EUROPEAN CENTRAL BANK

OPINION OF THE EUROPEAN CENTRAL BANK

of 4 November 2004

at the request of the Belgian Ministry of Finance
on a draft law introducing a tax on exchange operations involving foreign exchange, banknotes and currency

(CON/2004/34)

Introduction

1. On 12 July 2004 the European Central Bank (ECB) received a request from the Belgian Ministry of Finance for an opinion on a draft law introducing a tax on exchange operations involving foreign exchange, banknotes and currency (hereinafter the 'draft law').

2. The ECB is competent to deliver an opinion, since the draft law – in view of its subject matter, purpose and effects – directly concerns the fields of competence of the Eurosystem and the ECB. The ECB's competence is, in particular, based on the second indent of Article 105(4) of the Treaty establishing the European Community and on the first, second, third and sixth indents of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the draft law:

   (i) deals with foreign exchange, banknotes and currencies that are legal tender (third paragraph of Article 4); and

   (ii) provides for the possibility for agreements to be concluded with the 'central bank which controls the legal tender in Belgium', which would include verification measures regarding the application of the law (third paragraph of Article 12); and

   (iii) excludes foreign exchange transactions conducted by, *inter alia*, central banks (Article 9(2)); and

   (iv) if it enters into force, might have a significant impact on financial transactions conducted by financial institutions and on international capital flows, which, in view of their volume, might have a substantial impact on (international) financial markets.

3. The purpose of the draft law is to impose a tax on all exchange transactions involving foreign exchange (hereinafter 'foreign exchange transactions') taking place in Belgium. It contains the following elements:

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1 OJ L 189, 3.7.1998, p. 42.

(i) The draft law defines foreign exchange transactions extremely broadly (Article 2 and paragraphs 3 to 5 of Article 4). The tax envisaged by the draft law applies to transactions involving the exchange of the euro against a non-euro currency and *vice versa*, as well as involving the exchange of non-euro currencies. The ECB understands that a non-euro currency may be the currency of a Member State that has not adopted the euro (hereinafter 'non-euro area Member State'), or of a country outside the European Union.

(ii) The draft law also defines very broadly the factors determining whether a foreign exchange transaction is deemed to take place in Belgium and, thus, whether such transaction will be taxable under the draft law. According to the draft law, the place of establishment in Belgium of one of the parties or intermediaries to the transaction is only one of the three alternative factors (Article 5§1(1)). The two other factors are (a) the payment of, or the negotiations or orders for, the transaction take place in Belgium (Article 5§1(2)); or (b) one of the currencies in the foreign exchange transaction is legal tender in Belgium (Article 5§1(3)). Since the euro is legal tender in Belgium, the tax provided for in the draft law would apply to each foreign exchange transaction involving the euro, wherever the transaction is negotiated, concluded or executed and whatever the residence of the parties or intermediaries to the transaction. It is noted that the application of this third factor is subject to agreement by the 'competent European authorities' (paragraph 19).

(iii) The tax envisaged by the draft law consists of a two-tier system with (i) a normal tax rate of 0.02% on each foreign exchange transaction; and (ii) a tax rate of up to 80% on foreign exchange transactions carried out at an exchange rate outside a predetermined fluctuation margin around a 20 day moving average.

The draft law provides that it will only enter into force if either all Member States of the Economic and Monetary Union (EMU) include in their legislation a tax on foreign exchange transactions or if a Community directive or regulation is adopted on this issue (third paragraph of Article 13)[2].

Preliminary remark

4. The ECB acknowledges the good intentions underlying the draft law. However, for the reasons mentioned hereunder, the ECB considers that pursuing these intentions through the imposition of a tax such as envisaged by the draft law raises serious economic and legal difficulties.

Economic assessment

5. In his letter to the President of the ECOFIN Council of 21 September 2001, the ECB's President already conveyed the Eurosystem's assessment of a tax on foreign exchange transactions, generally

2 The ECB notes that a law providing for such a tax has existed in France since the end of 2001 (see Article 235ter ZD of the French General Tax Code). The French law provides for a maximum tax of 0.1% on foreign exchange transactions and not for an extraordinary tax in the event of major exchange rate fluctuations. The French law provides that it will only enter into force from the date that 'the EC Member States will have finished the integration in their legislation of the measures adopted by the Council that provide for the establishment, in all the Member States, of a tax on foreign exchange transactions, and at the earliest from 1 January 2003'.

referred to as Tobin tax. This letter was written in view of a discussion of this matter in the ECOFIN Council in 2001 under the Belgian Presidency of the EU.

6. From the explanatory memorandum to the draft law, the ECB understands that the rationale for the draft law corresponds to the three main arguments generally invoked for introducing such a tax. First, excessive short-term trading has often been blamed for extremely high volatility in foreign exchange markets. The tax has, therefore, been proposed to mitigate the part of exchange rate fluctuations that is not directly related to fundamentals and to allow a larger degree of monetary policy autonomy. Second, some variants of the tax, such as the Spahn variant, have been proposed as instruments to prevent and/or counteract speculative attacks. Third, the tax is considered as having great potential for raising revenue. However, in terms of effectiveness, such a tax would fulfil the abovementioned expectations only if (i) excessive trading created significant excessive volatility; (ii) this volatility significantly affected other economic activities, such as trading or investment; and (iii) the tax could reduce this excessive volatility without creating excessive distortions.

7. The ECB notes that economic analysis and empirical evidence indicate that there is reasonable doubt with regard to the general validity of each of these three conditions and that the tax could instead give rise to significant costs. First, economic literature provides little evidence that a transaction tax such as the Tobin tax would reduce exchange rate volatility. In fact, the effect of such a tax on volatility is ambiguous, i.e. it could also increase volatility, as it may result in reduced depth and liquidity of the foreign exchange markets. Therefore, the effectiveness of the tax with regard to its main objective could be seriously questioned. Second, as regards the impact of the tax on market efficiency and allocation, while daily turnover in short-term transactions is very high, a large part of it is related to hedging and distribution of risks among market participants. To the extent that the functioning of financial markets might be hampered by the tax, the risk-sharing benefits of deep and liquid markets might be reduced by its implementation. Furthermore, since the demise of the Bretton Woods system, there is a widespread view among economists that exchange rate volatility is inherent in floating exchange rate regimes and is not necessarily detrimental to international trade. On the contrary, a flexible exchange rate can play an important role in cushioning asymmetric shocks. Also, strong empirical evidence that exchange rate volatility has a negative effect on trade, especially among developed economies, is lacking.

8. The ECB also notes that, while excessive volatility may adversely affect economic transactions, allocation of investment and, hence, growth, significant exchange rate volatility and a high level of short-term capital flows do not necessarily signal market failure. Instead, they can frequently be interpreted as symptoms of underlying macroeconomic imbalances and cannot schematically be interpreted as being excessive. In these circumstances, the tax would on the one hand largely focus on the symptoms, while on the other hand financial market participants are likely to find ways to circumvent the tax. In particular, the tax might not help prevent speculative attacks, as any proposed levy from such a tax would be small compared with expected gains from exchange rate changes.

9. The Spahn variant of the tax, which is also proposed in the draft law, consists of a two-tier system with a very low 'normal' tax rate, and a very high 'extraordinary' tax rate in the event of extreme exchange rate market turbulence. The Spahn variant is presented as being more effective in regulating capital flows and avoiding speculative attacks. However, the ECB notes that economic theory often argues against variable-rate taxes because they create price uncertainty in the markets. In this case, ensuing widened spreads in financial markets are likely to make investment more costly, especially in countries whose currencies seem to be more prone to volatility, i.e. emerging markets.

10. Also, there is little evidence that, in today's world, monetary and exchange-rate autonomy would economically benefit from such a tax. Experience suggests that, in the main currency areas, sufficient monetary policy autonomy exists and there is no need to enhance it by introducing further distortions to the asset price setting mechanisms.

11. Finally, the introduction of such a tax would raise serious difficulties in terms of its implementation. The tax raises transaction costs and would create incentives among market participants to develop alternative instruments and/or to operate in financial centres not subject to the tax. In the latter case, offshore centres would become more attractive, thereby increasing opacity and facilitating fraud in financial transactions. Therefore, the feasibility of the tax is highly questionable, given the welfare costs arising from distortions in the working financial markets and the likely difficulties in agreeing on universal implementation of the tax at international level and bearing in mind the difficulty of enforcing sanctions against non-participants.

12. Considering the above, the ECB concludes that the economic and monetary usefulness of a tax, such as envisaged by the draft law, is highly questionable, given the uncertainty of its claimed benefits and the likely welfare costs arising from distortions in the working of financial markets. This assessment is reinforced by the difficulties expected with respect to its implementation.

Legal assessment

13. The euro area's exchange-rate policy is an exclusive Community competence. As the purpose of the tax envisaged by the draft law is to influence the euro's exchange rate vis-à-vis another currency, in particular to smooth exchange-rate developments and reduce volatility, the draft law would provide a national government with the means to impinge on the Community's authority to define and conduct exchange-rate policy. On these grounds, the draft law should be deemed incompatible with the Treaty, as its application would interfere with the Community's exclusive competence in the field of exchange-rate policy.

14. Furthermore, under the ECB's analysis, the tax provided for in the draft law is incompatible with the free movement of capital and payments between Member States, and between Member States and third countries (Article 56 of the Treaty). This tax is indeed a measure imposed by a public authority which may or will, directly or indirectly, hinder the conclusion and/or execution of the capital or payment transfer involving foreign exchange on which the tax is imposed. Also, the tax will imply

less favourable treatment of certain transactions in the currency of a non-euro area Member State or a third country compared to the same kind of transaction in euro only. It is underlined in this context that EMU's proper functioning depends on the fundamental freedom of capital movement and payments both within and beyond the boundaries of the EU. EMU is indeed based on completion of the internal market, of which the free movement of capital and payments is a centrepiece (Article 14(2) of the Treaty).

15. Furthermore, the ECB considers that the exceptions laid down in Article 57(1), Article 60(2), Articles 119 and 120, and Article 297 of the Treaty, which allow Member States to restrict under specific circumstances the free movement of capital and payments, do not cover the measures envisaged by the draft law. Also, Article 58(1)(a) of the Treaty only justifies a tax measure that distinguishes between taxpayers on the basis of their place of residence or the place where their capital is invested. However, the draft law does not distinguish according to taxpayers, but according to transactions. Considering the narrow interpretation of 'public policy' and 'public security' in Article 58(1)(b) of the Treaty, as well as the exchange-rate policy nature of the tax envisaged by the draft law (paragraph 12), the ECB is of the opinion that such a tax may not be introduced on such grounds. Similarly, the ECB is of the opinion that such a tax cannot be justified and objectively required for mandatory reasons of general interest.

16. The draft law considers as a 'State' the 'European Economic and Monetary Union or every other territory with a single currency' (second paragraph of Article 4). EMU includes all Member States and, thus, also the Member States that have not adopted the euro as their currency (these Member States are either in the second stage or in the third stage with a derogation). A reference to EMU for the purposes of defining a currency area is therefore inappropriate. Also, considering EMU as a 'State' is inconsistent with the draft law's intention to impose the tax on, *inter alia*, transactions involving the exchange of euro for the currency of a non-euro area Member State (paragraph 3), since this implies that the euro and the currencies of the non-euro area Member States are currencies of the same 'State'.

17. According to Article 5§1 of the draft law, 'the proceeds of the tax (…) shall be paid in full into a fund, managed by the European Union and to be allocated for cooperation and development, to promoting social and ecological justice and to conserving and protecting international public property'. A legislator of an individual Member State adopting this provision would attribute the management of a fund established at national level to the EU. However, the creation of new Community tasks by national legislation does not appear to be compatible with the Community legal framework and order.

18. The second paragraph of Article 8 of the draft law provides that the tax rate of maximum 80% will be established 'by a decision[3] adopted after deliberation in the [Belgian] Council of Ministers and respecting Article 59 of the EC Treaty and the secondary law derived from it'. The draft law also

3 It is understood that this will be a royal decree.

provides that such a tax will only apply ‘after the competent European authorities have given their agreement’ (second paragraph of Article 13). Article 59 of the Treaty concerns safeguard measures with regard to third countries where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of Economic and Monetary Union. It provides for an exclusive Community competence, whereby the measures are taken by the Council on a proposal from the Commission and after consulting the ECB – and not by, or on, a proposal from a Member State. Therefore, the procedures defined by the draft law for the adoption and implementation of the tax rate of maximum 80% do not comply with Article 59 of the Treaty. Also, if and when the conditions for applying Article 59 of the Treaty are fulfilled, the Community is free to assess whether or not to use this provision, as well as to assess and take any safeguard measure(s) that it deems appropriate, without being subject to, or bound and restricted by, a Member State’s legislation, procedures or measures.

19. The second paragraph of Article 13 of the draft law provides that the provision that a foreign exchange transaction is deemed to take place in Belgium if one of the involved currencies is the euro will only apply ‘after the competent European authorities will have given their agreement’. The ECB refers on this issue to the preceding paragraph 18 on the compatibility of the draft law with Article 59 of the Treaty.

20. The third paragraph of Article 13 of the draft law requires that ‘all Member States of the European Economic and Monetary Union have introduced a tax on the exchange of foreign exchange in their legislation’ as a condition precedent for the law to enter into force. However, a measure remains at Member State level and is not transformed into a Community measure if and because all Member States individually adopt such a measure under their respective laws. Therefore, the arguments raised in paragraphs 13 to 15 regarding a Member State’s competence to introduce a Tobin tax, as well as paragraph 18 regarding Article 59 of the Treaty, still fully apply if all Member States were to individually introduce such a tax in their national legislation. The draft law requires, as an alternative condition for its entry into force, ‘a European directive or regulation’ (third paragraph of Article 13; the ECB understands that this would be a directive or regulation introducing such a tax). In view of the subject matter of the present opinion (draft national legislation) and, therefore, without assessing the introduction of such a tax at Community level, the ECB refers also as regards this alternative condition to the above observations regarding the exclusive Community competence for exchange-rate policy of the euro area (paragraph 13) and to the relationship between Community and national law (paragraph 18).

21. Considering the subject matter of the draft law and the measures it envisages, the ECB would need to be consulted on any act or decree implementing the law (see, *inter alia*, the second and third paragraphs of Article 8, Article 9(2) and Article 12 of the draft law).

22. On the basis of the assessment above, the ECB is of the opinion that the introduction by a euro area Member State of a tax, such as envisaged by the draft law, is incompatible with the Treaty. This

assessment is without prejudice to an assessment of the draft law by the Community institutions that are entrusted with ensuring the application and observance of the Treaty.

Final remark

23. This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 4 November 2004.

[signed]

The President of the ECB

Jean-Claude TRICHET