The Politics of an EU Financial Transactions Tax

Policymakers across the European Union (EU) agree that some re-regulation of the European financial system is required; however, member states remain far apart on exactly what sort of regulations are called for. Most concur on the idea that capital requirements should be raised – and that member states should be allowed to demand that banks set aside more capital than required by the new Basel III international guidelines.[1] However, other European Commission proposals for a financial transactions tax (FTT) or the recently announced effort to centralize bailout rules in a way that ensures creditors absorb the cost of bank failures[2] have proven far more controversial.

This brief provides an in-depth examination of one of these initiatives: the popular yet contentious idea of levying an EU-wide FTT. The European Commission and European Parliament have pressed ahead with plans for such a measure despite strident opposition from certain member states, particularly the United Kingdom. Proponents of such a tax argue that it would enhance financial market stability, create a new source of government revenue, and potentially lead to increased growth. Critics maintain that it will only serve to raise the cost of capital for European businesses, depress growth, and route financial transactions away from EU financial centers.

The brief is structured as follows: the first section provides some background to the FTT concept and examines countries' experiences with similar taxes in the past; the second and third parts then provide a detailed analysis of the current EU proposal and its potential costs and benefits; the third section discusses the political context which will determine whether or not the EU proposal becomes reality; and the brief concludes with an assessment of the most likely outcome going forward.

Origins and Experiences

The FTT is sometimes – and somewhat erroneously – referred to as a "Tobin tax." Nobel Laureate James Tobin, writing in the 1970s, argued in favor of a small tax on all transactions in which one currency was converted into another. The purpose, as he put it, was to prevent "short-term financial round trip excursions into another currency," and thus "throw some sand in the wheels of our excessively efficient international money markets."[3] The idea of an FTT is guided by the same principle: that a small tax on all financial transactions places a brake on short-term and high-frequency trading, forcing investors to think more carefully before executing a trade. However, as Tobin himself has noted, the idea of doing this through a tax on *all* financial transactions – not only those which require currency conversion – was proposed by John Maynard Keynes in 1936.[4]

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Advanced economies have experimented with various limited forms of FTTs throughout the postwar era. Most OECD members imposed a tax on the transfer of publicly traded shares at some point. Some, like Belgium, the Netherlands, Sweden, and Germany, levied them on debt securities as well.[5] The vast majority of these measures were abolished during the 1990s, though Britain is unique among EU members for retaining its "stamp tax" on the transfer of equities.[6] However, the limited scope of the British tax makes it relatively easy to avoid: rather than purchase shares directly, investors can buy an untaxed derivative which mimics the securities' market performance. Moreover, British brokers have been known to register shares in their own name in order to shift ownership between their own clients without legally registering a sale.[7]

Sweden's FTT experience in the mid-to-late 1980s is frequently highlighted by academics and policymakers alike. The government placed the tax on both equities and debt securities and collected it through Swedish brokers. The latter point proved to be the undoing of this and similar schemes across Europe: it was very easy for investors to avoid the extra fees by executing transactions through foreign brokers. Within several years, more than 50% of all Swedish debt and equity transactions had moved to London.[8] Revenue gains from the FTT were thus offset by reduced capital gains taxes and suffering within the Swedish brokerage industry – ultimately leading to the elimination of the tax in 1991. This poor result remains a chief inspiration for today's opponents of an EU-wide FTT. Swedish Prime Minister Frederik Reinfeldt, speaking in opposition to the EU's tax proposal in 2011, went so far as to suggest that Sweden was the only country which could speak to the dire real-world consequences of such a tax.[9]

The EU Proposal

The lessons of the Swedish and British FTTs were clearly considered by the drafters of current proposals for an EU-wide FTT. The Commission's initial proposal was published at the end of 2011 and the Parliament overwhelmingly adopted the text with some adjustments in late May 2012. The resulting plan envisions an FTT of remarkably broad scope in order to combat tax avoidance. Even so, the technical details of how to implement and collect the tax remain vague.

The proposals[10] are intentionally far-reaching, effectively covering all types of financial instruments: trades in equities, debt securities, money-market instruments, and derivatives are explicitly included. All transactions – whether executed through organized exchanges or not – would be taxed, meaning that the large market over-the-counter (OTC) derivatives would also fall under the purview of the FTT regime. Also included is the transfer of structured financial products such as securitized assets. The plan aims to tax all non-derivative transactions at 0.1% of the value of the instrument and derivatives at 0.01% of the notional amount of the derivative traded.

There are several significant exceptions to the tax. First, transactions conducted through central banks would remain tax-free. This would prevent the creation of any new

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obstacles to bank liquidity support or refinancing operations. Second, although derivatives contracts based on currency markets would be taxed, currency transactions on spot markets themselves are explicitly exempted. This would preserve free capital movement and obviate concerns over double-taxation on contracts executed across currencies.

Third – and most importantly – the tax would not be levied on the primary transactions underpinning financial assets. In other words, households would not be taxed directly for taking out a mortgage and firms would not pay the tax when issuing bonds. The fee would only be imposed on secondary market trading. In principle then, the vast majority of the trades subject to the FTT would be conducted by large financial intermediaries. This theoretically makes collection easier and allows proponents to say that typical households and businesses would not pay the tax. In reality, however, the increased transaction costs involved in taxed secondary-market trading would be at least partially passed through to the original borrower.

As currently envisioned, the FTT would be levied according to both "residency" and "issuance" principles. The Commission's original proposal only relied on the residency principle. It stipulated that any transaction which included a party resident in the EU – even if the transaction itself occurred through non-European markets – would be subject to the tax. The Parliament added a second principle, calling for the taxation of all assets which originated in the EU regardless of where those assets are traded. In other words, if shares in a French firm are exchanged between two Americans on the Hong Kong exchange, they would still have to pay the fee.[11]

While the scope of the tax is established in detail by the Commission proposal, provisions for tax collection are largely left vague. Member states are directed to find their own means of collecting payment – preferably electronically and at the point of sale. This presents some problems: an IMF study into the feasibility of FTTs has found that, while taxes can be fairly easily implemented on instruments traded through public exchanges, it would be significantly more difficult to impose the tax on OTC transactions.[12] Partially as a response, the Parliament has proposed implementation along the lines of the UK's current "stamp tax." This means that ownership of a European financial instrument would not be legal unless any transfer in ownership was registered with state authorities in the region where the asset originated. This creates the incentive for compliance on the part of the buyer – if they want to be sure that their claim is legally recognized, they must ensure that the tax has been paid.[13] However, this would only apply to European assets; how the tax would work on non-European assets remains unclear.

Costs and Benefits

Supporters of an FTT argue that there are two primary benefits to the tax. First, they maintain that it will create an additional revenue stream for cash-strapped governments and compensate for the fact that financial services are exempt from paying value added taxes (VATs).[14] Estimates of these revenue streams vary wildly depending on the stance

the calculator takes toward the FTT: sympathetic estimates are as high as €57 billion annually – an amount which would accrue to either the EU budget (in the Commission proposal) or member states (as in the Parliament proposal).[15] In contrast, FTT critics argue that tax revenues will be far lower than anticipated due to investors shifting their activity away from European markets and assets. Moreover, they cite the Swedish experience as real-world evidence of this.[16] Supporters counter by arguing that the EU FTT would be far more difficult to avoid in the same way as the Swedish tax and that, even with some reduction taken into account, there would certainly be significant new revenues. There is some support for this: even the relatively easily-avoided UK stamp tax, for instance, continues to raise $5 billion annually.[17]

The second benefit envisioned by FTT supporters is also hotly contested: they argue that an FTT will enhance financial market stability. Here, proponents rely on Keynes' and Tobin's original argument in favor of an FTT. That is, by imposing a small tax on financial transactions, investors will be dissuaded from high-frequency trading and generally buying assets with extremely short-term objectives in mind. This is a difficult point to quantify, yet similar arguments have been advanced by a diverse group of present-day economists, executives, and thinkers including Joseph Stiglitz, Larry Summers, Warren Buffett, Bill Gates, Mark Cuban, and both the Vatican and Church of England.[18] An impact assessment solicited by the Commission found that these effects could increase long-run growth in the EU by 0.35% of GDP through reduced incidence of financial crisis.[19]

Advocates for financial markets reject this outright, arguing that an FTT would reduce liquidity by hindering the behavior of arbitrageurs, make price discovery more difficult, raise transaction costs, and therefore increase the cost of European borrowing.[20] Indeed, the Commission itself concedes this point, admitting that an FTT would reduce GDP growth. The Commission estimates this cost at 0.5% of EU GDP over the long term – a number which UK-based analysts argue is misleading because the costs would be much higher in places like Britain.[21] Similarly, the international body concerned with promoting trade in derivatives, the International Swaps and Derivatives Association (ISDA), has argued that any taxation on derivatives would result in costs as result of traders' reduced risk mitigation options.

The final objection to the FTT is technical, simply arguing that innovative financial engineers will always be able to find a way to avoid paying the tax. This challenge is a real one but is nevertheless dismissed by FTT supporters. As they point out, income tax evasion is common and costly yet income taxes are nearly universal.[22] Ultimately, it is extremely difficult to assess the potential impact of an EU-wide FTT with any confidence – and this uncertainty has only fueled the debate.

The Politics

The politics of the FTT are highly contentious, with strong polarization between supporting and opposing member states. The intergovernmental debate is further

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complicated by the fact that the idea of an FTT is extremely popular among the general population: Eurobarometer in 2012 put public support for a tax on financial activity at 66%, up from 61% in 2011. It is therefore not surprising that even the most hostile European governments have conceded the desirability – in theory – of the tax. However, where member states differ is in how much participation is required before they will consider involvement. The most strident opponents, led by Britain, reject anything short of a global FTT on the grounds that anything less would put the City of London at a competitive disadvantage. Other countries are more ambivalent, with some willing to entertain the idea of an EU-wide FTT but unwilling to impose one on a smaller subset of countries such as the eurozone.[23]

Under EU decision-making rules, any new tax policy imposed across the union would require unanimous approval – something which is extremely difficult to see happening given the adamant opposition from certain corners. Nevertheless, the Commission and Parliament have moved ahead with the proposal due to strong support from a powerful core group of supporters: Austria, Belgium, Finland, France, Germany, Greece, Portugal, Spain, and Italy. In Germany, for instance, the Social Democratic Party (SPD) have demanded that the government press for an EU FTT as the price for their much-needed support on the fiscal compact treaty and the creation of a more permanent European bailout fund.[24] This has compelled Chancellor Angela Merkel to seek a tax even if it only impacts a group within the eurozone and not the single currency area as a whole.[25] Former French President Nicolas Sarkozy had announced that France would unilaterally implement a domestic 0.1% tax if the EU did not.[26]

Opposition from the UK, Netherlands, Sweden, and others has centered on the problem of competitive disadvantage. They maintain that an EU or eurozone FTT would simply shift financial activity to other financial centers across the globe. These concerns are particularly strong in Britain, which is extremely economically dependent on London's role as a global financial center.[27] Immediately after the Commission unveiled its proposal, British Chancellor of the Exchequer George Osborne declared the idea "a bullet aimed at the heart of London" and refused to consider any tax which did not include the United States and China.[28] The debate has added to the already-potent anti-EU sentiment among the British financial sector, which has chafed at the fact that the EU can force financial regulations on Britain through the use of qualified majority voting – even though the UK provides, by far, the largest share of financial activity to the EU economy. By contrast, France can protect its sensitive agricultural sector because it holds a veto over decisions on the Common Agricultural Policy.[29] The FTT, by hitting this sore spot, has added fuel to Conservatives' drive to repatriate powers from the EU and get, as Prime Minister David Cameron put it, the kind of Europe that Britain wants.[30]

Looking Ahead

Ultimately, because the opposition group includes both eurozone and non-eurozone members and any FTT must be agreed to by all participants, the prospects for an EU- or eurozone-wide tax are slim. EU policymakers have largely acquiesced to this reality, with

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German Finance Minister Wolfgang Schäuble admitting that "we are obliged to concentrate on alternatives" to the proposal as currently envisioned because "the outcome of nothing would be disastrous."[31]

The most likely compromises are a watered-down initiative – potentially by restricting it to an issuance-based stamp tax only – or a tighter FTT enacted by a smaller group of continental economies. The stamp tax has the virtue of being relatively easy to implement but would be limited to financial instruments originating in EU members. While this would raise some revenue, it is entirely unclear whether such a plan would result in the stability hoped for by supporters. European financial markets would still be able to conduct unhindered trading in non-European assets. Moreover, it is also uncertain that such a plan could prevent the creation of derivative assets on non-European markets which could evade the tax and still be traded by European investors. Finally, while the UK does continue to impose its own equities stamp tax – and encourages willing member states to do the same at the national level – the present Tory government is prone to be suspicious of levying a more inclusive duty at the EU level.

A smaller but tighter FTT implemented in the nine strongest backers of the tax could theoretically achieve the hoped-for reduction in financial activity in their own markets. This could be accomplished though the enhanced cooperation process allowing for multi-speed European integration, bypassing the need for agreement from less amenable states. While this would result in a tax on any transaction including a party resident in the participating zone, it would presumably create distortions that an EU-wide tax would not: by imposing a tax irregularly over the single market, it could incentivize relatively simple cross-border moves by investors and firms. Moreover, the results of such a limited FTT would be extremely restricted relative to the objectives of the Commission and Parliament: the wholesale financial trade represented by the nine countries most in favor of the tax are only marginally larger than the British wholesale market alone.[32]

In the end, the pressure for enacting some sort of FTT – provided by prominent eurozone economies and the popular support for the idea – will be too great to completely resist. At the same time, the refusal of Britain to engage in the scheme at all, combined with the hesitance by other EU members to participate in a scheme which does not cover the whole union, means that imposing an ambitious FTT under unanimity rules is effectively impossible. The result will therefore be some sort of compromise measure, more likely to be geographically restricted than a watered-down EU-wide initiative. In either case, a compromise is liable to achieve only partial results. It would, however, provide some concrete data concerning whether an FTT is generally more beneficial than it is costly. Given the highly theoretical and ideological nature of the present debate over financial taxation, this might be helpful and would certainly govern how the wider debate plays out.

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