Chapter 3
Long-term orientation and sustainability through financial transaction taxes

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> It is almost certain that there is some level of trading activity that is not economically optimal, beyond what is optimal, and if we impose on that a relatively small tax we can be confident that at very least we will gather some money in way that is not harmful; because even if it somewhat reduces the trading activity, if we believed the trading activity was too much in the first place then we have not done harm (Lord Adair Turner, Chairman of the UK Financial Services Authority).[1]

1. Financial transaction taxes - geographic scope and legislative basis

This chapter analyses the rationale and current state of play for the introduction of financial transaction taxes (FTT) in Europe. FTT, which impose a small tax on financial transactions of specific kinds, are significant for a number of reasons. First, the introduction of FTT at least at EU level constitutes one of the cornerstones of the trade union agenda for financial market reform (Botsch 2011). Second, although the proposed FTT appears to be low (according to the Commission's 2013 proposal 0.1 per cent for securities and 0.01 per cent for derivate products) this would nevertheless significantly cut into the profits of speculative trading strategies and thus help redirect investment away from the short term. As such it is a significant policy measure that, together with other instruments, could help support the Sustainable Company.

Since 2011 significant progress has been made in this regard. On 14 February 2013, the European Commission adopted a proposal for a Council Directive implementing financial transaction taxes under the Enhanced Cooperation Procedure (ECP) in the Lisbon Treaty (EC 2013).

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1. Cited in Kapoor (2010: 92).

This followed the decision of the Council on 22 January 2013 to authorise enhanced cooperation between 11 Member States representing 2/3 of EU GDP (France, Germany, Belgium, Austria, Slovenia, Portugal, Greece, Slovakia, Italy, Spain and Estonia) and the consent of the European Parliament given on 12 December 2012.

For the first time since the Treaty of Lisbon entered into force on 1 December 2009, the European Union legislator has invoked the legal basis for enhanced cooperation among certain member states (article 20 of the Treaty on European Union, TEU and articles 326-334 of the Treaty on the Functioning of the European Union, TFEU) who declared themselves willing to introduce a comprehensive system of FTTs. The February 2013 proposal was preceded by a series of legal examinations, which included verification that the enhanced cooperation procedure (ECP) initiative is non-exclusive and open to all (at that time) 27 member states, that it does not fall under exclusive competence of the Commission and that it is not detrimental to the principles of the Internal Market. According to the draft Directive, all transactions except currency transactions would be subject to FTT, at a rate of 0.1 per cent for securities (shares, bonds) and at 0.01 per cent for derivative products.

A previous proposal of the Commission from September 2011 (EC 2011a) was based on articles 113 and 115 of the TFEU, arguing that taxation of the financial sector needed coordinated action at EU level to create a level playing field and to avoid fragmentation of the EU financial market and distortion of competition (EC 2011b). This had given rise to nine months of intense debate in the Council and the European Parliament, which resulted in the Danish presidency's conclusion in June 2012 that an EU-wide system of FTT could not be supported by all 27 member states. Invoking the Lisbon Treaty's Enhanced Cooperation Procedure has therefore become the last resort for a 'coalition of the willing' to proceed with FTT. Eleven member countries subsequently expressed their wish to proceed to ECP and submitted a formal request to the European Commission, specifying the scope and objectives of an ECP on FTT. In contrast to the ordinary legal procedure on taxation which requires unanimity, the decision by the Council was taken by qualified majority voting to allow ECP to go ahead. Unanimity is required only among those countries who wish to participate.

The Commission has proposed that a portion of the revenue could be used as an own resource for the EU budget, whereby the ensuing reduction of the national contributions of participating Member States could be used to help consolidate public finances, contribute to public investment or finance official development aid budgets. However, in a strictly legal sense, no earmarking of FTT revenue is foreseen so that participating Member States are free to decide how the revenues of the FTT should be used.

A comprehensive FTT levied by less than 27 EU member states requires effective built-in safeguards against tax evasion. These would ensure the tax to be levied on the basis of the EU residence of the counterparty of the transaction, combined with issuance and ownership principles to make sure the tax is paid as a pre-condition to legally enforce the transfer of ownership. Compared with the original FTT proposal of the Commission from September 2011, the new proposal enhances the safety net against potential relocation of financial sector activity outside the jurisdiction. On top of the 'residence principle', meaning that FTT will be due if any party to the transaction is established in a participating Member State, the proposal has added the 'issuance principle'. The issuance principle provides for tax collection even when both counterparties are outside the scope of the law but the traded securities originate from within. This means that financial instruments issued in the 11 Member States will be taxed when traded, even if those trading them are not established within the FTT zone, e.g. French securities traded on the London Stock Exchange. For any future EU legislation on taxation, it is significant that the Commission for the first time has accepted the principle of an exterritorial application of taxes when it comes to prevent unfair tax competition and to create a level playing field within the Single Market.

A report by the European Parliament, while not legally binding, has further enhanced the legislative proposals made by the Commission, by including currency transactions on foreign exchange (FX) spot markets (EP 2013). On the other hand, growing pressure by the financial industry on conservatives and liberals in the EP has achieved recommendations for the introduction of several exemptions in the Directive. Among these are exclusions from the FTT for inter-group transactions and market-making transactions purportedly meant to provide liquidity, and also the introduction of special rules for pension funds. For a transitional period of three years, up until 2017, the rate for pension funds' transactions on shares and bonds will be halved (limited to 0.05 per cent), as well as the rate for derivatives transactions (limited to 0.005 per cent). Similar rules would apply to transactions on sovereign bonds on secondary markets (rate of 0.05 per cent until 1 January 2017), while a tax rate of only 0.01 per cent would be levied on short-term repurchase agreements of duration of up to three months. With the latter, the inter-bank lending market has in fact gained a tax exemption of 90 per cent.

With the exception of the latter, these exemptions do not go too far in diluting the original proposals. However it has rightly been observed that exclusions and exemptions of any type can be exploited to the detriment of the tax's effectiveness (Gray *et al.* 2012). This judgement is broadly in line with demands from trade unions and civil society organizations across Europe, including a long-standing demand of the ETUC itself, for a comprehensive system of FTTs at a single tax rate of 0.05 per cent, levied on all transactions of shares, derivatives, currency units and bonds; furthermore, no exemptions should be made for any of the aforementioned, except for the primary issuance of government and corporate bonds and shares. In addition to the residence and the issuance principle, civil society organizations have demanded the application of the ownership (or exchange of legal title) principle, which would follow the example of stamp duties, i.e. a transaction would be legally valid only upon payment of the tax (ETUC 2011; Botsch 2012).

From 2013 to date (August 2015), negotiations among the 'coalition of the willing' have focussed on possible exemptions from the FTT as well as its tax base. France, Italy and Spain have sought to limit the burden on the financial sector in general, while the highly indebted countries in Southern Europe are aiming at a FTT break for their sovereign bonds. Technical talks on what assets to tax, which to exclude, means of tax capture etc. were locked in stalemate until the beginning of 2015, when the government of Austria, the strongest supporter of a broad-based FTT, took over the political coordination. At the time of writing, the most likely outcome of the enhanced cooperation procedure should be as follows: FTT should be implemented progressively starting early 2016, with taxation of transactions in shares and some of the derivatives being the first step, while other steps are to be taken after the completion of a forthcoming economic impact analysis. Member States that would like to impose taxation for other products that are not included from the beginning of a progressive implementation would be allowed to do so in order to maintain existing taxes. Both residence and issuance principles should apply, but cumulating the two principles may eventually apply to the EU-11 shares only. Revenue from FTT is however likely to be significantly lower than expected, since some countries are aiming at limiting taxation of intra-day trading to the net balance at the end of the trading day. Such a move would *de facto* drop one of the main rationales behind FTT by exempting high frequency trading from being effectively taxed. Other potential exemptions from the original Commission proposal concern the transactions of non-listed company shares, interest rate swaps and the valuation of the tax base for derivative products (notional vs. synthetic market value).

The first half of 2015 was over-shadowed by the Greek crisis. An agreement on the 'core engine' of the FTT was therefore postponed and should be expected during the second half of the year. Tax rates will be the last 'building block' element to be discussed. A political agreement by December 2015 is to be followed by drafting the text and adopting the final directive by the end of the Dutch Presidency (June 2016). The subsequent implementation procedures of the Directive through national parliaments would likely set the generation of first revenues to early 2018.

2. The different rationales behind FTT

Taxing financial transactions in individual European countries is not a novelty nor is the idea of international financial taxation new. The principle of taxing financial market flows was for the first time recognised in 1694, when Great Britain introduced a stamp duty at the London Stock Exchange on securities transactions. The tax is payable by the buyer of shares for the official stamp on the legal document needed to formalise the purchase of the security. It is the oldest tax still in existence in the UK. It provides billions of pounds' worth of stable revenue (USD 5.86 billion in 2008) and today's tax rate stands at 0.5 per cent. The fact that 33 countries (eight of which are European) are currently applying some form of FTT on various instruments, ranging from stocks and both corporate and government bonds to foreign currency exchange and foreign capital inflows,[2] is a clear indicator that the dangers of relocation are rather limited. In 14 countries, the annual revenue raised exceeds USD one billion, and total annual revenue is more than USD 51 billion for those countries where FTT tax revenues are available (Stamp Out Poverty 2012: 11).

2. See the list of countries and different tax instruments in Stamp Out Poverty (2012: 9-11).

Following the Great Depression in the 1930's, Keynes wrote in his General Theory of Employment Investment and Money: 'The introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise (...)' (Keynes 1936: 104). After the collapse of the Bretton Woods system of fixed exchange rates in 1972, James Tobin elaborated Keynes' idea further when he proposed an international currency transactions tax as 'a quite innocuous way, to throw some sand in the wheels of super-efficient financial vehicles. A half percent tax translates into an annual rate of four percent on a three months' round trip into a foreign money market, more for shorter round trips. It is this effect that creates room for differences in domestic interest rates, allowing national monetary policies to respond to domestic macroeconomic needs. The same tax would be a smaller deterrent to slower round trips. It would be a negligible consideration in long-term portfolio or direct investments in other economies. It would be too small, relative to ordinary commercial and transportation costs, to have much effect on commodity trade.'[3]

While the two classic rationales (Keynes 1936: Chapter 12; Tobin 1978) focussed on FTT as a regulatory means to keep irrational exuberance of financial markets in check and to ensure policy dominance over markets, the United Nations Development Programme UNDP in the 1990's advocated a 'Tobin Tax' whose revenues could finance a global North-South pact for development administered by the United Nations (see ul Haq *et al*. 1995), a proposal that James Tobin in turn distanced himself from (Tobin 1996: 63). Our view here is that earmarking of tax revenue is of secondary order to levying it in the first place.

3. Scope and regulatory purpose today

The international and European trade union movement formulated its demands for an international tax on foreign exchange transactions in the aftermath of the Mexican peso crisis in 1995, in combination with a demand for more stable parities between the currencies of the European Union, the Japanese Yen and the US Dollar to:

3. Tobin (1996: 65-66), also in TUAC (1995: 14).

> …replace the monetary chaos of the present situation with order. (…) The benefits of these initiatives would far outweigh the massive costs of policy inertia. Financial markets would still operate autonomously, but financial flows would be directed towards beneficial long-term investment and not short-term speculation; currency market volatility would be reduced, thus allowing traders in goods to plan ahead and obviate the need for hedging; and the degree of autonomy for government policy making would be expanded.[4]

Since 2009, the ETUC, its affiliated trade union organisations and civil society organisations across the EU have intensified their campaign for a broad based FTT that would generate significant revenues for public goods, e.g. to create jobs and growth, while also contributing to better regulation of European financial markets. FTT has been at the heart of the campaign 'Europeans for Financial Reform'[5] with six broad themes: (1) new rules for the financial system, (2) restoring publicly accountable authority over global finances, (3) controlling executive and shareholders remuneration and decent salaries for workers, (4) protecting public finances, (5) protecting consumers against toxic financial products and (6) bringing banks back to basics.

Since the turn of the century the volume of financial transactions has exploded. Financial 'innovation' brought about new products, turnover increased and holding periods for financial instruments decreased dramatically. In addition, transaction costs saw a sharp decline to about one tenth of where they were throughout the 1980s (Matheson 2011). Today, global foreign exchange market turnover among the ten most important currencies makes up more than 90 per cent of the currency trades with a volume traded of USD 5300 billion daily (BIS 2013). Flexible exchange rates and deregulated financial markets have fuelled a huge increase in speculation and market uncertainty. The global flexible exchange rate system constitutes one of the most important factors behind the growing instability of the world economy (Payandeh 2011). The absence of a new global currency system with a built-in mechanism for adjusting exchange rates implies that James Tobin's 'sand in the

4. Trade Union Statement To The OECD Ministerial Council And Halifax Summit May - June 1995, in: TUAC (1995: 22).
5. http://europeansforfinancialreform.org, co-founded on 21 September 2009 by the Global Progressive Forum, ETUC, UNI-Global Union, Solidar and FEPS.

wheels' argument is still valid - although Tobin himself had never imagined the devastating character of derivatives and excluded them from his tax proposal. At the time of his proposal, derivatives were primarily used for legitimate hedging against exchange rate risks rather than speculation. Today the situation is different. The notional amounts of outstanding OTC derivatives in 2011 were USD 700 trillion and exceeded global GNP by more than 1100 per cent.[6] Since 2000, the amount has increased sevenfold. An FTT would seriously affect the attractiveness of market entry of those instruments and thus contribute to crisis prevention. Briefly and succinctly, transactions of both spot and derivative assets must be taxed to capture the speculative nature of financially 'innovative' products.

According to the latest Bank for International Settlements' Triennial Central Bank Survey (BIS 2014), trading in global foreign exchange markets (FX) averaged USD 5.3 trillion per day in April 2013. This compares to 3.98 trillion in April 2010 and 3.3 trillion in April 2007. Foreign exchange swaps were the most actively traded instruments in April 2013, at USD 2.2 trillion per day, followed by spot trading at USD 2.0 trillion. Annual transactions amounted to USD 1405 trillion, exceeding world output 18 times and world trade more than 40 times. In 2011, less than four per cent of financial market turnover was needed for world trade in goods and (non-financial) services, and even if one allows for amply hedging against currency and interest risks of real trade, still more than 90 per cent of financial market turnover can be regarded as 'hot air' or speculation. The Commission's argument that levying currency transactions would constitute an undue restriction of European freedom of capital movements can be easily refuted. The general interest in stabilising financial markets by reducing speculative trading and its compatibility with WTO rules has been well established. It is therefore welcome that the EP has broadened the tax base compared to the Commission proposal to include foreign exchange currency transactions.

It is often argued, not least by the financial sector, that FTT would reduce liquidity in the markets, raise capital costs and thus, by raising obstacles to market efficiency, be detrimental to growth and ultimately employment.[7] This must be questioned seriously. Liquidity as such is not

6. Schäfer D. (2012), figures are from BIS, World Bank and WTO data.
7. See the discussion in European Commission (2011b).

a value in itself; it depends to which purpose financial market liquidity is being used, for diversity of investments or for betting following herd instincts. In his famous chapter on the state of long-term expectations, Keynes wrote in his General Theory:

> Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of 'liquid' securities. It forgets that there is no such thing as liquidity of investment for the community as a whole. The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of the most skilled investment to-day is 'to beat the gun', as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow (Keynes 1936: 102).

Much of the overheating of financial markets is due to a continuous decline in holding periods for financial instruments from an average of seven years to only seven months over the past 40 years (Schäfer 2012). High speed data transmission technologies have made High Frequency Trading (HFT) possible, a form of computerised trading driven by algorithms. It is the ‘herd instinct’ of machines and trend following, so that computers are buyers when markets are rising and sellers when markets are falling, which, as Griffith-Jones and Persaud have argued, reduces diversity and saps liquidity (Griffith-Jones and Persaud 2012: 9). Very likely to be most affected by FTT will be those engaged in high-frequency trading. This concerns a relatively small number of firms that nevertheless command up to 75 per cent of market share.[8] Affecting HFT by FTT is deliberate, since FTT *intends* to have distortive effects if it is to correct a situation that one wishes to change. The IMF in its assessment to the G-20 stated in 2010: ‘The impact on financial markets from a low-rate (less than 5 basis points), broad-based STT [securities transaction tax] would likely be fairly modest, beyond its reduction of very short-term trading’ (IMF 2010: 177).

The burst bubble and the ensuing financial crisis in many countries have led to balance sheet recessions (Koo 2012). Private as well as public sector

8. Computer-led Exchange Traded Funds (ETF) have lately generated higher stock market turnover than individual stock trading (FT 7 August, 2012).

debt has attained unsustainable highs, forcing economic agents, households, enterprises and public budgets alike, into synchronous deleveraging. The ensuing contraction of debt markets will make it more and more difficult for the asset surplus of creditors to find attractive investment opportunities for their net savings. This constitutes a macro-economic problem that proponents of supply-side economics are largely ignoring. A real risk consists in these assets remaining in the financial sphere, as long as the size and speed of financial markets continue to expand. FTTs should therefore help reduce the massive liquidity overhang in markets and remove those superfluous transactions, which are neither of social use nor serve an economic purpose. FTT will steer financial flows towards the long-term and thus help restore the fundamental economic role of the financial system of intermediation, allocation and transfer of capital to productive use: finance must serve the real economy not vice versa. Far from being a panacea, FTT still constitutes an essential element of a financial reform agenda that intends to achieve stable and cost-effective financing for the real economy, to stabilise macro-economic volatility and allocate finance to socially beneficial use.[9]

4. Tax revenues

Democracy and social justice are at risk if workers and their families are to bear the lion share of the financial crisis burden, the cost of which the Commission estimated to have reached € 4600 billion or 40 per cent of EU-27 GDP for bank bailouts (recapitalisation of financial institutions, guarantees on bank liabilities, relief of impaired assets and liquidity measures) by the second half of 2010 (EC 2011b), not taking account of the broader economic and social costs such as unemployment and output gaps. Output gaps from 2009-2011, i.e. effective lower GDP compared to potential output, amount to more than € 1400 billion or 12 per cent of potential wealth loss to the EU as a whole, resulting in a bill of the financial crisis to society exceeding 50 per cent of EU-27 GDP. It follows that democratic societies cannot accept that financial institutions expropriate public budgets with impunity because of perverse incentives for excessive risk taking or because of the prevailing moral hazard problem in financial markets. Taxing the hitherto under-taxed financial

9. See Botsch (2011) for more details.

sector has therefore come to the fore of the debate, not least because of the need to tap new and additional sources of revenue for heavily strained public budgets.

Both the IMF (2010) and the Commission have found that the financial sector is benefitting from direct and implicit tax subsidies. The Commission calculated the potential tax advantage of EU financial institutions from being VAT exempted ranging from € 14 to 23 billion or 0.12 – 0.19 per cent of GDP per year. It concluded that there was a problem of preferential treatment of the financial sector compared with other sectors in the economy as well as a distortion in prices (European Commission 2010; European Commission 2011b: 4-5). In addition, large systemic 'too big to fail' banks are getting an implicit subsidy from government (bailout in the event of future failure), which translates into a funding subsidy on their wholesale funding since (private) creditors are willing to lend to them at a rate significantly lower than the rate at which they would be willing to lend to their competitors who do not enjoy an implicit guarantee from the State.

The bank bailouts in Europe plus the revenue aspect of FTT are also the main drivers of the huge popular support that the tax has gained over the past four years. In September 2011, over 65 per cent of European citizens were in favour (European Commission 2011c: 15) and millions of people have joined national campaigns for FTT. The FTT has gained economic credibility; it has received high level political backing from over 1000 economists and from leading figures such as Bill Gates and Georges Soros, who have pointed to the technical feasibility and the moral right of the tax.[10] Thus FTT could help restore confidence in the financial sector that has been deeply shaken since the crisis, including in the eyes of a broader public.

Assuming that FTT would be levied on the basis of the residence, issuance and ownership principles altogether, potential revenue of FTT will depend both on the tax base and applied tax rate for different financial products. The European Parliament follows the Commission in supporting a rate of 0.1 per cent for securities (bonds and shares), excluding

10. See http://www.guardian.co.uk/business/2011/apr/13/robin-hood-tax-economists-letter. Signatories include i.a. Joseph Stiglitz, Paul Krugman, Dean Baker, Dani Rodrik and Jeffrey Sachs. The complete list can be found at http://www.guardian.co.uk/business/interactive/2011/apr/13/robin-hood-tax-economists primary market operations (i.e. the issuance of securities), and a tax rate of 0.01 per cent on the notional value of derivative contracts. In the Commission proposal these are minimum tax rates that leave room for member states to levy higher ones. Moreover, FTT is to be paid by both buyer and seller, so that if one counter-party resides outside the territorial scope of the Directive, the other counterparty is liable to pay the whole sum. This model of differentiated tax rates bears some problems though. The notional value of many derivative contracts is not denominated in Euro or other currency value, but can be index linked or hidden in other financial instruments such as index options or convertible loans. The most toxic assets in the US housing bubbles were highly complex multi-layered derivative products that only the designers of the contracts (if anyone) could understand. The notional value of these derivative contracts that serves as the tax rate in the EC and EP model appears difficult if not impossible to determine (Sieling 2012: 3). Since the risk of abuse is considerably high, a uniform tax rate of 0.05 per cent on all transactions would delimitate tax evasion effectively. Admittedly, it would increase the cost for risk prevention measures such as (legitimate) hedging, but, as has been argued above, hedging makes up only a tiny fraction of the global derivative market.

Applying the differentiated rates at EU-27 level, the Commission estimates total revenue of € 57 billion (EC 2011b), two thirds of which is levied at 0.01 per cent on either equity, currency or interest rate linked derivative contracts (37.7 billion), the other third (19.4 billion) levied at 0.1 per cent on securities. It should be noted though that the Commission proposal excludes currency transactions from FTT. But even then, a uniform tax rate of 0.05 per cent on transactions taxed after the Commission model could yield more than three times as much, namely almost € 200 billion for the whole EU.

In 2010, Schulmeister calculated FTT revenue based on scenarios with the assumption that transaction volumes will be reduced following the introduction of FTT (Schulmeister 2010: 47). In a medium ‘transactions-reduction-scenario’ trading volumes would decline by roughly 75 per cent at a tax rate of 0.1 per cent, by 65 per cent at a rate of 0.05 per cent and by 25 per cent at a rate of 0.01 per cent. The rationale for these assumptions makes sense since the intended regulatory effects of FTT are declining volumes of transactions that are shrinking the tax base and subsequently leading to falling tax revenues. Once these effects are occurring sensibly, the introduction of a Financial Activities Tax as suggested by the IMF (IMF 2010) should be considered in parallel to the FTT to keep revenue at a stable level. According to Schulmeister's calculations, initial FTT revenue for the EU-27 at our preferred tax rate of 0.05 per cent on all spot and derivatives transactions on and off exchanges (OTC) would amount to € 235 billion or 1.8 per cent of EU GDP (Schulmeister 2012: 88).

Schäfer and Karl from the German Institute for Economic Research DIW in a study published June 2012 calculated much higher revenues from FTT than forecasted by the Commission (Schäfer and Karl 2012: 17). According to them, the impact assessment of the EU Commission systematically underestimates the revenues of the FTT. Given the differentiated tax rate model of 0.1 per cent and 0.01 per cent as suggested by the EC, and assuming FTT would reduce the taxable base of securities trades by 15 per cent and that of derivatives by 75 per cent, total tax revenue would amount to € 37.44 billion for the nine countries alone that have declared to embark on an ECP procedure.[11] Under the same assumptions of FTT effectiveness, a uniform tax rate of 0.05 per cent would yield more than € 89 billion for the nine countries in question (Schäfer and Karl 2012: 31). In case that derivative markets would shrink heavily by 90 per cent, revenue would still amount to more than € 40 billion. The same study identifies two beneficial macro-prudential regulatory effects of an FTT which have been not been highlighted by most other authors so far: the practice of issuing credit default swaps would be significantly reduced as would be the interconnectedness of financial institutions.

In 2013, Schulmeister and Sokoll updated their calculations, using the EC tax rates and focusing on the application of the residence principle first for the 11 participating ECP countries only, and for the EU27 as a whole (Schulmeister and Sokoll 2013). In the case of ECP-11, they found that overall FTT revenue could amount to € 65.8 billion, more than estimated by the EC for the EU-27 as a whole, subject to London subsidiaries being treated as part of their parent company based in the ECP-11. However, if London subsidiaries were treated as British financial institutions, tax revenues would amount to only € 28.3 billion.

11. As of end July 2012, these include Austria, Belgium, Finland, France, Germany, Greece, Italy, Portugal and Spain. Others are likely to follow. The Netherlands for example could yield € 3.3 billion FTT revenue per annum.

A study commissioned by the German Ministry of Finance to Copenhagen Economics in 2014 (Næss-Schmidt *et al.* 2014) came to differentiated conclusions, estimating revenues for German governments alone at € 37.5 billion, and overall revenue at € 95.7 billion.

However, taking into account the negotiations among the ECP-11 since 2013, overall revenues are likely to be significantly lower than expected in the above mentioned studies. Countries have disagreed about the targeted revenue the tax should raise. While France has called for a phased-in approach that only covers a few types of trades at the start, Austria, Germany and others have said the tax needs to collect substantial revenue to be worthwhile. It is important to note that pre-funded pension systems have not figured among the items to be exempted from FTT.

To sum up, it appears difficult to discern the exact amounts of revenue of an FTT over time. When the FTTs show their intended regulatory effect as stated above, i.e. declining volumes of transactions leading to a contraction of the tax base and subsequently to falling tax revenues, the introduction of a Financial Activities Tax (FAT) as suggested by the IMF should be considered in parallel to the FTT. The question then arises how much revenue should and would a FAT yield that is introduced once the regulatory effects of FTT start to erode significantly their own tax base?

The IMF (2010) considered the possible use of a ‘financial activities tax’ (FAT) levied on the sum of financial institutions’ profits and remuneration, variously defined, for the purpose of raising revenue from the financial sector, while not ruling out the use of FTT for this and other purposes. According to the Commission, EU-27 revenue from a FAT would amount to anything between € 13.6 and 30.3 billion per annum (EC 2010), depending on the definition of the tax base. The major shortfall of FAT is that it can only be applied to banking and financial institutions, not to financial products being traded; therefore it is deemed proper to serve as a supplement not a substitute for FTT.

5. Effects on growth and income distribution

In the original impact assessment of its proposal, the Commission came up with an estimate of a total loss of 0.53 per cent GDP over the long run as a result of FTT (EC 2011b). The May 2012 update of the model used gave a far lower estimate for the impact of an FTT on the level of economic growth, equal to only 0.2 per cent GDP. However, the Commission estimates are based on a model that even in its revised form is incomplete and excludes some of the crucial positive impacts such as the reduction of systemic risk (thus the probability of further crises), the expansion of total aggregate demand for consumption, and the boost of the European real economy through fiscal consolidation. The positive effects not considered by the Commission are likely to more than compensate the negative effects. Therefore, the impact of FTT on economic growth is likely to be positive, at 0.25 per cent GDP as a minimum (see Griffith-Jones and Persaud 2012). Griffith-Jones and Persaud suggest in their analysis that the overall positive impact on growth could be even higher, for which they identify a number of different channels of fiscal redistribution, while highlighting the progressive nature of the tax.

The latter findings are confirmed by Schäfer and Karl, who point to the fact that lower income households in most cases have no income from financial assets, showing that in the French case the lower 19 twentieths of households yield merely 1.6 per cent of their income from financial assets (Schäffer and Karl 2012: 39). Since the distribution of assets (capital) in society is significantly more unequal than the distribution of income, the tax incidence is clearly socially progressive and is unlikely to affect the majority of the population in any tangible way.

Negative externalities from FTT are furthermore unlikely since most transactions in the foreign exchange markets are conducted between banks themselves or with other large players in the financial services industry. Transactions with individuals constitute less than 0.1 per cent of total transactions and trade-related transactions amount to less than five per cent (see above). A significant proportion of the tax burden is thus likely to be borne by the financial services industry itself, with a tiny fraction of the costs being passed on to trade related transactions. The final tax incidence will depend on the extent to which financial institutions can pass on the tax. This, in turn, depends on the extent of competition in different segments of the financial sector. Imperfect competition in finance would make the case for competition policies to intervene, rather than constitute an argument against FTT.

6. The battle for exemptions

> Anything that might hurt the privileged, such as higher tax rates or financial regulation, can be denounced as job-killing because it undermines confidence (Paul Krugman).[12]

Almost immediately after the European Commission adopted its first proposal in 2011, an unofficial, yet very well organised campaign of financial institutions started against the FTT (Schulmeister and Sokoll 2013: 20). Fiduciaries and asset managers of pension funds have pursued the aim to achieve tax exemptions for their business models, counting heavily on the 'fear factor' to intimidate both future and current generations of pensioners and policy makers in charge. Financial institutions such as BNP Paribas, Deutsche Bank, Goldman Sachs, Citigroup, Bank of America / Merrill Lynch, or Morgan Stanley have sought to show various detrimental effects of an EU-FTT on banks and the economy as a whole, with varying degrees of internal contradictions and methodological flaws. Institutions that are heavily engaged in short-term and/or high-frequency trading are at least aiming at exempting exchange traded derivatives, which constitute the most important vehicles of short-term speculation; others have focused on exempting the short-term inter-bank lending market while institutional market makers have warned against liquidity shortages if they are not exempted from FTT. Their common objective is to deter policy makers in governments from introducing FTT altogether, and for that purpose a number of 'studies' have been commissioned which are all using large arsenals of intimidation.[13]

For illustrative purposes, Schulmeister and Sokoll have analysed a study by Goldman Sachs Equity Research[14] which asserts a quasi-collapse of the inter-bank lending market (REPO) as a consequence of FTT. They conclude:

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12. Krugman P. *Phony Fear Factor,* New York Times 8 August, 2013, http://www.nytimes.com/2013/08/09/opinion/krugman-phony-fear-factor.html?_r=0

13. An impressive list of 'anti-FTT' studies commissioned by various vested interests can be found at https://secure.wiwo.de/finanzen/boerse/aktieninstitut-milliardenlasten-durch-finanztransaktionssteuer-/8514988.html. Not surprisingly, stock exchanges also figure among the sponsors.

14. Schulmeister and Sokoll (2013: 20-26). The Goldman Sachs study 'Financial Transaction Tax: How Severe?' calculates pro-forma estimates of FTT as a percentage of certain individual banks' profits before taxes for the year 2015 that range from 168 per cent (for BNP Paribas) to 423 per cent (for Natixis Banque).

> If banks were focused on financing activities in the real economy like real investment, production and trade of enterprises as well as housing and durables of private households, there would be no need to shortly raise millions or even billions through overnight REPOs. It is one objective of a FTT to change the incentive conditions in favour of real world activities at the expense of the profitability of 'finance alchemy' (Schulmeister and Sokoll 2013: 23).

Equally for exemplary purpose, we will focus here on the wide-spread assertion that FTT would effectively act as a tax on pensioners. The battle for exempting pension funds is a showcase for disguised short-term financial interests and for how FTT can act to re-orient markets toward more sustainability.

Following heavy pressure from alternative investment fund managers, asset managers of big pension funds and not least from MEPs adhering to the Alliance of Liberals and Democrats (ALDE) and European People's Party (EPP) groups in the European Parliament, the EP at its May 2012 plenary session voted for the exclusion of pension funds from FTT (EP 2012). We consider this a political blunder, since the arguments of financial pressure groups for excluding pension funds are highly questionable and fundamentally flawed. Even the Commission in its updated impact assessment of May 2012 did not go so far as to kowtow to hidden vested interests that declare themselves effectually to speak on behalf of the general interest. Exemplary for this has been a Memorandum on the Costs of Financial Transaction Taxes (FTT) for Pensioners from the largest pension fund in the Netherlands that was floated in the aftermath of the publication of the Commission proposal. The APG memorandum concluded that '…FTT would hit ordinary pension savers very hard and would result in pensioners paying for the FTT through reductions in the value of their pensions. Pension savers and investors could end up shouldering an unfair share of the burden of the FTT. As proposed [by the European Commission], this would be a tax on current and future retirees and on savers'.[15] This received echo by a number of politicians and academics who called FTT a 'big tax on pensioners', however it also completely ignores the debate about what the (socially useful) role of pension funds is.

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15. APG Memorandum, 31 October 2011, Amsterdam, http://www.apg.nl

The impact of FTT on pension funds depends firstly on the allocation of assets in portfolios, secondly on the frequency of trading of those assets and thirdly on the number of financial intermediaries involved in the transactions of securities. First, not all assets are taxable, e.g. cash and deposits, but also investment in land and real estate and private funds. In most European countries, the asset ratio not subject to FTT is roughly 20 per cent (OECD 2011a). Second, the alleged high tax burden on savings can only occur when either the frequency of trading or, thirdly, the number of intermediaries is high, since the tax rate is comparably low. It follows that FTT is negative for pensioners only when fund management strategies are aggressive or when asset managers are getting frontloaded by hedge funds or other alternative investment funds. It is indeed high frequency traders who front run pension funds on large orders. The FTT would make this business less profitable and would save pension funds money that could more than compensate for the FTT paid. The relevant question here is whether it is in the interest of the average pension saver that his or her pension fund is employing an excessively active fund management style for more return at higher risk.

Della Croce, Stewart and Yermo in a recent study on long-term investment have shown that investment holding periods have fallen significantly mainly due to the growing market presence of institutional investors, and ‘even supposedly long-term investors such as pension funds end up having portfolio turnover much greater than originally intended’ (Della Croce *et al*. 2011: 7). Their figures show that average holding periods on the major exchanges vary between 8-18 months (except for NASDAQ with 4 months in 2010), which is equivalent to a turnover per annum of effectively 0.66 to 1.5. The figure that APG circulated and that has largely been quoted by opponents to FTT is that, on average, the cost of FTT for pension funds would amount to €500/year/head or saver. How does one get to these amounts?

Suppose that an individual pension savings portfolio consists of 1000 securities of €100 value each, with assets totalling €100,000. A ‘passive’ asset manager would trade 25 per cent of the portfolio once a year, while an ‘active’ management would yield a turnover of all assets twice a year. The trading frequency of securities in ‘actively’ managed portfolios is thus eight times higher than that of the ‘passive’ management. FTT of 0.05 per cent is due at both the moment of buying and selling of assets. The passively managed fund would be taxed at only €25/year or 0.025 per cent of total assets, while €200/year would be due by the active manager, representing 0.2 per cent of total portfolio value. Moreover, it should be noted that annual operating costs and management fees of 1.2-2.4 per cent average six to twelve times FTT due, and that average net returns on savings (i.e. nominal returns minus administrative costs) reached 2.6 per cent in the period from 2008-2010 (OECD 2011b), a period characterised by historically low interest rates. The OECD findings also showed that conservative (or 'passive') investment portfolio strategies yielded higher returns than actively managed funds, since trading costs (e.g. fees and commissions) payable by the fund occur in line with the number of trades per year.

The negative effects of an aggressive trading frequency become even clearer when looking at the value of an asset portfolio of initially €100,000 over a period of 40 years. Given an FTT rate of 0.05 per cent, actively managed funds with high turnover would reduce total asset value by €5000 or approximately 12 times as much as a conservative fund.[16] In any case, asset managers of pension savings portfolios should be legally obliged to substantiate FTT levied on each individual portfolio, so that the contributing savers can easily identify the strategies of their fund management.

Lastly, what matters for the determination of the frequency of trading and the incidence of FTT derived from it, is also the number of financial intermediaries involved in the transactions of securities. A number of opponents to FTT have argued that in even a very simple securities transaction, assuming a base rate of 0.1 per cent as proposed by the Commission, the *effective tax rate* could end up as high as 1 per cent; it is argued that the cumulative effect on a pension fund with annual expected return on investment of five per cent could be significant[17], since a threefold turnover of a portfolio per year would dent 60 per cent of gross return with FTT of 0.1 per cent applied, leaving aside additional operating and management cost of the fund. The Deutsche Bank and others have made the following calculation for one securities transaction: the original vendor of the securities would pay 0.1 per cent tax, the broker as buyer 0.1 per cent and again 0.1 per cent as seller to the clearing member, the latter 0.1 per cent each in buying from the broker and selling to another clearing member through the central counter-party (non-taxable), the second clearing member again 0.1 per cent both as buyer from the first

16. Several examples are given by Schäfer and Karl (2012: 35-36).
17. See examples given in Deutsche Bank (2011: 7).

clearing member and as seller to another broker who ends up selling the securities to the pension fund. Taken everything together, such a hypothetical chain of financial intermediaries would indeed raise the effective tax rate to up to one per cent per securities traded. However since primary issuers and centralised counter-parties (clearing houses) are exempt from paying tax, a simple buyer-seller scheme would apply with potentially one intermediary in addition. A chain of seven intermediaries of which six are subject to (double) taxation is simply not conceivable. If this were reality, downsizing the chain of financial intermediaries who bite off chunks of workers' savings for their old age pensions would have to be eliminated through regulation, even without FTT applied. In any case, rent seeking intermediaries will have to be kept in check to protect workers savings for social security purposes, and FTT would help achieve this.

Others have argued that every time a worker reallocated his pension fund, the pensions would be reduced by five per cent (Kaserer 2013). The reality is somewhat different though. Workers' retirement income is not entirely financed by pension funds. Across Europe, low- and middle-income worker pensions rely primarily on pay-as-you-go, tax-financed or book reserve systems, all of which will remain unaffected by FTT. Yet in those countries where old-age security relies on pre-funded, capital market based systems, brokers and asset managers will take the bulk of the FTT, the cost of which will not automatically be transferred to pension funds, provided that there is competition in the marketplace and asset managers will want to keep their clients.

It is undeniable that FTT will have an impact on the portfolio composition of pension funds and their risk management policy. This is however intended. If and when pension funds under-invest in productive and longer-term capital such as infrastructure, green investments and SME finance and are excessively reliant on external asset managers' short-termism, a transparent FTT would encourage pension funds to reduce their exposure to short-term trading and to increase pension money in long-term investments (Botsch and Habbard 2011). Furthermore, pay-as-you-go pension systems bear neither the risk of fiduciary fees or capital market volatility nor do they risk being taxed in addition to income tax.

7. Conclusion

This chapter has analysed the rationale for and current state of play regarding the introduction of Financial Transaction Taxes (FTT) at EU level. The rationale for FTT are threefold: first and foremost, the volume of speculative transactions on financial markets would be curbed and both the size and volatility of financial markets shrunk. Short-term betting would be gradually substituted by longer-term investment. An EU-FTT would re-establish a more commensurate role for finance in society and the economy, and the financial landscape would become smaller in size, slower in speed, and less short-term oriented. Secondly, levying an EU-FTT would generate significant revenues and make the financial sector assume a fair and substantial contribution to offset the cost of the financial crisis by paying partly for the burdens associated with government interventions to repair the banking system. Last but not least, an EU-FTT would downsize the chain of financial intermediaries who bite off chunks of workers' savings for their old age pensions, at least in countries where pre-funded private pension systems play an important role.

As FTT would discourage short-term speculative strategies and support long-term investment it would represent an important measure in support of the Sustainable Company. Although there clearly is no 'silver bullet' in this respect, which means that a package of policy measures would been needed to a address a wide variety of institutions in Europe, nevertheless FTT could in principle be one of the most effective single mechanisms for lengthening the time horizons of financial investors.

As of the writing of this chapter, despite intense opposition from much of the financial industry, the passage of a FTT at European level appears likely in the near future. This passage would represent a significant step in the direction of promoting longer-term sustainable investment and the Sustainable Company.

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