KAMPAGNE

"STEUER GEGEN ARMUT - TRANSAKTIONSSTEUER"

Full input of the Campaign “Tax against Poverty” to five core areas of the debate around the introduction of a Financial Transaction Tax (FTT)

1. Some arguments concerning “Financial Activities Taxes” (FATs) in comparison to an FTT

By Dr. Stephan Schulmeister,
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Financial activities taxes (FATs) are taxes on the value added of financial institutions, i.e., on their profits and wages. “The idea here is to tax the outcome of a company’s activity in terms of profits and wages (…) it taxes profits independently from how they are earned” (EC document SEC (2010) 1166/3, p. 20).

The IMF and the EC distinguish three types of FATs:

- A broad FAT (FAT1) which would tax the total sum of profits and wages (value added) as substitute of a VAT (most financial services are exempt from the VAT).
- A FAT which aims at taxing the rents of financial institutions (FAT2), i.e., those parts of profits and wages (including bonus payments) which exceed a “normal” level. These “excess” earnings constitute the tax base.
- A FAT which aims at taxing “excessive” returns stemming from unduly risky activities (FAT3). The tax base is the same as in the case of the rent-taxing FAT, however, the threshold above which incomes are considered as “excessive” due to risk-taking would be higher.

The fundamental difference between the FATs and the FTT is the following: The FATs tax income components of financial institutions (i.e., their performance), irrespective from which activities these incomes stem, whereas the FTT taxes specific activities (i.e., short-term trading of financial assets, in particular of derivatives), irrespective who carries out these activities. The term “financial activities tax” is therefore a misnomer. Rather it should be called “special tax on income components of financial institutions”. At the same, the FTT is a truly “activities tax” since it focuses on transactions independent from the institution/person which/who carries them out.

Even though it sounds well-founded to distinguish between "normal" incomes, excess income due to rent-seeking and excessive income due to risk-taking, it is impossible to identify these components in a general and practical way (which is indispensable if a tax system is to be based on such a distinction).

This short-coming together with the fact that the FATs focus on institutions and not on activities, would cause several distortions:

- Income of banks which serve the real economy like (small) savings banks ("boring banking") would be taxed in the same way as income of "investment" banks which make most of their profits from short-term trading like Goldman Sachs or Deutsche Bank ("finance alchemy banks") in the case of FAT1.
- If a bank serving the real economy is very successful/profitable, e. g., in providing venture capital to innovative firms, then it would pay FAT2 and/or FAT3 in the same way as the "finance alchemy banks".
- Moreover, these internationally operating "masters of trading" will easier be able to shift their profits to those countries where no FATs apply as compared to, e. g., venture capital banks.
- Hedge funds can easily avoid the FATs by moving to offshore places.
- All kinds of short-term trading/speculation carried out by non-financial corporations would remain untaxed (in particular multinationals are much engaged in financial "investments", SIEMENS is just one example).
- The same is true for trading activities of amateurs (their number has risen tremendously over the last 15 years).

The concept of the FAT1 and FAT2 is based on the assumption that the high/excessive returns of financial institutions are due to rent-seeking and/or risk-taking (fostered by the "too-big-to-fail-condition"). However, there are very big differences in the profitability of financial institutions, and there might be other reason for that than rent-seeking or risk-taking. If banks like Goldman Sachs or Deutsche Bank, e. g., continuously report extremely high profits from trading financial assets, whereas many pension funds, but also hedge funds and in particular amateur traders suffer losses, then this might be just the outcome of a zero-sum-game between those who don't understand the system at all and those who don't understand it to a lesser extent.

Even if excessive profits would be due to risk-taking, risky activities as such are not necessarily negative. It depends crucially on the source of risk. E. g., if an entrepreneur in the real economy takes the risk of a certain innovation and makes high profits, then these profits from speculation in the real sphere should not be taxed. The reason is simple: Such a tax would represent a disincentive to innovative activities.

If, however, speculation focuses on zero-sum games (as with most financial innovations), then the respective activities should be taxed - not because they are risky (this does not seem to be the case for "finance alchemy banks") but because they are harmful to the real economy, in particular by destabilizing the most important prices like exchange rates, commodity prices, interest rates and stock prices.

2. Some arguments concerning the relocation of trading activities in reaction to the implementation of an FTT

By Dr. Stephan Schulmeister,
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Main propositions of critics of an FTT:

- A) If an FTT would be introduced in the EU as a whole, a great deal of transactions would "emigrate" to offshore places like the Cayman islands. This will be particularly pronounced as regards the activities of hedge funds.
- B) If an FTT would be introduced only in some euro countries like Germany, France, Belgium and Austria, then many/most trading activities would be moved to London.

Counter-arguments concerning A):

- Many funds do already operate from offshore places since these jurisdictions serve as tax heavens (i. e., for reasons of income tax circumvention).
- Many/most of them engage in in short-term trading ("trend-followers") which is exclusively done on organized derivatives exchanges all around the world. To the extent that they (have to) trade on exchanges in FTT countries (Eurex in Frankfurt, Euronext in London, provided that also the UK introduces an FTT), they have to pay the FTT at the exchanges.
- Those funds which do not trade frequently, e. g., private equity funds, would not be affected by an FTT, irrespective where they operate.
- The high-frequency traders cannot move offshore for their computer servers need to be located as close as possible to the servers of the exchanges.
- To the extent that offshore hedge funds trade in over-the-counter markets they would/could be forced to clear and settle their trades through Central Counterparty Platforms (CCPs) or Central Securities Depositories (CSDs). This is so because the G20 as well as the EU are determined to legally force all banks and other financial institutions to centrally clear their OTC transactions. In this case counterparties from countries outside the EU would also be obliged to use the CCPs if they want to do business with financial institutions from EU countries.
- To tone down migration, one could restrict the extent of this emigration of short-term trading by introducing a FTT-substitute-levy (FFTSL) in FTT countries. The FTTSL would be charged to any transfer of funds from a bank account in an FTT country to a brokerage firm or hedge fund in a non-FTT country. The size of the FTTST must be several times higher than the FTT. With an FTT of 0.05% the FTTSL could be 2% or even higher. If it were 2% it would be the equivalent of 40 "round-trip-transactions". The FTTST can be considered some kind of "security deposit" in case the FTT due to the transactions carried out abroad is not paid.

Counter-arguments concerning B):

It is true that a substantial amount of very "fast" trading activities would move to London if the UK does not implement such a tax. Hence, the centralized FTT deduction might not be feasible.

The essential difference between the centralized and the decentralized approach to FTT implementation is as follows (taking transactions on exchanges as example). According to the centralized approach, any exchange situated in a country where an FTT applies ("FTT country") has to deduct the FTT for all transactions ("territorial principle"). According to the decentralized approach, any resident of an FTT country who orders a transaction to be carried out at home or abroad is legally the debtor of the FTT ("personal principle"). The tax is charged to the account of the tax debtor and transferred to the tax authorities by the bank or broker which places the respective order to the exchange ("taxing at the source").

However, some hedge funds and investment banks might shift their (very) short-transactions (even more) from Frankfurt to London. The same might be true for some amateur "day traders" who would process their orders through brokers at London.

Some concrete counter-arguments are as follows:

- Introducing a FTT-substitute-levy (FFTSL) in FTT countries like Germany or France would strongly mitigate the emigration of trading activities to London. The FTTSL would be charged to any transfer of funds from a bank account in an FTT country to a brokerage firm or hedge fund in a non-FTT country like the UK (see above).
- FTT-supporting countries, in particular Germany and France, could/should try to convince also the UK of the usefulness an FTT. The chances are not so bad if the economic situation gets worse again at the global level (e. g., due to the catastrophes in Japan, the turbulences in then Arabic countries, the related rise in oil prices, etc.). In this case, the British economy would slid into a recession due to its severe austerity policy. Hence, the government would urgently need additional tax income which would not dampen the economy further. An FTT is the optimal tax in this regard. At the same time, the UK would receive the by far highest FTT earnings without risking an emigration of transactions (since also the other EU countries with important financial centres, in particular Germany, also implement an FTT).

Some complementary/general counter-arguments:

- This extreme concentration of transactions on relatively few market places clearly shows that network externalities of financial centers are the most important factor for their success. This in turn implies that an FTT of 0.05% or even only 0.01% will not induce any considerable "emigration" of transactions to places outside the EU as these are either not attractive (if in the same trading time zone like market places in Africa) or outside the European trading time zone.
- There is an additional reason for this presumption (this refers also to relocations within the EU, in particular from Germany to the UK). The most important "blue chip stocks" of German (and British) corporations will always be traded at their "home" stock exchange, and so will derivatives related to these stocks (this argument applies also to derivatives instruments related to "national" stock indices like DAX or FTSE).

- The same reasoning holds true for standard derivatives instruments related to interest rate securities like the Euro Schatz future, the Euro BOBL future and the Euro BUND future in the case of Germany.
- Finally, one should keep in mind, that the emigration of activities which are detrimental for the real economy, is not per se a negative development. The dampening effects of short-term trading are not only due to the destabilization of exchange rates, commodity prices, interest rates and stock prices (which would continue to exist if transactions are relocated), but are also due to diverting the striving for profits from (productive) entrepreneurial activities to (unproductive) “redistribution games”.

3. Does an EU-wide FTT affect the competitiveness of the European economy?

By Dr. Richard Böger,
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Disadvantages for companies located inside the EU are twofold: Non-financial companies that seek capital markets funding are penalized by higher financial transactions costs due to the FTT. Because of the small total FTT amount we do not see a significant charge on the respective companies and consequently no competitive disadvantages relative to areas which are not subject to the FTT.

Furthermore, with an FTT, financial companies are at a competitive disadvantage compared to the financial industry in countries without the tax.

Over the past years, especially from 1990 to 2008, we have witnessed the financial industry’s strongly rising share of GDP, especially in the US and the UK. This development was initially perceived as a result of those countries’ high financial sector competitiveness over other areas. The financial crisis, however, has demonstrated that the rising share of the financial sector relative to the GDP was part of the bubble. The financial sector growth was not caused by sustainable value creation but rather by risk taking.

The FTT will complicate the financial sector’s effort to achieve ever growing shares of GDP. This could be viewed as a distortion of fair competition. This development would, however, actually increase the stability of financial markets and consequently constitute an economic advantage.

Will the introduction of an FTT cause an exodus of financial markets participants to tax-free regions?

If the introduction of the FTT in the EU will lead to substantial volume of transactions migrating to non taxable domiciles, the overall effect of the tax will be negative. On the one hand, there will be no measurable tax receipts, and on the other hand there will be no guiding influence of the FTT.

It will therefore be critical to legally construct a taxation system which minimizes the probability of migration. It therefore is a necessary precondition that taxable residents cannot evade the scope of the tax by diverting financial transactions to FTT-free domiciles.

The following principles of taxation would hence be seen as advantageous:

- The taxable entity should be the **buyer** (i.e., bank, mutual fund, insurance company or an individual investor) of a security
- A **seller** of a security will only be subject to taxation if the transaction is being conducted with a dealer who is domiciled in a FTT-free country. This way an evasion of the tax by on-shore banks (i.e., the entire EU) dealing with off-shore banks will be prevented.

Additionally, off-shore products (i.e., mutual funds) will only be admitted for distribution inside the EU if subsequent taxation is ensured.

4. Does the FTT lead to double taxation?

By Peter Wahl,
World Economy, Ecology and Development (WEED), Berlin

According to the IMF study on the FTT, the tax would lead to double taxation of a same financial asset or product during its lifetime ("cascade effect") and this would be a double taxation.

In fact, if one asset is sold several times, each time the tax has to be paid. But this is not a disadvantage of the tax but by intention. It is exactly this which makes the regulatory effect of the FTT.

Selling a financial asset is not creating added value. The profit comes from using the difference in prices. When I buy a share Volkswagen on the 1st of September for 100 Euro, my expectation is that I can sell it on the 15th of September for 110 Euro. The profit is not generated by adding value to an existing product, but by speculating on the increase in the price. After having sold the asset, the business cycle is over and the new owner of the stocks might do the same. He then is taxed again, which is completely legitimate because it is a new business cycle. In that sense there is no double taxation of the same economic process or the same business.

The effect of this is that all those who trade/speculate often pay more taxes than those who trade only once. The more there is speculation, the higher the tax. In particular high frequency trade will be hit by the tax.

The effect will be that a part of the business will not be rentable anymore and will stop. Speculation will be reduced while there remains still liquidity. Financial stability increases, because an excess of speculation leads to crises, as we have seen with the crash.

5. Who levies the FTT? How is it distributed? What is it spent for?

By Peter Wahl,
World Economy, Ecology and Development (WEED)

The FTT is levied by the financial authorities of those countries which introduce the tax.

Technically this is best done at the point of settlement, i.e. the moment when a transfer is booked to the accounts of the seller and buyer.

The settlement is highly concentrated in a few institutions, such as the *Continuous Link Settlement Bank*, or the *TARGET* system.

The settlement systems have to report every transaction electronically to the Central Bank.

This allows identifying electronically the national origin of trading partners and distributing the share of the overall tax income according to the national origin of sellers and buyers. For instance if a Spanish Bank is trading at the Frankfurt stock exchange with a Finnish Bank, the Spanish and the Finnish authorities will get the tax, although the trade took place outside their countries.

What is the money used for?

Civil society is advocating since many years, that the tax revenues are used to finance the global public goods development and environment.

As the crisis has also incurred heavy costs on industrialised countries and increased public debt, a part of the money could also be used to cover the costs of the crisis, because they are narrowing the space to finance development, in particular the MDGs and environment. In many donor countries the budgets for development and environment have come under pressure.

The details of the distribution depend on the balance of power between the different interest groups and from the legal context, for instance whether the laws of a country allow for a specific earmarking of tax revenues.

In Germany an informal coalition of all parties in the parliament has already expressed their will to assign a certain amount of the revenues to development.

The French president has also spoken out to attribute the tax revenues to development.

At the end, it will very much depend on the pressure from civil society how much money will go into development and environment.