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# THE INTRODUCTION OF A EUROPEAN-WIDE FINANCIAL TRANSACTION TAX IN THE LIGHT OF THE GATS RULES ON THE MARKET ACCESS OF FINANCIAL SERVICES

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# 1. Need for redesigning the infrastructure of the global financial system

## Addressing externalities of global capital markets

As market imperfections cannot be taken out of consideration, it is required to come back to Keynes and establish ourselves on the supply-side economy because the demand-side economy has only been able to manage the global financial crisis up to the possibility of decreasing interest rates to zero

Paul Krugman, “How Did Economists Get It So Wrong?”, The New York Times (September 6, 2009), p. 12

## General principles concerning financial markets

- Sec. 1. Financial markets are not an end in themselves, but a means: they are supposed to perform certain vital functions which enable the real economy to be more productive:
  - a. Mobilising savings;
  - b. Allocating capital; and
  - c. Managing Risk, transferring it from those less able to bear it to those more able
- Sec. 2. While markets are at the centre of every successful economy, markets only work well when private rewards are aligned with social returns; Incentives matter, but when incentives are distorted, we get distorted behaviour
- Sec. 12. Those who impose costs on others (externalities) must be forced to pay those costs; This is not just a matter of equity; it is a matter of economic efficiency

Joseph E. Stiglitz, The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System; Principles for a New Financial Architecture; adopted by the General Assembly of the UN in 2009 (Stiglitz Commission Report)

## 2. Proposed European financial transaction tax

### Amended draft directive on FTT

Three main objectives:

- harmonisation of indirect taxation (in the original proposal: claw back);
- fair and substantial contribution of the financial sector (originally: remove under-taxation); and
- create appropriate disincentives for certain transactions (the same as before)

New: COM(2013) 71 of 14 February; old: COM(2011) 594 of 28 September

Comment:

The objective of harmonisation does not seem to be free of the inner contradiction between the fact of market imperfections and the rationale for harmonisation that is established on the assumption of market perfections

## Involvement in the scope of regulation the markets of goods and factors

Liberalisation of the services of commercial and investment banks	What to liberalise?	What to tax?
Cross-border movement of goods	Duty concessions (not relevant)	Reverse charge-based indirect taxes (not relevant)
Cross-border movement of services	Money market and related capital market transactions) through GATS	Reverse charge-based or B2C based indirect taxes
Cross-border movement of payments and capital	Spill over of services into investments through commercial presence	Direct taxation of capital on a worldwide basis
Cross-border movement of persons	Free movement of experts, freedom of establishment	Direct taxation of labour on a worldwide basis

Comment: Liberalisation of the services of commercial and investment banks through home country licensing on a consolidated basis – establishing the public law nexus on the personal scope of taxation instead of reverse-charge or even B2C? (erosion of tax law by the liberalisation of banking law)

## Ring-fencing under the original proposal:

- private households and SMEs;
- primary market transactions for raising capital, including conservative pension funds and public borrowing;  
and
- monetary policy-related transactions and central clearing houses

## Anti-relocation provisions

### Scope:

the scope of the original proposal is to cover all markets (regulated ones and over-the-counter transactions), all financial instruments and all actors

Under the original proposal: a financial institution is deemed to be established in the Member State of:

- the banking authorisation;
- the registered seat (legal seat), or the usual residence (effective place of business);
- a branch; and
- of a party (or counterparty) to a transaction, whether acting either for its own account, or for the account of another person, or in the name of another person

### Under the new proposal

complementing the original proposal with the issuance principle of certain financial instruments

## Taxable amount and tax rates under the original proposal

- In respect of the financial transactions other than those related to derivatives agreements the consideration paid or owed for the transfer, or the FMV
- Tax rate: 0.1% for each party to the transaction
- In respect of derivatives agreements the notional amount of a transaction
- Tax rate: 0.01% for each party to the transaction



## Justification issues:

- once justification of new measures cannot be traced back to the idea of free competition, legitimation becomes doubtful; and
- there should be existing rules, at which approximation could be targeted, but such rules do not exist in the field of the taxation of the financial sector

Tax legislation is deteriorated in the instances as follows:

- financial law follows home country licensing, and even on a scale of the globalised economy;
- financial regulations may be established on estimates;
- the burden that is laid on financial enterprises should even be adjusted from time to time, and some times subsequently, because financial enterprises operate in a changing environment;
- as the territoriality principle of taxation is superseded by financial law that is based on the residence principle, double charging cannot be avoided; and
- harmonisation of banking law is emerging while tax law remains fragmented

### 3. WTO rules on financial services

#### Overlapping between WTO rules and tax treaty rules concerning direct taxation

Rules concerning international trade and taxation have evolved separately:

- the GATT/WTO agreements are multilateral, requiring MFN and national treatment, and international taxation is agreed bilaterally, applying on a bilateral basis the national treatment principle only;
- WTO rules are subject to binding dispute settlement procedures, tax treaties are subject to non-binding dispute settlement; and
- direct taxes, like indirect taxes, are subject to the rules of WTO, notwithstanding efforts by tax authorities to secure specific exemptions for certain direct tax measures

Michael Daly, The WTO and direct taxation, Discussion Paper No. 9, WTO, Geneva, 2005

## The WTO has been relatively successful in resisting protectionism

- The WTO enjoys high legitimacy because of the large number of members
- Although it was able to reduce protectionism during the crisis, it failed to stimulate world trade by bringing the Doha Round to a successful conclusion (low level of effectiveness).
- Although the WTO's influence cannot be weighed precisely, its vigilance most likely contributed to keeping protectionism at bay

Katharina Gnath, Stormy-Annika Mildner, and Claudia Schmucker, G20, IMF, and WTO in Turbulent Times; Legitimacy and Effectiveness Put to the Test, Research Paper, No. 10 Stiftung Wissenschaft und Politik, August 2012 Berlin

## Article I of GATS on Scope and Definition (on the various modes of the supply of services)

For the purposes of the Agreement, trade in services is defined as the supply of a service:

- (a) from the territory of one Member into the territory of any other Member (cross-border supply);
- (b) in the territory of one Member to the service consumer of any other Member (consumption abroad);
- (c) by a service supplier of one Member, through commercial presence in the territory of any other Member (commercial presence);
- (d) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member (presence of natural persons)

According to the GATS agreement, trade in financial services can take different forms:

- Mode 1: cross-border movement of the service or "cross border trade": e.g., a financial firm established abroad is allowed to provide services to nationals such as banks deposits via internet banking;
- Mode 2: cross-border movement of the service consumer or "consumption abroad": e.g., an Indonesian art trader is allowed to take a loan from a bank based in the Netherlands;
- Mode 3: cross-border movement of the corporate service-provider through investments or "commercial presence": e.g., a country allows foreign banks to buy up domestic banks or to open up branches in its territory; and
- Mode 4: "cross-border movement of persons": e.g., a Brazilian manager of a Dutch bank is allowed to work at the offices of the Dutch bank in Amsterdam or New York

Procedure:

Under GATS, liberalisation of services takes place in a mechanism of requests, offers and commitments, starting from bilateral positions, and ending at multilateral positions, due to the MFN principle

## Scope of the regulation of factor markets under the Annex on financial services

Sec. 5 (a)(v)-(xvi) of the Annex delivers a broad definition of financial services, including both current and capital payments

Comments:

- The scope of GATS regulations on financial services cannot be clearly identified because the effect of the financial market activity goes beyond the participants of financial markets
- GATS is basically designed to address money market movements through the trade in financial services, it has the spill-over effect, however, resulting in affecting capital markets, and thus investment opportunities

Under GATS Article XVI on market access, Para. 2 prohibits:

- limitations on the number of service-suppliers (Art. XVI.a.) or service operations (Art. XVI. c.);
  - limitations on the value of service-transactions or assets (Art. XVI.b.);
  - measures that require specific types of legal entity or joint ventures (Art. XVI.e.); and
  - limitations on foreign ownership capital (Art. XVI.f.)
- Exceptions to non-restriction (free movement of goods and factors) are limited by the requirement of non-discrimination

Comment:

The GATS principles of non-restriction may prevent members from combating financial hyperactivity



## GATS Article XVI on market access includes footnote 8

that commits a country to allow a number of cross-border flows when it has opened up its market for particular (financial) services:

- the country must allow inflows and outflows of capital that are considered "essential" for (financial) services in mode 1 (e.g., e-banking); and
- allow inflows "related" to mode 3 (i.e. foreign services provided by firms established in the country)
- thus, countries can only regulate the outflow of capital except for mode 1, if they have not already deregulated capital flows by liberalising the capital account as many developing countries have done

Annex on financial services has the "prudential carve-out" as follows:

Sec. 2 on domestic regulation

(a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system

However, the principle of “pacta sunt servanda” or “effet utile” must be protected even if restrictions are allowed to apply exceptionally:

Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement

The Understanding on Commitments in Financial Services (Part. B.1.- 2.) invites WTO members not to apply exemptions which are allowed by the GATS agreement to financial services

- This means that regulations about procurement of financial services by public entities should be in conformity with the principles of national treatment and most favoured nation while this is not necessary according to Art. XIII;
- The Understanding also requires each WTO member to list in its schedule monopoly rights provided to financial services and strive to eliminate them (while they are allowed under GATS Art. VIII); and
- It is also requested to list and eliminate financial activities conducted by a public entity for the account of the government (allowed in the Annex on Financial Services Art. 1.(b).(iii))

Article XI of GATS is intended to guarantee the primacy of IMF rules in the area of international capital movements

Although Article XI GATS only provides for the liberalisation of money market movements as covered by IMF regulations, these liberalisation measures may also affect capital movements:

Under Article XI (1), a Member shall not apply restrictions on payments for current transactions; under Article XI (2), a Member shall not impose restrictions on capital transactions inconsistently with its specific commitments

#### 4. WTO-related legal environment of financial services

Open trade in financial services does not mean greater risk to the system's safety and soundness (?)

The above dogma is not in compliance with the realities experienced since 2008 autumn, the start of the global financial crisis, because it is a myth that markets tend to equilibrium, and disequilibrium is at random

Simon Lester, WTO Financial Services Rules and Domestic Regulation, <http://worldtradelaw.typepad.com/ielpblog/2012/03/wto-financial-services-rules-and-domestic-regulation.html>, 25 March 2012

## Talk about reform of ‘the’ financial architecture

Back in the 1990s, when many in Washington — and virtually everyone on Wall Street — embraced the deregulation that helped lead to the recent crisis, a vast majority of WTO nations made varying commitments to what’s called the financial services agreement, which loosens rules governing banks and other such institutions

Gretchen Morgenson, “Barriers to Change, From Wall St. and Geneva”, March 17, 2012, W.T.O. and Barriers to Financial Change - NYTimes.com, <http://www.nytimes.com/2012/03/18/business/wto-and-barriers-to-financial-change.html?pagewanted=print>

## Talk about reform of ‘the’ financial architecture – cont.

- Opening should not necessarily lead to liberalisation, setting aside the concerns about the global financial infrastructure; instead, international agencies should take over from protectionist nation states the responsibility of exercising supervision over institutional investors and private financial intermediaries
- IMF may provide more transparency in the operation of financial markets, OECD may provide more professionalism in regulation, the liberalisation of the trade in goods and services by WTO, supporting market access and non-discrimination, touches upon the systemic problems without discussing them on their merits

Myriam Vander Stichele, Critical Issues in the Financial Industry, SOMO Financial Sector Report, Update in April 2005 assisted by Jante Parlevliet, Published by: Stichting Onderzoek Multinationale Ondernemingen (SOMO) Centre for Research on Multinational Corporations, p. 6

## Liberalisation without regulation

- The home country principle of supervision may be unfair to the host country economy, being weaker than the economy of the capital exporting country
- The non-discrimination requirement may be detrimental to developing or transition economies because at the time of crisis foreign banks abruptly withdraw their investment from the market of these countries
- Host countries may worse off by refraining themselves from taxing dividends and the value added
- At the time when developed countries use Keynesian measures, developing countries have to maintain trade barriers to protect themselves

Myriam Vander Stichele, SOMO, End WTO deregulation of finance, “<http://somo.nl/dossiers-en/trade-investment/gats>”, February 2009;

Myriam Vander Stichele, SOMO, The financial crisis does not justify a WTO deal, “<http://somo.nl/dossiers-en/trade-investment/gats>”, February 2009



The arguments put forward by those in favour of liberalisation are:

- reduction in overhead expenses and profit-taking by domestic banks due to increased competition by foreign banks;
- increased efficiency and diversity of financial services; and
- spill-over effects of foreign bank entry, such as the introduction of new financial services and of modern and more efficient banking techniques, and the improvement of domestic bank management

The arguments put forward by those opposing foreign entry are:

- domestic banks are not able to cope with increased competition, and may stop operating;
- foreign banks will not provide additional credit during an economic downturn in a host country;
- foreign banks only provide credit to large and often foreign-owned (multinational) firms, and tend to lend less to small firms and poor consumers (cherry picking); and
- domestic supervisory and monetary authorities often fear that their influence on banks' behaviour may diminish as supervision of foreign banks' branches is done by the authorities of the home country

Myriam Vander Stichele, Critical Issues in the Financial Industry, SOMO Financial Sector Report, Update in April 2005 assisted by Jante Parlevliet, Published by: Stichting Onderzoek Multinationale Ondernemingen (SOMO) Centre for Research on Multinational Corporations, pp. 179-180

The major components for CSR in the financial industry concern:

- the financial industry's own operations (e.g., improvement of technologies, training of the staff);
- responsibility of the impact of financial services on the social environment (use of international standards, ensuring universal access, combating financial instability, etc.);
- other ethical issues (e.g., combating fiscal evasion); and
- advancing sustainable development

Responsibility of international agencies in the financial industry for:

- supporting green funds;
- disclosing investment policies; and
- re-investing in the local economy

Myriam Vander Stichele, Critical Issues in the Financial Industry, SOMO Financial Sector Report, Update in April 2005 assisted by Jante Parlevliet, Published by: Stichting Onderzoek Multinationale Ondernemingen (SOMO) Centre for Research on Multinational Corporations, pp. 127-128, 134

# Free trade versus prudential carve-out under GATS, being the ultimate arbiter of international financial regulation

## A spiral of liberalisation:

“[There is a] need to define prudential regulatory standards in a manner that promotes a synthesis between trade and regulatory values. ... The absence of a definition in this area means that finding such a synthesis will be left to the adjudication proceedings of the GATS, and potentially within the legislative jurisdiction of the WTO. ... This does not prepare for a promising integration of the financial systems. It only stands to disturb the constitutional balance of the international economic system by rendering GATS the de facto ultimate arbiter of international financial regulation.”

Alexander Kern, “The World Trade Organisation and financial stability: the need to resolve the tension between liberalisation and prudential regulation”, ESRC Centre for Business Research Cambridge University (Working Paper No.5), 2002, pp. 5, 45

## Danger of a chilling effect on new measures that would prevent a financial crisis

- WTO mechanisms continue to operate autonomously, failing to respond to the challenges arising from the global financial crisis, or even inadvertently deteriorating the situation
- The introduction of a “Tobin tax” to stop volatile cross-border capital flows could be accused by another WTO member of not being a prudential measure
- The GATS agreement only has weak instruments (Article IX on restrictive business practices), with which to tackle market abuse and restrictive business practices that will follow concentration and consolidation
- Market imperfections like the moral hazard with banks cannot be managed by means of GATS

Myriam Vander Stichele, Critical Issues in the Financial Industry, SOMO Financial Sector Report, Update in April 2005 assisted by Jante Parlevliet, Published by: Stichting Onderzoek Multinationale Ondernemingen (SOMO) Centre for Research on Multinational Corporations, p. 198