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Financial transaction taxes in the EU

Andreas Botsch

Policy recommendations

Andreas Botsch is a senior researcher on financial markets and macroeconomic policy at the European Trade Union Institute.

The European Union should introduce a comprehensive system of financial transaction taxes (FTT), at a single tax rate of 0.05%, levied on all transactions of shares, bonds, derivatives, and currency units. An FTT levied by less than 27 EU member states should have built-in safeguards against tax evasion and/or relocation of financial transactions outside the territorial scope of the measure. Such safeguards should combine the residence of the counterparty of the transaction with the issuance and ownership principles as pre-conditions for legally enforcing the transfer of ownership. Once FTT have produced their intended regulatory effect, the introduction of a financial activities tax (FAT) should be considered in parallel to the FTT.

Introduction

This paper analyses the objectives and the feasibility of introducing financial transaction taxes in at least nine member countries of the EU under the so-called Enhanced Cooperation Procedure of the Lisbon Treaty. After a short description of the state of play in the autumn of 2012, the paper identifies three main rationales that would justify the introduction of an EU-FTT. First and foremost, the paper points to FTT as a means of stabilizing financial markets. Secondly, a well-designed FTT could constitute an important new source of government revenue for socially beneficial use. Last but not least, the paper discusses to what extent savings in private pension systems would be likely to be affected by an FTT and how FTT can contribute to improving the allocation of savings by reducing administrative costs in parallel with the number of financial intermediaries.

Policy background: state of play and rationales for an EU-FTT

For many years, at least since the 1990s, a heated debate has taken place among policymakers and academia as to which level – global, European, Euro-area or national – would be the most appropriate for FTT to achieve its goals. This section describes the current state of play of this discussion and summarizes the rationales that would justify introduction of an EU-FTT.

On 28 September 2011, the European Commission adopted a Proposal for a Council Directive on a common system of financial transaction tax (EC 2011a). Nine months of debates in the Council and the European Parliament ensued. Articles 113 and 115 of the Treaty on the Functioning of the European Union (TFEU) served as the legal basis chosen by the Commission which argued that taxation of the financial sector required coordinated action at EU level in order to create a level playing field and to avoid both fragmentation of the EU financial market and distortion of competition (EC 2011b).

Since the Danish presidency concluded, on 22 June 2012, that the FTT would not gain the support of all 27 member states, an approach entailing reference to the Lisbon Treaty's Enhanced Cooperation Procedure (ECP, article 20 TEU and articles 326-334 TFEU) has become necessary. This would permit the formation of a 'coalition of the willing', i.e. the states wishing to proceed with FTT. At least nine member countries expressed their wish to

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move forward, in this manner, via the ECP, and it is now their task to submit a formal request to the European Commission in this respect, specifying the scope and objectives of an ECP on FTT[1]. Only participant member states take part in the vote, in which unanimity is required. Meanwhile, anticipating the stalemate in the Council on the original Commission proposal of 2011, the European Parliament has already consented to the alternative of launching an ECP under article 329 TFEU (EP 2012).

The objectives of an EU-FTT would appear to be threefold: firstly, it would serve to establish a regulatory element important for the stabilisation of financial markets. The volume of speculative transactions on financial markets would be curbed and both the size and the volatility of financial markets thereby shrunk. Short-term betting would be gradually replaced by longer-term investment. An EU-FTT could therefore re-assign a more commensurate role to finance in society and the economy; the financial landscape would become smaller in size, slower in speed, and less short-term oriented. Secondly, levying an EU-FTT could generate significant revenues to offset the cost of the financial crisis, insofar as such revenue could be used to relieve the burdens associated with government interventions to repair the banking system. Last but not least, an EU-FTT would downsize the chain of financial intermediaries who bite off chunks of workers' savings for their old-age pensions, at least in countries where pre-funded private pension systems play an important role.

FTT as a means to stabilize financial markets

Since the turn of the century, the volume of financial transactions has exploded. Financial 'innovation' has led to the introduction of new products; turnover has increased massively to the point where it now amounts to 16 times world output and 26 times world trade; at the same time, holding periods for financial instruments have decreased dramatically. Financial transaction taxes would reduce this massive liquidity overhang in markets and remove superfluous transactions that are of no social use or benefit. FTT would steer financial flows towards the longer term and thus help restore the fundamental economic role of the financial system of intermediation, allocation and transfer of capital to productive use. It would, in other words, help to shrink the financial bubble, thereby enabling finance to regain its role in servicing the real economy, rather than vice versa.

Financial transaction costs have seen a sharp decline to about one tenth of their levels throughout the 1980s (Matheson 2011). According to the latest Bank for International Settlements' Triennial Central Bank Survey (BIS 2010), in 2010 the global foreign exchange market turnover reached almost 4000 billion USD daily, or nearly 1000 trillion USD annually. In 2011, less than four per cent of financial market turnover was actually necessary for the conduct of world trade in goods and (non-financial) services, so that – even if one allows for ample hedging against the currency and interest risks of real trade – more than 90% of financial market turnover can still be justifiably regarded as 'hot air' or speculation. It is therefore welcome that the EP should have broadened the tax base, as compared with the Commission proposal, to include (foreign exchange) currency transactions.

Today, global foreign exchange market turnover among the eight most important currencies makes up 92 per cent of daily currency trades with a volume traded of 3981 billion US dollars (BIS 2010). Flexible exchange rates and deregulated financial markets have fuelled a huge increase in speculation and market uncertainty. The global flexible exchange rate system constitutes one of the most important factors behind the growing instability of the world economy (Payandeh 2011). The absence of a new global currency system with a built-in mechanism for adjusting exchange rates is evidence that James Tobin's 'sand in the wheels of finance' (Tobin 1996: 65) argument remains valid.

In contrast to the early 1990s, derivative contracts today no longer serve primarily the legitimate purpose of hedging against exchange rate risks but have themselves become crisis-prone instruments[2]. The notional amounts of outstanding over-the-counter (OTC)[3] derivatives in 2011 were 700 trillion USD and thus exceeded global GNP by more than 1100 per cent[4]. Since 2000, this amount has increased sevenfold, a clear indicator of how detached finance has become from the needs of the real economy. An FTT would seriously undermine the attractiveness of such instruments and the falling level of their entry to the market would contribute to preventing crises in the future. It follows that a comprehensive FTT would cover transactions of both spot and derivative assets, thereby capturing the speculative nature of a range of financially 'innovative' products.

Much of the overheating of financial markets is due to a continuous decline in holding periods for financial instruments, from an average of seven years to only seven months over the past 40 years (Schäfer 2012). High-speed data transmission technology has made algorithmic High Frequency Trading (HFT) into the predominant form of financial transactions, and thus the form likely to be most affected by FTT. Introduction of an EU-FTT would, in other words, significantly reduce the volume of very short-term trading (IMF 2010: 177).

FTT would increase tax revenues

Since the start of the financial crisis, public assistance for the faltering banking system has been provided in various forms, such as the recapitalisation of financial institutions, guarantees on bank liabilities, relief of impaired assets and liquidity measures.

1 As of September 2012, these included Austria, Belgium, Finland, France, Germany, Greece, Italy, Portugal and Spain, with others likely to follow.

2 Cf. Warren Buffet's famous description in 2003 of derivatives as 'financial weapons of mass destruction' that could harm not only their buyers and sellers, but the whole economic system, http://news.bbc.co.uk/2/hi/2817995.stm

3 OTC means the transaction takes place directly between seller and buyer without registration by a central clearinghouse or securities exchange. Sellers and buyers can be banks, financial institutions, fund managers or individuals.

4 Schäfer, D. (2012), figures are from BIS, World Bank and WTO data.

According to Commission estimates, the financial crisis burden had reached, by the second half of 2010, 4600 billion Euros, or 40% of EU27 GDP, for bank bailouts (EC 2011b), without taking into account the broader economic and social costs such as unemployment and output gaps. If these latter costs are incorporated into the equation, the bill to society in terms of the shortfall in wealth generated by the financial crisis is in excess of 50% of EU27 GDP. It is unacceptable that in democratic societies financial institutions should be in a position to expropriate public budgets with impunity because of perverse incentives for excessive risk-taking or because of the prevailing moral hazard problem in financial markets. The bank bailouts in Europe, alongside the revenue that FTT can be expected to generate, are accordingly the main drivers of the huge popular support amassed by the tax over the past four years: in September 2011, over 65% of European citizens stated that they were in favour of such a tax (EC 2011c: 15).

In order to avoid tax evasion, safeguards must be built into the manner in which the FTT is levied. Assuming that the FTT would be levied on the basis of a combination of the residence, issuance and ownership principles[5], the potential revenue of FTT will depend on both the tax base and the tax rate applicable in the case of the different financial products. The European Parliament follows the Commission in supporting a rate of 0.1% for securities (bonds and shares), excluding primary market operations (i.e. the issuance of securities), and a tax rate of 0.01% on the notional value of derivative contracts. In the Commission proposal these rates represent a minimum floor, with member states being given the option of levying higher ones.

This model of differentiated tax rates does, however, entail some problems. The notional value of many derivative contracts is not denominated in euros or other currency value, but can be index-linked or concealed within other financial instruments such as index options or convertible loans. The most toxic assets in the US housing bubbles were highly complex multi-layered derivative products that were comprehensible – if at all! – to the designers of the contracts alone. The notional value of these derivative contracts, which serves for establishing the tax rate in both the EC and the EP model, appears difficult, if not impossible, to determine[6]. In view of the rather high risk of abuse, a uniform tax rate of 0.05% on all transactions would be an effective means of limiting any propensity towards tax evasion.

Applying the differentiated rates at EU27 level, the Commission estimates total revenue of 57 billion € (EC 2011b), two thirds of this levied at 0.01% on either equity, currency or interest-rate-linked derivative contracts (37.7 bn.), the other third (19.4 bn.) being levied at 0.1% on securities. It should be noted, however, that the Commission proposal excludes currency transactions from FTT. But even retaining this exclusion, a uniform tax rate of 0.05% on transactions taxed according to the Commission model could still yield more than three times as much as the Commission's estimate, namely almost 200 billion € for the whole of the EU.

The EC has used a rather shaky model that appears highly questionable. Revenue depends on both the tax base and the tax rate, on neither of which is there a consensus. Two exemplary calculations should illustrate this, as follows. Schulmeister has calculated FTT revenue, based on the assumption of a shrinking tax base (Schulmeister 2010: 47) and taking into account the market-stabilizing effectiveness of the instrument. Even on this basis, FTT revenue for EU27 at a tax rate of 0.05% on all spot and derivatives transactions on and off exchanges (OTC) would still amount to 235 billion € or 1.8% of EU GDP (Schulmeister 2012: 88). Schäfer and Karl (2012:17) have calculated much higher revenues from FTT than forecasted by the Commission. On the basis of the EC proposal, total tax revenue would amount to more than 37 billion € for the nine countries that have so far declared their willingness to embark on an ECP procedure. Under the same assumptions of FTT effectiveness, a uniform tax rate of 0.05% would yield more than 89 billion for the nine countries in question (Schäfer and Karl 2012: 31). Even if derivative markets were to shrink impressively by as much as 90%, revenue would still amount to more than 40 billion €. The same study identifies, moreover, two beneficial macro-prudential regulatory effects of an FTT that have not, to date, been highlighted by most other authors: the practice of issuing credit default swaps would be significantly reduced, as would also the interconnectedness of financial institutions.

Once the inflow of FTT revenue becomes reliably established, the introduction of a financial activities tax (FAT), as suggested by the IMF (IMF 2010), should be considered, in parallel to the FTT, in order to keep revenue at a stable level. An FAT, introduced alongside FTT, could yield between 14 and 30 billion € per annum (EC 2010), depending on the definition of the tax base. The major shortcoming entailed by an FAT results from the fact that it can be applied to banking and financial institutions alone, and not to financial products being traded. For this reason it is deemed suitable as a supplement to, and not a as a substitute for, FTT.

What are the real effects of FTT on pension savings?

Following heavy pressure from the financial industry channelled through members of the ALDE and EPP groups in the EP, the Parliament voted for the exclusion of pension funds from FTT (EP 2012). We consider this to be a major political blunder, since pension funds were within the scope of the EC proposal. The industry asserts that 'FTT would hit ordinary pension savers very hard and would result in pensioners paying for the FTT through reductions in the value of their pensions.'[7] In this section we will show that the cost of FTT to pension savings would in fact

5 The EC has lately admitted that the sole residence principle (taxation at the place of establishment of the parties to the transaction) could constitute a major loophole in levying the tax. We therefore suggest to supplement it with the issuance principle (taxation at the place of issuance of the traded asset) and the ownership principle (transfer of ownership of the traded asset conditional on payment of the tax, as has been the case of the UK stamp duty since 1694).

6 See Sieling C. (2012 :3) for more detail.

7 Exemplary: APG Memorandum, 31 October 2011, Amsterdam, http://www.apg.nl

be lower than the cumulative costs represented by the fees levied by pension fund managers and fiduciaries, and that FTT would act as a disincentive to activist management and frequent trading of workers' savings in pension funds, thereby reducing the number of financial intermediaries and the total cost to future pensioners..

The impact of FTT on pension funds depends, firstly, on the allocation of assets in portfolios; secondly, on the frequency of trading of those assets; and, thirdly, on the number of financial intermediaries involved in the transactions of securities. First, not all assets are taxable. Those that are not may include cash and deposits, but also investment in land and real estate and private funds. In most European countries, a non-negligible amount of 20% of assets is not subject to FTT (OECD 2011). Secondly, the allegedly high tax burden on savings can occur only when either the frequency of trading or (thirdly) the number of intermediaries is high, since the tax rate itself is comparably low. The relevant question here, then, is whether it is in the interest of the average pension saver that his or her pension fund should be employing an excessively active fund management style for more expected return at higher risk.

The following calculation should illustrate this. Suppose an individual pension savings portfolio consists of 1000 securities of 100 € value each, with assets thus totalling 100,000 €. A 'passive' asset manager would trade 25% of the portfolio once a year, while an 'active' management would be quite likely to entail a turnover of all assets twice a year. The trading frequency of securities in 'actively' managed portfolios is thus eight times higher than that of the 'passive' management. FTT of 0.05% is due at both the moment of buying and that of selling of assets. While the passively managed fund would be taxed at only 25 €/year or 0.025% of total assets, 200 €/year would be due by the owner of the actively managed fund, representing 0.2% of total portfolio value. Moreover, it should be noted that, in striking contrast to this, annual operating costs and management fees of 1.2%-2.4% average six to twelve times any FTT due, and that average net returns on savings after deduction of management fees were 2.6% in the period from 2008-2010 (OECD 2011).

The OECD findings show also that, in general, conservative (or 'passive') investment portfolio strategies yield higher returns than actively managed funds, since trading costs (e.g. fees and commissions) payable by the fund occur in line with the number of trades per year. The negative effects of an aggressive trading frequency become even clearer when examining the value of an asset portfolio over a period of 40 years[8]. In any case, asset managers of pension savings portfolios should be legally obliged to substantiate FTT levied on each individual portfolio, so that the contributing savers can easily identify the strategies of their fund management.

Lastly, what matters for the determination of the frequency of trading, and the incidence of FTT derived from it, is also the number of financial intermediaries involved in the transactions of securities. The more intermediaries there are, the more often a euro 'changes hands'[9]. A number of opponents to FTT have thus argued that every time assets in pension fund are re-allocated, FTT would reduce the available amount of pension disbursements by 5% (Financial Times, 1 December 2011). Others have argued that the *effective tax rate* could end up as high as 1%.[10] Deutsche Bank and others assert an inconceivable chain of up to seven financial intermediaries for securities transactions subject to (double) taxation which includes some intermediaries that are effectively exempt from paying tax. In reality, a simple buyer-seller scheme would apply with, possibly but not necessarily, one intermediary in between. It can therefore be concluded that FTT would be of help in downsizing the chain of financial intermediaries who bite off chunks of workers' savings for their old-age pensions.

It is undeniable that FTT will have an impact on the portfolio composition of pension funds and their risk management policy. This is, however, an intended outcome. If and where pension funds under-invest in productive and longer-term capital, such as infrastructure, green investments, SME finance, etc., and are excessively reliant on external asset managers' short-termism, a transparent FTT would encourage pension fund managers to reduce the funds' exposure to short-term trading and to increase the amount of pension money in long-term investments[11]. Compared to the administrative fees applied to private pension portfolios, the cost of FTT for pension funds turns out to be relatively modest. Meanwhile, pure pay-as-you-go pension systems bear neither the risk of fiduciary fees or capital market volatility; nor do they risk being taxed in addition to income tax.

Conclusions

While it is undoubtedly far from representing a panacea for financial market regulation, FTT does, nonetheless, prove economically beneficial to the economy. Its social benefits derive from its regulatory effects, as well as the additional revenue channelled into public budgets. Last but not least, FTT also holds benefits for the individual pension saver, insofar as it results in a reduction in trading activities.

8 Several examples given by Schäfer and Karl (2012: 35-36).

9 Financial economics does not appear to provide satisfactory explanations for the increase in trading activities. However, as Philippon (2012) has shown for the US, excessive trading does not contribute to higher financial market efficiency. Moreover, in contrast to other economic sectors, the (increasing) cost of financial intermediation is proportional to the expansion of its activities.

10 See examples given in Deutsche Bank (2011:7).

11 See Botsch and Habbard (2011).

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