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Questions and answers: Financial Sector Taxation

What is a Financial Transactions Tax?

A financial transaction tax (FTT) is a tax applied to financial transactions, usually at a very low rate. Financial transaction means any exchange of financial instrument between two or more parties. There are possible scopes for such a tax. A financial transaction tax applied only to stocks and bonds, or a currency transaction levy, would be two examples of narrow base FTT. At the opposite end of the spectrum a very broad base financial transaction tax would be that which applies to all financial instruments including derivatives and structured instruments.

What is a Financial Activities Tax?

A financial activities tax (FAT) is a tax on profit and remuneration which applies to all activities of a financial sector company. It can tax all profit and wages (addition-method FAT) or can specifically target economic rents (rent-taxing FAT) and/or profits gained through riskier activities (risk-taxing FAT). In contrast to an FTT, where each actor on the financial market is taxed based on its transactions, the FAT targets financial corporations. This option was presented to the G20 in the IMF's report on financial sector taxation in June (see: http://www.imf.org/external/np/g20/pdf/062710b.pdf).

Why is the Commission looking at options for taxing the financial sector?

At the European Council in June 2010, it was agreed 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".

The European Parliament and some Member States have also called for the idea of financial sector taxation to be looked at from a European perspective, as well as from a global one. In recent months, a wide and public debate on the various possibilities for taxing banks in Europe and at global level has been taking place, with many divergent opinions. Through its in-depth analysis of this issue, and today's policy recommendations, the Commission aims to give the discussion on financial sector taxation more focus, in order to come up with the best approach for Europe.

Also, by putting forward options for a European approach, the Commission aims to avoid new obstacles to the Internal Market that could be created through a patchwork of different national bank taxes.

Finally, the Commission has always supported the idea of a global financial transactions tax to fund global challenges. It will use today's Communication as a basis for further discussion with Member States in order to consolidate the EU position prior to the G20 meeting in Seoul in November. The Commission intends to pursue the idea of a global financial transactions tax with its G20 partners.

Why might a new tax on the financial sector be needed?

There are a number of reasons why a new tax on the financial sector could be considered appropriate. First, the banks played a central role in creating the recent economic crisis, and it is generally agreed that they now need to make a fair and substantial contribution to the costs of recovery. Secondly, a new tax on the financial sector would raise important and much-needed revenue. The Commission has concluded that the financial sector is probably under-taxed compared to other sectors. Therefore, it would be justifiable to introduce a new financial sector tax which could help meet current revenue needs. Finally, some taxes have "corrective" characteristics, which could help to positively influence market behaviours and help prevent future crises. The Commission will, however, take into consideration the cumulative impact of taxes and regulation in order to ensure their complementarities and to allow the financial sector to fulfil its role in the "real" economy.

What is the basis for claims that financial services may be treated preferentially at present?

Financial Services are, in the majority of cases, exempt from VAT due to difficulties in measuring the taxable base. A number of studies[1] suggest this leads to the under-taxation of financial services.

In addition to this, the Commission has taken into account the privileged position that the financial sector enjoys in the economy compared to other sectors, the fact that it has benefited from economic rents and the implicit protection it has received from governments. These factors also need to be considered when weighing up what would constitute a fair contribution by the financial sector to public finances.

Why does the Commission support a global financial transactions tax?

The recent economic crisis was global in its causes and its effects. Responding to it, and recovering, therefore requires global solutions. Also, if ambitious global objectives are to be achieved, in areas such as development aid and climate change, international partners will need to agree on global financing tools. Given the potentially high revenues a global FTT could generate, it is an attractive funding solution for such global objectives. Economic analysis also shows that a financial transaction tax, in addition to the revenue it could raise, may prevent certain market behaviours (such as high speed trading) if implemented globally. So it would offer a "double dividend" in that it could help to raise important revenues while also contributing to more stable and efficient financial markets.

Are there estimates of how much revenue could be raised from a global Financial Transaction Tax?

If applied at global level, and at a rate of 0.1%, tax revenues from a financial transaction tax are predicted to be around €60 billion without derivatives. Values of more than ten times this amount are cited by some studies if derivatives are included, although for various reasons, these figures are not considered to be highly reliable.

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[1] Genser and Winker (1997) "Measuring the Fiscal Revenue Loss of VAT. Exemption in Commercial Banking", Huizinga (2002) "A European VAT on financial services? Economic Policy", De la Feria and Lockwood (2009) "Opting for Opting-In? An Evaluation of the European Commission's Proposals for Reforming VAT on Financial Services".

Why does the Commission consider the FAT to be a preferable option to the FTT at EU-level?

The Financial Transactions Tax is a tax more suited to global application – there are considerable risks (particularly of relocation) in its unilateral introduction. The Commission believes that the risks are considerably lower with the FAT, because profits and wages are less mobile than trading. The FAT appears to offer the advantages of being able to raise revenue and ensure a fair contribution from the banks, without the high risks associated with the FTT.

Why not propose an FAT at global level?

The Commission's analysis[2] suggests that the FAT is more suited to EU than global level, as it would fit in with the specificities of our economic / tax situation. It is not really a tax that could be uniformly applied in every region of the world, given the different approaches to taxation internationally. A financial transactions tax would, by its nature, be much easier to apply globally.

Are there estimates as to the amount of revenue that could be raised from an EU FAT?

The revenue of the FAT would depend on its design. In its most extensive form, as a tax on total remuneration and profit, the revenues for the EU27 could be €25 billion for a tax rate of 5%.

How would this revenue be used?

The Commission believes that it is important to first agree on whether such a new financial sector tax should be introduced, and how it should be designed and implemented in order to maximise its benefits. Only after that is agreed could it be feasible to discuss how revenues from such a tax could be used. The Commission has presented its recommendations for possible taxation of the financial sector. It will now need to present these options to the Member States, and continue the discussion. Any debate on what should be done with the revenue would come much later. Ultimately, it is for Member States to agree on how such revenue would be spent.

What will the Commission look at in the Impact Assessment?

The Impact Assessment will provide an opportunity to examine in more detail the economic, political and technical implications of the different options put forward for taxing the financial sector. It should help to ensure that any subsequent tax that is introduced for the financial sector is designed and implemented in a way that minimises possible risks and maximises the potential benefits.

See IP/10/1298

[2] European Commission (2010), Staff Working Document on the Taxation of the Financial Sector available at: http://ec.europa.eu/taxation_customs/index_en.htm