ECONOMIC IMPACT ASSESSMENT OF FINANCIAL TRANSACTION TAX (FTT)

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Abstract:
The last financial crisis, the role of financial institution in this process and the big scale of public aid to the financial institutions generate many ideas of introduction of new additional tax on financial institutions. There are proposals of financial transaction tax, financial activity tax and different bank taxes. The main ideas and assessment of financial transaction tax are presented in the article. The main subject of analysis are macroeconomic consequence of imposing special tax for financial institutions, the role of such tax for EU budget and stability of financial market.

Although the FTT achieves its fiscal target to a certain degree, it clearly misses its main objective. It cannot deter the financial sector from entering into risky business transactions, nor can it prevent future banking crises. The FTT can even jeopardise the stability of the financial markets, as minimum tax rates encourage the leakage of financial transactions within the EU. It is questionable whether a taxation of banks seated in third countries is even admissible at all.

Keywords: tax, finance, management, crisis, European Union

1. CONTEXT OF COMMON SYSTEM OF FINANCIAL TRANSACTION TAX

1.1. Financial and economic crisis context

The financial sector was a major cause of the crisis and received substantial government support over the past few years. To ensure that the sector makes a fair and substantial contribution to public finances and for the benefit of citizens, enterprises and Member States, the European Commission is following up on its original proposal for a financial transaction tax (FTT).

The introduction of the EU Financial Transaction Tax (FTT) has been largely debated since the beginning of the 2008 crisis. Following the ECOFIN meetings held on 9 October and 13 November 2012, the EU Commission envisages now to introduce a FTT amongst a subset of EU Member States and a new draft directive is expected to be released shortly.

The recent global economic and financial crisis had a serious impact on economies and the public finances. The financial sector has played a major role in causing the economic crisis. The financial crisis stressed the need for a more robust financial system, given the cost of financial instability for the real economy. There is a strong consensus within Europe and internationally that the financial sector should contribute more fairly given the costs of dealing with the crisis and the current under-taxation of the sector.

The financial sector should bear its fair share of the costs of the financial crisis. The financial sector support by Member States for a total of about EUR 4,6 trillion (39% of EU-27 GDP in 2009) worsened the situation of public finances and such situation is hardly sustainable from a fiscal point of view and imposes a heavy burden on the present and future generations.

In addition, financial sector benefit from VAT exemption of financial services. Article 135 (1) of the VAT Directive provides an exemption leads to a tax advantage for the financial sector in the range of 0,15% of GDP. It results in a preferential treatment of the financial sector of the economy as well as in distortions of prices (European Commission 2011a, p. 2).

1.2. Policy context

The European Council concluded on 17 June 2010, in preparation for the G-20 Toronto Summit, that ‘the 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.’ (European Commission 2010a, p. 2).

In March 2010, the European Parliament adopted a resolution on taxation in the financial sector. In October 2010, the Commission compared within a Communication (European Commission 2010a) the FTT with a financial activities tax which taxes the profits and remunerations of financial institutions. The result was that in the case of a unilateral introduction of a financial tax at EU level, the financial activities tax would be ‘more promising’, as a financial transaction tax entails a high risk of leakage. Nonetheless, on 29 June 2011, the FTT was included in the ‘Proposal for a Council Decision on the system of own resources of the European Union’ European Commission (2011b), as a new potential part of EU own resources. In its final statement of 4 November 2011 in Cannes, the G20 did not call for the introduction of an FTT; it simply took note of the fact that several of its members wished to introduce it (Baran A.-K., Eckhardt P. (2011, p. 3).

Given the difficulty faced in achieving a common agreement between the 27 Member States, a subset of EU countries have decided to go ahead and to support the introduction of the FTT through the enhanced cooperation procedure. As of today, 11 Member States have sent official requests to the EU Commission for enhanced cooperation on an FTT (the ‘Participating Member States’): Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain. The Netherlands also confirmed that they may under certain conditions be interested in joining the Participating Member States.

The EU Commission considered that all legal conditions for such cooperation are met and on 23 October 2012 it proposed to EU Council to authorise the enhanced cooperation in the area of the FTT. On 12 December 2012, the EU Parliament also gave its consent. A Qualifying Majority Vote of the 27 Member States is now required at the level of the EU Council: in other words, the blessing of the non-Participating Member States, i.e. the one which will not be adopting the EU FTT (e.g. UK, Sweden etc.) will be necessary to move ahead. During the ECOFIN meeting held on 22 January 2013, the council adopted a decision authorising the 11 member states to proceed with the introduction of a FTT through ‘enhanced cooperation’. A subsequent proposal for a Directive should now be released shortly by the EU Commission for discussion and adoption by the Participating Member States (Deloitte 2013).

On 14 February 2013 the European Commission adopted a proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, which mirrors the scope and objectives of its original FTT proposal of September 2011. This follows the decision of the Council on 22 January 2013 to authorise enhanced cooperation between 11 Member States and the consent of the European Parliament given on 12 December 2012.

2. FINANCIAL TRANSACTION TAX

2.1. The main objectives of FTT

The European Commission is planning to introduce an EU-wide financial transaction tax (FTT) in order to create new revenues for the public purse and to increase the stability of the financial markets. The main objective of the introduction of an EU-wide financial transaction tax is taxation financial instruments. FTT serves to: 1) ensure that the financial sector contributes to the costs of the financial crisis; 2) ensure that the financial sector is ‘taxed in a fair way’ compared to other sector; 3) generate revenue for the public purse; 4) motivate the financial sector to take part in less risky transaction; 5) prevent future crises (Baran A.-K., Eckhardt P., 2011, p. 1).

The tax is apply to a ‘wide range of financial instruments’, both in the organised markets and ‘over-the-counter’, and to a ‘broadly determined range of financial institutions’. The European Commission expects EU-wide tax revenues of roughly 57 billion EUR a year. They are to flow partly into the EU budget through an own resources system of the European Union (European Commission (2011b).

2.2. The characteristics of FTT

The taxation of financial transactions is carried out on the basis of the residence principle. A financial transaction is subject to FTT if at least one of the transaction parties is a financial institution established in the EU. In so doing, this institution may also act for the account of another person or on behalf of a party to the transaction. (European Commission, 2011c, Art.1 (2)). The Commission wishes to achieve the specific taxation of the financial sector. Consequently, only financial institutions are to pay FTT.

Member States must apply the provisions of the Directive from 1 January 2014 (European Commission, 2011c, Art. 17 (1)).

The taxation basis is as follows:

– For derivative transactions: the notional amount (the underlying variable that is used to calculate payments) of the agreement; where more than one notional amount is identified, the highest amount is to apply (European Commission, 2011c, Art. 6);
– with all other financial transactions the consideration paid or owed applies; if the consideration is lower than the market price, the latter applies. In the case of a transfer of risks associated with financial instruments within a group, the market price applies. (European Commission, 2011c, Art. 5).

The Member States could fix their own tax rates. They should be 'sufficiently high for the harmonisation objective' to be achieved but at the same time 'low enough so keep delocalization risks to a minimum'.

In so doing, the following minimum rates apply (European Commission, 2011c, Art. 8 (2) in conjunction with Art. 5 and 6):

- 0,01% for derivative transactions and
- 0,1% for all other financial transactions.

3. ASSESSMENT OF FINANCIAL TRANSACTION TAX IMPLEMENTATION

3.1. The impact of Financial Transaction Tax on Gross Domestics Products

Higher capital costs resulting from the tax reduce willingness to invest, which leads to declining growth rates. Thus negative impacts on employment can also be expected. The Commission expects the gross domestic product to decline by 0.53%.

Summarize the estimates prepared by the European Commission, it come up with an estimate of a total long run loss of GDP of -0,53% as a result of the FTT. More realistic model gives a far lower estimate for impact of FTT on level of GDP, equal to only -0.2%. If all other effects, proxied by the Commission in its previous analysis are added, the impact of FTT on level of GDP is equal to -0.1%. However, the Commission estimates are based on a model that even in this revised form is incomplete, and excludes some of the crucial positive impacts. Griffith-Jones S. and Persaud A. examined positive impacts and conclude that they are more than likely to compensate the negative effects so the impact of introducing an FTT on level of GDP, all things considered, is likely to be positive, at around +0.25% - as a minimum. Indeed, their analysis suggests that the overall positive impact on growth could be higher, and they identify a number of channels through which the FTT could support sustained growth. Outside of economic models, there are a great many factors that contribute, directly and indirectly, to growth and it is important not to exaggerate the effects of the FTT alone. Furthermore, it is certainly the case that many of the countries that do have FTTs have not been growth laggards, such as: South Korea, Hong Kong, India, Brazil, Taiwan, South Africa and Switzerland. On the contrary, they have been amongst the fastest growing economies in the world. (Griffith-Jones S., Persaud A., 2011, p. 2).

The European Economic and Social Committee considers it worth noting that the number of European citizens, interviewed by Eurobarometer, in favour of introducing an FTT has not fallen below the 60 % level since the autumn of 2010: autumn 2010: 61 %; spring 2011: 65 %; autumn 2011: 64 %. For this reason, the introduction of the FTT could mark an important first step towards restoring the confidence of the European public in the financial sector (Palmieri S., 2012, p. 4).

The residence principle, whereby not the location of a transaction is relevant for taxation but the business seat of the parties to the transaction, reduces the risk of leakage which is associated with FTT. However, FTT increases the capital costs of companies active in the EU. This has a negative impact on the EU as a business location as long as the FTT is introduced in the EU only.

3.2. The impact of Financial Transaction Tax on European Union budget revenue

The table 1 shows a simulation of FTT revenue on selected financial instruments in EU. The data source of financial instruments is Federation of European Securities Exchange (FESE).

Table 1: Simulation of FTT on selected financial instruments in EU in the year 2005 – 2010 (mln EUR)

Financial instruments	2005	2006	2007	2008	2009	2010
Bonds	10512,0	11042,8	10830,1	13167,3	15029,7	12638,4
Shares	12041,9	16778,2	22171,9	16090,3	8501,5	6294,6
Derivatives	2177,0	3503,2	5661,6	5480,9	3435,8	3890,6
Options and futures	37763,0	44057,9	52826,1	54037,9	45799,8	43024,7
Total FTT revenue	62493,8	75382,2	91489,7	88766,4	72766,8	65848,3
2/3 of total FTT revenue	41662,6	50254,8	60993,2	59177,6	48511,2	43898,9
Total EU budget revenue	107090,6	108423,0	117653,1	121700,1	117625,7	127926,5
FTT revenue share in total budget revenue (%)	38,9	46,4	51,8	48,6	41,2	34,3

Source: Own calculation based on Federation of European Securities Exchanges (http://www.fese.be/en/); European Commission, EU budget 2010, Financial Report, p. 72.

FTT, the new source of revenue of the EU budget is efficient. The efficiency of FTT proceed from high value of financial instruments trading on the stock exchange of EU Member States. In the article there was adopted for the analysis the most important financial instruments trading on stock exchanges, except for such OTC trading, currency trading courses and other specialized trading financial instruments. As a results, it is expected that the revenue from the FTT will be higher.

3.3. Economic Impact Assessment

The financial transaction tax could create the projected revenues for the public purse and thereby fulfil the fiscal purpose of a tax, it fails to achieve its steering function, namely to deter financial institutions from enacting risky business transactions and thus to prevent future crises. For it cannot systematically prevent economically harmful behaviour by making it more expensive; on the contrary, this would incur even greater damage.

Firstly, there is no conclusive proof as to which financial transactions, employing which financial instruments and under which circumstances jeopardise financial stability. The FTT could only provide such stabilising incentives if such evidence existed. The fact that for the FTT only minimum tax rates are introduced could even jeopardise financial stability. For Member States will use this room for manoeuvre to introduce different tax rates. This can lead to increased leakage in financial transactions and thus to a concentration within the EU. The interest of financial centres strengthened or created in this way in a reinforced financial market regulation is likely to be rather limited.

Secondly, the tax affects all market participants, including those who contribute to an efficient price-building and thus increase market efficiency. On the one hand, an FTT can be an appropriate instrument for reducing the attractiveness of high-frequency trading in which items are built and sold within minutes or even seconds, as the tax minimises or even eliminates the often low margins of this trade. However, this should not really be regarded positively, for it does not necessarily lead to a reduction in the volatility in markets. The tax would increase transaction costs and thus lead to a reduced number of market participants and to fewer potential business partners. As a result, single transactions could cause higher price fluctuations. High-frequency trade often contributes to the elimination of market inefficiencies and thus optimises price building (so-called price arbitrage). Moreover, the increased incentives to hold financial instruments for longer also increases the capital costs, as investors will demand equivalent payment for the increased holding periods which, eventually, will reduce market actors' willingness to invest.

Thirdly, the tax could create damages, as it is levied not only upon transactions which allegedly jeopardise the stability of the financial market, but also on derivative transactions to hedge risks and on other economically reasonable transactions, which would therefore become more expensive. The financial transaction tax will therefore not increase the stability of the financial market and, hence, does not contribute to preventing a new crisis in the banking sector (Baran A.-K., Eckhardt P., 2011, p. 3-4).

In the event that unanimity is not reached by the 27 Member States, at least nine Member States may introduce the FTT within the framework of a reinforced cooperation pursuant to Art. 20 TEC in conjunction with Art. 326 TFEU. In so doing, the requirements of the Directive concerning indirect taxes on the raising of capital (2008/7/EC) must be complied with, as a reinforced cooperation must adhere to Union law (Art. 326 sub-para. 1 TFEU). The Commission Proposal amending the MiFID Directive [COM(2011) 656] contains a new definition of the term 'financial instruments', according to which, in future, emission allowances are also to be deemed 'financial instruments' of FTT (Baran A.-K., Eckhardt P., 2011, p. 4).

4. ALTERNATIVES

Transaction taxes can take several forms. The proposed EU FTT is a combination of a securities transaction tax (STT) – a tax on trades of specified securities (equity, debt, and their derivatives) – and a currency transaction tax (CTT) – a tax on foreign exchange transactions and possibly their derivatives (although the EU proposal excludes spot transactions). The Commission, in its impact assessment, looked at other options, including a securities transaction tax on equities only. However, financial services taxes can also take the form of a capital levy (a tax on increases in all forms or select types of business capital or form of business), a registration tax (a tax on individuals on banks loans/registrations) and a bank transaction tax (on deposits and/or withdrawals from bank accounts).

The surcharge on systemically significant banks (SIBs), as envisaged by the Financial Stability Board (FSB) and Basel Committee, is a capital levy, so would act as yet another potential tax on the EU's financial services sector. While the EU Commission did not examine the SIB surcharge in its proposal for the FTT, one alternative it did actively consider was a financial activities tax (FAT) – a tax on the rents (i.e. profits and remuneration) arising from financial services activities over and above income and capital gains tax or social security contributions. It would appear that the FAT was ruled out on the basis that it had less revenue potential.

Another alternative to the FTT are bank resolution fund levies, which are expected to feature in the Commission's upcoming proposal for a crisis management regime or Financial Stability Contributions (FSC) suggested by the IMF. 13 Like the FTT, the motive would be to ensure that the financial services sectors pays when a crisis occurs, rather than the taxpayer and that the amount paid by each institution reflects their contribution to systemic risk. Such funds are used to finance the costs of resolving failed banks.

This is not an exhaustive list of alternatives and any policy would need to be designed to respond to the desired objectives, recognising the jurisdiction of each member state to adopt an appropriate fiscal response (Millar A., 2012, p. 12-13).

5. SUMMARY

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