the tax or the set rates as opposed to the basic concept of curbing speculation.

At the time of writing, the second phase of Enhanced Cooperation regarding the Financial Transaction Tax is still ongoing, but there is a very real possibility that no consensus will be achieved. If that is the case Enhanced Cooperation, in spite of its suitability to economic policy areas, remains a potential option for Member States wishing to introduce increased regulation to regulate unnecessary risk in the financial sector to use in the future. It is debateable as to whether or not Member States were previously reluctant to use Enhanced

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<sup>111</sup> See V Paeno, 'Online Gambling in Europe: Enhanced Cooperation' (2012), 11(7) *World Online Gambling Law Report* 3

<sup>112</sup> Article 10 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union February 2012

Cooperation, but the question remains as to why Member States are beginning to find the prospect of using Enhanced Cooperation so appealing? Rapid expansion of the EU and the alterations made to the Closer Cooperation process have provided greater possibilities for the Enhanced Cooperation process to be used, particularly if Enhanced Cooperation is viewed as a 'tie break' for legislative stalemates.

Another potential explanation for increased usage is increased familiarity with the procedure. Although explained in detail in the Treaties, it can be argued that the process was uncertain and Member States were wary, a fear of the unknown. It is highly unlikely that Member States were unaware of the procedure and that, as more case studies come about in order to assess the suitability of the Enhanced Cooperation process, Member States and draftsmen will be able to craft more suitable and efficient Proposals.

The positive obligations of inclusion of Enhanced Cooperation can be contrasted with the concept of an 'opt-out' in line with the *à la carte* model of integration, discussed in greater detail later in this chapter. Utilising opt-outs ensures that at least one Member State expressly excludes itself from proceedings via negotiation with other Member States, although this thesis suggests that *à la carte* integration too has been miscast in an overly negative light. It is arguable that the Enhanced Cooperation procedure is a much quicker method of adopting proposals relative to the opt-out procedure due to this negotiation process.

The Financial Transaction Tax Enhanced Cooperation saga has undoubtedly damaged the standing of the process in practice, however the language used in the Treaties is positive in nature relative to other methods of flexible integration. It is clear that although the process was introduced to recognise legislative tensions, Member States in ratifying the Treaties view it as an inclusive process. Many references are made towards non-participating Member States being able to join the process at any time. In particular, Article 328(1) TFEU allows Member States which have not agreed to the original establishment

of Enhanced Cooperation to adopt the measure at a later stage. It states that Enhanced Cooperation is available to Member States “at any other time, subject to compliance with the acts already adopted within that framework, in addition to those conditions.”<sup>113</sup> There are also obligations upon the European Commission and Member States to ensure that as many Member States as possible agree to pursue Enhanced Cooperation within that particular field. In this regard, complying with Treaty Articles to encourage participation could arguably have been the best mechanism by which to achieve Member State support. This does not however remove the critique that more support could have been possible if the 2011 Proposal were presented as more of a public good measure than a fundraising measure.

### **6.3. Ruthless Pragmatism?**

Yet it is equally arguable that the use of Enhanced Cooperation leads to negative consequences. The Treaties themselves refer to the process as a ‘last resort’. Yet negative within this context has a different meaning from everyday vernacular. The use of negative here does not mean that the process itself should not exist; in fact the development of the Enhanced Cooperation procedure should be applauded. Rather, it means that in pursuing integration the focus has shifted towards finding *pragmatic* solutions, with the need for its use being viewed as a failure for the standard legislative processes and Union forums i.e. the public good provided is not sufficient for unanimous action. Although the procedure allows proposals to be adopted with relatively little compromise from its original form, the Enhanced Cooperation procedure itself is a compromise. There is also the distinct possibility that the measure adopted by participating Member States will not be the same as the one originally proposed. For example, although there has been no indication of the

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<sup>113</sup> Article 328(1) TFEU

potential EU-10 Financial Transaction Tax's design, the 2013 Proposal included the issuance principle, something that was absent from the 2011 Proposal.

This may be an overly harsh assessment though. Ultimately, this thesis argues that flexible integration needs to be pursued as legislative stalemates occur, and in essence, every theory and mechanism of integration presented in the absence of unanimity is fuelled by pragmatism: unanimity is not possible. Therefore, what is the easiest way to find a solution? Enhanced Cooperation's relative advantage is that stage 1 can be completed in a relatively short period of time, circumventing much of the negotiation that the multi-speed, *à la carte* and opt-out options outlined in this chapter entail. Conversely, though, this lack of scrutiny through negotiation may be the cause of Article 263 TFEU actions.

Simply because a Treaty power is available for Member States to use does not necessarily mean that it has to be used. The Enhanced Cooperation procedure relies on proposals of a high quality to be produced by the Commission in order to be effective, otherwise legitimate concerns about the quality of the draftsmanship may be misconstrued as fundamental opposition to the original underlying concept. With regard to the Financial Transaction Tax, the map in the Appendices demonstrates there are many States which have been classed as being in favour of a form of a Financial Transaction Tax subject to certain conditions such as G-20 adoption or non-applicability to certain areas. Admittedly, this map is from 2012 and positions may have changed over time, but it is arguable that their original concerns were justified.

## **7. Article 136 TFEU**

Article 10 of the Stability Treaty also referred to Article 136 TFEU, which states that:

“In order to ensure the proper functioning of economic and monetary union, and in accordance with the relevant provisions of the Treaties, the Council shall...adopt measures specific to those Member States whose currency is the euro.”<sup>114</sup>

Article 136 TFEU therefore provides a legal basis for deeper integration within the euro area as opposed to being open to all EU Member States. At present 19 of the 28 EU Member States are in the euro area, with all States bar Denmark and the UK legally required to adopt the Euro once they fulfil the convergence criteria. The EU-ten are all members of the euro area. Legislative cooperation following the crisis has developed far quicker among euro States, for example, the Stability Mechanism as part of the European Banking Union is comprised exclusively of euro area States. Therefore the question arises as to whether or not, for the proper functioning of Economic and Monetary Union, Article 136 TFEU could be used as a means by which to adopt a common Financial Transaction Tax.

Article 136 TFEU does contain guidance for the Council as to the scope and rationale of measures that can be adopted. There are two prescribed functions, firstly to ensure that Member States observe budgetary discipline and secondly to establish economic guidelines compatible with other Treaty Articles.

### **7.1. QMV And Article 136**

Finally, Article 136 TFEU outlines that the voting mechanism for these measures is QMV among euro area members only:

“For those measures set out in paragraph 1, only members of the Council representing Member States whose currency is the euro shall take part in the vote.

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<sup>114</sup> Article 136 TFEU

A qualified majority of the said members shall be defined in accordance with Article 238(3)(a)."<sup>115</sup>

Therefore, the voting requirements are for a qualified majority of the euro area members as opposed to the unanimity requirements of Article 113 TFEU. The Treaty of Lisbon sought to simplify QMV, thus there is reference to the double majority Article 238(3)(a) TFEU procedure, applicable from 1<sup>st</sup> November 2014. Article 238(3)(a) states:

“A qualified majority shall be defined as at least 55%<sup>116</sup> of the members of the Council representing the participating Member States, comprising at least 65% of the population of these States.

A blocking minority must include at least the minimum number of Council members representing more than 35% of the population of the participating Member States, plus one member, failing which the qualified majority shall be deemed attained.”<sup>117</sup>

This includes the concept of a blocking minority – in theory due to the weighting, it is possible based solely on votes for three Member States to block a vote. This explains the aforementioned reference to ‘plus one member’, therefore a minimum of four Member States, representing 35 per cent of the population can block a Proposal. However, the key phrase is the referral to ‘representing the participating Member States.’ This reinforces the possibility realised in Article 136 TFEU for the nine non-euro area Member States to be unable to influence the final decision, since the vote does not affect them as such.

The present QMV procedure known as the ‘demographic verification’ method was introduced by the Treaty of Nice, which came into effect in 2003. It is based upon the allocation of voting weights as calculated based upon a State’s population, the idea being

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<sup>115</sup> Ibid

<sup>116</sup> For a Proposal from the Commission or the High Representative. For other Proposals the required rate is 72 per cent of Member States

<sup>117</sup> Article 238(3)(a) TFEU

that, for example, an elected government in Germany<sup>118</sup> represents a greater number of citizens than an elected government from Malta.<sup>119</sup> From 1<sup>st</sup> November 2014 the double majority procedure has been the standard QMV procedure. Until 31<sup>st</sup> March 2017 Member States could request that the demographic verification method from Nice should be applied instead. This is known as the 'Ioannina Compromise'.<sup>120</sup> In order for a Proposal to be adopted under the demographic verification method, a majority of Member States<sup>121</sup>, representing 74 per cent of the total weighted votes<sup>122</sup> and 62 per cent of the Union's population must vote in favour of a Proposal.

Since both methods are mentioned in Article 10 of the Stability Treaty as a means to further integration in economic matters it is logical to compare the hypothetical success of utilising Enhanced Cooperation and the likelihood of success with Article 136 TFEU as a legal basis with regard to the FTT. The major strength that Article 136 has relative to Enhanced Cooperation is that it is not a two-stage process. Although both mechanisms include a form of QMV, they are for different purposes. For Enhanced Cooperation there is a QMV vote to authorise the second stage, followed by a second vote among participating Member States to achieve unanimity. However, the QMV vote in Article 136 TFEU is for the adoption of the measure itself. Furthermore, Article 136 TFEU does not refer to the internal market, avoiding much of the discussion identified in the previous chapter as to whether the 2011 Proposal advances the internal market as required by Article 113 TFEU.

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<sup>118</sup> Which along with France, Italy and the UK has the highest voting weight of 29 votes

<sup>119</sup> Which has the lowest voting weight of just three votes

<sup>120</sup> Europa Glossary, 'Ioannina Compromise' (*EUR-Lex*)  
<[http://europa.eu/legislation\\_summaries/glossary/ioannina\\_compromise\\_en.htm](http://europa.eu/legislation_summaries/glossary/ioannina_compromise_en.htm)> Accessed 6 April 2018

<sup>121</sup> This is a simple majority if a Proposal is from the Commission. This equates to 14 Member States. For other Proposals, the majority must be 67 per cent of Member States. This equates to 18 Member States

<sup>122</sup> This means currently support must have totalled at least 255 votes out of a possible 345 votes

Hypothetically how successful could a vote by Qualified Majority as prescribed by Article 136 be for adopting an FTT among euro area states? Following the accession of Croatia to the EU, the voting weights in the council have been amended accordingly from 1<sup>st</sup> July 2013. The total number votes for 28 EU Member States is 352 votes. The euro area comprises 224 votes in total. Of the 19 euro area Member States, eleven of them initially pursued Enhanced Cooperation. This fulfils the simple majority requirement, since 58.9 per cent of Euro area Member States would vote in favour. This totals 175 votes (78.125 per cent of the total votes). To establish the position of the remaining eight Member States that are set to adopt the euro in the future it is necessary to consult the 2012 KPMG map in Appendix A. This shows that Finland and Lithuania were considered to be largely in favour of introducing a Financial Transaction Tax and therefore could be considered to vote in favour of a Proposal. This raises the support to 68.4 per cent of Member States totalling 84.375 per cent of voters. The remaining six Member States,<sup>123</sup> comprising 33.33 per cent of the euro area states in the Council are largely opposed. Their combined voting weight is 38 votes covering 15.625 per cent of the euro area votes.

Applying these statistics to the Nice demographic verification method, it is clear that more than 50 per cent of the euro area Member States are in favour of the basic notion of forming a Financial Transaction Tax. Furthermore, this majority represents more than 74 per cent of the total votes. The population represented by the measure is also greater than the required 62 per cent. Applying them to the Lisbon double majority method, more than 55 per cent of Member States are in favour representing more than 65 per cent of the population of these States. There is insufficient support to create a blocking minority and therefore hypothetically any Financial Transaction Tax introduced under Article 136 TFEU

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<sup>123</sup> Cyprus, Ireland, Latvia, Luxembourg, Malta and the Netherlands

can be passed in terms of overcoming the percentage requirements. There would, however, be serious problems in using Article 136 TFEU.

There are two key drawbacks which make Enhanced Cooperation the preferred option of the two for the purposes of the Commission's Financial Transaction Tax. The first of these is that certain key terms are unclear or vague, for example 'economic policy guidelines' and the requirement to maintain euro area discipline. The Treaties do not explain what an economic policy guideline is. Consequently, was the Commission's 2011 Proposal truly an economic policy guideline? Is it completely necessary in order to maintain euro area discipline? This leads into the second major problem. As a consequence, are measures adopted via Article 136 TFEU are even more open to legal challenge akin to the *Tobacco Advertising* case than Enhanced Cooperation? Can a Financial Transaction Tax be imposed on any State against their will through QMV? A significant number of Member States are required to adopt the euro once they fulfil the convergence criteria. A state that fundamentally opposes a Financial Transaction Tax that is committed to adopting the euro would not only have a significant interest in raising an Article 263 TFEU action, they would also have convincing grounds of legitimacy and *ultra vires*. This cannot be the case and therefore Article 136 TFEU would be unsuccessful and inappropriate to use solely because of these reasons.

## **8. Classical Theories of Differentiated Integration**

In addition to the Enhanced Cooperation and Article 136 TFEU provisions, there are practical examples which pre-date these specific Treaty based mechanisms. These can best be outlined with reference to theories of differentiated integration. Specifically, this chapter discusses three major theories: multi-speed Europe, *à la carte* integration and variable geometry. However, it is simplistic to state that there is no scope for crossover, whereby more than one theory can be used to explain an advancement in legislative

cooperation. The following section outlines the basic concept of the three theories, discussing their relative advantages and disadvantages including case studies.

### 8.1. Multi-Speed Europe

Also referred to at times as ‘two-speed Europe’, a European Parliament research paper from 1985 explained the theory by using the analogy of two passenger trains heading to the same destination:

“The points of departure and of arrival are common to both and agreed by all the passengers – only the speed of travel differs. At certain previously agreed points, passengers may transfer from the slow to the fast train, but not normally from the fast to the slow one.”<sup>124</sup>

This is significantly different from the discussion concerning Enhanced Cooperation, since under the multi-speed Europe process there is wider scope for flexibility in how to proceed to attain a common goal as opposed to whether or not to do so. In its more modern form, multi-speed Europe seeks to proceed with the notion of common action from the Treaty of Rome by common agreement on the *acquis communautaire* by all Member States. Nevertheless, it acknowledges that certain States for various reasons may be unable to implement the policy in question at the present period of time. Multi-speed Europe does not necessarily involve a fixed timetable of implementation. In the 1997 Glossary, the Commission defined multi-speed Europe as the term describing differentiated integration as a process “whereby common objectives are pursued by a group of Member States both able and willing to advance, it being implied that the others will follow later.”<sup>125</sup> Although

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<sup>124</sup> European Parliament General Secretariat DG for Research and Documentation ‘Two-Speed Europe’ Political Series No. 11 September 1985

<sup>125</sup> *Supra* n.41

Enhanced Cooperation also seeks to promote common action it is not implied that others will follow later, but the possibility remains.

Former West German Chancellor Willy Brandt is credited with advocating this particular theory in 1974 in a speech to the 'Organisation Française du Mouvement Européen'.<sup>126</sup> Brandt later distanced himself from the resulting dialogue, indicating that his original idea had been altered.<sup>127</sup> Brandt was a keen proponent of integration, however he sought ways in which to increase the efficiency of the process and thus strengthen the community:

“If the objectively stronger countries in terms of their economic situation could pursue commercial integration while other countries initially participate in stages on the basis of their objectively different situation.”<sup>128</sup>

As discussed previously, one of the contentious elements of the Enhanced Cooperation process is the cost on participating States. This vision of multi-speed Europe acknowledges costs involved, but unlike Enhanced Cooperation, there is an express recognition that additional short-term support may need to be provided to foster integration. Although economic prosperity is not conclusively determinant of the ability of a state to integrate in a particular area, they nevertheless play a large role in a state's ability to integrate. Brandt's position is ultimately pragmatic based on economic factors objectively having differing effects on different Member States. The statement was also made at a time of great economic uncertainty, with a smaller number of Member States as

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<sup>126</sup> W Brandt 19 November 1974 “Speech to the Organisation Française du Mouvement Européen in Paris”. In *Europe-Archiv Folge 2* (1975) 19 November 1974

<sup>127</sup> European Parliament General Secretariat DG for Research and Documentation ‘Two-Speed Europe’ Political Series No. 11 September 1985

<sup>128</sup> M Lamping ‘Enhanced cooperation - a proper approach to market integration in the field of unitary patent protection?’ (2011) 42(8) *International Review of Intellectual Property and Competition Law* 879. Extracts from original source Brandt, speech to the Organisation Française du Mouvement Européen in Paris on 19 November 1974, extracts reproduced in: “Europa-Archiv D33”, (1975); see also LANGEHEINE, “Europäisches Gemeinschaftsrecht und abgestufte Integration” 7 (1988).

members of the then European Economic Community. As greater numbers of states become members, the gaps between the objectively stronger states and the objectively weaker states may widen, with pragmatism dictating it is easier to continue to adopt a measure as widely as possible at the time rather than wait for the objectively weaker states to catch up. Following the euro crisis, Member States have had their economic strength damaged with many of the states that have indicated support for the Financial Transaction Tax being those which have been hit hardest by the euro crisis and the transfer of private debt to national treasuries.

Clearly aware of the gulf between objectively weaker and stronger Member States, Brandt emphasised that this differentiation should not be permanent, creating a system referred to as 'Abstung der Integration' (translated as 'Graduated Integration'), which included an obligation for the European Communities and Member States that had adopted the measure in question to assist other Member States to be able to progress in policy areas. Further concretisation for multi-speed Europe and the divergence between economically stronger and weaker States came in 1976 with the publication of the Tindemans Report<sup>129</sup> which sought to define the term 'European Union':

"It is impossible at the present time to submit a credible programme of action if it is deemed absolutely necessary that in every case all stages should be reached by all the States at the same time. The divergence of their economic and financial situations is such that, were we to insist on this progress would be impossible and Europe would continue to crumble away."<sup>130</sup>

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<sup>129</sup> Leo Tindemans. (1975) *European Union. Report by Mr. Leo Tindemans, Prime Minister of Belgium, to the European Council. Bulletin of the European Communities, Supplement 1/76. Available at <[http://aei.pitt.edu/942/1/political\\_tindemans\\_report.pdf](http://aei.pitt.edu/942/1/political_tindemans_report.pdf)>* Accessed 21 November 2014

<sup>130</sup> Ibid

Furthermore, Tindemans built upon the idea of states not necessarily being able to integrate fully and made further reference to an obligation to assist Member States to catch up on the Council, Commission and other Member States:

“Those States which have reasons for not progressing which the Council, on a proposal from the Commission, acknowledges as valid do not do so, but will at the same time receive from the other States any aid and assistance that can be given them to enable them to catch the others up.”<sup>131</sup>

Since one of the main obstacles for adopting policies is economic pressures, it is possible that if aid and assistance were to include monetary or financial assistance, then there is a transfer of resources from richer regions of the European Union to poorer regions. Yet ‘aid and assistance’ is a particularly vague term and therefore this need not necessarily mean assistance in the form of monetary value, for example, there could be administrative assistance provided. For example, in relation to a common Financial Transaction Tax, States could share the cost of developing computer software to automatically collect payment of the tax at the moment the transaction is completed.

Multi-speed Europe is dependent on common agreement in policy areas, therefore differentiation is pragmatic on the grounds of time caused by the ability of a state to integrate as opposed to policy objectives. Hypothetically, the Union may wish to introduce new forms of protection and guarantees for workers in order to reinforce job security in a recession. However, as the arguments Brandt and Tindemans demonstrate, the ability to integrate is often due to economic prosperity. It may be popular for reinforced job security to be implemented in a recession-hit Member State, yet public finances may mean that the provisions cannot be introduced immediately. It would be impractical to deny those which are able to implement measures to proceed, though as Brandt and Tindemans state, there

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<sup>131</sup> Ibid

should be an obligation on participating Member States to support others to catch up. It is far more difficult to classify the theory in terms of leaning towards intergovernmentalism and supranationalism. Clearly, there is an element of individual Member States working together in agreeing the *acquis communautaire* in the first instance. Nonetheless, there is also a supranational element in the sense that overall authority comes from the Union institutional structure rather than a conferred power by Member State governments. In relation to the Financial Transaction Tax, this version of a multi-speed Europe approach may mean that those Member States hit hardest by the economic crisis, and who could potentially benefit the most in terms of protection or containment of future financial speculation may need to be supported by larger or more prosperous Member States.

### **8.1.1. Merits and Disadvantages**

One of the strengths of multi-speed Europe is that it is a moderate theory of integration in the sense that it bears as close a resemblance as possible to the original goal of uniform integration from the 1957 Treaty. It assumes that uniform consensus is possible and is therefore ambitious in establishing the scope of the *acquis communautaire*. Measures continue to be adopted within the Union's legislative framework and reflects that the Union is not a homogenous collection of Member States; 27/28 Member States will only be able to progress at different times due to various factors.

One area where multi-speed Europe does excel with regard to the following theories of integration is that it takes a maximist approach to integration, meaning that like Enhanced Cooperation, it seeks to incorporate as many States as possible, however it is not a Treaty requirement. The literature on multi-speed Europe dates back to the mid-1970s and expressly recognised the likelihood of further expansion of the Union by future accessions. Multi-speed Europe may not have foreseen the possibility of a mass accession of Union Member States, but it does recognise the widening aspect of the 'widening and deepening' mantra coined by Brandt and the former French President, Georges Pompidou. With

regard to common tax policy, in cases such as the Financial Transaction Tax, the multi-speed Europe theory therefore is on paper the preferred theory to follow if possible, since in including in theory all Member States of the Union at different stages of integration, an eventual wider public good is provided relative to the other forms of integration listed in this chapter.

Furthermore, other theories of differentiated integration are more divisive in nature and could stoke the risk of excessive fragmentation, the permanent separation of Member States in policy areas. Multi-speed Europe limits fragmentation concerns, since the legislative end point and a flexible timeframe is agreed upon. The risk of fragmentation is diminished further when adopting Brandt and Tindemans' assertions that Member States should assist each other to progress and eventually reach the agreed end point – in order to incentivise this assistance, the provision needs to provide a truly collective public good agreeable to both States.

Although one of the supporting arguments for multi-speed is limitation of permanent fragmentation, at times it is possible to criticise this model as being potentially naïve and failing to recognise practical difficulties of application. Some policy areas such as the European Arrest Warrant are inevitably going to be too sensitive for certain Member States to cooperate in, making it impossible to achieve common accord.<sup>132</sup> In addition, agreement on the *acquis communautaire* requires lengthy discussions, which prolong the integration process and which may ultimately reduce the overall quality of policies through concessions and increase fears of a lowest common denominator or 'race to the bottom' if universal agreement cannot be reached on a matter. For example, in the area of

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<sup>132</sup> For example see R Mason, 'Peers Protest Over Tory Handling of European Arrest Warrant' (*Guardian News*, 13 November 2014) <<http://www.theguardian.com/politics/2014/nov/13/peers-protest-conservatives-european-arrest-warrant>> Accessed 6 April 2018

corporate governance at EU level Will Hutton, an advocate for greater harmonisation of corporate regulation at a high level of social protection, states that:

“There can be no indulgence of particular member states who want to take a more lenient view of the responsibilities attached to incorporation, rather as the US indulges Delaware...that will only generate lowest common denominator corporate practice and a race to the bottom.”<sup>133</sup>

Furthermore, a situation may arise whereby a group of Member States are unable to catch up with those Member States which have adopted policies within a particular area. Another alternative is that a State may, as it is entitled to do so, alter its stance regarding a certain policy. This could be due to a wholly domestic change in the state of affairs such as a change in government or a reaction to perceived over reaching at Union level. By way of example, the 2011 Proposal was published under the conservative French Presidency of Nicolas Sarkozy. The 2013 Proposal and subsequent agreement to partake in the Enhanced Cooperation process came to fruition during the socialist Presidency of Francois Hollande. At the time of writing, following the 2017 Presidential elections, the centrist candidate Emmanuel Macron is President. It is unusual for a Member State of the EU to have three fundamentally differing governments over the course of six/seven years, but it does highlight that within a relatively short period of time a State’s position on policy matters, such as the Financial Transaction Tax could change dramatically, This may lead to cases of a ‘two-tier’ Europe, often perceived as a negative consequence, since it fails to adopt the common action approach in the Rome Preamble, the approach which multi-speed Europe seeks to protect as much as possible. Whether or not two-tier is negative<sup>134</sup> the situation cannot arise unless a certain number of Member States have pressed ahead

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<sup>133</sup> W Hutton, *The World We're In* (Little Brown 2002) 318

<sup>134</sup> Stubb classifies it as subsection of variable geometry Europe

with an agreed policy. The problem of failure to adhere to agreements may be further exacerbated by a frequent lack of imposed deadlines for adoption. For example, with regard to the EMU integration process all Member States bar two have legal obligations to adopt the single currency once the five convergence criteria are met. However, Sweden's economic policy deliberately ensures that it cannot comply with the convergence criteria and it does not have a prescribed deadline for compliance.

## 8.2. À La Carte

Although no definition was provided by the European Commission in its 1997 Glossary the *à la carte* theory of integration is relatively simple on paper. Stubb notes in his classification of differentiated integration terminology that there were few synonyms or variations of the original term, stating that the metaphor is self-explanatory, asserting that "it is easy to understand that according to this form of differentiated integration a Member State is allowed to pick-and-choose, as from a menu, from respective policy areas."<sup>135</sup>

At first glance, Stubb is correct, yet in reality there have been subtle variations in the meaning evoked by different individuals' understanding of the phrase, which have cast *à la carte* integration in a negative light. Originally, the notion of *à la carte* was greeted with a great degree of trepidation. The previous section included quotes from the former German Chancellor, Willy Brandt, regarding multi-speed integration being temporary in nature. If not temporary this creates a two-tier Europe instead, and in making these statements, Brandt removed himself from accusations of supporting an *à la carte* ideology, since *à la carte* integration assumes permanent differences on policy grounds. Furthermore, the concept of *à la carte* integration is alluded to in the Tindemans report, although again in a relatively negative manner:

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<sup>135</sup> *Supra* n.1 at 290

“This does not mean Europe *à la carte*: each country will be bound by the agreement of all as to the final objective to be achieved in common; it is only the timescales for achievement which vary.”<sup>136</sup>

The impetus for *à la carte* being discussed as a serious potential solution to malaise in the area of European integration was granted by Professor Ralf Dahrendorf in a lecture to the European Union Institute in 1979. Dahrendorf stated that the common decision making process established by the Rome Preamble meant that detrimental restrictions were put on the ability to legally integrate, which would ultimately lead to the Commission becoming irrelevant:

“European Union has been a remarkable political success, but an equally remarkable institutional failure...; so far as the framework for taking common decisions is concerned, we have locked ourselves into procedures and institutions which at times do more damage than good.”<sup>137</sup>

Therefore, the address was designed to set out his vision for a ‘Third Europe’. This consisted of three elements. First, emphasis on the European interest, establishing the goals that Europe wished to achieve on the world stage. Secondly, political legitimacy for the Commission and finally, and most crucially for this thesis, a “readiness to accept an Europe *à la carte*.”<sup>138</sup> Dahrendorf highlighted the perceived fears of the Community towards *à la carte* reflected in Tindemans’ Report and explained how he failed to understand how the notion was seen as a step backwards. Any move towards *à la carte* was:

“Not only somewhat odd for someone who likes to make his own choices, but also illustrates that strange puritanism, not to say masochism which underlies much of

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<sup>136</sup> Supra n.129

<sup>137</sup> R Dahrendorf, ‘A Third Europe?’ Presented at EUI Florence, 26 November 1979 <<http://aei.pitt.edu/11346/2/11346.pdf>> Accessed 6 April 2018

<sup>138</sup> Ibid

Community action: Europe has to hurt in order to be good. Any measure that does not hurt at least some members of the European Community is (in this view) probably wrong. In any case it is regarded as unthinkable that one should ever allow those members of the Community who want to go along with certain policies to do so, and those who are not interested to stay out.”<sup>139</sup>

Dahrendorf argued that this attitude was an obstacle to further integration and consequently developed a unique *à la carte* ideology as the next logical step in order to counter and mitigate these fears in later, stating that “there is a wide scope for action *à la carte*, and more often than not such action will in the end lead to common policies.”<sup>140</sup>

Unlike the overall classification of the *à la carte* theory of integration provided by some, Dahrendorf’s version includes a common action narrative similar to that of Enhanced Cooperation, but equally echoing the view of a two-tier Europe, in that a core will continue to elect to integrate through common action, which would be seen as mutually beneficial by both participating and non-participating States. This is a positive view of *à la carte*, designed to complement, rather than be a detriment to the European integration project. As Europe expands any perceived over reach caused a rise and reinvigoration of Eurosceptic sentiment. Therefore, the basic concept of a more selective approach appears in theory to satisfy many of these concerns, but there are clear divergences between significant political figures which are telling. This thesis ultimately argues that for the purpose of common action in important areas such as taxation, if *à la carte* integration is to be considered to an appropriate standard, that it is Dahrendorf’s vision which should be presented. However, Dahrendorf’s positive vision was not universally accepted and consequently the notion of *à la carte* shifted to the more commonly recognised ‘pick and choose’ approach. In particular, this was the viewpoint adopted in the late 1980s and early-

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<sup>139</sup> Ibid

<sup>140</sup> Ibid

mid 1990s by the Conservative British Prime Ministers Margaret Thatcher and John Major, highlighted in particular prior to the 1996 Inter-Governmental Conference. Major's version of a Europe *à la carte* was a stricter pick and choose approach centred upon the single market, rather than political or social Union. It can be explained by two different pressures. Firstly, on a domestic level during Major's tenure as UK Prime Minister between 1990-1997, the Conservative party faced its most troublesome internal struggle with regard to Britain's relationship with Europe prior to the election pledge to hold the Brexit referendum in 2016. On the one hand, further, stronger economic ties were desirable, but without the need for further granting of sovereignty to Europe. This pressure pre-dated Major's mandate, with his predecessor Margaret Thatcher reflecting strong euro scepticism, outlining that:

"Working closely together does not require power to be centralised in Brussels or decisions to be taken by an appointed bureaucracy...we have not successfully rolled back the frontiers of the state in Britain only to see them re-imposed at a European level, with a European superstate exercising a new dominance from Brussels."<sup>141</sup>

However, during his tenure Major faced a particular problem in signing the Maastricht Treaty. The Conservative party had a slim majority government at the start of Major's time in office, yet fell victim to the Maastricht rebellion, whereby a number of Conservative MPs voted against the government or abstained in voting. In March 1993 26 Tory MPs voted against the Major government, with 16 abstaining, resulting in Labour's Amendment 28 to the European Communities (Amendment) Bill being adopted.<sup>142</sup> Further opposition to

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<sup>141</sup> J Campbell, *Margaret Thatcher Volume 2: The Iron Lady* (Random House 2007) 605

<sup>142</sup> HC Deb 8 Mar 1993 Division No. 174

Major's signing of the Maastricht Treaty came from Baroness Thatcher, stating in the House of Lords that she could:

“Never have signed this treaty. I hope that that is clear to all who have heard me. The Bill will pass considerable further powers irrevocably from Westminster to Brussels, and, by extending majority voting, will undermine our age-old parliamentary and legal institutions, both far older than those in the Community. We have so much more to lose by this Maastricht Treaty than any other state in the European Community. It will diminish democracy and increase bureaucracy.”<sup>143</sup>

As a result in spite of a successful leadership election in 1995<sup>144</sup> the subsequent political infighting ultimately (although not exclusively) brought down the Major government with a landslide victory for the Labour party in 1997. Towards the end of his time in office Major, due to numerous defections was operating with a minority government.

The second pressure was linguistic, a question of semantics raised by the Maastricht Treaty, which introduced the ‘European Union’ in addition to the European Community.<sup>145</sup> In part perhaps this can be attributed to the immediate perception of ‘European Union’ in everyday English vernacular. Tugendhat states that:

“The words ‘European Union’ create a good deal of difficulty in the English language. They sound clear and firm, like ‘United Kingdom’ or ‘United States’, and are often taken to convey the same sort of meaning. In other languages and cultures they imply something less precise, more compatible with separate national identities.”<sup>146</sup>

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<sup>143</sup> HL Deb 7 Jun 1993, vol 546 col 565

<sup>144</sup> For further information see R Brazier, ‘The Resignation of John Major’ (1995) *Win Public Law* 513

<sup>145</sup> Post-Lisbon Treaty the European Community no longer exists

<sup>146</sup> C Tugendhat, ‘How to Get Europe Moving Again’ (1985) 61 *International Affairs* 421

The move towards *à la carte* integration again has been pragmatic and caused by external pressures. Thatcher and Major had demonstrated euro sceptic sentiment in the UK, however in France the Maastricht Treaty, expected to be approved by landslide by the French electorate, was adopted by the smallest of majorities. Lord noted that “More than any other single event, it was the crisis in 1992-3, provoked by the ratification of the Maastricht Treaty on European Union (TEU), which shattered any illusion that the legitimising of EU power was a ‘non-problem’.”<sup>147</sup> With this in mind, it is therefore highly understandable why in addition to the financial might of the City of London a Conservative UK government is likely to launch an Article 263 TFEU action for measures seeking to introduce a Financial Transaction Tax, reflecting the political obstacles outlined in chapter 1.

Unlike multi-speed Europe, differentiation in the area of *à la carte* Europe, whether the positive approach adopted by Dahrendorf or the more negative approach taken by Major, is based not on timescale but instead solely on policy matters. The pragmatic approach taken is that policy agreement is not possible, but that to prevent Member States from proceeding to cooperate in certain areas is illogical. Unlike multi-speed Europe, it is also easy to categorise *à la carte*, particularly the Thatcher/Major concept as promoting a firmly intergovernmental approach to EU law. *À la carte* Europe functions based on the EU recognising particular exemptions, known as ‘opt-outs’. The Commission’s Glossary defined opting out as:

“An exemption granted to a country that does not wish to join the other Member States in a particular area of community cooperation as a way of avoiding a general

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<sup>147</sup> C Lord, ‘Legitimacy, Democracy and the EU: when abstract questions become practical policy problems’ Policy Paper 03/00 <jamal.shahin.org/pdf/tceu/lord2000.pdf> Accessed 6 April 2018

stalemate...these opt-outs set important precedents in the current debate on flexibility, a key element in the Intergovernmental Conference.”<sup>148</sup>

The fact that the Commission was willing to define opt-outs, but not *à la carte* in its Glossary may reflect that 18 years after Dahrendorf’s lecture, the term *à la carte* remained taboo. There have been many clear examples in which the EU has been willing to recognise opt-outs to avoid legislative stalemates.

The classification of *à la carte* as a positive or negative form of integration is still debated long after Dahrendorf, Thatcher and Major made their stances known. The UK’s renegotiation of its membership with the European Union prior to the Brexit referendum was dependent on an increased degree of *à la carte* integration, echoing the sentiment of Thatcher and Major. This is controversial as evidenced by the reaction of Ministers from other Member States, for example the former French Prime Minister and Foreign Minister Laurent Fabius saying that the UK could not have “Europe *à la carte*.”<sup>149</sup>

Beyond the UK, Rebecca Adler-Nissen has written about the diplomatic connotations associated with the process of national opt-outs. Although opt-outs can occur in high profile contentious cases, such as common security defence policy, they can also be successfully negotiated in relatively low profile cases, such as Protocols on reindeer husbandry in Finland and Sweden, acquiring second homes in Malta and Swedish chewing tobacco.<sup>150</sup> Traditionally, Eurosceptics claim opt-outs protect national sovereignty and act as an example to other Member States<sup>151</sup> whilst Europhiles argue a loss of political

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<sup>148</sup> Supra n.41

<sup>149</sup> R Adler-Nissen, *Opting Out of the European Union* (Cambridge University Press 2014) 152

<sup>150</sup> Ibid at 9

<sup>151</sup> See for example P Giddings, ‘Westminster, the EMU and the Euro’ in P Giddings (ed), *Britain in the European Union: Law, Policy and Parliament* (Palgrave 2004) 158

influence at Council of Ministers meetings.<sup>152</sup> Adler-Nissen states that due to the diplomatically sensitive nature of negotiating opt-outs they instead provide “an opportunity to reflect on how the sovereignty of member states is challenged in ways that governments have difficulty handling, not to mention explaining to their populations.”<sup>153</sup> In other words, where a Member State’s sovereignty is challenged by a particular measure, an opt-out can be beneficial due to the difficulties in justifying the EU integration project to national populations. Negotiating opt-outs in certain areas may facilitate integration in other areas by encouraging cooperation as opposed to being antagonistic. It is arguable that the design of the 2011 Proposal, in being pitched as a fundraising tool, was overly antagonistic and consequently there concessions may have been possible to achieve a wider range of support beyond the Enhanced Cooperation States.

### **8.2.1. Merits and Disadvantages**

Historically there has been trepidation about embracing the *à la carte* approach as a means of encouraging integration. It is considered to be the most radical of the classical theories of integration, since it flies in the face of the notion from the *Costa* case that “the executive force of Community law cannot vary from one state to another (...) without jeopardising the attainment of the objectives of the Treaty”<sup>154</sup> and fails to respect the Rome Preamble. By definition, common action is not always possible when taking into account individual state will. Therefore, *à la carte* is the opposite of multi-speed Europe theory and as a consequence, the positive qualities of multi-speed Europe, such as reduced fragmentation are lacking in the *à la carte* approach and become criticisms.

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<sup>152</sup> See for example B Burkitt and A Mullen, ‘European Integration and the Battle for British Hearts and Minds: New Labour and the Euro’ (2003) 74(3) *Political Quarterly* 322

<sup>153</sup> *Supra* n.149 at 189

<sup>154</sup> *Case 6/64 Flaminio Costa v. ENEL [1964] ECR 585*

This historical trepidation may be misguided though. À la carte undoubtedly provides positive arguments for its application in EU integration. In order to put the *à la carte* theory of integration into effect, there must first be a Proposal at EU level, otherwise the provisions are adopted through domestic legislative processes. In the previous section, regarding multi-speed Europe, the quality of measures adopted is brought into question. In the *à la carte* approach there is genuine agreement that differences are irreconcilable and cannot therefore form part of the overall *acquis*. This means that the probability of having to find the lowest common denominator is diminished; there are discussions and it is clear that any measures adopted via *à la carte* must be considered as failed ventures in discussions for multi-speed Europe.

Yet this is a negative view of *à la carte* integration. *À la carte* in everyday vernacular is not focused on exclusion. At an *à la carte* restaurant, a customer makes a positive choice to have a meal. They do not make their selection by excluding themselves all other options on the menu. Far from focussing on opt-outs, this thesis advocates that a more positive classification of opting in would allow States to sign up to optional protocols beyond a commonly agreed base standard in addition to permitting them to exclude themselves from a particular area of taxation through non-participation as opposed to active exclusion in the most contested areas, meaning that more ambitious measures and arguable higher quality measures can be adopted with regard to taxing individual financial instruments. This theory is discussed in greater detail in the following chapter.

The major benefit of the *à la carte* approach, whether the Dahrendorf or Major pick and choose interpretation is used, is the degree of flexibility that it offers to Member States in the integration process, due to the emphasis on choice. Adler-Nissen notes that the

etymology of opt-out *optare* translates as meaning ‘to choose’ or ‘to wish’.<sup>155</sup> In contrast to the lengthy process of multi-speed Europe, it is far easier to examine Member State will and allow Member States to act accordingly. Stubb classes *ad libitum* integration as being in the same family as *à la carte* integration. This has a negative context, since it implies that there is little focus on which policies are being adopted and that integration becomes effectively a free for all. However, the reality is that proposed policies are far more considered and reflect external pressures. The examples highlighted later in this chapter illustrate that even if an *à la carte* integration is pursued, the majority of Member States continue to cooperate, since the Union offers a common platform to make policies function, rather than an opportunity for *ad libitum* policy making. With regard to the level of Member State support for a Financial Transaction Tax, there is clearly a core that wish to continue to cooperate, reinforcing Dahrendorf’s positive interpretation of *à la carte*. In times of a rise in intergovernmentalism, *à la carte* provides a degree of considered integration in the absence of unanimous agreement, since intergovernmentalism reflects a greater emphasis on the interests of individual Member States relative to a more supranational recognition of the collective authority of the EU.

Time wise, once irreconcilable differences are identified and accepted, this process allows for a rapid degree of integration. This is in part due to the exclusion of any obligation on Member States to aid and assist other Member States as mentioned by Brandt and Tindemans in relation to multi-speed Europe. There is no notion of relocation of resources from richer regions to poorer regions and the emphasis at least in theory is on fulfilling the will of individual states is in reality actually based on a self-sustaining ideology. Overall, it is arguable that there may be lower economic costs borne across the Union.

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<sup>155</sup> *Supra* n.149 at 15

The final point to consider is that in adopting a minimalist approach to integration, neither Dahrendorf nor Major's versions of *à la carte* cater for future accession. Intergovernmentalism indicates that individual Member State concerns, such as those of the UK in relation to the 2011 Proposal are taken into account. As a result of hypothetical increases in the use of the *à la carte* approach to integration, potential candidate Member States may feel that their individual concerns will be addressed and EU membership may increase, leading to widening of the union as envisaged in the Treaties.

### 8.3. Variable Geometry/Concentric Circles

Variable geometry pre-dates the other theories of integration presented and as a consequence it has garnered support, in particular from French politicians including former President Mitterrand<sup>156</sup> and Prime Minister Balladur in 1994.<sup>157</sup> Again, at times this concept has changed and different terminology has been used. A frequently used term in this area is 'concentric circles'. Stubb's classification groups variable geometry and concentric circles within the same group and often in academic writing the two terms are used interchangeably.<sup>158</sup> However, the concentric circles theory is more conducive to a graphical representation than variable geometry. A greater distinction between the two terms is discernible in the aforementioned Commission's 1997 Glossary, which provided two separate definitions for 'Variable-Geometry Europe' and 'Concentric Circles'. Firstly, it states that variable geometry:

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<sup>156</sup> See V Gibert, 'L'Europe à l'horizon 2000: Prospective Institutionnelle' (1994) Rapport de Stage (Intern Report) Strasbourg

<sup>157</sup> See Prime Minister Balladur's article to the French people in *Le Monde*, which proposed the use of concentric circles. E Balladur, 'Pour un Nouveau Traité de l'Élysée' (*Le Monde* Paris 30 November 1994)

<sup>158</sup> For example B Laffan, *Integration and Co-Operation in Europe* (Routledge 1992) refers to variable geometry, whereas M Avbelj, 'Revisiting Flexible Integration in Times of Post-Enlargement and the Lustration of EU Constitutionalism' (2008) 4 *Croatian Yearbook of European Law and Policy* 132 refers to concentric circles

“Acknowledges that there are irreconcilable differences within the integration structure and therefore allows for a permanent separation between a group of Member States and a number of less developed integration units.”<sup>159</sup>

Applying this definition, the Commission appear to view variable geometry as a hybrid between multi-speed Europe and *à la carte*. Multi-speed assumes a common policy goal across all Member States and promotes collective action, yet the reference to irreconcilable differences in this definition incorporates the choice element of *à la carte*. This collective action appears to be more formalised and far less ad hoc than *à la carte*, with the reference to ‘integration units’ indicating a more concrete version of cooperation than that envisaged by Dahrendorf. Variable geometry assumes core policies are agreed to in a particular area, but that any States which are not in agreement with the proposed measures are unlikely to come up to the same level in the near future. The separation is therefore more permanent than multi-speed Europe, akin to a two-tier Europe. Pragmatism in this context provides a more formalised structure for policies than afforded by multi-speed Europe or *à la carte* approaches.

In contrast, the Glossary definition of concentric circles stated that the concept involved “a Europe structured out of subsets of States which have achieved different levels of integration. It is not confined just to the integration structure of the European Union.”<sup>160</sup> Variable geometry provides some form of structure, however concentric circles includes subsets and introduces the idea of layers of policy integration. Concentric circles can therefore be described by using the analogy of a bird’s eye view of a tiered wedding cake. This method looks at the continent of Europe as a whole, including States waiting to accede, rather than focusing exclusively upon individual policies. For example, Iceland,

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<sup>159</sup> *Supra* n.41

<sup>160</sup> *Ibid*

Norway and Switzerland are signatories to the Schengen Agreement, which is designed to facilitate the EU freedom of movement for persons, in spite of their non-membership of the EU. States are designated into concentric circles “so that around the smallest central layer several other layers are arranged.”<sup>161</sup> The size of circles increases proportionately with the distance from the centre. The closer to the centre a particular grouping is, the greater the degree of integration taking place in that particular field. The further away from the centre, the more flexible integration is and the lesser the degree of common action. Tugendhat described his vision of concentric circles as “a spherical core surrounded by a series of concentric circles”<sup>162</sup> with the Common Market, Common Agricultural Policy, Common External Trade Policy and Competition Policy at the centre, with new cooperative ventures being created from this core.

The two terms are distinct, yet the development of concentric circles cannot be considered without reference to variable geometry and vice versa, since there is a common link. The policy area in question ultimately remains outside of the EU’s institutional framework, whether by protocol or by common action in another forum. For concentric circles, this means that common policies can be negotiated outside of the institutional structure from the outset, whereas for variable geometry the measure can start within the Union’s institutional structure and then move outside once there is a lack of consensus. This means that differentiation in this area is often referred to as being on the grounds of space as opposed to purely on the grounds of policy or time.

The UK’s accession to the EU appears to have triggered a revival in support for variable geometry Europe as a more inclusive alternative to *à la carte* integration. Jaques Delors, in his role as Chairman of the Economic and Monetary Committee of the European

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<sup>161</sup> Supra n.39 at 397

<sup>162</sup> Supra n.146 at 426

Parliament from 1979-1981, is credited with proposing a variable geometry Europe as a means to appease the perceived gradual withdrawal of the UK from the European project in 1980. In doing so, Delors sought to incorporate the element of choice, of key importance to the UK, in the integration project. He stated:

“The attitude of the British stems from profound disagreements. I prefer to propose to them a variable geometry Europe rather than to see them deliberately moving away from the Continent of Europe.”<sup>163</sup>

Further support was provided by François Mitterrand in a speech to the European Parliament. Mitterrand stated that variable geometry was a step that must be taken, but in a manner complementing, rather than competing with the Community's central structure.<sup>164</sup> Variable geometry therefore would offer a viable, flexible structure by which to allow integration based on choice as an alternative to the standard policy making framework leading to legislative stalemates. Whilst these comments do also support the multi-speed theory of integration, the ‘Two-Speed Europe’ report from 1985 concludes that the European Parliament had opted for variable geometry in anticipation of the signing and ratification of a new Treaty on European Union:

“In these circumstances, the states in the Union will have adopted different, wider objectives than those which opt to remain out of the Union. The Europe thus resulting could not accurately be described as ‘two-speed’ or ‘multi-speed’ but rather as a ‘variable geometry Europe.’”<sup>165</sup>

Édouard Balladur's vision of variable geometry saw a collective group of Member States (i.e. the founders) driving integration forward as an upper tier. The idea would be to

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<sup>163</sup> European Parliament General Secretariat DG for Research and Documentation ‘Two-Speed Europe’ Political Series No. 11 September 1985

<sup>164</sup> Ibid

<sup>165</sup> Ibid

incentivise other members to follow suit, but the core group would dictate the overall pace and direction of integration. This is analogous to previous discussion in this chapter concerning the democratic legitimacy of non-participating States joining any EU-ten Financial Transaction Tax agreed because of Enhanced Cooperation. Balladur's interpretation to a degree mirrors a multi-speed Europe ideology, but the reference to tiers indicates layers of integration not present in the multi-speed Europe analysis. In practice, Balladur's interpretation has been followed to a certain extent, for example, the six founding Member States have been the driving forces involved in the historical development of EMU. Although certain elements of EMU, particularly the European Monetary System, can be classified as examples of variable geometry in action, the EMU's previous elements of economic integration and ultimately EMU have now been incorporated as part of the Union's legal framework. Since the pragmatic solution afforded by variable geometry is an alternative framework, differentiation in this area is on the grounds of space and EMU cannot generally be considered as an example of variable geometry in spite of Balladur's interpretation.

### **8.3.1. Merits and Disadvantages**

The question regarding the suitability of using variable geometry to present a means by which to introduce a common Financial Transaction Tax is considered in greater detail later in this chapter, specifically in relation to the discussion concerning Heikki Patomäki's proposal for an international tax charged on financial transactions. However, it is necessary to discuss the general merits and disadvantages of variable geometry before considering its suitability to financial taxation and regulation.

Variable geometry is the earliest of the three theories of integration to be presented and therefore adequately reflects the practical reality that six core Member States founded the Union and were therefore more able to cooperate in policy areas than those acceding at a later date. Consequently, it has achieved political endorsement in light of its ability to

strike a balance between cooperation and individual choice. The rebuttal is that whilst variable geometry may have had a historically significant role, more modern theories, such as *à la carte* and multi-speed Europe, may be more appropriate when assessing EU measures adopted exclusively by EU Member States. In practice, variable geometry has at times acted as a stop-gap for certain policy areas. For example, the European Monetary System was superseded by Economic and Monetary Union, which forms part of the Union's legislative framework and is now primarily considered as an example of multi-speed Europe in action.

It is possible to conclude that one of the major advantages of variable geometry is that it appears to be a halfway house between multi-speed Europe and *à la carte*. Variable geometry differs from multi-speed, since it does not assume unanimity is possible in policy areas, but it is far less radical than *à la carte*, and is far more integrationist in nature, particularly when contrasted with the Major view of *à la carte*. Nevertheless, the question arises as to whether or not variable geometry leads to the 'best of both worlds' or merely incorporates the negatives of both approaches as outlined previously in this chapter. The compromise appears to be an effective application of pragmatism; Member States still wish to cooperate, but individual choice needs to be considered and therefore it is far easier to cooperate outside of the standard institutional framework at times.

Multi-speed Europe and *à la carte* theories can on occasion be naïve and fail to consider external pressures from outside of the EU and fail to fully consider context. Therefore, another particularly appealing aspect of variable geometry is its flexibility in recognising this pursuance of measures outside of the strict confines of the EU's institutional structure. This chapter later includes discussion of Heikki Patomäki's proposal to create a new Tobin Tax Organisation for cooperation in order to consider how his international relations arguments might inform the discussion on creation of a new common Financial Transaction Tax.

Since each of the presented theories come under the wider term of 'flexible integration', different degrees and concepts of flexibility are essential. The concentric circles model highlights fragmentation well in incorporating different layers. However, when applying the concentric circles model, policy areas may be deemed as relatively simplistic. Whilst visually it may be useful to invoke the analogy of the tiered wedding cake, this does not reflect the complexity or context of integration.

## **9. Case Studies**

The following case studies demonstrate high profile examples and how developments in each area can be interpreted as supporting each of these approaches. Often a particular policy objective may require more than a single approach, reflecting that a universal approach has not been agreed. This reflects the theme running throughout this chapter, that, in the absence of unanimity, there has often been a need to adopt pragmatic approaches that Member States and the Union have taken in introducing flexibility into EU policymaking. Often there are examples within policy areas of more than one type of classic differentiated integration. The advantages and disadvantages of each of these theories and their practical application in these case studies will serve to inform the overall conclusion with regard to the appropriate theory to advocate in order to adopt a Financial Transaction Tax. However, although these case studies concern sensitive policy areas, as detailed throughout this thesis, determination of tax policy is a distinctly sensitive aspect of the EU's legislative agenda. It is therefore arguable that a more bespoke form of flexible integration is required to introduce necessary reform in financial markets through taxation, i.e. that a combination of approaches may be an option to consider. This argument is developed in chapter 4 in relation to classifying financial regulation to ensure stability and decreasing volatility as a public good, with a regulatory pluralistic approach being required.

## 9.1. Economic and Monetary Union Integration via Multi-Speed

### Europe, à la Carte and Variable Geometry

EMU is particularly relevant within the context of this thesis, since the Euro area sovereign debt crisis has fuelled arguments that tax receipts attributable to a Financial Transaction Tax could be used to mitigate national deficits. Renewed impetus was given to European integration during negotiations for the Treaty of Maastricht, with EMU forming a key part of the larger forum of economic integration. There are six recognised degrees of economic integration with a differing set of requirements for each stage to be achieved, namely<sup>166</sup>:

- 1) Preferential trading area
- 2) Free trade area
- 3) Customs union
- 4) Single market
- 5) Economic and monetary union
- 6) Complete economic integration

At present, all stages up to and including the fourth requirement, establishment of the single market, have been achieved. Consideration has been given previously in this thesis as to the merits of the 2011 Proposal in advancing the internal market as a result. However, Full integration towards the fifth requirement, Economic and Monetary Union, has not been completed at the time of writing, although there have been significant steps towards its development.

Historically the Union has taken an incremental approach towards economic integration in this area due to a fundamental change in the aims of the Union to progress through each of these degrees of economic integration. Initially the aim was to build a customs union and a common market for agriculture. The remit expanded over time and the common

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<sup>166</sup> European Commission, 'Economic and Monetary Union' (*European Commission Economic and Financial Affairs*) <[http://ec.europa.eu/economy\\_finance/Euro/emu/index\\_en.htm](http://ec.europa.eu/economy_finance/Euro/emu/index_en.htm)> Accessed 6 April 2018

market was extended to include goods and services in a single market. Maastricht was an important step further in the process of economic integration, a clear indication from the Council that the Member States sought to achieve the fifth step in economic integration, which in addition to creating a single market sought to introduce a common currency and monetary policy.

EMU contributes to a greater degree of economic integration, since it is concerned with the coordination of economic and fiscal policies, a common monetary policy, and a common currency in the Euro. A key aspect of EMU however, is that there is no single institution which is entirely responsible for the coordination of economic policy. Rather, different institutions and Member States adopt differing roles in the process. Member States are responsible for setting domestic budgets within agreed limits in addition to determining structural policies concerning labour, pensions and capital markets.

Progression towards EMU can be divided into four distinct phases.<sup>167</sup> Phase 1 sought to achieve EMU by 1980, yet was characterised by the turmoil in international currency markets between 1968 and 1969, which prompted James Tobin's original tax proposal. Phase 2 was triggered by the publication of the Werner Report in 1970, signalling progression towards the EMS with Member States agreeing in principle to the first narrowing currency fluctuations. Again, this period was characterised by further currency instability and oil crises, until eventually the European Monetary System was launched in 1979, heralding phase 3 of EMU. The EMS was built on exchange rates defined with reference to a newly created European Currency Unit (ECU), a weighted average of EMS currencies. In addition, an Exchange Rate Mechanism (ERM) was used in order to keep participating currencies within a narrow band. EMS' success fuelled appetite for achieving

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<sup>167</sup> European Commission, 'The Road to EMU' (*European Commission Economic and Financial Affairs*) <[http://ec.europa.eu/economy\\_finance/Euro/emu/road/index\\_en.htm](http://ec.europa.eu/economy_finance/Euro/emu/road/index_en.htm)> Accessed 6 April 2018

EMU and consequently Delors initiated phase 4 of EMU in publishing a report seeking to address how EMU could be achieved. Delors proposed a timeline, accepted by the Member States at Maastricht, which culminated in the first issuing of Euro banknotes and coins.

## 9.2. EMU as Multi-Speed

Multi-speed Europe played a key role in ensuring the creation of EMU, particularly in relation to adoption of a common currency. A common currency overseen by a central bank can only work if participating Member States' economies and financial systems are deemed to be sufficiently similar. Therefore, there are a certain number of economic and social criteria that a Member State must fulfil before adopting the Euro as a currency.<sup>168</sup> These convergence criteria were agreed upon by Member States at the same time as the recommendations of the Delors report were accepted.<sup>169</sup>

At present, the 19 EU Member States have adopted the Euro as its currency, with seven of the remaining Member States obliged to adopt the Euro once they fulfil the convergence criteria. The vast majority of States legally required to adopt the Euro are States which acceded to the Union in 2004 and 2007 at a time when their economic policies were not sufficiently designed to coordinate with Euro area members. Therefore, in accordance with multi-speed Europe, time has been granted to them in their Treaties of Accession to allow them to make the necessary arrangements prior to adopting the euro. Currently, each of these seven Member States is classified as having its own individual 'derogation'. Article 140 TFEU prescribes every two years or at the request of the individual Member States

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<sup>168</sup> European Commission, 'Scenarios for Adopting the Euro' (Economic and Financial Affairs) <[https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/introducing-euro/scenarios-adopting-euro\\_en](https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/introducing-euro/scenarios-adopting-euro_en)> Accessed 6 April 2018

<sup>169</sup> A full list of the convergence criteria is available at ECB, 'Convergence Criteria' (*European Central Bank*) <<https://www.ecb.europa.eu/ecb/orga/escb/html/convergence-criteria.en.html>> Accessed 6 April 2018

the Commission and ECB can report to the Council on the progress made by the Member States to comply with the Euro area requirements.<sup>170</sup> Once a derogating Member State has fulfilled the criteria, the derogation is 'abrogated' by the Council and consequently the Member State adopts the Euro.

In recent years, adoption of the Euro has been a particularly contentious area of EU policy following sovereign debt crises and implementation of austerity programmes as a condition for financial support packages for Member States. The requirement for new Member States to adopt the Euro was particularly pertinent in the debate surrounding and leading into the Scottish independence referendum in 2014 in light of the Euro crisis: the Yes campaign stated that an independent Scotland would seek to accede to join the European Union and argued that a currency union to keep the Pound Sterling was possible, while the No campaign disputed this.<sup>171</sup> It is therefore possible to see that in applying a multi-speed Europe approach Member States that were able to proceed with adopting a single currency were allowed to cooperate, with concessions made to other states to join at a later date once able to fulfil certain criteria in order to achieve the fifth stage of economic integration.

### **9.3. À la Carte: Opting-Out of EMU**

There remain some Member States which have been able to exercise an opt-out from EMU and are therefore legally not obliged to adopt the Euro. Denmark and the UK have a formally recognised opt-out from the Euro negotiated as part of the Maastricht Treaty

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<sup>170</sup> European Commission, 'Who Can Join and When?' (*European Commission Economic and Financial Affairs*) <[https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/who-can-join-and-when\\_en](https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/who-can-join-and-when_en)> Accessed 6 April 2018

<sup>171</sup> See A Campbell, 'The Future of United Kingdom Monetary Union and Scottish Independence' (2013) 7(5) *Law and Financial Markets Review* 239

discussions based on preserving national sovereignty and are therefore not obliged to join the Euro area:

“All Member States of the European Union, except Denmark and the United Kingdom, are required to adopt the Euro and join the Euro area. To do this they must meet certain conditions known as 'convergence criteria'.”<sup>172</sup>

However, the UK and Denmark are open to annul their negotiated opt-outs and join at any time in the future should they wish to do so, provided they have also met the convergence criteria. From the UK perspective there was an indication of an underlying willingness to participate in the future during the entry into force of the Euro. The original opt-out was negotiated by Major's 1990-1997 Conservative government, but the subsequent Labour Party Chancellor, Gordon Brown, drafted a five stage test in 1997 which needed to be successfully answered in order for the UK to join the Eurozone, illustrating a will to cooperate, but at the same time exercising a certain degree of choice for the UK.<sup>173</sup> Denmark on the other hand was able to negotiate an opt-out thanks to the Edinburgh Agreement following a failed referendum on the Maastricht Treaty.

### 9.3.1. The *de facto* opt-out

Although legally required to join the Eurozone, Sweden is in a unique situation, highlighting how failure to adhere to the multi-speed Europe approach can lead to a Member State being able to exercise choice. Sweden has sought to avoid joining the Euro area and therefore has not fulfilled the requirements to adopt the Euro for two reasons. Firstly, in order to comply with the Euro area entry criteria, Sweden is required to alter its central banking legislation and secondly, Sweden has failed to participate in the voluntary

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<sup>172</sup> Supra n.170

<sup>173</sup> See P Howells and K Bain, *The Economics of Money, Banking and Finance: A European Text* (Pearson 2008) 500

Exchange Rate Mechanism (ERM II), an exchange rate mechanism established in January 1999, which is designed:

“To ensure that exchange rate fluctuations between the Euro and other EU currencies do not disrupt economic stability within the single market, and to help non Euro-area countries prepare themselves for participation in the Euro area.”<sup>174</sup>

Via this legislative loophole, Sweden has its own derogation, which can be described as a *de facto* opt-out. Yet unlike the opt-outs negotiated by the UK and Denmark, once these two criteria are met Sweden is legally required to join the Euro area. Once Sweden is certain that it wishes to participate it can choose to opt-in, rather than having a legal obligation imposed upon the national government.

#### **9.4. Variable Geometry: EMS as Precursor to EMU**

The EMS played an important role in the development of EMU. EMS aimed to create a zone of monetary stability. Once in effect the European Unit of Account, which had been used to express the monetary values of national currencies, was replaced by the European Currency Unit (ECU) to be used in the settlement of debts between monetary authorities. Laffan notes there were three primary reasons for the EMS' pertinence<sup>175</sup>, specifically that European states were not in favour of excessive fluctuations synonymous with this period of floating exchange rates, that high rates of inflation in European States undermined business confidence and furthermore that there was disillusionment with American leadership in the monetary field.

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<sup>174</sup> European Commission, ‘ERM II – The EU’s Exchange Rate Mechanism’ (*European Commission Economic and Financial Affairs*) < [https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/introducing-euro/adoption-fixed-euro-conversion-rate/erm-ii-eus-exchange-rate-mechanism\\_en](https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/introducing-euro/adoption-fixed-euro-conversion-rate/erm-ii-eus-exchange-rate-mechanism_en)> Accessed 6 April 2018

<sup>175</sup> B Laffan, *Integration and Co-Operation in Europe* (Routledge 1992)

As a result smaller States favoured monetary cooperation. Italy and Ireland were willing to cooperate in exchange for payments to facilitate adjustments. Britain opted to remain outside of the exchange rate mechanism of the EMS until 1990. Greece, Portugal and Spain remained outside of the EMS following accession. The EMS was disbanded in 1992 following currency crises such as 'Black Wednesday' in the UK. However, EMS has played a vital role in achieving EMU and the different levels of legal coordination can be illustrated as follows, using a diagram of concentric circles. With regard to the potential application to the Financial Transaction Tax, it demonstrates that with regard to economic policy it is possible to have different levels of integration whereby arrangements outside of the EU's legislative framework can later become concretised as EU Policy. However, there may need to be opt-outs offered if this is to be the case for a Financial Transaction Tax and in addition, there is no reason why the agreement cannot remain outside of the EU's institutional framework as long as participating Member States comply with their obligations under EU law:

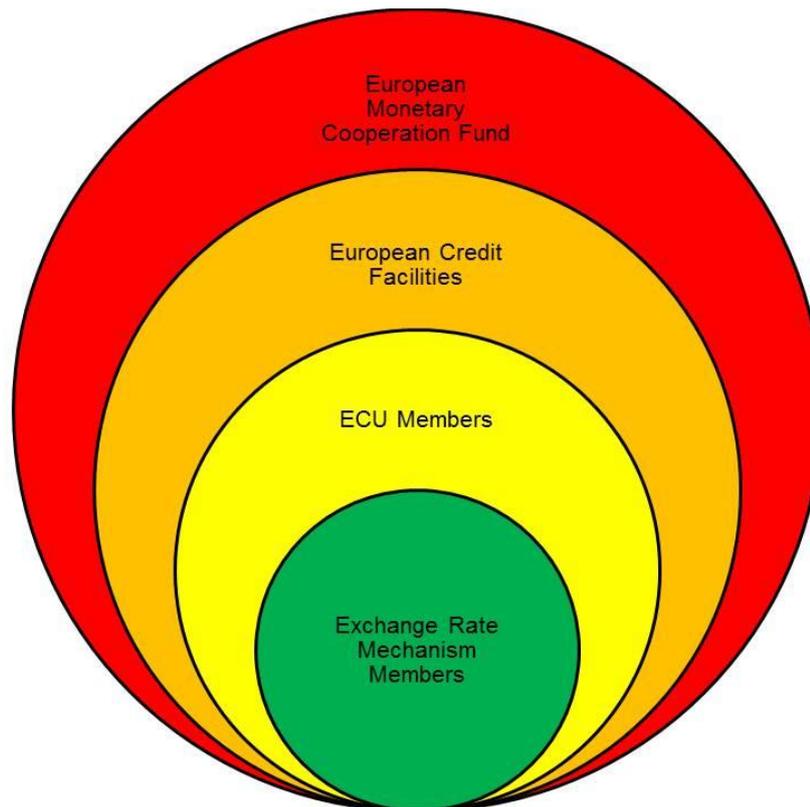


Figure 1. Diagram Illustrating Variable Geometry in European Monetary System Policies

Appendix B contains Stubb's classification of various examples of case studies which he considers as indicative of the classical theories of integration as detailed in this chapter in action, with a view to aiding classifying the most appropriate form of flexible integration to use to ultimately provide a public good of financial stability. The following section of this chapter discusses Stubb's classification of the Schengen Agreements as being an example of exclusively variable geometry in action. Although the section agrees with the conclusion that the Schengen Agreements are a strong example of variable geometry in action, it also differs in stating that there is evidence supporting an *à la carte* classification. Nevertheless, if the classification of Schengen as variable geometry is accepted, this also supports the case that following on from the EMS, the EMU too consists of elements of variable geometry. The preservation of a pre-existing arrangement is prevalent for the Euro outside of the Union's legal structure, a principle that is also recognised through the

UK and Ireland opt-outs from the Schengen agreement. The Euro is used as a *de facto* currency in Kosovo and Montenegro<sup>176</sup>, but not through the same monetary agreements as non-EU States such as Andorra and San Marino.<sup>177</sup> Prior to the entry into force of the Euro the German Mark was the *de facto* currency. An alteration in German currency therefore led to an automatic change in Kosovo and Montenegro. This specific aspect may be considered as illustrating variable geometry.

### **9.5. Schengen Agreements via Variable Geometry and à la Carte**

Free movement of persons was a fundamental freedom introduced to complete the internal market, however border checks remained in place, acting as a practical restriction to individuals' exercising of free movement rights. The debate concerning the meaning of free movement of persons resurfaced in the 1980s, with some Member States believing that that concept should apply solely to EU citizens. If this interpretation prevailed, then border checks would be necessary for the purpose of distinguishing between citizens of EU states and citizens of non-EU states. The alternative interpretation was that free movement applied to all, which would lead to the termination of internal border checks. Consequently, in 1985 in the Luxembourg town of Schengen, five Member States (France, Germany and the Benelux States) elected to create a territory without internal borders. This intergovernmental agreement led to a convention being signed in 1990, with obligations coming into effect from 1995. The Schengen agreement was incorporated into the EU's framework in 1999 thanks to a Protocol attached to the Treaty of Amsterdam.<sup>178</sup>

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<sup>176</sup> European Commission, 'The Euro Outside the Euro Area' (*European Commission Economic and Financial Affairs*) < [https://ec.europa.eu/info/business-economy-euro/euro-area/euro/use-euro/euro-outside-euro-area\\_en](https://ec.europa.eu/info/business-economy-euro/euro-area/euro/use-euro/euro-outside-euro-area_en)> Accessed 6 April 2018

<sup>177</sup> Ibid

<sup>178</sup> 11997D/PRO/02 Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts - Protocol annexed to the Treaty on European

On this assessment, it is arguable that the Schengen Agreement is potentially the most high profile example of variable geometry in action. Stubb states “the Schengen Agreements could be considered a good example of a conglomeration of states which pursue deeper integration within a separate integrative unit”<sup>179</sup> and continues to explain why he believes that Schengen should not be considered as an example of multi-speed Europe or *à la carte* theories in action. Under Stubb’s assessment the Schengen Agreements are outside of the common objectives established in the TEU. Stubb is correct to conclude that the Schengen Agreement is not a pure example of multi-speed Europe in action, but it is incorrect to state that this is because Schengen does not fulfil a Union objective.

Although Schengen is designed to facilitate free movement from the 1957 Treaty, the Agreements remain outside of the Union’s institutional framework and also clearly examine Europe as a continent as opposed to focusing solely on EU Member States since Norway, Iceland and Switzerland are included in the Schengen area. Clearly, this reflects that the alternative legislative framework that characterises variable geometry is in effect for the Schengen agreements.

Schengen seeks to guarantee free movement of persons by removing internal border controls and establishing one singular external border, applying a common standard of identical procedures upon entry into the Schengen area. Security within the Schengen agreement is established by the implementation of compensatory measures which include “improving cooperation and coordination between the police and the judicial authorities in

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Union and to the Treaty establishing the European Community - Protocol integrating the Schengen acquis into the framework of the European Union

<sup>179</sup> *Supra* n.1 at 292

order to safeguard internal security and, in particular, to fight organised crime.”<sup>180</sup> In order for a Member State to join the Schengen area, it must be prepared and have capacity to access the Schengen Information System (SIS) database. Before joining the Schengen area Member States undergo a process of evaluation by the Council in order to establish if they have fulfilled the ‘Schengen acquis’.

However, the Schengen Agreement remains a controversial policy area, particularly in the light of the recent refugee crisis.<sup>181</sup> Member States are able to temporarily re-introduce border checks in certain circumstances.<sup>182</sup> Once a visa is issued by one of the Schengen states an individual can travel freely within the Schengen area, which can lead to Member States expressing fear about potential migrants. For example, the Arab spring caused numerous individuals to flee to Europe. The arrival of these refugees caused political controversy, particularly in Italy which in spite of concerns expressed by other Schengen states (particularly France and Germany) elected to offer approximately 25,000 6 month entry visas to the refugees. In April 2011 France blocked trains of migrants heading from Italy for fear that migrants would remain in France.<sup>183</sup> This demonstrates that although the Schengen Agreement can be presented as a clear example of flexible integration, the overall policy is not immune from crises increasing pressure on Member States to seek to adopt means by which to suspend cooperation in accordance with national interests. By extension, in relation to tax policy, this indicates that a degree of flexibility in relation to

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<sup>180</sup> European Commission, ‘The Schengen Area and Cooperation’ (*European Commission Summaries of EU Legislation*) <[http://europa.eu/legislation\\_summaries/justice\\_freedom\\_security/free\\_movement\\_of\\_persons\\_asylum\\_migration/133020\\_en.htm](http://europa.eu/legislation_summaries/justice_freedom_security/free_movement_of_persons_asylum_migration/133020_en.htm)> Accessed 6 April 2018

<sup>181</sup> See for example C Fijnaut, ‘The Refugee Crisis: The End of Schengen?’ (2015) 23(4) *European Journal of Crime, Criminal Law and Criminal Justice* 313

<sup>182</sup> For example, Germany re-introduced checks for the 2006 FIFA World Cup. See Euromove, ‘The Schengen Area’ (*Euromove*) <<http://www.euromove.org.uk/index.php?id=18538>> Accessed 6 April 2018

<sup>183</sup> Ibid

Member State choice should be factored into the design of a legislative process, but with incentives to continue to participate in order to continue to provide a public good of financial stability. This flexibility is reflected in the Common Finance Policy proposed later in this thesis.

There remain some Member States which are not part of the Schengen agreement. Some Member States have not satisfactorily fulfilled the Schengen *acquis* requirements, although there appears to be less of a deliberate act than Sweden's refusal to enter ERM II. However, there are certain formal opt-outs in place which further exemplify an *à la carte* approach to European integration. The UK and Ireland have an opt-out in order to preserve the pre-existing Common Travel Agreement between the two States. In addition, Denmark has a negotiated clause for matters within Title IV of the TFEU. Denmark can exercise individual choice in these matters and decide whether to adopt measures in this area, including the Schengen *acquis* via Protocol.

The position of the UK, Ireland and Denmark on Schengen also introduces the notion of opting-in to provisions. This further concretises the idea that *à la carte* integration includes a positive choice as envisioned by Dahrendorf as opposed to a more purely exclusionary view. Denmark has signed the Schengen agreement and is therefore bound by certain measures under the common visa policy. Furthermore, both the UK (1999) and Ireland (2000) requested to incorporate elements of the Schengen *acquis*, more specifically police and judicial cooperation in criminal matters, counter drug measures and access to SIS. These requests were approved by Council decisions.<sup>184</sup> The freedom to opt-in or out of particular fields of cooperation within the full Schengen *acquis* indicates that *à la carte* is based fundamentally upon choice.

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<sup>184</sup> Council Decisions 2000/365/EC; 2002/192/EC and 2004/926/EC

The requirement to fulfil certain conditions before participating in the Schengen area may be deemed indicative of support for the multi-speed Europe theory of integration. Over time, the number of Member States which have agreed to and comply with the Schengen provisions has increased, with the majority of states indicating at least willingness to participate in the process. Yet, unlike the adoption of the Euro within EMU Member States are not legally required to join the Schengen agreement. Therefore, in this case, the absence of a legal obligation, but a majority collective of Member States electing to cooperate nevertheless, supports Dahrendorf's vision of *à la carte* integration, that a group of Member States will cooperate to form common provisions, as opposed to a multi-speed Europe classification.

An *à la carte* approach resulting in legally recognised opt-outs in this area, whilst not ideal, in accordance with the spirit of the Rome Preamble and in the absence of a legal requirement to cooperate, afforded the European integration project appropriate pragmatic solutions. The UK and Ireland Common Travel Arrangement pre-dated Schengen and would have unfairly created a clash of legal norms. Denmark obtained the opt-out as a concession to the failed referendum on the Maastricht Treaty at the signing of the Edinburgh Agreement; to not have offered the concessions would have meant drafting a new Treaty from scratch.

In contrast to this assessment, Stubb states Schengen cannot be considered *à la carte* integration mainly because they are forms of opting-up/in, as opposed to opting-down/out. For the aforementioned reasons this is a restricted assessment of what can constitute *à la carte* integration. The common theme throughout this thesis is that *à la carte* implies choice – Member States have had a choice to opt-out or to opt-in with regard to Schengen. The choice need not be positive or negative. Furthermore, Stubb's seminal article, while providing an invaluable blueprint as to how to classify theories of flexible integration was written prior to the UK and Ireland opting into certain provisions, such as the SIS in the

Schengen Agreements. These opt-ins have created different layers of integration. Bizarrely it can be concluded that if Schengen is truly an example of variable geometry in action, it is thanks to the choice provided by *à la carte* methods of integration.

## 10. Potential Negatives of Differentiated Integration

The aims of the aforementioned mechanisms of integration are to facilitate widening and deepening of the Union. Within the context of this thesis, differentiation is portrayed as a positive solution in order to achieve legislative accord in the area of financial stability, rather than a negative consequence of a failure to achieve consensus. Some empirical studies have shown that in the areas of Schengen and the EMU that the use of multi-speed and *à la carte* may have the desired deepening effect. However, this does not necessarily translate across all areas of Union competence. The particular case studies presented have been selected in order to highlight how flexible forms of integration have been established as pragmatic and workable in particular situations. Yet there are several potential problems with differentiation relative to uniform integration. As Junge states:

“Most of the scepticism against differentiating the European integration process is based on the fact that it appears to undermine some of the fundamental principles that have long underpinned the European integration process:

- The gradual process towards ever closer union;
- The principle of solidarity among EU member states;
- Non-hegemonic (consensual) decision-making;
- Democratic decision making.”<sup>185</sup>

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<sup>185</sup> *Supra* n.39 at 398

In assessing European integration, the phrasing of the Rome Preamble is pertinent. This sought a gradual transfer of power to achieve the goal of ever closer union, a paradigm which is effectively challenged by flexible forms of integration, in particular Enhanced Cooperation, *à la carte* and variable geometry, which prescribe permanent differentiation based on individual choice as opposed to collective action in the best interests of 28 members.

The probability of overuse of differentiated integration means that there is unavoidable fragmentation and as a consequence, the EU may break into consisting of a series of sub-systems, rather than having the envisioned collective identity. Throughout this chapter there has been reference to two-tier Europe, the likelihood is that if Member States are unwilling or unable to agree to common provisions there would be several tiers, which would be difficult to repair even if there were a change in attitude, such as a change in national government or a fundamental alteration in economic factors.

There is also a question of democratic legitimacy of decisions and policies adopted via flexible integration. Naturally, more integration inclined Member States will be involved in the negotiation and drafting stages of a particular measure. By way of example if the Member States participating in the Financial Transaction Tax negotiation were to agree to a provision and another Member State elected to participate at a later date, they would effectively have had no input into the design of the tax without reform. States which elect to join at a later date, whether in the multi-speed, *à la carte* or variable geometry model, have little choice but to comply with what has previously been decided, meaning they become decision takers instead of decision makers, although the counter to this is that States are expected to conduct due diligence before adopting measures.

In the standard legislative procedure Member States participate in the drafting and adoption of legally binding measures, yet the democratic deficit question remains. The democratic deficit gap is widened if Member State governments are therefore unable to

be held fully accountable for the differentiated policy in question. Allied to this is the idea that larger Member States dictate the will of smaller Member States in differentiated policy areas. Therefore, instead of creating merely a multi-tier system, the issue becomes one of a multi-class system. This to an extent is clear in the Tugendhatd assertion that more economically capable Member States would support less capable States to adopt measures via multi-speed Europe, but is exposed particularly when using *à la carte* and variable geometry models.

The final point is that if a Member State objects to a particular policy or decision, there is an underlying rationale to said objection. From a quality control standpoint, apparent sheer stubbornness on the part of a particular Member State may be confused with legitimate concerns about the quality of draftsmanship in the best interests of the collective 27/28 Member States as opposed to preserving its own interests. A particular Member State may actively agree with a particular objective but have identified potential national or union wide issues. In theory these objections should be fleshed out in the negotiation stage, yet how a group of states perceives another's objection cannot be guaranteed in advance.

## **11. Heikki Patomäki: The Creation of a New Tobin Tax**

### **Organisation**

In previous chapters, this thesis has indicated that Heikki Patomäki's 2001 work<sup>186</sup> from an international relations perspective, advocating a new international organisation, the Tobin Tax Organisation. Patomäki's argument pre-dates the 2008 financial crisis, with currency crises, such as the Mexican crisis in 1994/95 living in recent memory.<sup>187</sup> Early in the book,

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<sup>186</sup> H Patomäki, *Democratising Globalisation: The Leverage of the Tobin Tax* (Zed Books 2001)

<sup>187</sup> See for example M Damill et al, 'Financial and Currency Crises in Latin America' in M Wolfson and G Epstein (eds) *The Handbook of the Political Economy of Financial Crises* (Oxford University Press 2013)

he explains that his arguments focus primarily on Forex markets (i.e. currency markets), but states that similar arguments can be made with regard to bonds and share markets, since financial markets are inseparable.<sup>188</sup> Although not referred to in the book as such and ultimately the design of the final tax differs substantially from the 2011 Proposal, the central conclusions reflect a hybrid approach of both the variable geometry and multi-speed forms of flexible integration as outlined in greater detail later in this section. Certain elements of the approach have merit and can provide a valuable insight from a more political perspective regarding adoption of at least some form of taxation on speculative financial transactions, highlighting that there is a potential for crossover in academic discussions. However, the book attempts to use the tax primarily as a form of democratising finance by elevating the standing of less financially developed States, which is not a consideration that this thesis undertakes.

Much of the book is predicated on the view that the deregulation of financial markets, in a drive to create new liberalised service based economic models, had created instability and volatility. To support this assertion, Patomäki estimates, based on 1995 OECD data<sup>189</sup> that currencies since the 1970s have become three times more volatile. Emphasising the need to move away from a deregulated system, he continues and states:

“As a response to the financial crisis, it has been realised that markets have to be governed by appropriate rules in order to exist and function properly. Hence the attempt to re-regulate the recently liberalised financial markets.”<sup>190</sup>

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<sup>188</sup> *Supra* n.186 at 2

<sup>189</sup> M Edey and K Hviding, ‘An Assessment of Financial Reform in OECD Countries’ (1995) OECD Economics Department Working Papers 154, OCDE/GD(95)60

<sup>190</sup> *Supra* n.186 at 8

One of the most striking points to draw from the above quote is that, although written seven years prior to the 2008 financial crisis, its core argument continues to be applicable to post-2008 discussion; financial markets are not regulated to a high enough standard to enable them to be governed effectively. The book also recognises concerns about the projected volume of trading, forecasting that by 2010, 15 per cent of the world's GDP value would be traded in Forex (Foreign Exchange Markets) per day, meaning the equivalent of global GDP would be traded within seven days.<sup>191</sup> This reflects not only Tobin's original concerns, but also reflects the Thomas Lin discussion regarding algorithmic and High Frequency Trading in chapter 1.

Patomäki argues that there are two ways in which to assess financial crises after the fact. Either there is blame on the individual institution (i.e. victim blaming) or the overall system can be criticised.<sup>192</sup> A free market economist would focus on the former approach, with the 'invisible hand' correcting the marketplace as a result of poor oversight on the institution's part. However, a more Keynesian economist would adopt the latter approach. Regardless of the approach taken, there is great difficulty in identifying dangers in financial markets until bubbles burst and have an adverse economic effect. This can to an extent lead to advocacy after the fact. For example, if X had not happened, would we have known that Y was a weakness? Krugman warned of 'twenty-twenty hindsight', stating that:

“Now that we know that Japan and Korea have experienced a devastating economic setback, we start to imagine that we always knew that they had feet of clay.”<sup>193</sup>

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<sup>191</sup> Ibid at 5

<sup>192</sup> Ibid at 18

<sup>193</sup> P Krugman, *The Return of Depression Economics* (Penguin 1999) at xii-xiii

Allied to this statement is that historically, reforms have been adopted following financial crises, yet these only work until the next financial crisis and which arguably mask States from undertaking substantial reform to neoliberalist models. In other words, thus far in the history of financial regulation, regulation has not been bold enough.

Patomäki therefore proposes the introduction of a new, global Tobin tax through the formation of a supranational organisation, the 'Tobin Tax Organisation', reflecting a variable geometry method of integration (the creation of an agreement outside the EU legal structure) and presents two different models, both of which adopt a two-phase process, reflecting a more multi-speed approach. In both versions of the tax, he argues that the States of the Economic and Monetary Union instigate the process along with a group of other likeminded States, with an agreement to continue to invite other States to participate.

Version A<sup>194</sup> in phase 1 would introduce an underlying transactions tax of up to 10 basis points, with the bank within the Tobin Tax area paying the full amount when transacting with a counter party outside of the area. There would also be a tax of up to two per cent on domestic-currency lending to non-domiciled actors and up to 25 per cent tax on any capital outflows and inflows to and from non-co-operative tax havens. Version B contains the same elements in phase 1, but with the including of an exchange surcharge triggered by exceptional changes and the formation of a global intervention fund to stabilise exchange rates. For version A, phase 2 establishes a universal and uniform Tobin Tax at a higher rate when all major financial centres and most other countries have joined phase 1. For version B<sup>195</sup>, phase 2 would keep the exchange surcharge, a punitive tax against tax havens and the Global Intervention Fund. The design is different from the 2011

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<sup>194</sup> *Supra* n.186 at 157

<sup>195</sup> *Ibid* at 163

Proposal, however, what is also noteworthy is the recognition that a gradual approach needs to be taken and to not adopt all provisions in a 'big bang' scenario as the 2011 Proposal envisaged.

This organisation would consist of two parts, the 'Council of Ministers', acting as the main decision making body, with all participating governments represented and weightings based on population. These powers would be checked by the 'House of Democracy', which would have the right to set motions, control the budget and have a qualified veto right.<sup>196</sup> The stated example breakdown for a House with 600 seats is for 350 seats to represent national parliaments, weighted in accordance with population size, and 250 seats for representatives of civil society.<sup>197</sup> This would include labour unions and other NGOs who would apply for a seat and go through a screening process to determine independence and popularity of their respective bases. The clear emphasis in the structure is on creating a platform for a democratic discussion of issues of taxation in financial matters. Although for the 2011 Proposal there was an impact assessment, which discussed options for taxation with businesses, the Union framework does not incorporate civil society into the legislative process in this manner.

Patomäki favours the introduction of a Tobin style tax for a number of reasons. Firstly, he subscribes to the socio-economic consequences of financial crises, stating "even in the case of apparently quick recovery or stabilisation, financial crises tend to have far-reaching socio-economic consequences."<sup>198</sup> In addition, the preface discusses the Tobin Tax as a form of development financing. This was the same starting point used by the Commission before drafting the 2011 Proposal yet there are divergences. Principally, Patomäki adopts

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<sup>196</sup> Ibid at 203

<sup>197</sup> Ibid

<sup>198</sup> Ibid at 29

a more philanthropic view of the proposed Tobin Tax as raising global funds, with 30 per cent of revenues allocated to OECD States, 60 per cent of revenues to other States and 10 per cent to the central fund of the Tobin Tax Organisation.<sup>199</sup> This is in stark contrast to the 2011 Proposal, which allowed national treasuries to keep all revenue they collected as opposed to redistribution from a central fund in a fiscal federalism model. This thesis primarily argues that the revenue raising side of this tax is not the primary aim, rather the policy itself should disincentivise risk in order to provide a long public good over short-termism. However, in attempting to demonstrate the potential incentives for States to participate, Patomäki does discuss funds being required for economic, social and ecological problems<sup>200</sup>, which although they have become increasingly transnational, does not feature in Tobin's original 1978 Article. Furthermore, version B of phase 1 does expressly state 'punitive'. This thesis argues that other mechanisms, such as clawback and malus are the punitive methods which should be adopted, but that (when extended to the 2008 crisis and at the time of writing) introducing a tax 10 years after the event to punish a sector is disconcerting in the least.

This thesis is critical of framing and classifying the introduction of new reforms to the financial sector in fairness, since it distorts debate away from underlying economic arguments, to a more political classification of 'fairness'. This thesis is therefore critical of Patomäki's second stated reason for supporting a form of Tobin Tax. Patomäki argues that there are moral justifications to determine whether or not financial markets are fair, ultimately using John Rawls' *Theory of Justice*<sup>201</sup> in his assessment. He indicates ultimately

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<sup>199</sup> Ibid at 204

<sup>200</sup> Ibid at 123

<sup>201</sup> Rawls' concept has been revised and updated several times. For first publication, see J Rawls, *A Theory of Justice* (Harvard University Press 1971)

that financial markets are unfair, stating that the gamble made by many institutions is “heads I win, tails the taxpayer loses.”<sup>202</sup> Under this characterisation, bail outs are unfair. He also highlights that classically, financial market dominance has been used by developed States, such as the United States, in order to act as a quasi-foreign policy tool to advance American aims. As a result, he argues that better and more just economic policies can be adopted by reducing powerlessness and vulnerability among individuals by including civil society in his model. Furthermore, he considers there to be great emancipatory potential for developing States, giving a seat at the table to all States that participate in the Tobin Tax Organisation. Yet it is possible to argue that the design of the organisation’s Council of Ministers does not differ that greatly from the EU’s framework. Voting weights and the number of MEPs are both contingent on the population size of Member States. For a hypothetical Tobin Tax Organisation, there is one specific aim as opposed to the economic and social areas in which the EU has sovereignty, but similar issues in terms of unanimity and qualified majorities may arise.

However, there are real positives in Patomäki’s work, which could influence the process towards a common form of Financial Transaction Taxation in the EU. The graduated approach, based on targeted goals is not present in the 2011 Proposal. Discussion of how temporal slowness can help to introduce sensitive tax policies is discussed in the following chapter, but Patomäki’s proposals reflect the major criticisms in this thesis of the 2011 Proposal. In addition, Patomäki does not present his tax as a panacea. In the preface of *Democratising Globalisation*, he states that it is merely the tip of the iceberg in regulating financial markets. This thesis recognises that the 2011 Proposal had its limitations and could not cure all ills. There is no reason why a well-designed Financial Transaction Tax as the immediate check on speculative trading could not operate alongside bank levies as

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<sup>202</sup> Ibid at 125

a longer-term check on risk exposure and a form of VAT to recover funds from financial institutions. There is also an implied recognition that if there is a consensus beyond EU States, the variable geometry method of integration is a possibility, if not a probability.

When considering a variable geometry centric approach in this area, a new organisation needs to be established, creating further complications. The thesis thus far has centred principally on the economic arguments concerning the introduction of a common Financial Transaction Tax, with almost exclusive emphasis on introduction within the EU's institutional framework. For example, it should be recalled when discussing the 2011 Proposal in chapter 1 that it would be for Member States to apply a minimum tax rate, that national treasuries were to collect tax receipts and that Member States would individually determine how to allocate any funds raised by the tax. However, if a variable geometry model were followed, which sought to include the cooperation of non-EU states, practical considerations are raised, which would need to be agreed upon independently of economic arguments supporting a tax. Applying Patomäki's concerns, these include, for example, the location of the Tobin Tax Organisation's headquarters, determining the exact structure of the organisation, its decision making process, surveillance and enforcement mechanisms for non-compliance for businesses and States, and how to provide technical support to all members. At present, as the Enhanced Cooperation processes negotiation process indicates, underlying political will is one thing – it is another entirely to design a tax base acceptable to all participating States, particularly if Patomäki's stated allocation of funds is subscribed to as a primary rationale. The economic arguments still need to be made regarding support for a common Financial Transaction Tax, but political support must be deeply entrenched in order to proceed to these practical considerations.

In addition, Patomäki discusses the possibility in phase 2 for the Tobin Tax Organisation to be subsumed by another international organisation. On the one hand, the IMF has technical expertise and is a well-established institution. However, Patomäki is of the view

that the IMF subscribes to the 'Washington Consensus', and in the requirement to fulfil the stated objective of emancipation of States, the IMF is poorly placed. Instead, he looks towards the United Nations in its capacity as a truly universal organisation, recommending that the functions of the Tobin Tax Organisation either are incorporated into the remit of an Economic Security Council or form part of the existing Economic and Social Council (ECOSOC).<sup>203</sup> Ultimately, instead of stating that the tax could be administered by the IMF as Tobin had done, Patomäki advocates that the objectives of a Tobin Tax Organisation would be best served in by being incorporated into a reformed ECOSOC, with an Economic Security Council being a marginally less favourable option. Nevertheless, he does acknowledge that the chances of democratising the UN are slim, placing greater importance on the timeline for phase 1. He does not consider the EU's Economic and Finance Committee undertaking these functions. However at the time of writing, Enhanced Cooperation had not been used in the EU, there were 15 States instead of the current 28 Member States and in addition, the emphasis was on including Member States, particularly in Latin America, who had been hardest hit by the currency crises of the 1990s.

Fundamentally, the aim to create an international organisation does advance the debate and it is particularly accommodating to include an international relations perspective as opposed to fixing exclusively on finance, tax and economics literature. These have not framed a tax on speculation as a form of enhancing democracy by including civil actors and, in addition, Patomäki's work recognises the need for there to be a graduated approach, which was lacking in the 2011 Proposal.

Still, again the discussion concerns the amount of money to be levied by the proposed tax and its subsequent functions which may provide public goods, as opposed to the practical

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<sup>203</sup> Ibid at 205

effect of the tax on financial markets to decrease volatility in accordance with Keynesian economics in order to create the long-term public good of dissuasion from systemic risk. The following chapter therefore examines this concept of public good in greater detail in tandem with the requirement for a graduated approach through the theory of 'temporal slowness'.

## **Chapter 4 – Starting From Scratch? Correcting Flaws to Encourage Integration**

The previous chapters have examined the context behind the 2011 Proposal and the concept of flexible integration. It would be possible to conclude from the content of these chapters that the 2011 Proposal is the only means by which to consider the adoption of taxation on financial transactions. In other words, could the 2011 Proposal, in the face of all of the legislative and political difficulties it has faced, be re-worked and nuanced in order to encourage integration? The previous three chapters explain not only why a common form of transaction tax should be encouraged, but also explains the legal obstacles that the Proposal has encountered. Yet these chapters have not in themselves presented a criticism of the process that the European Commission elected to follow in its attempts to introduce the tax.

This thesis states that there are two key faults with the 2011 Proposal which need to be addressed, particularly if the current process, characterised by the use of the Enhanced Cooperation mechanism, fails to implement any form of common Financial Transaction Tax. Similar considerations also factor in to other financial regulation provisions at EU level, for example, prudential supervision principles and capital adequacy requirements. They may also be particularly pertinent to other tax measures agreed at EU level, although in general (i.e. bar bank levies and financial transaction taxes), tax regulation is distinct from financial regulation. The previous chapters have failed to address these faults thus far, since they have focussed primarily on the underlying principles of integration in financial matters and how to proceed in the light of the 2011 Proposal. Ultimately, this chapter argues that a change in approach could long-term create a more sustainable

financial sector, combining elements of the 2011 Proposal with other financial regulation measures and the concept of public goods.

This thesis is clear in its support for the basic concept of a tax on speculative trading, primarily on the basis of curbing volatility, as opposed to raising revenue. The purpose of this chapter therefore is to assume that, in order for at least some form of European-wide consensus on taxing the financial sector to exist, with an aim of limiting excessive risk, there has to be a change in approach, with the current situation being unsustainable. Not only do these faults with financial markets, which led to the 2008 crisis, need to be identified, it is also necessary to explain how to address these faults, in order to inform policymakers how to alter the methods by which they seek to progress away from past mistakes. This change could mean wholesale redrafting of Proposals, or more minor changes, which either reduce the immediate impact or the overall scope of a tax. At the time of writing, a common form of taxation has not been adopted. If it is the case that the 10 Member States participating in the Enhanced Cooperation Procedure adopt a common Financial Transaction Tax, then this chapter has an element of hindsight, demonstrating an alternative approach to foster greater cooperation, whilst introducing radical change to the culture of financial investments post-2008.

This thesis states that the 2011 Proposal's first flaw was the manner in which the tax was framed, which led to misinformation about the tax's motives and the scope of its application when being openly discussed. This, to a degree, has been augmented by several terms mistakenly being used interchangeably. Campaign groups, such as the Robin Hood Tax group, have presented variants of financial transaction taxes which have a philanthropic rationale, whereas others, such as the IFS report in chapter 2, view the tax as a means of funding the EU institutions directly. This thesis argues that, since the underlying principles of a common Financial Transaction Tax are rooted in Tobin's currency tax, the Commission's Financial Transaction Tax should primarily have sought and stressed long-

term stability, by dissuading risk and modifying investor behaviour. Although technically funds are attributable to the tax, the 2011 Proposal forecasted a 0.5 per cent decrease in EU wide GDP. This 0.5 per cent decrease, when combined with the founding principles of Tobin's tax, emphasise that the primary rationale cannot be on fundraising. Furthermore, the Proposal stated that it would be for national treasuries to collect funds, which they could allocate however Member State governments deemed appropriate. The funds could be used, for example, to finance the contributions of Member States in order to pay for their EU budgetary responsibilities, and therefore indirectly provide funds for the EU. Claims that the Proposal is philanthropic in nature or acts as a new stream of financing for the European Union institutions distort the core economic rationale for a common Financial Transaction Tax, exacerbating the 'identity crisis' that the 2011 Proposal faced.

In other words, the Commission failed to successfully convey the fundamental reasoning to introduce a Financial Transaction Tax to its audience, instead allowing the debate to centre on fairness, fundraising and historical non-application of VAT to financial services, as opposed to an essential alteration of conduct and decision making in investments. The first part of this chapter considers how to address the issue of the framing of the tax to incentivise regulatory intervention, by examining the literature concerning public good theory, with various examples of how to classify an activity as a public good, methods of raising the level of public good provided and tying it to constitutional and regulatory pluralism for legal authority.

The second fault that this thesis identifies is that the 2011 Proposal was far too ambitious in outlining a widespread tax to be introduced in one fell swoop in 2014. This may have been as a result of increasing political pressure to be seen to respond to the financial crisis in an authoritative manner. The 2011 Proposal clearly generated much debate and achieved widespread approval of 65 per cent support from individuals in a Eurobarometer

survey.<sup>1</sup> By nature, the burden of the tax is not perceived to fall on individual high street consumers, but instead to banks and investment organisations. The backlash from financial institutions has indicated that the tax was seen as several steps too far, even though certain existing elements of the tax (i.e. stamp duty on share transactions in the UK) were included in the 2011 Proposal. The behaviour and decision making which led to the 2008 financial crisis was in need of urgent reform, but not rushed reform. The aim has to be to create sustainability. Therefore, the second part of this chapter addresses the criticism of the Commission being too forthright in its ambition, by recasting the 'parable of the warm frog' to have a positive impact, as opposed to being viewed as a means by which to explain a creeping threat. It draws on the example of the Common Consolidated Corporate Tax Base (CCCTB) to support the assertion of a gradual approach being beneficial in the long-term.

## 1. Public Good Theory

Public good theory is becoming increasingly recognised in international law scholarship as a means by which to provide legitimacy and incentives for legal agreements and allocation of government resources to socially advantageous projects. It a mechanism by which it is possible to demonstrate, provided that certain criteria are met regarding the benefits of a particular endeavour, that intervention is either necessary or desirable. This concept of a common benefit for individuals being derived from government action has strong historical foundations. For example, Adam Smith wrote of goods which "though they may be in the highest degree advantageous to a great society are, however, of a nature that the profits could never repay the expenses to any individual or small number of individuals, and which

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<sup>1</sup> European Parliament Eurobarometer (EB Parleментар 75.2) Summary of 22 June 2011. Available at [http://www.europarl.europa.eu/pdf/eurobarometre/2011/juin/22062011/eb752\\_financial\\_crisis\\_analytical\\_synthesis\\_en.pdf](http://www.europarl.europa.eu/pdf/eurobarometre/2011/juin/22062011/eb752_financial_crisis_analytical_synthesis_en.pdf)

it therefore cannot be expected that any individual or small number of individuals should erect.”<sup>2</sup> The theory recognises the need for government intervention in select areas. The greater the degree of intervention required in a particular area, the greater the amount of resource allocation and thus expenditure justifiable. Therefore, if a fundamental public good can be demonstrated, then even those from a more libertarian background cannot object to governmental intervention. This thesis argues that, due to the widespread influence of financial markets to individuals, as demonstrated by the 2008 crisis, there is a common benefit in regulating to limit volatility in investment markets and fostering sustainability in banking practice. In order to convey this argument, this core concept needs to be adapted and updated from the Adam Smith iteration, in order to demonstrate how governments can regulate to facilitate the development of a common benefit.

Public good theory was extended to economic thinking by Paul Samuelson<sup>3</sup> and later applied to political science by Mancur Olson.<sup>4</sup> The previous chapters have outlined the legal bases for flexible integration. Within the context of this thesis, public good theory can be used to argue not only whether there is a requirement for EU wide intervention in regulating the financial sector, but also the degree of intervention required in order to achieve its aims, taking into account the principle of subsidiarity and the provision of local public goods. Public good theory can be complementary to flexible integration as outlined in the previous chapters and, in particular, the ‘weakest link’ assessment, discussed later in this chapter, echoes similar ideas to the ‘race to the bottom’ discussion in chapter 3.

In order for this to be successfully applied, it is necessary to determine how to classify activities, items, objects and projects as public goods. In order to be considered as a public

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<sup>2</sup> A Smith, *The Wealth of Nations* (First Published 1776, Wordsworth 2012) 721

<sup>3</sup> P Samuelson, ‘The Pure Theory of Public Expenditure’ (1955) 36 *Review of Economics and Statistics* 387

<sup>4</sup> M Olson, *The Logic of Collective Action* (Harvard University Press 1965)

good, two characteristics must be present: non-rivalry and non-excludability. This thesis advocates that ensuring a stable financial sector through the introduction of a Financial Transaction Tax produces a result, or externality, which is both non-rival and non-excludable. This in turn leads to the conclusion that regulating to introduce the tax creates a public good of stability, which differs from the rationale that a tax is philanthropic in nature or funds EU institutions directly.

### **1.1. Non-Rivalry of Consumption and Indivisibility of Benefits**

The core concept of non-rivalry is that provision of the good provides a common benefit, which does not exclude individuals from deriving benefit from its provision. In contrast, goods which are rival in nature present cases of 'perfect divisibility', when consumption of the good prevents others from deriving a benefit from it. This can apply to many kinds of everyday goods, including fuel and food. Once a particular fuel, for example a piece of coal, has been burned it is not possible for the same fuel to be burned by others. Likewise, once food has been eaten, it is not possible for someone else to eat the same individual piece of food. As a result, an individual piece of food, for example, cannot be a public good. However, there is a debate that a consistent supply of food is a public good.<sup>5</sup>

Instead, public goods consist of 'imperfect divisibility'. Goods can be considered to be non-rival or indivisible when a unit of the goods can be consumed by one individual without detracting, in the slightest, from the consumption opportunities still available to others from the same unit.<sup>6</sup> In other words, this means that once the good has been used by one

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<sup>5</sup> For a discussion of the impact of public goods in agriculture and sustainable food supply, particularly post-Brexit, see D Helm, 'British Agricultural Policy After Brexit' (1<sup>st</sup> September 2016) Natural Capital Network Paper 5 and T Cooper et al, 'The Provision of Public Goods Through Agriculture in the EU' (Institute for European Environmental Policy, 2009)

<sup>6</sup> R Cornes and T Sandler, *The Theory of Externalities, Public Goods and Club Goods* (Cambridge University Press, 1986) 6

individual, others are also able to derive benefit from the same good. In terms of policies and international agreements, nuclear deterrence systems provide a sound example of a non-rival good. The good of deterrence does not diminish as more allies join an alliance and share in the benefit of threat based protection. As a result, it can be stated that strategic nuclear weapons programmes yield non-rival benefits. This can also be seen in other goods, such as pollution control devices, weather monitoring stations, disease-eradication programs, crisis-warning monitors and information dissemination networks.

Furthermore, goods can be classed as excludable and non-excludable. Goods whose benefits can be withheld without further cost by the owner or provider of the good display excludable benefits. Benefits which are available to all once the good has been provided are non-excludable. For example, firework displays, pollution control devices and street lighting, present non-exclusive benefits, since it is extremely difficult, if not impossible, to exclude individuals from the benefits provided. This may mean that individuals are unable to withdraw from the 'benefits' of a good. For example, if a free public music concert is provided in a park, surrounding residents may be unable to avoid the music if they wish to do so.

In contrast, it is possible for certain goods to produce excludable benefits for individuals. Primarily this relates to property, for example if a workplace provides secure bicycle storage for its employees, the storage can only be accessed and used by employees who have a key to the storage area, excluding the general public from enjoying the benefit. In this case it can be stated that the bicycle store is a private good. In these circumstances, there may still be an incentive for the private institution to provide the facilities, but government intervention is not required.

## 1.2. Classification of Goods

With these criteria in place, it is possible to classify goods accordingly, although there has been criticism from authors, such as Margolis, that it may be difficult to find situations that precisely fit the model.<sup>7</sup> In its simplest form, pure public goods are non-rival and non-excludable in nature, whereas a private good is fully rival and excludable.

Yet often there are examples of between points, which may lead to impure goods. For example, at the time of writing, the toll booths at the Severn Bridges (the 'new Severn Bridge' along the M4 and the 'old Severn Bridge' along the M48) have been removed. The bridges allow motorists to cross the River Severn between England and Wales, saving motorists a large amount of time. However, when the toll booths were in effect, the direction of travel for the motorist resulted in a different classification of the good provided. Motorists travelling eastbound towards England never had to pay the toll. This fulfils the criteria for a pure public good: the good provided is crossing the river Severn, which continues to be enjoyed by others once an individual has crossed the bridge and the lack of payment of a toll meant that no motorists were excluded from enjoying the benefit. However, motorists travelling westbound into Wales paid a toll. Although the good is non-rivalrous, because once an individual crosses the bridge the benefit can still be enjoyed by others, it could not be considered to be non-exclusive because of the toll. Therefore, when travelling westbound, the bridges could not be considered to provide a public good. The only way to cross the old bridge in both directions without payment of a toll was either via motorcycle or by using the pedestrian and cyclist pathway on the bridge.

Applying the bridge analogy to the financial sector, this indicates that through a Financial Transaction Tax, service providers may pay (the tax) to access the good (trading), but that

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<sup>7</sup> J Margolis, 'A Comment on the Pure Theory of Public Expenditure' (1955) 37 *Review of Economics and Statistics* 347

there is still the possibility of providing a wider public good (stability in the wider economy) regardless for those who avoid accessing markets in what is perceived to be a more harmful manner.

Furthermore, situations in which an activity gives rise to more than one output are referred to as a 'joint product'. This would include scenarios whereby an individual's consumption of a benefit reduces the quality of a service available to others, referred to as 'congestion', which Cornes and Sadler explain as a 'public bad'.<sup>8</sup> This can be demonstrated by analogy with traffic. Initially, a road will not have any vehicles using it, yet as more individuals use it, each one exercises their ability to derive a benefit from it. Once an individual uses the road, the quality of service provided for other road users diminishes, for example there may be delays due to the volume of traffic or the air quality could diminish for cyclists and pedestrians. Applying this principle to the regulation of the financial sector, it is crucial that the public good provided by a common Financial Transaction Tax is not weakened by the scope of its design. The tax must be designed to try to provide the same level of benefit for all as opposed to a select few, above which the returned benefit proportionately diminishes. In theory, this can be achieved through commonly agreed rates, however cities, such as London and Frankfurt, have a larger financial sector than other states. If it is agreed that introduction of a common Financial Transaction Tax is desirable, as outlined in previous chapters, these states would derive a proportionately larger benefit than smaller states. However, this disparity can be narrowed, to an extent, by economic pluralism, as discussed later in this chapter. Economic pluralism, highlights the economic ties between states.

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<sup>8</sup> Supra n.6 at 124-128

Finally, it is also important to acknowledge the existence of 'club goods'. Club goods are, by nature, those which are non-rival and non-exhaustive in terms of consumption, yet they are exclusive in nature because the benefits extending from the good are shared amongst a club. Clubs are voluntary groups deriving mutual benefit, based upon sharing production costs, the members' characteristics, or a good characterised by excludable benefits. Club goods focus on the last of these three. For example an association of leading financial institutions, such as the British Bankers' Association would be classed as a club, with any specific benefits they derive being exclusive to its members.

The same action can cause both a wider public good and a club good. For example, according to Kordel, ensuring good corporate governance among representatives of the financial sector can be understood as a club good.<sup>9</sup> Managers, directors, employees and shareholders of a corporation form a club i.e. a voluntary group of individuals who derive mutual benefit from participating in the corporation and in good corporate governance. Although a corporation does conduct its business with outside consumers and businesses, a corporation can, for the purposes of consideration of public goods provision, be considered as a privately owned and operated club, with the potential to derive a club good. Yet there may be an argument that particularly in the UK, with taxpayer funded bail outs and recapitalisation of financial institutions such as RBS leading to majority public ownership, this has developed to become more of an imperfect public good than a club good, with a wider public benefit. If the function of a Financial Transaction Tax is to modify behaviour of financial institutions for the benefit of individuals, this would be primarily a public good, however there would be a secondary club good in ensuring good corporate governance within the financial sector. If these arguments were at the fore of the 2011

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<sup>9</sup> G Kordel, 'Behavioural Corporate Governance From a Regulatory Perspective: Potentials and Limits of Regulatory Intervention to Impact the Conduct of Corporate Actors' (2008) 9(1) *European Business Organization Law Review* 29

Proposal, the emphasis changes and demonstrates an incentive to both States and individual institutions to participate as opposed to the more antagonistic approach adopted.

### **1.3. Acting Upon Public Goods**

Determining whether an activity can be classed as a public good is a valuable tool in determining whether government intervention to provide the good is required. Furthermore, classifying action as a public good provides a concrete means by which supporters of a provision, such as a common Financial Transaction Tax, can frame their arguments to convince critics, with understandable reservations, that the core aim provides a wider common benefit. The classic connotation is that public goods require public provision, whereas if a good is classed as private, it should be resourced by the private sector. This is linked to externalities, which were defined by Meade:

“An external economy (diseconomy) is an event which confers an appreciable benefit (inflicts an appreciable damage) on some person or persons who were not fully consenting parties in reaching the decision or decisions which led directly or indirectly to the event in question.”<sup>10</sup>

By extension, it is therefore possible when determining public goods to classify cases in which government action is essential. Meade’s definition of externalities allows the possibility of determining rates of taxation, including a Financial Transaction Tax, which in combination with the other examples outlined previously highlight that the theory of externalities, public goods and club goods can help determine corrective Pigouvian taxes, provision levels, tolls or user fees and financing decisions.

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<sup>10</sup> J Meade, *The Theory of Economic Externalities. The Control of Environmental Pollution and Similar Social Costs* (Sijhoff 1973) at 15

As a consequence of determining that a public good exists, governments can shape their rates of taxation and policies accordingly, resulting in redistribution of income in various forms for reasons of equity. However, as demonstrated by the discussion of political economy obstacles included previously in this thesis, a government's taxation policy ultimately takes into account political considerations, which will appeal to voters. Many States, for example, now provide socialised medicine, social security, promotion of growth and income stabilisation measures which can be classed as a priority public good. However, political discussions shape the extent to which each of these goods are provided, for example a political party may pledge to voters to allocate greater resources to education, whilst another may seek to reduce expenditure on social security.

In highlighting the public good nature of a common Financial Transaction Tax, this thesis does not overlook that VAT, bank levies, stamp duty and CCCTB (as outlined later in this chapter) can contribute to the provision of public goods by raising funds for national government. Yet it does argue that the manner in which the wider public benefit can be derived differs, in that it is the policy outcome of behaviour modification which is ultimately beneficial, as opposed to funds raised by a tax, which are then reallocated to fund provision of other public goods. Regardless of the output, Hochman & Rodgers argue that redistribution in itself can be viewed as a public good.<sup>11</sup>

There may be difficulty in determining the level of public good required and incentivising public action. For example, it is necessary to factor in the size of the group that is likely to be affected by the provision of a public good in a manner consistent with the principle of subsidiarity. For instance, the upkeep of a local park, although not exclusive, is only likely to benefit those in the surrounding area. This is a local public good and can be provided

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<sup>11</sup> H Hochman and J Rodgers, 'Pareto Optimal Redistribution' (1969) 59(4) *American Economic Review* 542

by a local council. On a broader scale, preservation of green belt land is nationwide and therefore a wider 'state group' may be affected, requiring a higher level of governance to provide the public good. It is also possible to determine a public good above State level, requiring international provision and maintenance of the good.<sup>12</sup> These scenarios provide an inherent degree of legitimacy for international organisations such as the European Union. By way of example, the four fundamental freedoms of the internal market are intended to produce public goods. In removing internal trade tariffs, producers derive a benefit from exporting to other markets and consumers are able to access a wider range of products. This is non-rival and non-exclusionary as the free movement provisions remain in effect. This chapter seeks to explain that maintaining a stable financial sector, due to its interconnected nature and potential impact on the wider economy, needs to be classed as a priority global public good over other forms of public good, something which was not stated in the 2011 Proposal. The good cannot be provided at local level, and whilst some national measures can be adopted, such as the introduction of bank levies, the necessary change to financial market conduct must be facilitated on an international scale. This does not mean, however, that the concerns of an individual state should be overlooked when seeking to provide a public good at international level. There is still scope for divergence of popular opinion in determining whether a public good should be provided above state level. For example, when assessing action on climate change to limit the rise in sea levels, small island states are more likely to derive a benefit than others, but there may be a disproportionate cost on certain states to provide the overall public good by cutting carbon emissions, such as developing industrial nations or oil rich nations. An alternative example is positioning wind turbines on the coast. The public good provided

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<sup>12</sup> See for example D Bodansky, 'The Legitimacy of International Governance: A Coming Challenge for International Environmental Law?' (1999) 93 *American Journal of International Law* 596 and D Esty, 'Good Governance at the Supranational Scale: Globalizing Administrative Law' (2006) 115 *Yale Law Journal* 1490

would be low carbon, sustainable electricity for households, however locals may deem them an eyesore on the coastline. There may also be uncertainties about whether or not an activity is ostensibly a public good, for example for every vaccination programme there will be many that question the efficacy and consequences of vaccination. None of these examples of public goods is without fault, supporting Margolis' argument about the basic classification of public good theory being too simplistic. However, extending the underlying principles of these examples further, it is therefore impossible, when providing the public good of sound financial stability to create a common Financial Transaction Tax which is pareto efficient. Some of the criticisms, in particular preference for alternative forms of taxation for fundraising purposes, would remain even if the public good aspect of the 2011 Proposal were stressed. In addition, whilst global public goods may provide legitimisation for global organisations such as the European Union, it can be difficult at times to legitimise the public good itself, though stability of the financial sector is on the face of it easy to legitimise, since the consequences of a failed volatile financial sector live strongly in recent memory and unquestionably continued financial stability can be classed as a public good.

## **2. Determining the Extent of Public Goods Provided**

Once the existence of a public good has been established, the question then moves from whether intervention is essential to measuring the degree to which the public good has been provided already and, furthermore, how to incentivise allocation of greater resources to either maintain the standard of public good provision, or to increase the standard of provision. In other words how are public goods measured, and how can the extent of the public good provided be improved? The method varies depending on the particular type of good being provided, and in general can be classed into three distinct categories, namely aggregate effort, weakest link and single best effort. The themes from this section

echo the discussion in Chapter 3 regarding the 'race to the bottom' and the need for hard law to introduce a common Financial Transaction Tax.

## **2.1. Aggregate Effort Problems**

One method of examining the effectiveness of a public good is by examining collective actions. Most discussions assume that total supply of public goods depends on aggregate efforts of all actors involved. For example, preventing or mitigating climate change is a pure public good, because once the measures have been taken, the benefits continue to be felt (non-exhaustive) and every individual benefits from a more sustainable environment (non-exclusionary). This will normally be achieved by reducing greenhouse gas emissions around the world. A state may go further than others in terms of its efforts in reducing its greenhouse gas emissions, though ultimately the degree of success is dependent on the overall community's collective efforts.

This assessment does cause a problem in terms of incentivising Member States to contribute equally to achieving the public good, however. On paper, public goods can highlight areas for government allocation of resources, though a government may have finite resources and not derive an economic benefit itself from providing the good. A global benefit of a public good may be higher than global cost of producing it, but a country may not receive enough individual benefit from the provision of a public good to justify costs. In this example, states can benefit from the efforts of others, since aggregate efforts do not necessarily mean states contribute equally. Perhaps the best known international agreement on greenhouse gases pre-2016 is the Kyoto Protocol. In advance of these negotiations, the United States Senate unanimously adopted the Byrd-Hagel Resolution, which declared that it would not accept a climate change agreement that required the US

to reduce emissions but not developing states.<sup>13</sup> Later international cooperation on climate change was established in 2016, with the signing of the Paris Climate Agreement, set to come into effect in 2020.<sup>14</sup>

Environmental protection measures are well-suited to the discussion of global public goods, due to the interconnected nature of carbon dioxide emissions raising temperatures globally. By analogy, due to the interrelated nature of the financial sector and the wider economy, as evidenced by the economic pluralism discussion later in this chapter, financial stability based on a speculative debt-based financing model can similarly be considered as a global aggregate public good.

One of the issues that the Commission's Financial Transaction Tax has faced is that many financial actors and regulators, in particular in the UK as the EU's largest financial sector, have insisted on a wider application of the tax to include, for example, the remaining members of the G20. This therefore raises a big challenge for international organizations; effective policies can still often rely on participation of 'big players'. With regard to the Paris Climate Agreement, this would include the US. With regard to global transaction taxes this would include both the US and UK at present.

How, therefore, is it possible for international organisations to facilitate participation? Of primary importance is a comprehensive and cohesive dialogue between States. It is well-established that international institutions can provide a forum for negotiations. For example, in the EU, particularly following the financial and Euro area crises, greater impetus has been given to negotiations which take place in the European Council. Furthermore, the role of the President of the European Council, outlined in Article 15 TEU,

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<sup>13</sup> Byrd-Hagel Resolution 105<sup>th</sup> Congress First Session S.Res.98 25 July 1997

<sup>14</sup> For a discussion of the Paris Climate Agreement, see C Ogbumgbada, 'The Paris Agreement: An Imperfect But Progressive Document' (2016) 8 *International Energy Law Review* 320

is to chair meetings and provide assistance to negotiations in particularly contentious areas. It can be argued that with regard to a common EU system of Financial Transaction Taxation, that all avenues, including European Council negotiations, have been explored. This adds greater credence to the decision to pursue Enhanced Cooperation, as discussed in the previous chapter, due to the requirement in Article 20 TEU that the process is used as a 'last resort'.

Secondly, international organisations can promote a learning process, so that states change their evaluation of a cost-benefit analysis. Initially, a State may examine that the costs of actively participating in an agreement and allocating government resources to provide a global aggregate public good are more than the expected output, creating a limited incentive to cooperate. However, if the international organisation can change this perception, so that the costs of inaction are deemed to be greater than the costs of participating, this is a much easier problem to solve. For a common Financial Transaction Tax, this would either require amendments to the 2011 Proposal or changes appearing in a subsequent EU-ten Financial Transaction Tax, which other States later agree to implement. One option to achieve this is to lower the costs of participating in an agreement. The other is to raise the cost of staying out of an agreement. It is possible to have a combination of the two. For example, the Montreal Protocol on Substances that Deplete the Ozone Layer<sup>15</sup> is considered one of the most successful environmental agreements to date, coming into effect in 1989. It adopted a two-pronged approach. Alongside raising costs for non-participation, the costs of participation were lowered by providing a multi-lateral fund for implementing commitments. Taking this into account, with regard to the Financial Transaction Tax, the 2011 Proposal does not make any provisions for financial assistance in introducing a new form of taxation, for example funding electronic calculation

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<sup>15</sup> Montreal Protocol on Substances That Deplete the Ozone Layer [1987]

software in order for institutions to establish how much tax is payable on electronic transfers. This would reduce some of the costs of participation and would be more palatable than developing a method of effectively penalising Member States for non-participation. The latter would also reinforce a vision of the EU imposing its will and questions of democratic legitimacy would likely surface.

Finally, international organisations are able to empower domestic supporters of a public good. Not only do they provide a platform for State actors to negotiate, they are also able to mobilise individual actors and campaign groups such as ATTAC and the Robin Hood Tax group. Social activism is welcome in this area, but at the same time can amplify misinformation and miscast the aims of regulations. The social activism connotation of public good refers to a positive social benefit as a consequence of funds accrued from the tax as opposed to the specific mechanisms by which to identify and encourage government intervention where necessary. In other words, it uses Transaction Taxes as a desirable outcome, not a determining mechanism to encourage behavioural change and cultural reform.

In contrast to the Robin Hood Tax campaign, the Association pour la Taxation des Transactions financières et pour l'Action Citoyenne<sup>16</sup> (ATTAC), which is far more wide-ranging in its ambitions and anti-globalist, has used the term 'public good' as far back as 2011 when presenting its arguments that continued financial stability is an essential area that should be maintained.<sup>17</sup> As a result there are inconsistencies in this area for campaign groups. Not only has the European Commission overlooked the concept of public goods in relation to taxing financial services, but the campaign groups, particularly those which

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<sup>16</sup> Association for the Taxation of Financial Transactions and for Citizens' Action

<sup>17</sup> See for example ATTAC, 'The Co-President of ATTAC Candidate to the General Direction of the IMF' (ATTAC, 6 June 2011) <<https://www.attac.org/en/Stories/co-president-attac-candidate-general-direction-imf>> Accessed 8 April 2018

are philanthropic in their vision, have failed to sufficiently establish the tax as a public necessity for financial stability, instead of an option to raise funds for philanthropic causes in their campaigning. However, whilst ATTAC does include references to public goods in its campaigning, it must be recalled that ATTAC's stated goals are at odds with Tobin's rationale for his 1978 currency conversion tax proposal. Therefore, the link back to Tobin's rationale must also be presented in tandem with advocacy of public good provision.

## **2.2. Weakest Link Problems**

In some cases it does not matter how much effort others make, the amount of public good provided is only as good as the lowest effort from the participating states. Two often cited examples of these scenarios are maintaining dykes as a flood prevention mechanism and attempts to eradicate diseases. Unlike the aggregate effort problems, these scenarios predominantly arise after cooperation has been established within a particular area. Therefore, if a formalised common system of taxation on financial transactions could be established, the initial assessment would be aggregate best effort, but its maintenance once in place would merit a weakest link assessment. States have an incentive to provide the public good, so long as they are convinced that others will also do so. Barrett<sup>18</sup> indicates that there are three methods by which a State may become a weakest link. Firstly, a state may lack raw materials or administrative resources, for example, it may be difficult for a state to provide a public good of a vaccination programme if there is either a lack of medical expertise or physical vaccines themselves. Secondly, as a state is only able to attribute a finite amount of resources to the provision of public good, a state may prioritise one public good over another, seeking to provide a greater return for the same cost or administrative provision. An increase in tax receipts, for example, from an increase in income tax, may

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<sup>18</sup> S Barrett, *Why Cooperate? The Incentive to Supply Global Public Goods* (OUP 2007)

provide a government with a greater amount of resources to provide public goods overall, however, governments will still face choices in prioritising one good over another. The final method, as indicated by Barrett, is that a state may make a positive choice not to contribute to global efforts, discussed in the following section.

### **2.2.1 Elevating the standard of the weakest link**

Identifying that a state is acting as a weak link is only one half of the equation, however. There are therefore two mechanisms which the global community can use to raise the standards of the weakest link, which in turn provides a higher quality or greater degree of public good in the process. A weak link state may incentivise a larger, or more developed state to subsidise them if there is a benefit in doing so in a *quid pro quo* manner. Alternatively, a state may be in a position whereby it has reached a threshold in public good provision i.e. no further benefit can be derived from allocation of a greater amount of resources to providing a public good. However, there may still be an interest to continue to provide this good. A state may have its own interests in offering to subsidise a weakest link state in order to improve the provision of the public good in an international context. This, to an extent, mirrors the versions of multi-speed and *à la carte* integration detailed in chapter 3, in which Member States that participate early in an agreement provide assistance to states joining at a later date in order to accelerate the process.

However, in the public good context, there is some express mention or recognition of a reward for the subsidising state which goes beyond the classic multi-speed and *à la carte* theories. At first glance, this may seem to be benign, however, the public good and benefit derived needs to be made transparent in order to address questions regarding legitimacy of the subsidising state's actions. It should be recalled that one of the criticisms of enhanced cooperation, in particular, is that states which elect to adopt resulting legally binding provisions have little impact, if any, in the design of the provisions. If an express recognition of rewards and benefits for subsidising states is included in framing an

argument within public good theory, the question arises as to which point incentivising is tantamount to bribery.

Another obstacle is the willingness of a weakest link state to engage with providing a public good. With regard to a conscious effort not to contribute to global public good provision, there does not necessarily have to have been an international agreement for this to happen: the only pre-requisite is that the public good can only be provided globally. This thesis argues that the public good of financial stability can only truly be provided by international regulation, such as a common Financial Transaction Tax. The public good can be difficult to achieve, particularly if a weak link state benefits economically from non-participation. An example from international law concerns the registration of ships to a particular 'flag state'. Once registered, the flag state has jurisdiction over the vessel and assumes responsibility for inspecting its safety and the crew's working conditions. The aim is to ensure that merchant ships are properly regulated. The divergence in systems of registration has led to a system of 'open registries', which have been dubbed as 'flags of convenience'.<sup>19</sup> The Panamanian flag and other open registration systems offer clear benefits to owners. Registration is cheap, tax burdens can be reduced or removed, regulation can be minimal and cheap labour can be sought.<sup>20</sup> The allegation is that in order to continue to receive the registration revenue, States such as Panama actively do not fulfil their obligations for economic reasons, with potentially fatal consequences, compromising public good provisions associated with maritime safety.<sup>21</sup>

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<sup>19</sup> For more on flags of convenience see a report by the Environmental Justice Foundation, 'Pirates and Profiteers: How Pirate Fishing Fleets are Robbing People and Oceans' (2005)

<sup>20</sup> See for example International Transport Workers Federation, 'Appalling Conditions on Ghost Ship Uncovered' (*International Transport Workers Federation*, 29 January 2013) <<http://www.itfglobal.org/en/news-events/news/2013/january/appalling-conditions-on-ghost-ship-uncovered/>> Accessed 8 April 2018

<sup>21</sup> See for example the death of a cadet on a Panamanian flagged tanker uncovered by the International Transport Workers' Federation. ITF Dockers and Seafarers, 'ITF Inspectors Expose Cadet Death Scandal'

By analogy, it can be argued in relation to a common Financial Transaction Tax that the public good provided, in ensuring a stable financial sector, can be only as effective as the state with the least degree of implementation and supervision. It has been stated previously in this thesis that hard law is required in order to prevent a race to the bottom and create an enforcement mechanism to ensure compliance. However, this is an extreme example and may overlook the practical application of a common Financial Transaction Tax provision creating distortions between states. For example, for the EU-ten Financial Transaction Tax, it could be possible that one State is unable to allocate as many resources to calculating and collecting the amount of tax payable and effectively act as a weak link.

Globally, if an EU Financial Transaction Tax is approved, financial institutions may relocate to other financial sectors with a lesser degree of taxation and regulation, which due to the interconnected nature of the global economy, could mean that a financial sector outside of a prospective Financial Transaction Tax zone could be the cause of another financial crisis. A State may agree to a series of common regulatory and supervisory rules and principles, but supervisory authorities in each State may differ and, if a financial sector is known to have difficulties in enforcing rules, this may encourage speculative transactions to occur there instead. In this regard, there would be a weakest link problem, which is exacerbated if financial regulation is entirely dependent on soft law principles with a lack of concrete enforcement.

### **2.3. Single Best Effort Problems**

The final method by which to measure the degree of public good provided is the Single Best Effort method. Certain global public goods may be able to be provided entirely by one

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*(ITF Dockers and Seafarers, 11 September 2012) <<http://www.dockers-seafarers.org/news/itf-inspectors-expose-cadet-death-scandal>> Accessed 31 January 2016*

State, for example scientific and medical discoveries, although as detailed previously, there may be an overlap whereby a weak link state encounters difficulties in administering a treatment. The question in relation to financial stability and by extension for this thesis, a common Financial Transaction Tax, is whether a single state can provide the public good of financial stability.

Provision of a public good by a single best effort differs from a single state having a large influence on the aggregate provision of a public good, for example, if speculative financial transactions in a large financial sector, such as the City of London were within the tax, this would contribute significantly to the global aggregate provision of a public good of financial stability. Provision of a public good by a single best effort, on the other hand, can take two forms. Firstly, a public good might only provide a benefit if at a certain threshold level. In this scenario, there is a minimum level and a maximum level above which no further allocation of resources by states provide additional benefits. For example, once a vaccine for a disease has been discovered, no further benefit can be derived from allocating resources to researching the disease. Alternatively there can be an aggregate public good up to a threshold, above which it becomes a single best effort public good i.e. there is no maximum threshold. For instance, in efforts to combat global warming, one state may act further than others and disperse sulphur into the atmosphere to increase the amount of sunlight reflected.

However, the single best effort method of determining the amount of public good provided is not suitable for assessing financial stability since, as demonstrated, the financial sector is susceptible to weak links. A state may be strict on enforcement, but this may lead to a higher degree of relocation from the individual state, as identified by the examples of the Swedish Financial Transaction Tax in the 1980s and in the 2011 Proposal. Therefore the level of financial stability public good provision must be measured and incentivised by a combination of both global aggregate assessments and global weakest link assessments.

### 3. Murphy and Nagel: Public Goods and Tax Policy

The discussion of public goods thus far has concerned general classifications and the application to environmental law and policy. Murphy and Nagel's 'Myth of Ownership'<sup>22</sup> is a philosophical assessment of determining personal income taxation, but includes consideration of provision of public goods in its assessment. Whilst the authors do not present a discussion regarding tax policy providing a public good in itself by changing behaviour, as is argued in this thesis, their concept and classification as to how governments look to provide public goods through designing tax policy is invaluable. Ultimately, this thesis looks to adapt these concepts to move beyond personal income tax and nation state government funding to non-financial benefits of tax policy, such as behaviour modification and international cooperation to achieve global public goods.

Murphy and Nagel's arguments are framed in the role of government and how interventionist it should be. There are frequent references to satisfying small government, libertarian principles by stressing that, once government identifies a public good as essential, there is an obligation to intervene to provide the good, which negates libertarian objections. The key is for governments to determine the level of public good that it wishes to provide and tax individuals accordingly in order to achieve these goals. This approach differs significantly from more traditional principles of taxation, such as the benefit principle, discussed in more detail later in this section, which argues that those who access publicly provided services the most should be obliged to contribute the most in taxation to support them. The benefit principle can be reflected in an argument frequently made post-2008 financial crisis, that because financial institutions accessed public funds, that they should pay more in taxation. However, this has led to potential taxes, such as President

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<sup>22</sup> L Murphy and T Nagel, *The Myth of Ownership* (2002 OUP)

Obama's Financial Crisis Responsibility Fee, being presented as thinly veiled punishments. Murphy and Nagel's arguments regarding individual taxation are more nuanced. The public good should be identified first and then tax policy should be determined in order to achieve that specific aim. When adapted to financial regulation, proposals, such as the 2011 Proposal, provided that Tobin's economic rationale is adhered to, compare favourably relative to punitive tax measures, as a more nuanced means by which to provide a specific public good.

Murphy and Nagel's discussion includes general examples of classic public goods including defence, domestic security, legal system, environmental protection and public health, but in addition, some important aesthetic, social and cultural goods that cannot be supplied privately i.e. education, which extends to arts, culture and research. Although not expressly listed as providing a public good, they do state that financial regulation is a function of government.<sup>23</sup> The authors also use the term "public duties"<sup>24</sup>, which are goods in themselves as opposed to being specifically applicable to individuals, for example measures to prevent famine and epidemics.

The authors recognise that taxation arouses strong passions, which are fuelled not only by conflicts of economic self-interest, but by conflicting ideas of justice or fairness. The assessment is made on the basic recognition that taxes are not just methods of payment for government and public services, but they reflect a government's political decision making process in terms of economic or distributive justice. Echoing the political economy discussion previously in this thesis, they recognise that tax battles are fought primarily through elections. This assessment places taxation into a tension between a socially liberal 'big government' argument and a small government free market economist

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<sup>23</sup> Ibid at 27

<sup>24</sup> Ibid at 81 and 93

argument. In the former, government provides a greater degree of public service, and therefore public goods. In the latter, governments only provide public services where essential. The economic arguments advanced in this thesis indicate support for a greater degree of provision of public services.

The question that Murphy and Nagel ask concerns social and economic justice, raising philosophical questions about who to tax, to what degree and ultimately if there is any moral basis for either individuals or companies, such as financial institutions, to retain earnings at all? In designing a tax policy, advocates must provide an argument of political morality as to why that is the most appropriate policy to adopt at the expense of other social outcomes. By application to the 2011 Proposal, organisations, such as the Robin Hood Tax group, proffer moral arguments that introducing the tax would penalise those perceived to have exacerbated public hardship. In contrast, those opposed to the 2011 Proposal frame their arguments in the adverse economic impact of relocation of financial services. Yet these are two extremes. As previously stated more nuanced approach needs to be taken to determine the morality of the 2011 Proposal. A suggested blueprint of a Common Finance Policy, which reflects a nuanced approach, is presented later in this thesis.

Aligned to morality arguments are considerations as to what constitutes a 'fair' tax policy. Murphy and Nagel state "fairness in the traditional conception focuses on treatment of people – equal for alike and unlike persons unequally"<sup>25</sup>, but this does not explain how to determine equal treatment or equity. On a basic level, this can be fleshed out by introducing the principles of vertical equity and horizontal equity. If a tax provision is vertically equitable, persons are taxed at different levels according to their level of income

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<sup>25</sup> Ibid at 12

and consumption of goods, whereas if it is horizontally equitable, persons at the same level are treated equally. Fairness does not automatically translate to determining the justification for assessing payment to the national treasury for the provision of public services.

This introduces two contrasting traditional principles relating to how national governments allocate finite resources, the previously mentioned benefit principle, discussed in more detail in this section, and the contrasting ability to pay principle. Murphy and Nagel's argument is that these two principles lead to unfair externalities. Under the benefit principle, individuals are taxed according to the level of benefit that they receive from government i.e. taxpayers pay proportionate to the degree of consumption of public goods. Murphy and Nagel state however, that this principle is inconsistent with any theory of justice since, for example, individuals from a poor economic background are more likely to access public services, such as socialised healthcare systems and the welfare state, than those from middle and upper class communities.<sup>26</sup> Applying this principle would, in effect, be a form of punishment due to economic circumstance. Given the pressures on public finances in the era of austerity post-2008 financial crisis, and the increased dependence on the welfare state, if a state seeks to introduce a revenue raising tax, it should not be charged on those who suffered the greatest impact of the crisis. However, it is possible to make the argument that through bail-out mechanisms, the financial sector has received a proportionately larger share of benefit than individuals have. It would be unfair though to strictly apply this principle to the financial sector, and not to other businesses and individuals, since financial institutions would be singled out. This sentiment was expressed previously in the thesis regarding the UK government bail out of

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<sup>26</sup> Ibid at 18

the financial sector in comparison to the lack of financial government support for the UK's steel sector in Port Talbot.

The alternative traditional principle to adopt is the ability to pay principle, meaning that tax policy is designed to accumulate funds from individuals who are able to contribute more. President Obama's Financial Crisis Responsibility Fee speech outlined previously in chapter 2 of this thesis makes reference to banks being in a position to be able to pay bonuses, with similar arguments made by campaign groups, such as the Robin Hood Tax group. The ability to pay factors into the design of the tax itself and is a calculated approach to targeting individuals to provide tax receipts for the continued provision of public services.

### **3.1. Murphy and Nagel's Alternative Principle**

Murphy and Nagel instead submit that the classification of which individuals should bear the burden of taxation is dependent on aggregate utility i.e. the total increase in social value attributable to the State's economic policy instead of fairness, not the ability to pay as such. This raises questions about whether a government can introduce a tax policy which benefits many, but which is detrimental to others, instead of designing a tax policy to increase every citizen's welfare. They argue "what matters is not whether taxes – considered in themselves – are justly imposed, but rather whether the totality of government's treatment of its subjects, its expenditures along with its taxes, is just."<sup>27</sup> Applying this statement to the 2008 Financial Crisis, how is it possible to best balance expenditure by governments with collection of revenue collection, given the impact on public finances? Murphy and Nagel do characterise financial regulation as a government service<sup>28</sup> and argue that since there is no market without government, and no government

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<sup>27</sup> Ibid at 25

<sup>28</sup> Ibid at 27

without taxes, markets, and by extension financial institutions, have no moral right to retain profits. On this assessment, in theory, legislators can morally tax financial institutions to an unlimited amount on profits (i.e. corporation tax), however the aim of a common Financial Transaction Tax, in line with Tobin's economic rationale, is not to charge the tax on profit, but to tax to dissuade from potential losses, decrease volatility and create sustainability.

Consequently, Murphy and Nagel's assessment of tax relates not to the determination of a fair share of tax burdens, but instead asks what the legitimate ends of governance are, and the legitimate means by which to achieve this, tying the discussion into property rights. Taxation determines how much private property (e.g. income made through speculative financial trading) comes under government control and how it is distributed. Governments are required to provide essential public duties, but there is ultimately a political question as to whether the role of government is to go further and provide additional public goods, promoting equality in the process. The policies that governments adopt determine the lives that individuals can lead and the operation of businesses. In designing tax regulation, Murphy and Nagel state that there is either a consequentialist assessment<sup>29</sup> which focuses on the outcome of the policy, in which there is no pre-institutional conception of property, or a deontological approach<sup>30</sup> taken, which focuses on the actions of the policy, which assumes a natural entitlement to property. Evoking property rights enters into the debate as to whether taxation is considered as theft, versus the idea that taxation forms part of the social contract. Murphy and Nagel state that ends which are capable of being considered as legitimate must either provide public goods, benefits to individuals or

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<sup>29</sup> Ibid at 42-45

<sup>30</sup> Ibid

distributive justice.<sup>31</sup> Of these three aims, “Public goods are the least controversial, since they include minimal conditions considered necessary in any theory of government for all the other advantages of civilization.”<sup>32</sup> By extension, provision of benefits to individuals or distributive justice, as is the argued justification of the Robin Hood Tax campaign group, are more controversial.

This distinction indicates that if the 2011 Proposal had been presented as a public good measure, a less contentious environment would have been created, which could have encouraged a greater degree of cooperation among EU Member States. Nevertheless, there should also be a focus on the legitimate means by which to determine tax policy. Although the benefit principle in isolation should be followed strictly, some are more likely to benefit from the provision of public goods than others. For example, allocation of resources to provide a public good of “the coast guard on hurricane warnings...have limited value for residents of Nebraska though tornado alerts may help to even things out.”<sup>33</sup> Public goods therefore create a system of political horse-trading for priority, and the likelihood is that some individuals and companies will bear a greater tax burden than others.

The imposition of taxes can either be viewed as an appropriation by the state of what antecedently belongs to individuals and businesses, or that ownership is determined by the legal system, in which case taxes do not violate property rights, although there is a clear distinction between property rights of individuals and businesses. This thesis argues that there is a genuine case for a Financial Transaction Tax to be charged on institutions for the benefit of others in the wider economy. This should be above appropriation of funds

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<sup>31</sup> Ibid at 46

<sup>32</sup> Ibid

<sup>33</sup> Ibid at 80-81

(since the tax should not be fundraising in nature), therefore this thesis supports the latter assessment that the legal system, including tax policy, shapes an institution's ability to operate. The Common Finance Policy proposed later in this thesis, is based on governments and international organisations being able to adopt financial regulation and taxation measures, which allow financial institutions to operate in a sustainable marketplace, leading to a wider public good of financial stability.

Since public goods are provided to all, if a public good can be established, every individual or institution can derive some form of benefit from maintaining it, therefore even if states and businesses were to act in their own self-interest, this would still be to achieve a common goal. The cost of providing public goods is great though, raising questions of priorities of one public good over another and the level of provision. A more libertarian view is to provide only essential public goods, with the 'invisible hand' guiding the market. However this thesis subscribes to a more socially liberal view to provide a greater degree of public goods where possible. Murphy and Nagel state "the broader the legitimate aims of government, the more it will be entitled to do through design of the system of property rights to affect the lives of its citizens and the relations among them."<sup>34</sup> This quote raises the idea that morality (i.e. financial institutions have no moral right to retain profits due to the facilitation of business by the marketplace) and legitimacy (i.e. the political means by which to present tax policy) must be balanced against each other. There remains a recognition that, as expressed previously in this thesis, ultimately tax policy is largely defined by political considerations:

"The political problem of taxes is that it is risky for a politician to attempt to appeal to those better angels of our nature...it is not clear how a transformation in the

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<sup>34</sup> Ibid at 57-58

public conscience might be achieved, which would make socioeconomic justice less dangerous as an argument for taxation.”<sup>35</sup>

In presenting a more restricted view to taxation and the role of government, Murphy and Nagel focus primarily on the ideals of libertarianism. They classify libertarianism as only permitting taxation for the general good in exceptional cases, and their belief that “people should have a right to do what they wish with their property provided they don’t hurt others.”<sup>36</sup> Since Murphy and Nagel frame taxation within a discussion of property rights, they highlight the libertarian argument that “the state has no more right to demand a cut of the profits for redistribution in exchange for its maintenance of the peaceful conditions of cooperation than it would have to demand adherence to a particular religion for the same reason.”<sup>37</sup> Under this political classification, the 2011 Proposal goes too far. However, “even a libertarian will not be able to leave the market, or an imaginary market, the pricing of public goods”<sup>38</sup>, reinforcing that if a genuine public good can be presented as part of the social contract, even the most sceptical of political opponents cannot rationally be opposed to legislation to ensure its provision. As stated previously, Murphy and Nagel’s arguments predominantly concern taxation of individuals i.e. personal income taxes to provide revenue for governments to provide public goods, such as social healthcare systems. Yet, the 2011 Proposal acknowledges a likely decrease in GDP and a central tenet of this thesis is that the tax should be seen as a behaviour modification tool, as opposed to a fundraising tax.

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<sup>35</sup> Ibid at 72

<sup>36</sup> Ibid at 65

<sup>37</sup> Ibid at 66

<sup>38</sup> Ibid at 85

It is this point at which this thesis' interpretation of tax policy creating a public good differs from Murphy and Nagel and seeks to adapt their core principles to behaviour modification. The authors do not refer to Pigouvian taxes in their assessment and therefore do not appear to consider how taxes can modify behaviour. This thesis argues that a well-designed common Financial Transaction Tax can create a public good in itself by dissuading from excessive risk in speculative markets, due to the widespread economic impact of crises, such as the 2008 crisis. This is independent of any discussion on allocation of revenue, which appears to be the justification for advocacy groups, such as the Robin Hood Tax group, but framed within the context of distributive justice.

Although not targeted at financial taxation, Murphy and Nagel provide further credence to this argument in their general discussion, that an ultimately just tax policy will take into account the conduct of individuals who would benefit from public goods as a result of their own negative conduct:

“If responsibility and desert should in fact play a major role in determining the design of a just system of property, this will have consequences in two directions. First, it means that the system should encourage rewards for effort and initiative, even beyond what is needed to provide optimal incentives. Second, it should discourage bailing people out of bad situations that are the fault of their own laziness or improvidence, again even beyond what is needed to provide optimal incentives.”<sup>39</sup>

Yet the principle remains, that a tax policy should seek to exclude the need to provide greater financial assistance (i.e. bail out) or allocation of resources relative to other actors. Considering the evidence of improvidence as a cause of the 2008 financial crisis, tax

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<sup>39</sup> Ibid at 60

policies need to be designed to prevent a repeat for the public good and therefore provisions, such as the 2011 Proposal, should be introduced in order to achieve this.

## **4. Economic Pluralism and Public Goods**

The identification and the recognition of a global public good, whilst indicating that intervention is desirable to achieve a common benefit, does not in itself provide *authority* for international cooperation within that particular area. It only serves as a tool within which to frame a persuasive argument for action to achieve an aim. It is one thing to identify that increased financial stability through a global public good may be achieved via a tax on speculative trading, but in order to be critical of the 2011 Proposal, the argument must not only contain a justification, but a legitimacy for international cooperation. The theory of constitutional pluralism, as presented in this section, provides the underlying basis for cooperation through the application of Ernst-Ulrich Petersmann's work within the field of international economic law. Petersmann extends the basic idea of constitutional pluralism, that national constitutions are interlinked, by demonstrating that national economies have been bound together for much longer. When combined with the discussion of public goods, detailed in this chapter, this nuanced interpretation of economic pluralism provides a form of authority to act to achieve financial stability as a public good. In order to understand the progression towards economic pluralism, it is necessary to present a traditional understanding of constitutional pluralism.

### **4.1. Walker and Constitutional Pluralism**

The traditional Westphalian view of constitutional authority is that of the sovereign nation State. In this respect, there is a vertical relationship. National governments must comply with the provisions set out in a national constitution. This can be described as 'constitutional monism'. As States and international organisations have developed, a more

modern view of constitutional authority, constitutional pluralism, has grown in stature to challenge this traditional view.

The history of the European Union's formation and increasing integration provides the basis for constitutional pluralism. It recognises that the European order has developed beyond inter-national law, and has its own constitutional claims independent of those of the nation state. These claims remain separate to those of the nation state in a horizontal/heterarchical relationship, as opposed to the traditional vertical/hierarchical relationship provided by constitutional monism. As a result, constitutionalism, and the subsequent regulations adopted, should be viewed as a process of nuances and balances as opposed to a black and white clear cut.

Walker<sup>40</sup> notes that there are three different dimensions to claims of constitutional pluralism. The first of these is the 'explanatory claim', which is the least controversial. Attempting to explain post-Westphalian constitutionalism in the one-dimensional terms of constitutional monism is considered to be trying "to force square pegs into round holes"<sup>41</sup> which fails to take into account or adequately explain the degree of change. The second claim is the 'normative claim' which states that the "only acceptable ethic of political responsibility for the new Europe is one that is premised upon mutual respect between national and supranational authorities."<sup>42</sup> The modern day European Union was initially built upon the national recognition of a supranational body, in the form of the European Coal and Steel Community, which provided the basis for the 1957 Treaty. The third claim concerns 'epistemic pluralism'. For this claim, the EU and its Member States act as distinct constitutional 'sites'. It is only possible to determine what these sites are by identifying a

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<sup>40</sup> N Walker, 'The Idea of Constitutional Pluralism' (2002) 65(3) *Modern Law Review* 317

<sup>41</sup> *Ibid* at p.337

<sup>42</sup> *Ibid*

new starting point from which to assess constitutional authority, i.e. a different epistemic starting point. If the epistemic pluralism claim can be successfully made, then the other two claims naturally follow.

The European Union, in particular the reference to recognition of supranational authority, provides the most convincing and well-developed template in which to explain constitutional pluralism as a concept. This does not necessarily mean that the concept should be confined to the Union and its pursuance of the common market. As Walker states, his intention was to “propose a scheme for building upon a baseline of strong epistemic pluralism that seeks to address the various critiques and meet the criteria of renewal, in so doing ranging beyond the particular focus of the European Union.”<sup>43</sup> The theory of constitutional pluralism going beyond the EU framework, when combined with the concept of global public goods, means that greater legitimacy may be granted to cooperate internationally on matters such as global financial stability. Yet a more nuanced adaptation towards economic pluralism, as an advancement of constitutional pluralism, can also utilise the European Union’s supranational authority as the most appropriate mechanism against which to test the theory and reinforce legitimacy to financial regulation.

#### **4.2. Petersmann: Constitutional Pluralism and Public Goods**

Ernst-Ulrich Petersmann’s recent work incorporates constitutional pluralism and interdependent public goods, specifically in the field of international economic law.<sup>44</sup> The central tenet of Petersmann’s work is that international economic law is in crisis. Consequently, a new form of thinking away from the Westphalian model is required in order to secure genuinely effective change. This echoes Walker’s epistemic claim, i.e. that

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<sup>43</sup> Ibid at 339

<sup>44</sup> E Petersmann, *International Economic Law in the 21<sup>st</sup> Century* (Hart Publishing 2012)

international economic law needs to start from a new point of reference, with explanatory and normative claims following automatically. Petersmann does not focus solely on economic agreements to support his arguments. Instead, he describes that individuals should enjoy rights, which in turn lead to increased overlap and a greater degree of integration, explaining that particularly in the area of human rights, there has been a balancing act to determine the regulatory level at which legislative cooperation is necessary i.e. at international organisation level or at a lower level in accordance with the principle of the EU principle of subsidiarity and locally provided public goods:

“The need for ‘multilevel constitutionalism’ is confirmed by the ‘composite nature’ of aggregate public goods like human rights, rule of law and sustainable development whose international protection must build on their local and national protection in conformity with principles of subsidiarity.”<sup>45</sup>

Petersmann’s argument is that collective action problems in the supply of global aggregate public goods can be overcome only on the basis of multilevel protection of cosmopolitan rights, transnational rule of law, and respect for constitutional pluralism at national and international levels. In order to provide an adequate degree of aggregate public good, three constitutional goals should be sought.<sup>46</sup> He characterises these goals into three differing concepts. Firstly, Petersmann makes reference to ‘enabling constitutions’, which empower citizens and governments to collectively supply interdependent public goods. Secondly, Petersmann outlines the operational mechanisms of ‘limiting constitutions’, which limit governance and market failures by introducing rights based regulation. Finally, Petersmann discusses ‘multilevel constitutional safeguards’, which reconcile competing increasingly overlapping regimes, whilst respecting constitutional pluralism.

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<sup>45</sup> Ibid at 77

<sup>46</sup> Ibid at 30-31

For the purposes of this thesis, there are other international agreements, aside from individual human rights agreements, in international law scholarship that provide overlaps which support Petersmann's attempts to combine the provision of public goods with multi-level governance, through constitutional pluralism. These examples extend beyond the European Union's EMU policy and the Member States in the Euro area as discussed later in this Chapter as examples of economic ties, supporting an argument of economic pluralism and provision of public goods in the introduction of financial regulation measures, such as the 2011 Proposal. Although constitutional pluralism provides a legal authority for measures to be adopted, it does not provide guidance on the best manner by which to achieve this. Consequently, constitutional pluralism overlaps with the concept of *regulatory* pluralism.

### **4.3. Regulatory Pluralism**

Regulatory pluralism states that adopting a single approach to law making is misguided, since each method of adopting legislation has its own relative strengths and weaknesses. For example, economic agreements tend to be efficient, but not dependable. Gunningham and Sinclair<sup>47</sup> argue that a result, utilising the relative strengths of individual mechanisms, whilst simultaneously compensating for their weaknesses through additional legal instruments i.e. a mix of regulatory instruments, would lead to a better strategy. However, regulatory pluralism does not necessarily provide the same degree of legal authority as constitutional pluralism. Therefore, it may be better for lawmakers, including, by extension, those looking to introduce regulation to achieve financial stability, to combine the concepts of constitutional pluralism and regulatory pluralism, and adopt a new concept of 'inter-regulatory pluralism' underpinning their strategy.

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<sup>47</sup> N Gunningham and N Sinclair, 'Regulatory Pluralism: Designing Policy Mixes for Environmental Protection' (1999) 21(1) *Law and Policy* 49

A good example of overlapping international organisations in international economic and banking law, supporting this concept of inter-regulatory pluralism, is the Bank for International Settlements, established in May 1930. This comprises 60 Member State central banks<sup>48</sup> including all EU Member States and the European Central Bank. Participating States encompass approximately 95 per cent of the world's GDP, with the organisation seeking to "serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks."<sup>49</sup> The BIS also played a significant role in the later formation of the Basel Committee on Banking Supervision, in providing the Committee's secretariat.<sup>50</sup> This includes 18 States not in the European Union<sup>51</sup>, 3 observing states<sup>52</sup> and other regulatory bodies as observers.<sup>53</sup>

The decisions that the Committee makes have no legal force. Rather, supervisory standards and guidelines are recommended in the expectation that individual authorities will implement them<sup>54</sup> through the influence of soft law. Applying the claims of constitutional pluralism of a recognised new epistemological starting point post-Bretton Woods may provide the legal authority for decision making outside of the European Union's institutional

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<sup>48</sup> Bank for International Settlements, 'BIS Member Central Banks' (*Bank for International Settlements*, 13 October 2014) <[http://www.bis.org/about/member\\_cb.htm?m=1|2|601](http://www.bis.org/about/member_cb.htm?m=1|2|601)> Accessed 8 April 2018

<sup>49</sup> Bank for International Settlements, 'About BIS' (*Bank for International Settlements*, 17 October 2014) <<http://www.bis.org/about/>> Accessed 8 April 2018

<sup>50</sup> The EU is a Member and 9 EU Member States are members in their own right

<sup>51</sup> Including the USA, China and Switzerland

<sup>52</sup> Chile, Malaysia and the UAE

<sup>53</sup> Basel Consultative Group, Bank for International Settlements, European Banking Authority, European Commission and the International Monetary Fund

<sup>54</sup> Bank for International Settlements, 'A Brief History of the Basel Committee' (*Bank for International Settlements*, October 2014) <<http://www.bis.org/bcbs/history.pdf>> Accessed 8 April 2018. For a greater outline on the soft law nature of the Basel III standards see E Lee, 'The Soft Law Nature of Basel III and International Financial Regulations' (2014) 29(10) *Journal of International Banking Law and Regulation* 603

structure. This may echo the Schengen agreement as discussed in the previous chapter, and allow for a Financial Transaction Tax to be adopted via the variable geometry theory of differentiated integration, akin to Patomäki's theory, also presented in the previous chapter. However, unlike the European Commission, the Committee has made historical reference to stable financial supervision being a public good in its 1997 'Core Principles for Effective Banking Supervision'.<sup>55</sup> The 25 principles were approved by the core G-10 countries. The document does not make reference to increased taxation being a public good, but it does highlight banking supervision and financial stability as a public good. It also refers to the incentivising States to participate in an aggregate collective public good by stating the costs of non-participation are higher than participation:

“Strong and effective banking supervision provides a *public good* that may not be fully provided in the marketplace and, along with effective macroeconomic policy, is critical to financial stability in any country. While the cost of banking supervision is indeed high, the cost of poor supervision has proved to be even higher.”<sup>56</sup>

[Emphasis added]

This indicates that as far back as at least 1997 international organisations were aware of the link between public goods and financial stability. The basic premise of the last two chapters of this thesis is that this link needs to be reinforced in order to incentivise cooperation to adopt legally binding measures to achieve financial stability and decrease volatility, such as the 2011 Proposal.

However, there is a crucial distinction between general principles on effective banking supervision and speculative taxation in the form of a Financial Transaction Tax, which is

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<sup>55</sup> Basel Committee on Banking Supervision 'Core Principles for Effective Banking Supervision' September 1997

<sup>56</sup> Ibid Section I p.8

related to a general 'identity crisis' as to how to categorise a Financial Transaction Tax Proposal. On the one hand, the Proposal could be considered to be primarily a tax Proposal. These Basel principles do not acknowledge the application of public goods to taxation proposals and, if applied strictly, these principles cannot be used to legitimise a tax Proposal. On the other hand, if the 2011 Proposal is viewed primarily as a banking standards and practices measure, designed to curb volatility and reinforce financial stability, as this thesis advocates that it should be, then these principles are analogous. Therefore, if financial stability can be primarily incorporated into a taxation agreement as an aggregate public good, and good corporate governance included as a secondary club good, the Financial Transaction Tax can gain global legitimacy via constitutional pluralism due to the interconnected nature of the financial markets on a regulatory level beyond the confines of the European Union's institutional structure. Member States' economies have been linked for far longer than their constitutions. Furthermore, establishing an international organisation which, at least at its creation, had the express aim of interlinking national economies in a common market, has accelerated and advanced the legitimacy which could be afforded to a common Financial Transaction Tax, far beyond Keynes' discussion in the 1930s and even Tobin's presentation of a currency conversion tax, discussed in chapter 1 of this thesis.

The 2011 Proposal was not framed in this manner and therefore, the aforementioned methods of incentivising participation in aggregate public goods and recognising inter-regulatory pluralism were not observed. Instead, a more antagonistic approach has been adopted, moving away from the public good of financial stability and decreased volatility in financial markets, with arguments instead framed in 'fairness' and historical exemption of financial transactions from VAT. Therefore, if the EU-ten Financial Transaction Tax fails to be introduced, but the Commission retains a desire to introduce taxation on individual transactions, the tax must both be firmly designed as and portrayed as establishing an

aggregate public good as a mechanism to provide financial stability, instead of pitching the tax as being a punitive, fundraising 'bank bashing' proxy tax to repay the cost of Member State bail outs. Furthermore, with express international economic links, it must not rely solely on making this argument in the European Union forums, but also in other forums such as the Basel Committee and the EU's membership of the G-20, in order to alleviate concerns about the European Union acting alone. This would be a combination of a hard law and soft law approach, or regulatory pluralism. If a consensus can be reached in these forums, taxation of individual transactions to decrease speculative trading could be incorporated into the EU legal order in a variable geometry manner as argued by Patomäki. However, aggregate public goods cannot be entirely compatible with the *à la carte* method of integration. Therefore, there needs to be a means of drafting a Proposal which can provide for an element of choice, but also makes the Proposal less intimidating to Member States, to widen participation and create a higher aggregate public good. In other words, a common core is necessary, with elective additional elements in order to accommodate an *à la carte* approach. This approach is incorporated into a suggested means of reform via the introduction of a common finance policy later in this thesis.

## **5. A Graduated Approach: Systems Thinking**

In addition to misrepresenting the nature of a Financial Transaction Tax, this thesis is also critical in that the 2011 Proposal was perceived as being too onerous in the resultant obligations for financial institutions, strengthening resolve against necessary progress towards a more sustainable financial system. With this in mind, this thesis advocates that systems thinking can be applied in order to correct this, indicating that a more gradual approach is preferable for contentious policy areas, such as financial regulation, in order to achieve positive long-term regulatory change, leading to the provision of a public good.

There are elements of systems thinking which can assist in explaining how changes may occur over a period of time, particularly in the area of business management. A full examination of all aspects of systems thinking is beyond the scope of this thesis, however in summary, it seeks to examine the entirety of an organisation as opposed to isolated snapshots of a system, with the aim of clarifying and explaining patterns within systems/organisations and provide clarification on how to change this. To a degree, this is comparable with adopting a macroeconomic approach to assess financial markets as a whole, as opposed to a microeconomic approach, assessing individual institutions.

Senge explained his interpretation of systems thinking by drawing a comparison with a rainstorm.<sup>57</sup> Clouds mass and darken, indicating to us that it will rain. After the storm passes, the rainfall runoff feeds into groundwater a distance away and the sky clears. These series of events are distant, yet remain connected within a pattern. Each of these series of events will have an influence on the rest, which may be hidden from view. In systems thinking, business and other human endeavours are systems too bound by a series of “indivisible fabrics of interrelated actions, which often take years to fully play out their effects on each other.”<sup>58</sup> Identifying these actions at an earlier date and time can lead to a competitive advantage. Mella adds that systems thinking also allows for future predictions, stating “the models that we can produce with systems thinking are among the most effective because they allow us to “see the impossible”, to predict the future, to dominate complexity.”<sup>59</sup>

Systems thinking is particularly important from a business management standpoint, and Senge’s work posits that the most successful business corporations would be those which

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<sup>57</sup> P Senge, *The Fifth Discipline* (Random House 1999) 6-7

<sup>58</sup> Ibid at 7

<sup>59</sup> P Mella, *Systems Thinking: Intelligence in Action* (Springer 2012) 29

become 'learning organisations'. These organisations would excel by discovering how to tap into their employees' commitment and capacity to learn, and to react accordingly. This information could be internal to the organisation, for example, an in-house review of Northern Rock's lending practices prior to the financial crisis, or external, for example reviewing practices in line with a more wide scale review into the causes of the financial crisis. In this regard, it is necessary for the company to have knowledge of the entirety of its practices. Systems thinking in business management allows for the construction of such a model. The companies that do not learn in this manner either will not live up to their full potential, or ultimately will fail. By extension, a financial sector comprised of non-learning organisations will either not provide as great an economic benefit as possible, or will fail in a manner similar to the 2008 financial crisis.

Senge states that for the majority of companies that do fail, there is objectively a large volume of evidence beforehand that the firm is in difficulty. This is not necessarily caused by wilful neglect of the evidence. There are, according to Senge, seven factors which can hinder an organization's ability to learn. Senge refers to these as "learning disabilities."<sup>60</sup> There is no reason why Senge's advocacy of a learning organisation cannot be extended to other non-business entities that draw conclusions on previous data to modify behaviour, including political and law-making organisations such as the European Union.

Much can be said about the Union's institutional capacity to learn and predict future patterns using this theory beyond the scope of this thesis, however this chapter focuses on one of Senge's learning disabilities, referred to by Mella as 'temporal slowness', but which can be illustrated with reference to the parable of the boiled frog. This chapter seeks to explain that in the context of business management this may have a negative

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<sup>60</sup> Supra n.59 at 17-26

implication, yet in terms of introducing policies for the EU institutions, temporal slowness may in fact have a positive connotation by allowing policymakers to draft more effective legislation to achieve a public good, such as financial stability. It argues that a more patient, graduated approach from the European Commission could yield greater, long-term stable results and that ultimately, this model should have been followed for the 2011 Proposal.

### **5.1. The Parable of the Boiled Frog and Temporal Slowness**

Temporal slowness is a more abstract theory than public good theory, which can be used in a variety of situations to explain the process of gradual change. Mella states that this is intrinsically linked to the learning principle of temporal slowness. The principle is based on the observation that the environment, primary sensory signals and internal representations of the environment develop on different timescales. Organisations are more than a series of systems. These systems develop at different rates.<sup>61</sup> Temporal slowness can be explained by analogy, by examining the process of how individuals react to sensory stimulation. For example, in order to react to an environmental factor, firstly individuals rely on primary sensory signals, such as the response of individual receptors in the retina in order to begin the process of seeing an image.<sup>62</sup> Secondly, this information must be processed. This takes place on a slower timescale, and can take a few seconds. These first two actions are comparable to the publication of a public consultation on matters such as financial stability, followed by individual actors comprehending the specific aims of the consultation when drafting new regulations. Finally, once information has been processed, an image forms and the individual has an internal representation of the surrounding

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<sup>61</sup> L Wiskott, 'Slow Feature Analysis: A Theoretical Analysis of Optimal Free Responses' (2003) 15(9) *Neural Computation* 2147

<sup>62</sup> These can change very quickly, for example small eye movements or changes in the texture of objects may lead to rapid changes of light intensity received by a receptor neuron.

environment, they react accordingly. Each process is a system, though each has a differing timescale. Temporal slowness assumes that if we are able to extract slowly varying features from quickly varying signals in a non-trivial manner, then it is possible to learn useful information, to form a more accurate image of the overall environment and consequently react in a more appropriate manner. This chapter seeks to demonstrate that this approach can apply to law making generally, before specifically considering how this could inform financial regulation and taxation policymaking.

The parable of the boiling frog is an analogous extension of this. It is built upon the premise of the means by which it is possible to boil a live frog in a pan. If placed into a pan of already boiling water, the frog will detect the heat and jump out of the pan to avoid injury. The fierce change in conditions alerts the frog to potential danger and it seeks to escape. If placed into the pan of water and the temperature is increased too quickly, the frog will again notice the change in conditions and jump out of the pan. The solution therefore is to adopt a more patient approach and place the frog in a pan of cool water, increasing the temperature gradually. The frog does not notice the change is taking place, and consequently does not jump out of the pan. This parable and temporal slowness explain that substantial changes can take place over a long period of time. Whether it is within a business organisation, or a political organisation such as the EU, it may be necessary to adopt a patient and gradual approach to achieve a particular aim, giving individual actors time to acclimatise as opposed to an aggressive short-term approach, provoking a hostile reaction from individual actors. Conversely, the parable also demonstrates that if a business is slow to react to market conditions, there could be a negative consequence of at least poor efficiency, but at worst insolvency. Overall, when applied to law-making this creates a balancing act, but once legislation commences in the interest of providing a public good, in theory legislators should be ahead of businesses if the change is sufficiently

gradual. The same approach can be adopted regarding a collective of organisations, such as the financial sector.

Mella states that from this we can learn that “some phenomena are so slow that often we cannot perceive them”<sup>63</sup> and as a consequence, systems thinking ensures careful consideration of seemingly small and slow differences, which, if not perceived appropriately, can lead to mass change due to the interconnected nature of a system. In order to ensure these are noticed, systems thinking proposes an operational rule of amplifying weak signals of change. Senge attaches a negative connotation to this parable in classing it as a ‘disability’, acting as a threat in the background to creeping influence. By way of a practical example, demonstrating the impact of businesses being slow to react, he cites the American automotive industry as a model.<sup>64</sup> In the 1960s, the three big Detroit manufacturers dominated North American production. In contrast, in 1962 the Japanese automotive industry had a less than 4 per cent market share. In 1967 this approached 10 per cent and in 1974 this increased again to approximately 15 per cent. Senge states that the big three manufacturers did not assess their corporate practices until the early 1980s, with the Japanese market share increasing to 30 per cent by 1989.

This chapter seeks to argue that, particularly with regard to taxation of the financial sector, temporal slowness can in fact have a positive connotation and act as a means by which to achieve calculated, patient, long-term change. For example in Senge’s American automotive industry example, the failure to identify the increasing market share of Japanese manufacturers is a negative for the American companies, but acts as a positive for the Japanese manufacturers and ultimately for the consumer, since an increase in manufacturing means a greater degree of competition and choice, which leads companies

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<sup>63</sup> *Supra* n.61 at 30

<sup>64</sup> *Supra* n.59 at 22

to alter their behaviour for the benefit of consumers either by raising the standards of production or decreasing costs paid by the consumer. While these may not be public goods as such, due to the nature of the benefit being almost exclusively for motorists, it does provide a club good.

## **5.2. Application to the Financial Transaction Tax**

With regard to regulation of the financial sector, the EU's great strength is that it offers a wide and diverse platform upon which to implement common policies, to prevent and to mitigate further crises. This strength is also its weakness. The EU as an organisation is a complex system, meaning there is an increased chance of a more hostile reaction from an individual actor or Member State, if progress is deemed to be too rapid and markets have not had time in which to acclimatise. Furthermore, each Member State has different pressures upon it from the electorate, interest and lobby groups and unions, complicating this system further. The example running throughout this thesis is the UK, in having the largest financial sector in the EU, is under different pressures relative to other EU Member States and will behave differently. However, the Commission is not immune to these pressures either. As indicated previously in this thesis, trade unions played a key role in arguing against the introduction of a Financial Activities Tax, leading the Commission to instead draft the 2011 Proposal.

This does not necessarily mean that Member States have to share a commonly held belief about the best means by which to ensure financial stability, with Member States unwilling to compromise. Yet temporal slowness does mean that policymakers and those Member States in favour of introducing taxation of the financial sector should adopt a more strategic approach to address this. To this end, the ambition of the Commission's original Financial Transaction Tax Proposal in September 2011 may be applauded, but the Commission has potentially played its hand too soon in revealing its ultimate intentions and the omission of a prescribed graduated timeline for its introduction is a weakness. Although discussed in

chapter 1, the focus of this section concerns the stated timelines in the 2011 Proposal. It stated by the end of 2011 the Commission as part of the Union's ambitious regulatory reform programme would propose the full range of financial services reform around four particular goals, namely, improving supervision of the financial sector, strengthening and providing for recovery of financial institutions, making financial markets safer and more transparent, and increasing consumer protection.

The 2011 Proposal was designed to complement these and sought to introduce a wide-ranging tax, to come into effect by 1 January 2014<sup>65</sup>, as part of the Commission's Lisbon 2020 Strategy. The Proposal included, not only references to share transactions, but in addition, derivative agreements, chargeable any time a new agreement was formed or an existing agreement was amended. These were to be adopted at the same time, not in a two-stage process. As a means to mitigate any potentially negative impact of the tax, Article 16 of the 2011 Proposal did include a review clause, with the first assessment to be conducted by at least 2016. If the tax had been designed in a manner that was detrimental in its full form, this can be interpreted as assessment after the fact, failing to address Member States' concerns about impact. Following the realisation that the Enhanced Cooperation procedure would be used, the participants made a second mistake in the subsequent 2013 Proposal for a Council Decision to authorise Enhanced Cooperation, by again failing to introduce a graduated timeline for introduction. The first recognition of the need to adopt a progressive timeline was provided by a joint statement by the then eleven Member States participating in the Enhanced Cooperation procedure in May 2014, a full two and a half years after the 2011 Commission Proposal. The

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<sup>65</sup> 2011 Commission Proposal, Article 17

statement explained that a progressive timeline for introduction was required in order to consider the impact on the wider economy:

“The work on the introduction of a harmonised financial transaction tax is to be based on a progressive implementation of the tax. The progressive implementation will first focus on the taxation of shares and some derivatives. Our approach is essential to ensure that each step towards full implementation of the financial transaction tax is designed in a manner that takes due consideration of the economic impact.”<sup>66</sup>

At the time of writing, the EU-10 are still negotiating, with a self-imposed deadline of January 2016 being missed. Yet there are clear instances of overlap in taxation and regulation of the financial sector, for example differing forms of stamp duty on share transactions and bank levies.<sup>67</sup> Therefore, post-2008 there has been a clear underlying thread across the Union that tax policy can be used to dissuade from risk. However, in being too ambitious, the 2011 Proposal failed to build upon these solid foundations. If a much more gradual approach were adopted, which in turn emphasised the public good aspects of such a tax, greater cooperation may have been possible.

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66 Federal Ministry of Finance, ‘Joint Statement on Financial Transaction Tax’ (*Federal Ministry of Finance*, 6 May 2014) <<http://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Taxation/Articles/2014-05-06-joint-statement-financial-transaction-tax.html>> Accessed 8 April 2018

<sup>67</sup> For example see KPMG, ‘Overview of Financial Transaction Taxes Within the EU’ (*KPMG*, 28 July 2013) <<https://home.kpmg.com/xx/en/home/insights/2013/07/overview-of-taxes.html>> Accessed 8 April 2018 regarding stamp duty equivalences and Said Business School, Bank Levy Information (2013) <[http://www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Docs/Publications/Working\\_Papers/Series\\_13/BankLevydata.pdf](http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_13/BankLevydata.pdf)> Accessed 8 April 2018 regarding domestic bank levies as of October 2013

## **6. Caveats to a Positive Interpretation of Temporal Slowness**

The absence of a progressive timeline may prove to be difficult to overcome and there is the possibility that if the ten Member States cannot agree on a means by which to tax the financial sector, the endeavour to introduce some common form of Financial Transaction Tax fails. If it elects to revisit transaction taxes, the Commission may be forced to draft a new version of a Financial Transaction Tax, which addresses the timeline problem. If there is to be a re-draft, then the starting point should be commonly agreed areas, such as stamp duty on shares. This approach is reflected in the Common Finance Policy Recommendation later in this thesis. In this context, a positive interpretation of temporal slowness explains that a patient approach must be taken for the Commission to achieve its larger aims, however there remain certain caveats to using this approach.

The theory can be used to explain both positive change and negative, yet it is not always clear as to whether or not a change is a positive. For example, referring to Senge's previously discussed American automotive industry case study, there is the argument that increased competition ultimately should benefit the consumer, which is a positive. However, in order to remain in business the American automotive industry may be forced to cut operating costs by increasing redundancies. Not only is this a negative threat from a business management perspective, but the effect may be wider spread, for example, a decrease in domestic productivity and an increase in the rate of unemployment in one geographical area. This thesis is grounded in the advocacy of neo-Keynesian macroeconomics, campaigners and the Commission view that a common Financial Transaction Tax will be successful for consumers in modifying the behaviour of the financial sector, creating disincentives for risk. However, equally, there are those who argue that the tax will be detrimental in the long-term for the financial sector and those employed in the financial sector. These are well-founded reservations, particularly in terms of the need for international introduction to avoid relocation of financial services to

international markets. Of these two competing interests however, this thesis is of the view that financial intermediation theory and economic theory as discussed in chapter 2 provide that the financial sector is distinct from the automotive industry and therefore this is not a direct comparison. The scale of the impact of the 2008 crisis places greater emphasis on consumer protection. Furthermore, as discussed in this chapter, financial regulation, designed to achieve stability and decrease volatility, should be considered to provide a legitimate public good. Public goods provide benefits and therefore can be ascribed as positive. If a public good is achieved by adopting a temporal slowness methodology, then the end result should, by definition, be positive.

Secondly, there is also an issue with regard to the speed at which change occurs. In terms of the Financial Transaction Tax, if the change is designed to occur in a manner in which Member States and financial markets fail to anticipate, there is also an obligation on the Commission to monitor the speed of implementation. For this process to work, the Commission needs to be fully aware of all developments and reactions throughout, though if the degree of change is too nuanced, the Commission may lose control of the introduction of a tax, or overlook certain red flags during the course of the its introduction. Retracting the policy would ultimately prove to be damaging to the image of the tax too.

The final and potentially the most important caveat is the degree of democratic legitimacy afforded to measures adopted via temporal slowness, which are arguably less legitimate than measures adopted via differentiated integration as outlined in previous chapters. It is this aspect which differentiates temporal slowness from the multi-speed Europe theory of integration. By the basic nature of temporal slowness, the particular change is designed not to be noticed by those affected by the change. Introducing a measure 'under the radar' is a calculated series of events and consequently has a low degree of democratic legitimacy. It is clear that for legitimacy to be attained, policymakers should be able to be held to account by elected representatives, and furthermore, the policy itself should be

debated accordingly. Although the Commission and the ten Enhanced Cooperation States may believe that a common Financial Transaction Tax is a beneficial policy, opponents, whether financial institutions which bear the burden of a tax, sceptical MEPs or Member State governments, should be able to debate a proposal. By way of contrast, the multi-speed Europe theory of integration relies on participating parties expressly determining the desired end result and prescribing timelines for this to occur. There is a clearer roadmap for the introduction of policies agreed to by all Member States and therefore there is a higher degree of democratic legitimacy.

Therefore, this chapter does not argue that temporal slowness should be followed precisely, as a means by which to deceive Member States and financial markets into being bound by a measure they are truly unaware of. It does argue that being overambitious or wanting change too quickly has been detrimental to the prospects of a long-term, larger scope Financial Transaction Tax being introduced as widely as possible. In the event of this incarnation of a Financial Transaction Tax not being introduced across a significant number of Member States, the argument is instead that a more patient, long-term approach, rooted in macroeconomic stability, stressing the public and club good benefits to States and institutions as opposed to short-term political aggrandising and 'bank bashing' is in the best interests of EU citizens, by allowing financial markets time to acclimatise to changes and phase in the introduction on a step by step basis. Legitimacy is provided by the principles of economic pluralism. Participating states may agree to particular policy aims, but this needs to be allowed to develop over time and be open to reform. The discussion of bank levies and European Banking Union in chapter 2 indicates that there is common ground, which is reflected in the proposed Common Finance Policy in this dissertation. This does not mean, however, that bank levies and a version of the Commission's Financial Transaction Tax are incompatible or exclusive forms of taxation. The EU-ten States are all members of the euro area and therefore view them as

compatible, and furthermore, the concept of regulatory pluralism indicates that multiple forms of legislation should be adopted in order to achieve desired legal effect. As a consequence, there are two potential scenarios for the Financial Transaction Tax to be successfully introduced taking this into account. The first scenario is that the EU-ten States act as trendsetters and establish the frameworks and timetables by which to adopt a Financial Transaction Tax in the future, reflecting a multi-speed Europe approach to introduction. The second scenario is far wider and more ambitious, but would take far longer to successfully implement. Establishing common areas of financial regulation as a base standard would grant an opportunity to go beyond taxing shares and derivatives as the Commission has envisaged, but a greater degree of patience and time for the financial sector to acclimatise to phased introduction would be required on the part of policymakers and regulators.

## **7. EU Tax Proposals and a Graduated Approach: The Case Study of CCCTB**

In order to support the underlying assertions made in this chapter of the thesis, the following case study demonstrates a graduated, transitional approach being adopted with regard to a common tax being adopted at an EU level, the Common Consolidated Corporate Tax Base (CCCTB). Discussions with regard to the adoption of an EU-wide policy regarding the introduction of a CCCTB pre-date the discussions which led to the 2011 Proposal, yet there are valuable insights that can inform the common Financial Transaction Tax discussion. The European Commission included CCCTB in the 2001 tax agenda for the single market in 2001<sup>68</sup> as a concerted effort towards long-term corporation

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<sup>68</sup> Commission Communication (2001) 582 Towards an Internal Market Without Tax Obstacles: A strategy for Providing Companies with a Common Consolidated Corporate Tax Base for their EU-Wide Activities.

tax reforms in order to increase efficiency in intra-community trading, in part by decreasing compliance costs, due to the divergence of domestic tax provisions. The idea received academic support as a means by which to resolve many of these issues<sup>69</sup>, however there were some authors who believed that there would be detrimental economic effects, which outweighed the potential stated advantage of increased efficiency.<sup>70</sup> In 2003, the European Commission made clear that it viewed introduction of CCCTB as the biggest priority<sup>71</sup> to achieve European company tax reform, leading to the formation of a Working Group. Following a series of plenary meetings, debates and working papers, the Working Group eventually proposed the first CCCTB Directive in 2011.<sup>72</sup>

The overall aim of the Directive was to provide a 'one-stop shop' for corporate taxes in the EU, to reduce costs for businesses and prevent double taxation in certain circumstances. This was with a view to promoting growth, competitiveness and to generate employment in the single market, by allowing businesses to allocate compliance funds into staffing costs. One of the benefits of having a single system as opposed to divergences between states for Member State finances was that the CCCTB Proposal included a package for anti-tax avoidance measures, meaning that there should be a greater proportion of funds paid in tax receipts to treasuries, relative to markets without a CCCTB provision. As Khan Niazi notes:

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<sup>69</sup> For example, see P Sorenen, 'Company Tax Reform in the European Union' (2004) 11 *International Tax and Public Finance* 91 and J Martens-Weiner, *Company Tax Reform in the European Union* (Springer 2005)

<sup>70</sup> For example, see R Cline et al 'Study on the Economic and Budgetary Impact of the Introduction of a Common Consolidated Corporate Tax Base in the European Union' 2010 <<http://estaticos.expansionpro.orbyt.es/estaticas/descargas/2011/02/informeeyoung.pdf>> This report was commissioned by the Irish Department of Finance

<sup>71</sup> Commission Communication (2003) 726, *An Internal Market without Company Tax Obstacles: Achievements, Ongoing Initiatives and Remaining Challenges*

<sup>72</sup> COM(2011) 121/4 – 2011/0058 European Commission Proposal for a Council Directive on a Common Consolidated Corporate Tax Base

“The proposal promised harmonization of rules to compute the individual tax bases of all group members of multinationals qualifying for the CCCTB regime. The tax bases of enterprises that opt-in for the CCCTB regime would then be consolidated and shared by Member States through an apportionment formula that would equally weigh sales, labour and tangible assets.”<sup>73</sup>

The proposed CCCTB was incredibly ambitious in its aims. This is even in comparison to the 2011 Financial Transaction Tax Proposal, since the CCCTB, if adopted, would have entailed Member States cooperating to cede sovereignty concerning a form of direct taxation, as opposed to the Financial Transaction Tax’s indirect tax design. This echoes the argument made previously in this chapter, that nothing is necessarily objectionable with the Union wishing to be ambitious in its legislative agenda, but the pace of change can be a determinant factor in these discussions. As a result of the inherent link between fiscal sovereignty of Member States and legislative manoeuvres towards common action, historically in this particular area, proposed legislation which has been implemented has, in its design, been more considered, calculated and most notably, cautious, by comparison.

As a result of the overly ambitious nature of the 2011 CCCTB Proposal, the proposed Directive did not pass the Council, with the UK and Ireland in particular proving hesitant. At this point, there is a clear divergence from the path followed in relation to a common Financial Transaction Tax. There was some discussion with regard to the possibility of using Enhanced Cooperation in relation to CCCTB. These discussions pre-date the 2011 Proposal, for example in 2004 the Commission indicated Enhanced Cooperation as a potential solution to adopting a CCCTB.<sup>74</sup> Following the publication of the 2011 CCCTB

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<sup>73</sup> S Khan Niazi, ‘Re-Launch of the Proposal for a Common Consolidated Corporate Tax Base (CCCTB) in the EU: A Shift in Paradigm’ (2017) 44(3) *Legal Issues of Economic Integration* 293 at 297

<sup>74</sup> See European Commission, Non-Paper to informal Ecofin Council, 10 and 11 September 2004: A Common Consolidated Corporate Tax Base (7 July 2004), at 4. See also L Cerioni, ‘The Possible Introduction

Proposal, the European Parliament, exercising its consultative powers, added that if that Proposal were to prove unsuccessful, that Enhanced Cooperation could be invoked for Member States of the currency union, proposing the following amendment be added to the Commission's CCCTB Proposal:

“(4a) As the internal market encompasses all Member States, a Common Consolidated Corporate Tax Base (CCCTB) should be introduced in all Member States. However, if the Council fails to adopt a unanimous decision on the proposal to establish a CCCTB, it is appropriate to initiate without delay the procedure for a Council decision authorising enhanced cooperation in the area of the CCCTB. Such enhanced cooperation should be initiated by the Member States whose currency is the euro but should be open at any time to other Member States in accordance with the Treaty on the Functioning of the European Union.”<sup>75</sup>

Of particular note is that recourse to Enhanced Cooperation was one of the six proposed amendments to the 2011 CCCTB Proposal by the European Parliament, exercising its consultative powers in the discussion process. However, in contrast to the approach adopted in relation to a common Financial Transaction Tax, as detailed previously in this thesis, recourse to Enhanced Cooperation was not sought by a group of Member States in relation to CCCTB.

Although this thesis has defended the use of the Enhanced Cooperation procedure, it is possible to argue that the CCCTB model should have been followed instead, in order to temper a perceived antagonistic approach by the Commission, in response to Member States' objections to CCCTB's promulgation in the proposed form. The European Commission recognised that the original CCCTB Proposal would not be adopted.

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of Common Consolidated Base Taxation via Enhanced Cooperation: Some open issues' (2006) 46 *European Taxation* 187 and L Bettendorf et al, 'Corporate Tax Consolidation and Enhanced Cooperation in the European Union' (2010) 31 *Fiscal Studies* 453

<sup>75</sup> European Parliament, Report on the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) ), Report A7-0080/2012 (2012)

Therefore, renewed impetus was required, and in 2015 the CCCTB was revived in a European Commission action plan for a fair and efficient corporation tax system in the EU.<sup>76</sup> CCCTB was at the core of this action plan, with the Commission indicating two distinct variations from the 2011 CCCTB Proposal. Firstly, the new draft was set to be a mandatory tool for companies. Secondly, there was to be a two-stage process as opposed to the original 'single-shot' approach.

The acknowledgement of a two-stage approach identifies, in accordance with the arguments in this chapter, that the legislature recognised that the process of change was too rapid and broad in scope. Therefore, in order to adopt some form of progress, a new approach was required. The two stages relate to splitting the original CCCTB Proposal's aims, treating "common" and "consolidation" separately, to achieve legislative accord with regard to common taxation before considering consolidation at a later stage. In other words, not all solutions were to be proposed in a single piece of legislation, demonstrating the efficacy of legislative models based on regulatory pluralism, outlined previously in this chapter.

The debate concerning the Commission's need to adopt a more patient, considered approach in this area was not an overnight development, with several indicators that the Commission recognised a more gradual approach would ultimately be beneficial. In addition to articles by authors such as Lang<sup>77</sup>, in April 2012 the Council discussed a 'trimmed text' of the original draft directive, omitting the final few chapters.<sup>78</sup> This included

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<sup>76</sup> COM(2015)302 final Commission Communication, A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas of Action (17 June 2015)

<sup>77</sup> M Lang, 'The Principle of Territoriality and its Implementation in the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)' (2012) 13 *Florida Tax Review* 307

<sup>78</sup> Council of the European Union, Proposal for a Common Consolidated Corporate Tax Base (CCCTB), doc. 8387/12 FISC 49 (2012)

the consolidation part of the Proposal. Later, in June 2013, the Council discussed a road map for adopting the CCCTB<sup>79</sup>, which included a two-stage adoption process, with consolidation and apportionment being discussed after common taxation. This roadmap was submitted to national governments. A compromise document was later drafted in 2014 and discussed at Council level, omitting the most contentious parts, in an attempt to foster cooperation.<sup>80</sup>

The 2015 Action Plan stated that the Commission was set to draft new Proposals by the end of 2016. Consequently, two Proposals were published, one for adopting a Common Corporate Tax base and one for a Common Consolidated Corporate Tax Base.<sup>81</sup> At the time of writing, these two Proposals have not been adopted, however there appears to be far greater support for common action relative to the original 2011 discussions, which is beneficial, not only for the efficiency of the Union legislature, but also, in theory, for the Member States and businesses which would be able to benefit from implementation of a CCCTB process.

## **7.1. The Influence of a non-EU International Organisation: OECD**

### **Membership**

This chapter aims to demonstrate the impact that a graduated timeline can have in relation to the adoption of contentious issues, designed to reform tax policy within the EU. However it would be naïve to assume that, with regards to the CCCTB, the renewed impetus is

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<sup>79</sup> Council of the European Union, ECOFIN report to the European Council on Tax Issues, doc. 11507/13 FISC 138 (2013), at 30–31

<sup>80</sup> Council of the European Union, Proposal for a Common Consolidated Corporate Tax Base (CCCTB), doc. 15756/14 FISC 197 (2014).

<sup>81</sup> Com 2016( ) 683 Final Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) 2016/0336 (CNS) and Com (2016) 685 final Proposal for a Council Directive on a Common Corporate Tax Base 2016/0337 (CNS)

exclusively attributable to a more considered approach. As stated in the previous section, in the new Proposals, there is a far greater emphasis on countering tax avoidance measures. This is no coincidence and reflects the aims of the OECD's Base Erosion and Profit Shifting (BEPS) project.<sup>82</sup> 22 of the 28 EU States are members of the OECD<sup>83</sup>, highlighting that an international organisation which is external to the EU's structure can influence the EU's legislative agenda. By analogy, membership of an organisation, such as the Bank for International Settlements, which, as demonstrated previously in this chapter recognises public goods, can potentially have a similar influence on cooperation at EU level in matters concerning financial regulation. The 2013 BEPS action plan states that, while globalisation has been overall a positive for the world economy, as markets have become more integrated, Multi-National Enterprises (MNEs) have found ways to reduce their tax burdens. The action plan indicates that this has the following impacts for States and citizens:

“These developments have opened up opportunities for MNEs to greatly minimise their tax burden. This has led to a tense situation in which citizens have become more sensitive to tax fairness issues. It has become a critical issue for all parties:

- Governments are harmed. Many governments have to cope with less revenue and a higher cost to ensure compliance. Moreover, Base Erosion and Profit Shifting (BEPS) undermines the integrity of the tax system, as the public, the media and some taxpayers deem reported low corporate taxes to be unfair. In developing countries, the lack of tax revenue leads to critical under-funding of public investment that could help promote economic growth. Overall resource allocation, affected by tax-motivated behaviour, is not optimal.
- Individual taxpayers are harmed. When tax rules permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income

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<sup>82</sup> OECD, Addressing the Base Erosion and Profit Shifting (OECD, 2013)

<sup>83</sup> All Member States bar Bulgaria, Croatia, Cyprus, Lithuania, Malta and Romania

producing activities are conducted, other taxpayers in that jurisdiction bear a greater share of the burden.

- Businesses are harmed. MNEs may face significant reputational risk if their effective tax rate is viewed as being too low. At the same time, different businesses may assess such risk differently, and failing to take advantage of legal opportunities to reduce an enterprise's tax burden can put it at a competitive disadvantage. Similarly, corporations that operate only in domestic markets, including family-owned businesses or new innovative companies, have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax. Fair competition is harmed by the distortions induced by BEPS.<sup>84</sup>

The action plan recognises that Member States' fiscal sovereignty is important, however gaps have appeared in tax laws, which MNEs utilise, particularly in a growing digital economy, to reduce tax burdens. Chapter 3 of the BEPS Action Plan indicates that international standards are required in order to address these challenges, with 15 action points being outlined, which included avoidance provisions. To this end, the Council called upon the Commission to draft legislation reflecting BEPS within the existing CCCTB discussion.<sup>85</sup> BEPS elements are therefore reflected in the two Proposed 2016 Directives.

## **8. Moves Towards a Common Finance Policy?**

This thesis has been critical of the role played by advocacy groups, such as the Robin Hood Tax group, in presenting a distorted picture of Keynes and Tobin's macroeconomic foundations, and aligning its principally philanthropic nature with progress towards a common Financial Transaction Tax at EU level. In spite of some of the positive aspects of

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<sup>84</sup> OECD Base Erosion and Profit Shifting Action Plan 2013 at 8

<sup>85</sup> Council of the European Union, 'Base Erosion and Profit Shifting (BEPS) – Council conclusions', doc. 15150/15 FISC 185 (2015) at points 17 and 18

Patomäki's *Democratising Globalisation*, presented in the previous chapter, the same criticism can be applied in that the underlying justification is focused not on the underlying economic arguments in support of a tax, but that a notion of 'fairness' acts as the catalyst for suggesting reform. Nevertheless, it is undeniable that they have played a vital role in raising general public awareness of the debate on taxing financial institutions, in particular advocacy groups in using celebrities to reach a more mainstream audience than the Commission can in isolation. As a result, political pressure has increased following the financial crisis for States to adopt ambitious reforms, such as the Financial Transaction Tax, to prevent future crises. The BEPS action plan recognises the public sensitivity to MNE avoidance measures detailed by the publication of documents, such as the Panama papers and the Paradise papers. This public sensitivity is key to the OECD's action plan, which ultimately can influence EU policy. This thesis therefore does not seek to dismiss the impact that these advocacy groups have made, but is critical of some of their representation of core macroeconomic principles and public goods.

To this end, creating public sensitivity in the area of taxing speculative financial transactions in this manner is a salient strategy. Furthermore, the CCCTB case study demonstrates that international bodies outwith the EU can provide the necessary impetus for EU cooperation in contentious tax policy areas, in spite of concerns about national fiscal sovereignty. However, while the OECD has launched investigations into transfer pricing, BEPS and consumption taxes, at present it does not have an investigation into Financial Transaction Taxes. There are groupings, such as the Financial Action Task Force (FATF), however its remit is reserved for anti-money laundering provisions, not reinforcing financial stability and decreasing volatility. Therefore, arguments made in support of increased financial stability as a result of financial regulation provisions, such as the 2011 Proposal, may be made in other international forums outside the EU

institutional structure in order to achieve a consensus, which can be incorporated into the EU's legislative framework.

This chapter has previously discussed the Bank for International Settlements. Unlike the OECD, 26 of the 28 EU Member States' central banks are members. The remaining two Member States are Cyprus and Malta, both of which have adopted the Euro as their respective currencies. The European Central Bank is also a member of the BIS and therefore all Member States have some degree of coordination with these standards. If public good principles can be reinforced in relation to financial stability provisions at BIS level, a new form of cooperation for all Member States of the EU may develop, specifically with regard to a common financial transaction tax, provided that the tax is identified as a financial stability measure, as opposed to a fundraising, punitive form of taxation.

Building upon the concept of public goods outlined previously in this chapter and the alternative examples of banking reform which have managed to achieve inter-state consensus, it is possible to use a regulatory pluralism approach, which draws from the positive experience in relation to CCCTB, to act as a blueprint to create a Common Finance Policy. This Common Finance Policy could actively include elements from the 2011 Proposal being implemented in a more gradual manner, with the stated aim of providing a public good, as opposed to basing an argument on principles of fairness or historical exemption from VAT. Yet a Common Finance Policy could also include provisions from other financial regulation initiatives, in order to create a long-term, broad policy, to provide a public good of financial stability.

A wider policy applicable to financial markets beyond taxing individual transactions could seek to include regulation of payment systems and assist in the development and creation of digital markets including online crypto currencies such as Bitcoin. Due to the ultimate size of any successful Common Finance Policy, this would likely require the gradual approach that is offered by the positive interpretation of temporal slowness. Creating a

Common Finance Policy is more ambitious than the Commission outlined in the 2011 Proposal. This thesis and this chapter have been critical of the original Proposal for being too ambitious. Although ambition in the area of financial regulation is not a problem, practical implementation is. Temporal slowness, as discussed in this chapter, informs lawmakers what may happen if even proposed change is too rapid. A Common Finance Policy would need to be a genuine, gradual, long-term policy open to reform, designed to come into effect ultimately over a number of years and be sustainable for not just the next 5 to 10 years as the 2011 Proposal was, but over the next 20 to 30 years and beyond. In developing the initiative within the EU's legislative and institutional framework, a Common Finance Policy would mitigate practical questions concerning, for example, the operational base of an international organisation and the decision making process to amend the application of policies. The proposed structure of the policy is demonstrated in figure 2 at the end of the conclusion.

## Conclusion

This thesis has primarily sought to address the legal feasibility of introducing a version of an inter-state common Financial Transaction Tax on speculative transactions within the EU's legal framework, assessing classical theories and the more modern mechanisms of flexible integration. It accepts that Article 113 TFEU is the correct legal basis and predominantly seeks to examine potential legal methods of allowing Member States that do wish to adopt the tax to use the EU's legal framework in order to do so, but is ultimately critical of the manner in which the 2011 Proposal was presented, with an emphasis on fundraising and perceived inequities of historical exemption of financial services from VAT, as opposed to achieving a public good of financial stability. Furthermore, it is also critical of the scope of the 2011 Proposal, arguing that a more graduated approach would have led to a greater level of cooperation between EU Member States. This thesis does recognise that a common Financial Transaction Tax cannot, in isolation, provide the level of reform required post-2008 crisis without further regulation. Therefore, whilst this discussion focuses on the case study of the 2011 Proposal, many of the points made in this thesis with regard to reinforcing the public good and adopting a gradual approach apply more generally to future financial regulation and taxation Proposals in an enlarged Union.

The assessment provided is critical for the future of the EU integration project and has sought to determine how this is possible while maintaining democratic legitimacy. With 27/28 Member States currently forming the Union, and with candidate states likely to accede in the future, the need to pursue methods of flexible integration is set to become increasingly important. Some of these concerns have already been reflected by the CCCTB case study presented in chapter 4 in which renewed impetus was given to an

ambitious Proposal, by adopting a graduated approach. However, the international forum which the EU provides should be open to more flexible forms of integration in policy matters which provide a public good, such as increased financial stability.

Although it is not written from an economics perspective, chapter 1 includes a discussion of the underlying macroeconomic arguments in favour of taxation. As a consequence, the conclusions presented are dependent on the belief that there is a clear and compelling case to ensure that the behaviour of the financial sector is altered in the future, and that the introduction of new regulation is the way forward. Chapter 2 includes discussion as to why this should be a hard law provision. The conclusion that new regulation was required to alter conduct in financial markets leads to the argument that the 2011 Proposal did not adequately reflect or represent the underlying macroeconomic arguments of Keynes and Tobin's work with regard to behaviour modification and dissuasion from risk. The thesis also is dependent on the belief that existing measures cannot simply be extended in scope, and that new regulation is needed, with a form of taxing individual transactions being an appropriate step to take, in spite of the acknowledged 0.5 per cent decrease in EU GDP in the 2011 Proposal.

A long-term reduction in GDP which seeks to achieve a more sustainable form of growth is an argument that outweighs the short-term boom and bust approach that financial markets have historically adopted. In reducing, but not prohibiting, incentives, a degree of risk is removed, which proves beneficial not only to citizens, but also to the institutions themselves. There has been an 'identity crisis' created by the conflation of various different terms being used interchangeably when discussing regulating the financial sector through tax policy. As a result, the barometer has moved away from Tobin's aims to amend behaviour in currency speculation markets to being viewed as a fundraising tax. Consequently, the public good aspects of decreasing volatility in speculative financial

markets to ensure stability for the wider economy has been lost, causing hesitation on the part of Member States and institutions.

This thesis does argue that some form of integration is necessary, the difficulty is determining what degree of integration is appropriate in line with the Treaty requirements of subsidiarity and proportionality. The question therefore arises as to what would count as a successful outcome to satisfy this question? Once this is determined, it is possible to select one of the methods of flexible integration outlined in the previous chapters to achieve that aim. Whilst this thesis does seek to recommend that a blended approach should be followed, both in terms of regulatory pluralism and in application of theories of integration, it does recognise that, ultimately, it is for legislators to determine the level of integration that they wish to pursue regarding the introduction of the core aims of the 2011 Proposal. The following recommendations therefore represent different options available to achieve these aims, framed in the idea as to what policymakers would consider to be a 'successful' result.

### **Minimum Form of Taxation: Stamp Duty Model**

Would achieving at least some form of increased taxation be considered as a satisfactory result? If this were the case then the form of Financial Transaction Tax which would be the most appropriate would be the stamp duty model of taxing share transactions. This would likely be unproblematic to implement, since the majority of EU Member States already have a domestic form of stamp duty. This would raise little objection and, if necessary, the multi-speed theory of integration is an appropriate form of flexible integration to advocate, since the differentiation afforded would not be dependent on policy, but on time instead. Yet this thesis maintains that amending stamp duty on share transactions is insufficient. Many of these duties were in place prior to the 2008 financial crisis and did not cover the most toxic of assets, derivative agreements. In that regard, while it might be possible to

achieve EU consensus in this area, the Commission was correct to try to implement a wider ranging tax.

## **All 27/28 Member States: The European Commission's 2011**

### **Proposal**

It is possible to argue that success in this area can only be defined as all 27/28 Member States adopting the European Commission's 2011 Proposal. Any other outcome falls short of the initial target, and therefore alternative mechanisms carry with them a degree of failure. If this is the case, the only way in which it could be possible for all 27/28 States to adopt the Proposal is through a multi-speed Europe approach. Yet this stands little chance of succeeding. Too many events must occur in order for all 28 Member States to agree to the Proposal, for example changes in government. It is clear in the literature and the launching of Enhanced Cooperation in 2013 that, at present, the differentiation is on the grounds of policy, not time. If a multi-speed Europe approach were adopted, it would be very likely that there would be a permanent two-tier Europe in this particular area. Two-tier is often viewed as a negative consequence of a failed multi-speed effort. However, if the Dohrendorf interpretation of *à la carte* integration is adopted, there is a deliberate distinction on the grounds of policy, not time. This means that although multi-speed Europe might not be possible in this area, an element of choice may ensure that as wide a collection of Member States as possible participate in a version of a financial transaction tax. Equally, this distinction may be possible through use of the Enhanced Cooperation procedure.

## **A Significant Number of Member States: Enhanced Cooperation and Article 136 TFEU**

If it is impossible for all 27/28 Member States to agree to the original Proposal, would a significant number of Member States, adopting a version of an inter-state Financial Transaction Tax, which bears a close resemblance to the original Commission Proposal, be classed as a success? If so, the EU-eleven States were correct in requesting to use Enhanced Cooperation in this area. But the Estonian decision to withdraw from the cooperation, and the action for annulment launched by the UK, appear to have complicated negotiations on the scope of the tax further and currently the possibility of consensus is fragile, in spite of the apparent agreement of a 'core engine' among participating States. Enhanced Cooperation allows a form of differentiation with the collective action aspect of multi-speed Europe, but on the grounds of disagreements in policy in line with *à la carte* integration and has achieved a degree of success. Enhanced Cooperation may be suitable for certain policy areas, primarily in social matters, but for matters of taxation, the process is susceptible to challenge and viewed as a way to actively circumvent unanimity requirements. This thesis is critical of the 2011 Proposal and acknowledges its imperfections, but is more sympathetic to the decision of Member States to try to use Enhanced Cooperation. If ultimately successful, other beneficial Proposals, potentially even extension of VAT to financial services, could progress. Yet it is only through testing the process that States can understand the limits. Alternatively, Article 136 TFEU may have raised the possibility for all euro area States to adopt a Financial Transaction Tax. This would not be problematic if all 19 euro area States voted to adopt the tax, however this is unlikely to be the case, and therefore imposing a tax through QMV would be open to legal challenge, a challenge that would probably succeed.

## **Global Adoption: Variable Geometry**

One of the stated aims of the European Commission's Financial Transaction Tax was to act as a trendsetter for other financial markets beyond Europe to adopt a similar form of taxation. When confined to one particular region i.e. Europe, the tax can be classed as inter-State. There is an indication that the US may be heading towards taxing Wall Street if a Democratic President is elected in 2020, yet there is a means of incorporating the tax into the EU's legal order, while simultaneously applying it globally. The Schengen Agreement, as outline in chapter 3, was formed outside of the EU legal order and incorporated in through variable geometry. The EU could and perhaps should have made the case for a global financial transaction tax through either the Basel Banking Committee or the Bank for International Settlements to draft an agreement which could have been incorporated in a similar way to Schengen. In order to do this, they would have had to adopt the aggregate public good approach outlined in chapter 4 to encourage uptake by members of these committees. If this case had been made, then far more EU Member States would have participated.

However, there is no guarantee that the design of this hypothetical tax would be the same as the 2011 Proposal. Therefore, the likelihood of collaboration cannot be tested in the same manner as using the EU's institutional structure and a draft Proposal. Therefore chapter 3 contains an assessment of Heikki Patomäki's argument to create a new international Tobin Tax Organisation. This would operate outside of the EU's legal framework and is presented as a means by which to 'democratise globalisation' by allowing developing States to influence a supranational organisation. These arguments do reflect a variable geometry approach to integration, however, there are many practical difficulties in terms of establishing the structure, the location of the organisation and funding. Furthermore, Patomäki views the tax as being a fundraiser. Whilst these funds could be used to provide philanthropic goods, it does not in itself created a public good of

financial stability. This thesis argues that is key. Therefore in order for variable geometry to work as a means for integration, public goods need to be highlighted to potential States and club goods need to be stressed to institutions, however the practical difficulties regarding decision making and accountability are, perhaps, too difficult to resolve.

### **Incorporating Choice: À la Carte**

It is clear from the evidence provided that any solution to the flexible integration problem has to incorporate an element of choice i.e. *à la carte* integration. Traditionally *à la carte* integration has been viewed in a negative manner, and associated with opting out of areas of policy. Rebecca Adler-Nissen challenges this view, arguing that opting-out may in fact in the long-term encourage integration. Yet it is possible to be more critical of those who have labelled *à la carte* as being negative. Choice can be both negative *and* positive. Opting-in is a matter of choice and, as Ralf Dahrendorf argued, reversing *à la carte* integration to be a positive would likely lead to a core block of Member States participating in agreements. It is clear that in order to be truly successful, the imposition of increased amounts of taxation must incorporate an element of choice, but that does not mean that Member States should have entirely free reign in the area of taxation, and this should not be a *de facto* solution. In other words, there cannot be too high a degree of fragmentation. The 2011 Proposal was written in such a way as to be ambitious, but antagonistic. Among the noise created in the debate are genuine concerns regarding its efficacy and its scope. A more collaborative approach may have led to a more positive view of *à la carte* integration, as opposed to an exclusionary portrayal. If a negative understanding is taken, given that eleven States sought Enhanced Cooperation, this would mean there were 16 opt-outs granted. Based on the KPMG Map in Appendix A, a higher common standard may have reduced the number of opt-outs granted to three. However, this thesis wishes to convey *à la carte* integration in a more positive light. A common standard, built upon

reinforcing a public good with a graduated timeline for introduction and optional incentives to participate therefore seems to be possible.

## **A Common Finance Policy?**

This thesis recognises that the 2011 Proposal was not a panacea to resolve all the ills of financial institutions, but instead reflects common themes, with the establishment of EBU, that the Commission's aim is to protect consumers and increase standards in financial institutions. The emphasis is on avoiding recourse to taxpayer funds, in order to resolve private debt crises having a detrimental effect on the wider economy. Although there may be some subtle variations in tax scope, bank levies are calculated on exposure to risk. However, unlike a common Financial Transaction Tax, bank levies do not operate on each individual transaction. There is clearly, therefore, more than can be achieved in terms of reform of financial markets, and there are already areas of EU convergence in operation to protect consumers, such as depositor insurance and the Single Banking Rulebook. To this extent, it is clear to see that there is a common foundation of aims which could have been built upon at EU level. A recognition among all Member States that these provisions are intended to provide a public good, these core ideals could be acceptable to all States, or at least a greater number than the EU-10 could potentially have avoided recourse to Enhanced Cooperation. In other words, the aims of the 2011 Proposal should not have been viewed as distinct from other forms of financial regulation and supervision. With common interests, this raises the possibility of a Common Finance Policy.

How, therefore, could a Common Finance Policy operate and be structured? The EBU, the Basel Banking Accords and the Closer Cooperation systems were designed to include a multi-pillar structure. The basic idea of a multi-pillar structure, which States are already accustomed to in financial regulation and EU lawmaking could be used to create a wide-reaching policy beyond the 2011 Proposal. Since there are ideals which are common to

Member States regarding financial regulation, they can be grouped into one pillar. These would be compulsory provisions. Elements of the Financial Transaction Tax could therefore form part of a wider policy of financial regulation and could ultimately lead to the creation of a Common Finance Policy using some of the legal instruments already in operation.

Yet there are also measures which, objectively, could be deemed to be desirable, but not to all States. The previous chapters included discussion of the negative view of *à la carte* integration, arguing that it can be re-framed to act as a positive opt-in system. A second pillar, containing these more contested provisions, with optional protocols, reflects the Dahrendorf version of *à la carte* integration. Additionally, there may be some policies which concern functions of money levied in the first pillar. For example, although there is overlap with regard to bank levies, the UK model ensures that tax receipts are payable to the national treasury, yet the EU-wide bank levy places banks in participating Member States within the supervisory remit of the Single Supervisory Mechanism and, as part of this, funds the activities of the Single Resolution Mechanism. There are also other considerations that would be beneficial in changing the behaviour of financial services, for example, although as has been highlighted previously in this thesis, banks are privy to sensitive private information a greater degree of transparency, such as publication of and justification of basic salaries and bonuses for high risk investors may encourage a greater degree of social responsibility. Pillar two of the proposed structure in Figure 2 also includes a reference to a corporation tax surcharge on financial institutions, a policy which the UK has adopted in order to offset the impact of reducing the rate of the bank levy.

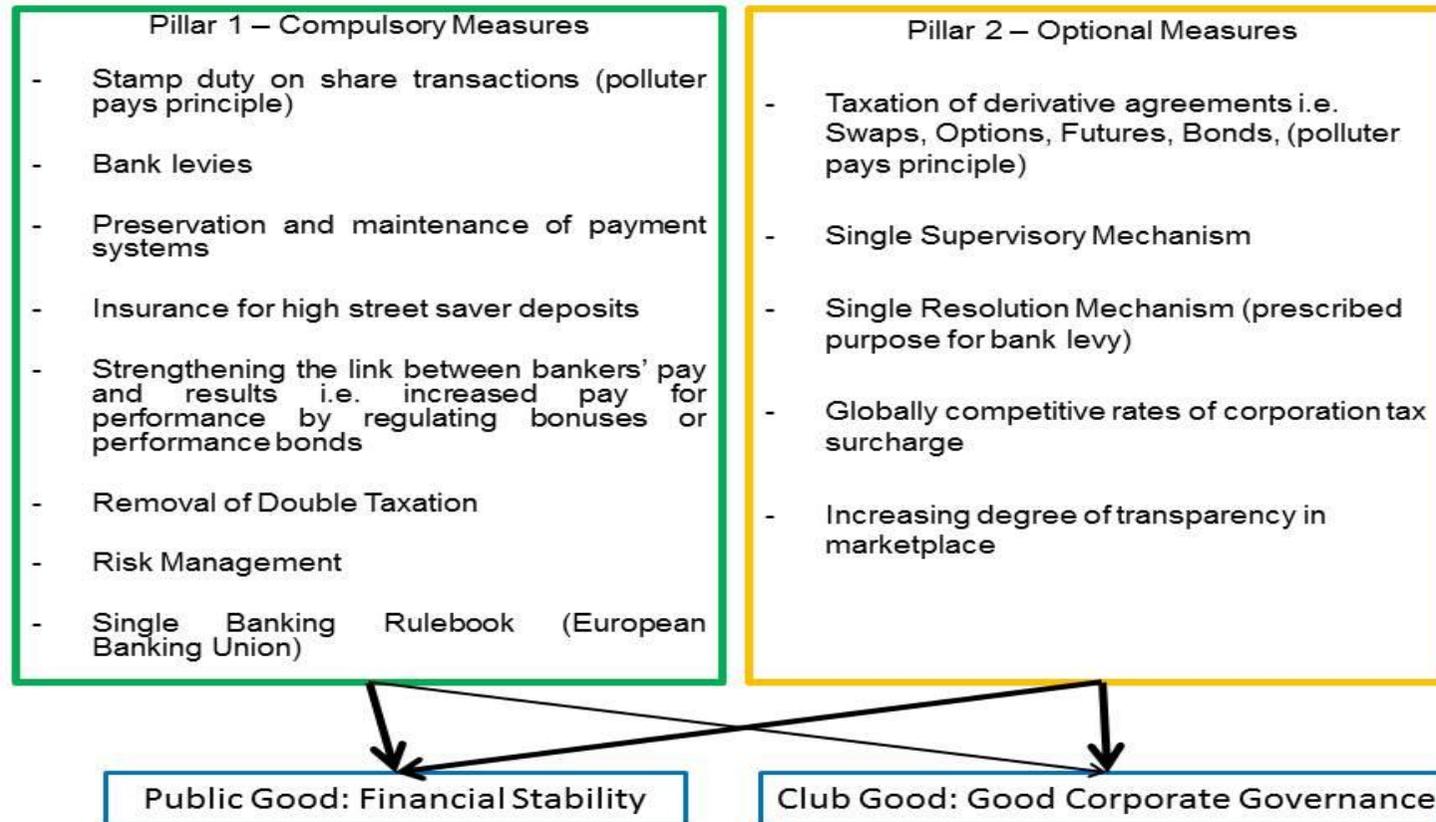
A well-designed two-pillar system contains measures that complement each other, since it includes minimum standards and optional extras. It also incorporates a greater degree of flexibility for Member States to incentivise more Member States to participate, by building upon commonly held beliefs and existing provisions such as depositor insurance

and the Resolution Fund. Nevertheless, due to its wider ranging nature in order to be successful or accepted, it is essential that a long-term gradual approach in line with the positive view of temporal slowness is followed. Not all measures in pillar one can be introduced or regulated at the same time. If introduced too rapidly the market will not have enough time to adjust to the changes and relocate. With regard to measures in the second pillar, these would be actioned in the form of commonly agreed optional protocols in line with a positive view of *à la carte* integration. The two-pillar system that this thesis proposes can be illustrated in Figure 2.

Therefore, this thesis argues that, although its aims were to be admired, the 2011 Proposal encountered a series of legal and political obstacles, which were exacerbated by the manner in which it was presented. There should have been a stronger emphasis on public goods, and a regulatory pluralistic model should have been followed. In addition, there should have been a greater connection with the core macroeconomic arguments, as opposed to framing the debate in terms of 'fairness' or revenue raising. This approach has left lawmakers with the option of either abandoning the legislative efforts, which may lead to redrafting and renewed attempts to introduce a tax in the future, or to attempt to proceed as far as possible with integration with a flawed 2011 Proposal as its foundation stone. If the former occurs, then the blueprint presented in this thesis regarding moves towards a Common Finance Policy should be followed. If the latter approach is adopted, then concessions would need to be made to achieve one of the other results presented in this conclusion.

Figure 2 Proposed Structure of a Common Finance Policy

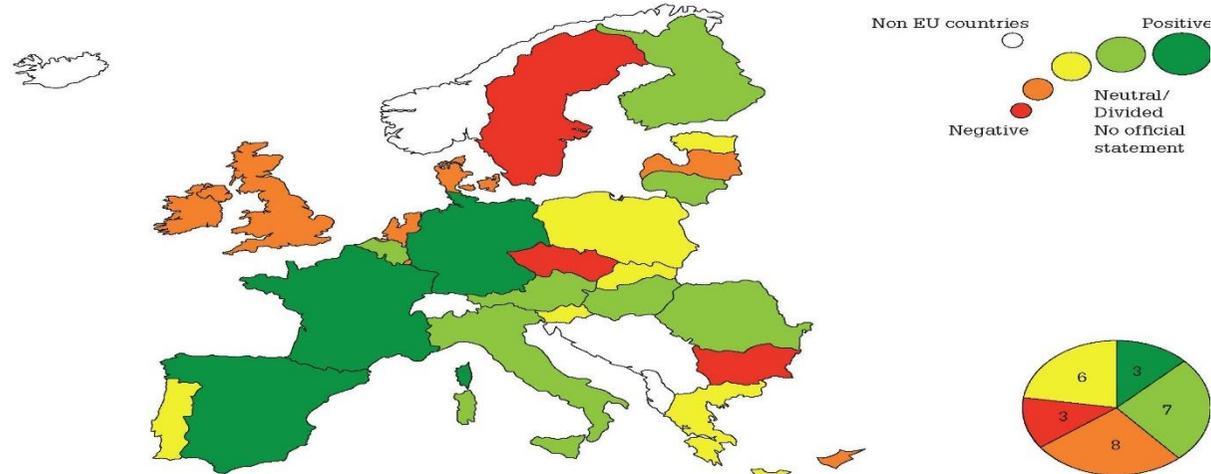
## Proposed Structure of a Common Finance Policy



Appendix A: 2012 Support Map Lane S, 'Reviewing Member State Support For The FTT' (2012) 1111 *Tax Journal* 16

**The Financial Transaction Tax 'thermometer'**

The following 'map' shows the position of the 27 Member States



**Level of support**

- In support
- Supporting subject to conditions such as global or EU introduction, and are overall more positive
- Neutral, divided or have not yet expressed an opinion
- Supporting if certain conditions are satisfied, such as global or EU introduction, but are overall less positive
- Against

**EU Member State**

- France, Germany & Spain
- Austria, Belgium, Finland, Hungary, Italy, Lithuania and Romania
- Estonia, Greece, Poland, Portugal, Slovakia and Slovenia
- Cyprus, Denmark, Ireland, Latvia, Luxembourg, Malta the Netherlands and the UK
- Bulgaria, the Czech Republic and Sweden

## Appendix A: Summary Table of Differences in Transaction Taxes

	<b>Tobin Tax</b>	<b>Robin Hood Tax</b>	<b>2011 Proposal</b>	<b>2013 Enhanced Cooperation</b>	<b>UK Stamp Duty</b>	<b>College for All Act</b>
<b>Rate</b>	0.5-up to 2%	0.05%	0.1% & 0.01%	0.1% & 0.01%	0.5% and 1.5%	0.5%, 0.1% & 0.005%
<b>Applies to</b>	Currency conversions only	All stocks, bonds, foreign currency and derivatives	Financial transactions based on residence principle	Financial transactions based on residence and issuance principles	Share transactions only	Purchases in the US or sellers in US on residence principle
<b>Exemptions</b>	N/A	None stated	Raising government capital. Corporate & private lending Transactions with central banks Refinancing government debt	TBC	N/A	Initial issues Short-term indebtedness Securities lending
<b>Application</b>	Global	Global	27 EU Member States	11 EU Member States	UK Only	US Only
<b>Revenue p.a.</b>	Unknown	Up to £250 Billion	Up to €57 Billion	Up to €35 Billion	£2.9 Billion	Up to \$300 Billion
<b>Allocation</b>	World Bank/IMF	Charitable causes	National treasuries	National Treasuries	National Treasury	National Treasury
<b>Rationale</b>	Behaviour	Philanthropic	Behaviour	Behaviour	Fundraising	Fundraising

Appendix B: A Stubb, 'A Categorization of Differentiated Integration' (1996) 34(2) JCMS 285

A CATEGORIZATION OF DIFFERENTIATED INTEGRATION

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Table 1: Categorization of Differentiated Integration

<i>Variables</i>	<i>Time</i>	<i>Space</i>	<i>Matter</i>
<i>Main Concept</i>	<i>Multi-Speed</i>	<i>Variable Geometry</i>	<i>A la Carte</i>
Definition	Mode of differentiated integration according to which the pursuit of common objectives is driven by a core group of Member States which are both able and willing to go further, the underlying assumption being that the others will follow later.	Mode of differentiated integration which admits to unattainable differences within the integrative structure by allowing permanent or irreversible separation between a hard core and lesser developed integrative units.	Mode of differentiated integration whereby respective Member States are able to pick-and-choose, as from a menu, in which policy area they would like to participate, whilst at the same time holding only to a minimum number of common objectives.
Sub/related concepts and general jargon	<p><b>English</b> Two-speed Step-by-step Graduated integration Differentiation Hard core Variable speed Flying geese Orchestrating Europe</p> <p><b>Français</b> <i>Plusieurs vitesses</i> <i>Deux vitesses</i> <i>Intégration échelonnée</i> <i>Directoire</i></p> <p><b>Deutsch</b> <i>Abgestuft Integration</i> <i>Kern</i> <i>Harter Kern</i> <i>Fester Kern</i> <i>Kerneuropa</i> <i>Teilintegration</i></p>	<p><b>English</b> Concentric circles Opt-in Opt-up Two-tier Multi-tier Two-level Multi-level Variable differentiation Swing wing Circles of solidarity Many circles Imperial circles Restrained differentiation Multi-track Two-track Multi-floor Two-floor Structural variability</p> <p><b>Français</b> <i>Cercles concentriques</i> <i>Géométrie variable</i> <i>Plusieurs niveaux</i> <i>Plusieurs étages</i> <i>Plusieurs voies</i> <i>Variante unionnaire</i> <i>Deux niveaux</i> <i>Plusieurs niveaux</i> <i>Noyau dur</i> <i>Noyau solide</i> <i>Directoire</i> <i>Différenciation restreinte</i> <i>Avant-garde</i></p> <p><b>Deutsch</b> <i>Abgestufte Integration</i> <i>Harter/Fester Kern</i> <i>Kerneuropa</i> <i>Teilintegration</i></p>	<p><b>English</b> Pick-and-choose Overlapping circles Opt-out Opt-down Bits-and-pieces <i>Ad libitum</i> integration</p> <p><b>Français</b> <i>A la carte</i> <i>Ad libitum</i></p> <p><b>Deutsch</b> <i>A la carte</i> <i>Ad libitum</i></p>

Table 1 (Cont):

	<i>Variables</i>	<i>Time</i>	<i>Space</i>	<i>Matter</i>
<i>Main Concept</i>		<i>Multi-Speed</i>	<i>Variable Geometry</i>	<i>A la carte</i>
<b>Examples</b>	<b>EMU</b> Harmonization of VAT Articles: 7c, 36, 100, 115, 130t Accession Agreements Transition periods		<b>AIRBUS, ESA</b> <b>ARIANE, JET</b> Schengen Agreements EMS <b>WEU, EUROCORPS</b> <b>EUROFOR,</b> <b>EUROMARFOR</b> <b>EUREKA</b> Articles: J.3(7), J.4(5), K.7, 130K	<b>UK and Social Charter</b> <b>UK and EMU</b> DK and EMU DK and defence DK and citizenship Derogations ERDF ESPRIT Ireland and abortion
<b>Nature of concept</b>	Supranational		Supranational/ Intergovernmental	Intergovernmental
<b>Relation to <i>acquis</i></b>	Inside		Outside	Inside/outside
<b>Relation to pillars</b>	Mainly in pillar I		Mainly in pillars II and III	Pillars I, II, and III
<b>Main uses in current debate</b>	CDU/CSU document Socialist 'Reflections' Herman Report		CDU/CSU document Edouard Balladur Alain Lamassoure	John Major
<b>Main use in historic debate</b>	Willy Brandt (1974) Tindemans Report (1975) Dooge Committee (1984)		Commissariat Général du Plan (1980) Jacques Delors (1980)	Ralf Dahrendorf (1979) Margaret Thatcher
<b>Main authors</b>	Brandt Tindemans Lamers and Schäuble Westendorp		Tardy Delors Lamers and Schäuble Maillet and Velo Quermonne Kohl and Chirac	Ralf Dahrendorf John Major Margaret Thatcher
<b>Relation to theory</b>	Neofunctionalism Neofederalism Federalism		Neofunctionalism Functionalism Realism	Functionalism Realism Neorealism
<b>Position on integration</b>	Maximalist		Maximalist/ minimalist	Minimalist

Appendix B C Hellepute, 'Financial Treatment of Derivatives' (The Present and Future VAT Treatment of the Financial Sector, University of Copenhagen 26 September 2017). Summary of OECD, 'Indirect Tax Treatment of Financial Services and Instruments' 22 Oct 1998

## How are derivatives treated for VAT purposes

- Snapshot (OECD report, 1998)

	Belgium	Germany	Japan	Norway	Austria	Finland	New Zealand	UK
Future	Outside the scope (unless lead to supply of goods)	Outside the scope	Outside the scope	Outside the scope	Exempt	Taxable (unless relating to currency or securities)	Exempt only if done on a future exchange	Zero rated on the TMO
Options	Outside the scope, exempt or taxable	Taxable	Outside the scope	Outside the scope	Taxable	Taxable (unless relating to currency or securities)	-	Zero rated on the TMO or taxable
Swaps	Outside the scope on commitment, exempt at maturity	Exempt	Outside the scope, exempt or taxable	Outside the scope	Exempt	Exempt	-	Exempt

Appendix B: M Keen et al, 'The Financial Activities Tax' in M Keen et al (eds) Financial Sector Taxation The IMF's Report to the G-20 Background and Material  
September 2010

Financial Sector Taxation: The IMF's Report to the G-20 and Background Material

Table A6. 1. Financial Activity Taxes—Potential Tax Base  
(In percent of GDP, unless otherwise indicated)

Country	FAT1				FAT2		FAT3	
	Profits [1]	Capital formation [2]	Wages [3]	Tax Base [4]=[1-2+3]	'Surplus' Wages [5]	Tax Base [6]=[1- 2+5]	Profit in excess of 15 percent ROE [7]	Tax Base [8]=[5+7]
Australia	3.2	0.7	3.8	6.4	0.5	3.0	0.4	0.9
Austria	2.1	0.8	2.7	4.0	0.3	1.7	1.5	1.8
Belgium	2.2	0.8	2.8	4.2	0.3	1.8	1.1	1.5
Canada	3.0	1.3	3.9	5.6	0.5	2.2	0.3	0.8
Denmark	1.8	0.4	2.5	4.0	0.3	1.8	0.4	0.7
Finland	1.1	0.3	1.2	1.9	0.2	0.9	0.0	0.2
France	1.4	0.8	2.7	3.3	0.3	0.9	0.5	0.8
Germany	1.5	0.3	2.3	3.6	0.3	1.5	0.2	0.5
Hungary	2.1	0.3	1.9	3.6	0.2	2.0	0.6	0.9
Iceland	3.2	0.9	4.2	6.5	0.5	2.8	3.3	3.8
Ireland	5.9	0.6	3.2	8.4	0.4	5.7	1.4	1.8
Italy	1.7	0.4	2.3	3.6	0.3	1.6	0.1	0.4
Japan	4.6	...	2.2	6.8	0.3	4.9	0.1	0.4
Korea, Republic of	4.5	0.6	2.5	6.4	0.3	4.2	0.2	0.5
Luxembourg	14.9	0.7	9.0	23.2	1.1	15.3	4.6	5.7
Netherlands	2.7	1.1	3.3	4.9	0.4	2.0	0.2	0.6
Norway	1.8	0.4	1.4	2.7	0.2	1.5	0.2	0.3
Portugal	3.8	1.6	2.6	4.8	0.3	2.6	0.2	0.5
Spain	2.1	0.7	2.1	3.5	0.3	1.7	0.7	0.9
Sweden	1.2	0.6	1.9	2.5	0.2	0.9	0.4	0.7
United Kingdom	2.8	0.7	3.9	6.1	0.5	2.7	0.6	1.1
United States	3.2	0.9	4.4	6.6	0.5	2.8	0.2	0.7

Source: OECD - STAN Indicators Database, WEO, BankScope, IMF staff estimates.

Note: The FAT1 and FAT2 tax base for Japan may be overestimated because fixed capital formation is not reported in OECD STAN and thus is not deducted from the base. Data for Canada reflects year 2005; for all other countries year 2006 is used.

Columns:

[1] Gross operating surplus and mixed income in the financial intermediation sector as a share of GDP.

Due to lack of data availability, profit for Canada is calculated as gross value added at basic prices minus labor costs (equivalent to gross operating surplus and mixed income plus other taxes net of subsidies on production).

[2] Gross fixed capital formation in the financial intermediation sector as a share of GDP.

[3] Labor costs in the financial intermediation sector as a share of GDP.

[5] The wage differential is calculated by applying an adjustment factor of 12 percent to the wage in the sector, as described in the paper

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