Financial Transaction Tax

Sensible, Feasible, Overdue

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What began in 2008 as a global financial crisis and developed into an economic crisis has now reached its apogee – at least in Europe – in the destabilisation of public finances. Its causes are to be sought in regulatory and supervisory liberalisation across the globe, spawned by a radical free market ideology concerned solely with the maximisation of profit, investment returns and bonuses, totally eclipsing the financial markets' original function in the service of the public interest. The basis for this is formed by an enormous quantity of money which, furthermore, is the result of redistribution in favour of enterprise profits and at the expense of labour income. Between 1990 and 2010 the volume of global financial market transactions has swelled from seven times global GDP to twenty-six times and with an upward trend. At the same time, the magnitude and integration of actors has increased.

As a consequence of the crisis public debt in the EU member states has risen from 60 per cent of GDP in 2007 to 80 per cent in the subsequent years. The financial sector has received enormous financial assistance from governments. For example, EU member states spent 4.6 trillion euros to rescue the financial sector. Furthermore, the financial sector has benefited from low taxes in recent years. The VAT exemption enjoyed by financial services represents a tax benefit worth around 18 billion euros a year. But the financial sector's regulatory privileges are increasingly stifling growth of the real economy. Europe stands at a crossroads: will it introduce policies to halt speculation against the crisis-countries and once more offer European states the prospect of real growth?

One instrument repeatedly discussed in this context is the financial transaction tax. Similar to Germany's value added tax,[1] it is a tax on all financial transactions. This means all exchange and over-the-counter transactions, in other words, every purchase or sale of shares, foreign currency, derivatives, securities, bonds and other financial products are taxed. It thus kills two birds with one stone:

On one hand, it makes speculation more expensive. With high frequency trading, high-performance computers employing algorithms trade into and out of investment positions thousands or tens of thousands of times a day. It is the sheer volume of transactions that generates profits. However, if each individual trade is taxed traders' profits are appreciably lowered, making such transactions less attractive.

On the other hand, it has a substantial fiscal effect. A financial transaction tax would help to recoup part of the costs where speculation does the most damage. Studies show that for Germany alone such a tax could bring in up to 20 billion euros a year.[2]

The debate on the taxation of financial transactions is not new. James Tobin proposed a tax on currency transactions decades ago. Some states have long had similar taxes. For example, since 1694 Great Britain has levied a tax on securities transactions. Stamp duty to this day provides billions of pounds' worth of stable revenue. In Germany, too, up to 1991 a stock exchange tax was levied. Under the Red-Green coalition, efforts were made to introduce a financial transaction tax, but the deregulatory fervour of the time was against it. The notion was revived in Germany because of the financial crisis. After

1. In more precise terms, the financial transaction tax corresponds to the land transfer tax which applies to every trade and not – as a consequence of the pre-tax deduction in the case of VAT – only to value added.

2. Schulmeister, Stephan (2009): Die Finanztransaktionssteuer – Konzept, Begründung, Effekte. In: Informationsbrief Weltwirtschaft & Entwicklung.

initially being raised in the parliamentary election in 2009 there were parliamentary initiatives in the Bundestag,[3] which largely determined the debates in combination with civil society initiatives.

The debate has been given fresh impetus by the European Commission's proposal for a directive on a common financial transaction tax in the EU in September 2011.[4] The tax would be levied on all transactions implemented by means of financial instruments between financial institutions, as long as at least one of the counterparties is resident in the EU. Share and bond trading would be subject to a tax rate of 0.1 per cent and derivatives contracts 0.01 per cent. In its proposal the European Commission estimates EU-wide revenues of 57 billion euros.

Is This Feasible Only on a Worldwide Basis?

Does the introduction of a financial transaction tax in the EU or even in the Euro area make sense in a context of globalised financial markets? Like a mantra, its opponents insist that it has to be introduced on an international basis – or at least Europe-wide – in order to prevent distortions of competition or flight. But this argument is just a pretext whose insinuation is all too clear. At the level of the G20 no progress is likely on the financial transaction tax for the foreseeable future. The United States and other countries have already made clear their opposition and thus nothing will be achieved for the time being.

Sweden is always cited as the classic example of a failed introduction below the global level. In 1985 the country introduced a stock exchange transaction tax. In next to no time, bond trading fell by 85 per cent and the trading volume of futures and options by 98 per cent. Would a continental European solution without the United Kingdom meet the same fate?

In its proposed directive the European Commission presents an idea that can properly be described as »intelligent«: the gist of it is that every transaction would be taxed in which either the buyer or the seller comes within the scope of the directive. The decisive difference between the Commission's proposal and the (failed) Swedish model is that under the latter the tax liability depended on the location of the transaction and not the domicile of those transferring the shares. If a tax along the lines proposed by the Commission were introduced it could be avoided only if both counter-parties were outside the scope of the law. In future, therefore, financial companies would have to completely renounce their European customers if they wish to avoid the tax. If the tax was thus introduced in the EU or in the Euro-area, for example, Deutsche Bank would have to transfer its corporate seat if it wanted to avoid liability. That is highly unlikely, particularly because the tax is so small.

The proposed directive is vulnerable in this connection, however. So far, the foreign subsidiaries of European financial actors have not been included. Furthermore, the focus on financial institutions harbours the danger that they will take on the guise of non-financial institutions simply to avoid paying the tax. The question also arises of whether transactions will be taxed both of whose counterparties are outside the scope of the law but which involve securities that originate within the jurisdiction covered by the tax: for example, if a trader in Singapore sells shares in Mercedes to a trader in New York. According to the so-called »issuance principle« – the Mercedes shares were issued within the scope of the tax – this transaction, too, could be subject to the tax. An »R plus I« (residence plus issuance) solution would thus be desirable in order to minimise the possibilities for avoidance. Ultimately, it must be considered whether – on the model of British stamp duty – a transaction would be legally valid only on payment of the tax.

Different Tax Rates – Does One Size Fit All?

The draft directive lays down minimum tax rates that leave member states room to levy higher ones. On this basis, financial transactions are not to be taxed below 0.1 per cent of the gross value of the transaction. In the case of derivatives the tax rate is to be 0.01 per cent. Moreover, these rates are to be paid by both buyer and seller. If, in the end, one counterparty resides outside the

3. See motions by the SPD parliamentary group Bundestags-Drs. 17/527 and 17/6086, the motion by the Bündnis 90/Die Grünen group Bundestags-Drs. 17/1422, and the motion of the DIE LINKE group Bundestags-Drs. 17/518.

4. Proposal for a Council Directive of 28 September 2011 on a common system of financial transaction tax and amending Directive 2008/7/EC [COM(2011) 594 final.

scope of the directive the other counterparty is liable for the whole sum.

In the case of derivatives the nominal amount at the time of the transaction shall apply, in other words, the tax's basis of assessment is not a derivative's purchase price, but the whole volume of the transaction underlying the derivative. To take an example, if a bank buys an option at a price of 100 euros to buy a barrel of oil six months later at 120 euros this option will cost the bank 15 euros: according to the EU proposals the basis of assessment would be the nominal value of the option, in this case 120 euros.

At first glance, the European Commission's grounds for taxing derivatives at their nominal value are convincing. Taking the nominal value prevents »creative« framing of the derivative contract since there would be no tax incentive to enter into a contract based only on price and value differences. Furthermore, taxation at the moment the derivative transaction is carried out is thus possible and not when the contract – often only after a long while – matures. However, often nominal amounts of derivatives are not based on value in euros, but on an index, for example, the DAX. How can the value be fixed in this instance? Derivatives are also often contained in other financial instruments, such as convertible loans or index options. In this case, delimitation with effects on the tax rate is accompanied by considerable difficulties. Varying tax rates ultimately harbour the risk of abuse. A better solution would thus be a uniform tax rate on all transactions of at least 0.05 per cent.

Exemptions from the Tax

In its proposal the European Commission exempts transactions on so-called primary markets – in other words, the issuance of securities – from the tax. If a company issues bonds, therefore, no tax would be payable. The idea of exempting the real economy from the tax is persuasive. In this context, critics relentlessly describe the financial transaction tax as a »brake on growth« and economically harmful. The European Commission has also addressed this question, concluding that the long-term negative consequences of a financial transaction tax on EU GDP are »negligibly low« – according to the most recent calculations, at most a fall significantly below the 1 per cent mark is to be expected.[5] In contrast, revenues from the financial transaction tax, according to the European Commission, are suitable for stimulating the economy if, for example, they are invested in a country's infrastructure.

In addition, capital raising by public budgets and currency transactions are exempted from the tax in the Commission proposal. In particular, the exemption for currency transactions gives pause for thought because the Tobin tax – the original model for the taxation of financial transactions – was designed only for currency trades. The European Commission regards a tax on currency transactions as a restriction of the basic freedom of capital movement in the European single market, enshrined in the European treaties. Accordingly, the member states are obliged to clear away hindrances to cross-border capital movements and payments, to the extent this is required for the functioning of the single market.

The exemption of currency transactions goes too far. The restriction of European freedom of capital movements – as far as it is due to taxation – can easily be justified in the general interest as stabilising the financial markets by reducing speculative trading. This has been exhaustively documented. Even its compatibility with WTO law has been adequately established.[6]

If the financial transaction tax is to have as broad a basis of assessment as possible small investors could also be affected by it. The proposed EU directive foresees a series of exemptions in this respect: transactions concerning, for example, insurance, mortgages or consumer credit are not to be subject to the tax from the outset. That is to be welcomed. Purchases of investment funds, however – including so-called Riester funds – would also be subject to the tax.

The frequently repeated imputation that such a tax would constitute a heavy burden on small savers, however, does not follow. A total of 85 per cent of the trades subject to the tax take place solely between financial institutions. And even if a small part of them can be passed

5. Ludwig, Thomas (2012): Transaktionssteuer weniger schädlich als angenommen. In: *Handelsblatt* (22.1.2012), available at: http://www.handelsblatt.com/politik/international/steuerkommissar-semeter-transaktions-steuerweniger-schaedlich-als-angenommen/6096288.html (accessed on 28.2.2012).

6. Mayer, Franz C./Heidfeld, Christian (2011): Europarechtliche Aspekte einer Finanztransaktionssteuer. In: EuZW 2011: 373 ff.

on to clients the low tax rates of 0.05 per cent (resolution of the SPD parliamentary group 2011) or 0.1 per cent (the value proposed for the EU directive) mean that only those transactions will be discernibly taxed which have a high turnover frequency. If an investor, for example, puts 10,000 euros into an equity investment fund he pays a subscription fee of 200 euros and on top of that the financial transaction tax would be 5 euros. The bank's commission is therefore 40 times larger than the tax. A Riester fund would have the same outcome: assuming an annual deposit by the saver of 1,200 euros, a contract period of 20 years and a yield of 5 per cent, taking into account compound interest and redeployment effects, the tax liability would be 70.17 euros – and even then, over a period of 20 years![7]

After all this, however, nothing has yet been said about what the revenues from the tax could be used for. The directive proposed by the European Commission takes a middle course, according to which the tax revenues would flow, wholly or partly, as own resources into the EU budget and, at the same time, substitute own resources paid from national budgets to the EU.

Finally, there remains the simple question of whether a financial transaction tax is technically feasible. Since a relatively small number of actors would be affected by it, it would be relatively easy to administer. Her Majesty's Revenue and Customs (HMRC) in the United Kingdom (the tax authority) reports that collection of the tax on share trades is the most efficient of all, costing less than 0.05 per cent of derived revenues. By comparison, it costs ten times as much to collect income tax. Trading in securities, derivatives and foreign currency largely takes place via electronic trading systems (so-called clearing houses). Furthermore, the forthcoming EU financial market initiatives, such as MiFID and EMIR will ensure that proprietary trading will also be systematically included. Levying the tax can thus be established incredibly easily on the basis of existing trading systems and structures. All that is needed is to adjust the trading software.

The Time Has Come

The European Commission's proposal is on the table. Despite all the open questions and possible improvements it represents a good basis for introducing a financial transaction tax. Now European governments are being called on to introduce the tax in the EU, although perhaps also within the framework of extended cooperation between at least nine member states. In an unprecedented action on the part of civil society the campaign »*Steuer gegen Armut*« (Taxes against poverty) in a few weeks in 2009 collected over 60,000 signatures for the introduction of the tax. This showed once again that many people want real change in financial market regulation. The time has come.

7. Statement by the CEO of the *Bank für Kirche und Caritas eG,* Dr Richard Böger and Prof. Dr. Max Otte on the financial transaction tax at the public hearings of the parliamentary Finance Committee, 17 May 2010 and 30 November 2011.

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