FINANCIAL TRANSACTION TAX – The European Approach

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Overview

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Starting Points

Efficient Market Principle is dead

Current crisis speaks clearly against the paradigm of efficient price formation in highly liquid financial markets. If markets do not work efficiently anyway, one can hardly claim that financial transaction taxes would destroy efficient pricing.

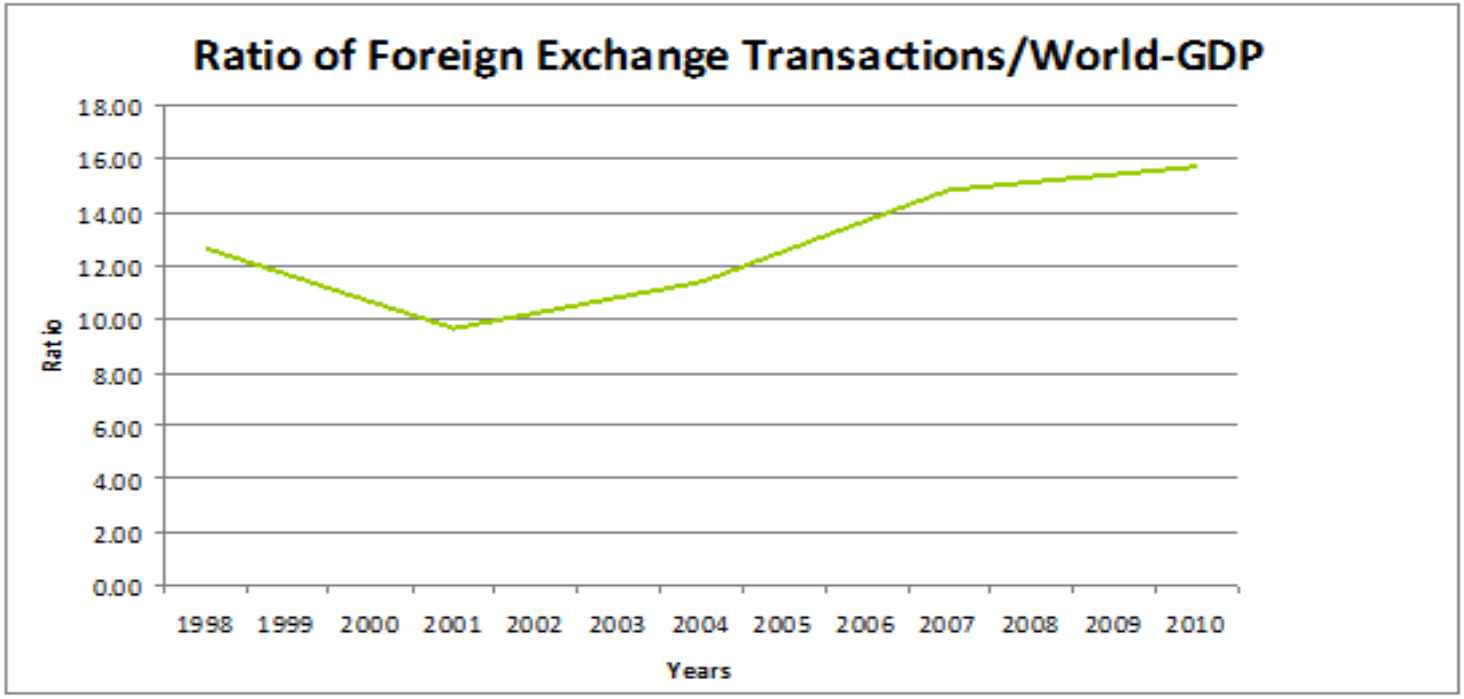
Stability in the financial markets is a public (club) good

No exclusion, no rivalry in consumption

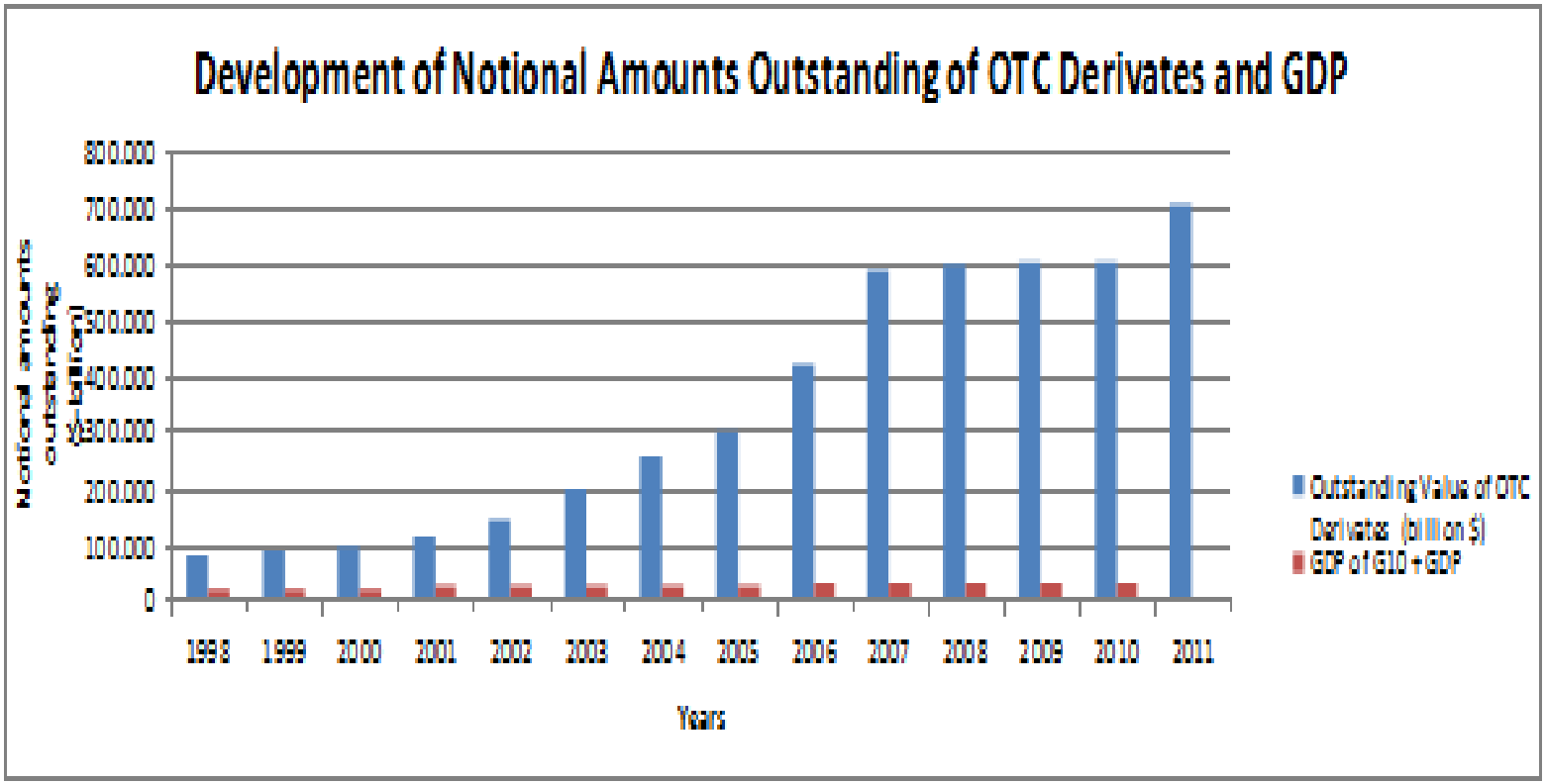
Financial markets driven by self-interested parties tend to overuse *financial stability* and are unable to provide stability by themselves. Only the state can provide financial stability. Trading can be interpreted as using the public good "financial markets' stability". Against this background FTT is a mean to prevent over-usage and to contribute to the financing of the public good.

Decoupling of Real and Financial Economy

Foreign Exchange Transactions have increased more than GDP (Trade Volume) despite the financial and sovereign debt crisis.

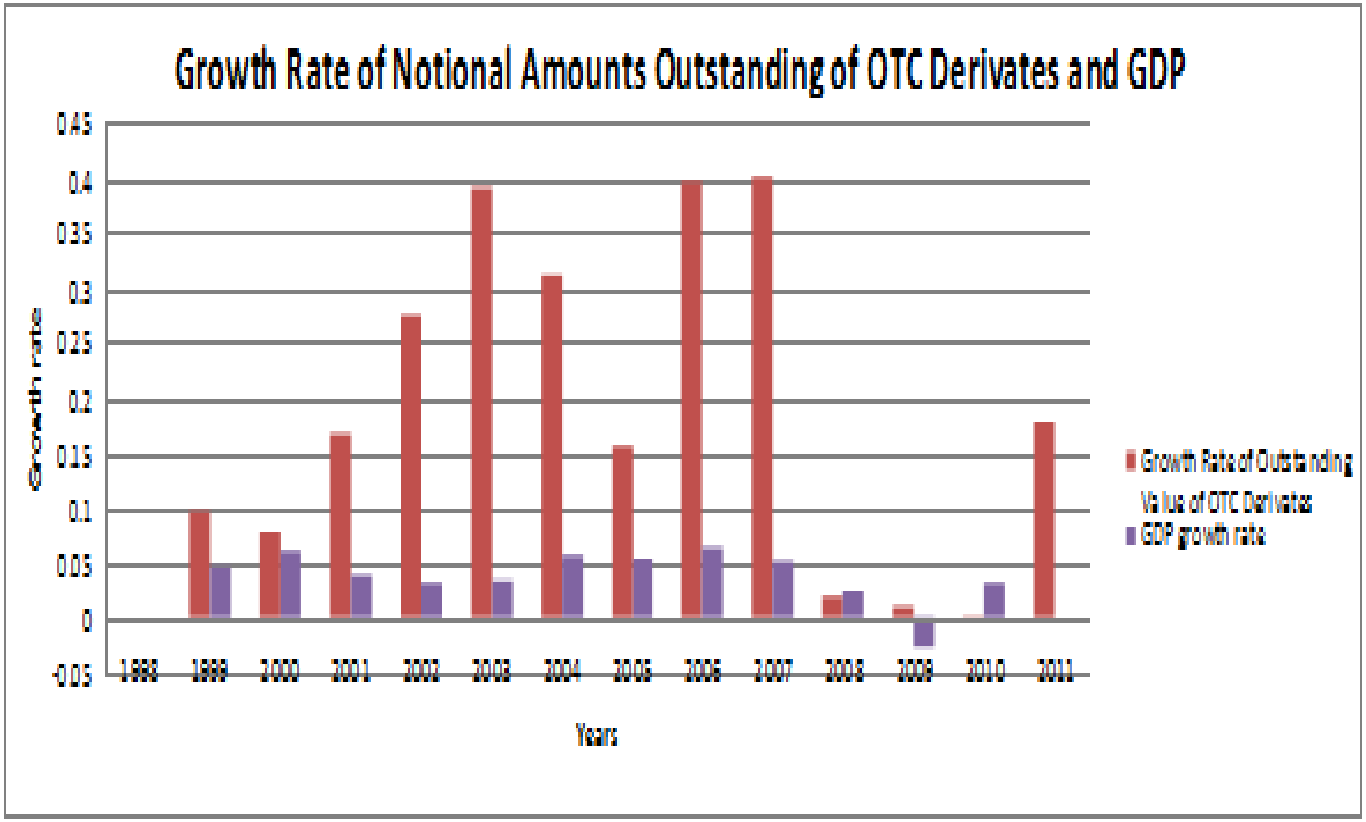


Explosion of Outstanding Value of OTC



Some Empirical Facts

Growth Rate way beyond .....



Tax rate and revenue estimation of EU commission (2011)

Transaction Volume 2010

	Tax Rate	
Product	***0,001 x 2***	***0,0001 x 2***
Securities (Total Amount of Transactions)	**19,4**	
Equity shares	6,8	
Bonds	12,6	
Derivatives (Total Notional Amount)		**37,7**
Derivatives based on equity shares		3,3
Derivatives based on interest rate products		29,6
Derivatives based on foreign currency transactions		4,8
In total	**57.1 billion Euro**	

Tax Burden

Nominal value - derivatives

Example: Call option

Maturity 3 months, exercise price 100 € (right to buy for 100 euros), the option value at the time of purchase: 8 euros, market price of the underlying: 80 €. Option is exercised, if share costs more than 100 Euros.

Taxation based on market price of the underlying, tax burden per right to purchase one share: 0.0001 x 2 x 80 = 1.6 cents.

Example: credit insurance (credit default swaps)

Tax base: the amount of the insured loan amount

Tax Burden is high if, and only if, trade activity is high

Simple example:

Let us assume a portfolio of 12 equity securities at a price of 100€ per asset.

Fairly passive manager: trades 25 per cent of the portfolio once a year

Active management: sells the complete portfolio and buys a new one twice a year.

Active manager shows an eight-fold higher trading activity.

Tax burden caused by the passive manager: FTT 0.6 Euro = 300€ x 0.001 x 2

Active manager: FTT 4.8 Euro = 2400 Euro x 0.001 x 2

Tax Burden and growth

Estimate of the EU Commission in introducing the FTT in the EU27 countries

Gross domestic product in 2050:

81.1 percent above the current level compared to about 81.4 percent in case of non-introduction

However, this minor growth loss arises under the assumption that tax revenue will be paid back to households as a lump sum transfer.

However, assuming that the public sector invests the tax revenue productively, the European Commission (EU Commission 2012) expects positive effects in the amount of 0.2 percent to 0.4 percent of gross domestic product.

FTT helps to avoid detrimental activities

A cascade of new products derived from standard financial instruments multiplies trading activities.

FTT: each step of the cascade would be subject to the tax and also the subsequent trade of the new instruments. The more derivatives financial institutions construct and trade the higher would be the tax burden in the system.

→ curbs new product generation

→ reduces turnover frequency

→ makes quid-pro-quo transaction less attractive and curbs interdependency of financial institutions

Quid-pro-quo transactions (closing)

Bank A: Credit insurance of bank B over 1 million euros for a premium of 6%.

A-bank does not need the credit insurance anymore:

Bank C: Bank A sells a credit insurance over 1 million euros at a mininum premium of 6%, with a maturity equal to the residual maturity of the A-B-bank contract.

Offsetting cash flows cancel out for Bank A.

Consequence: Bank A is not only connected to bank B but also to bank C.

FTT helps to avoid detrimental activities

Speculation with derivatives like naked short selling and credit default swaps (selling of a security that the trader does not have) also tends to grow explosively as the cost of entry into the market is very low for a large financial institute. In times of crisis the European stock exchange supervisory ESMA is allowed to temporarily ban naked short selling and trade in naked credit default swaps.

But an FTT would permanently decrease the attractiveness of market entry with such instruments and thus dampen the overall activity of financial institutions in this segment.

FTT helps to avoid detrimental activities, cont.

A dampening effect of the FTT can be also expected in financial transactions that are made solely for regulatory reasons:

- Financial institutions with large balance sheet amounts but a too low capital basis may use REPOS for window dressing.

  FTT makes such cosmetic transactions less attractive.

- FI outsource often assets into the shadow banking system (SPV or hedge fund). Outsourcing turns previously internal transactions into trading between independent units.

  FTT would punish outsourcing and reward internalizing transactions. This effect would contribute to combat the shadow banking system.

COUNCIL DIRECTIVE
implementing enhanced cooperation (11 members)

Principles of taxation: combination of country of origin, issue and trading location

- **The tax is levied**
  - **if a party to the contract is based in the taxation zone (country of origin principle)**
  - **the financial instrument is issued by a financial institution in the taxation zone**
  - **if trade takes place within the taxation zone.**

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Revenue Estimate for 11 countries

		in billion Euro		
	Distribution of tax revenue according to	BIP (EU Commission 2013)	Profits + Salaries (DIW 2012)	Assets of credit institutions (DIW 2012)
1	Belgium	1,7	1,6	1,6
2	Germany	11,7	9,9	11,2
3	Estonia	0,1	0,1	0,0
4	Greece	0,9	1,1	0,7
5	Spain	4,8	4,2	4,9
6	France	9	7,1	10,8
7	Italy	7,1	6,2	5,3
8	Austria	1,4	1,3	1,6
9	Portugal	0,8	0,9	0,7
10	Slowenia	0,2	0,2	0,08
11	Slovakia	0,3	0,3	0,08
	Total 11	38	32,7	37,6
12	Danmark	1,09	1,03	1,64
13	Cyprus	0,08	0,06	0,20
	Total 13	39,12	33,8	39,4

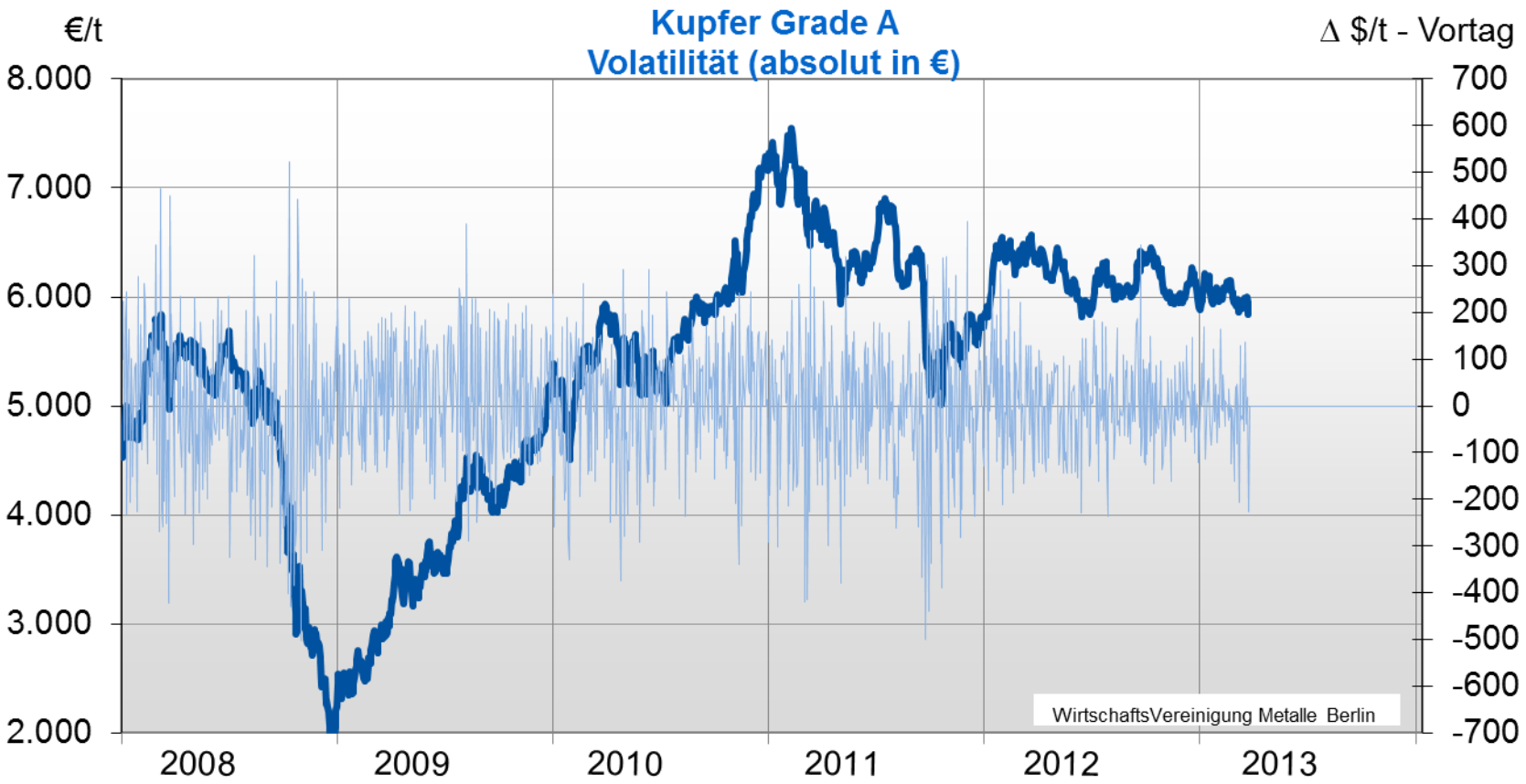
6 Main Con of FTT

Pure hedging activities are not identifyable

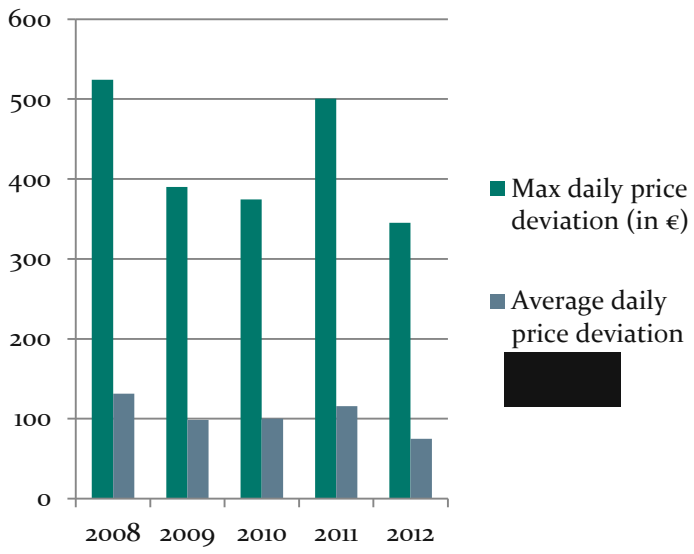
Hedging for the real economy is subject to taxation

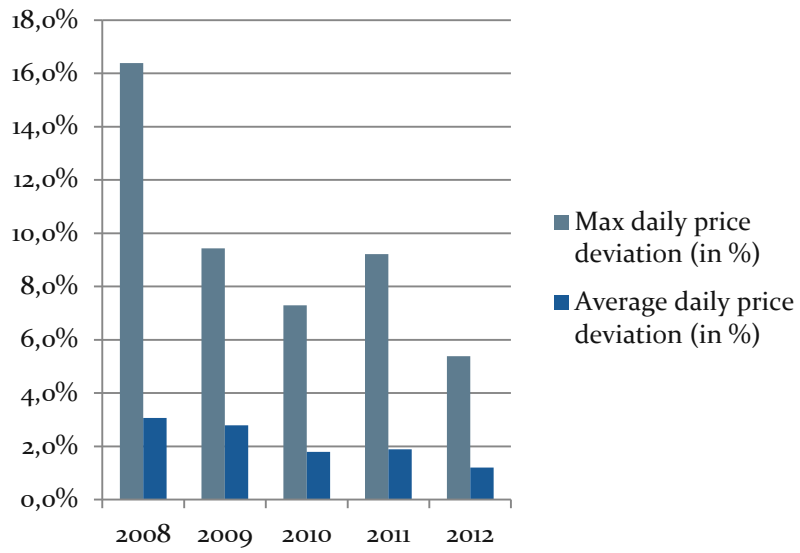
Real economy „will be punished“ for seeking security against excessive price fluctuations

6 Volatility Example: Copper



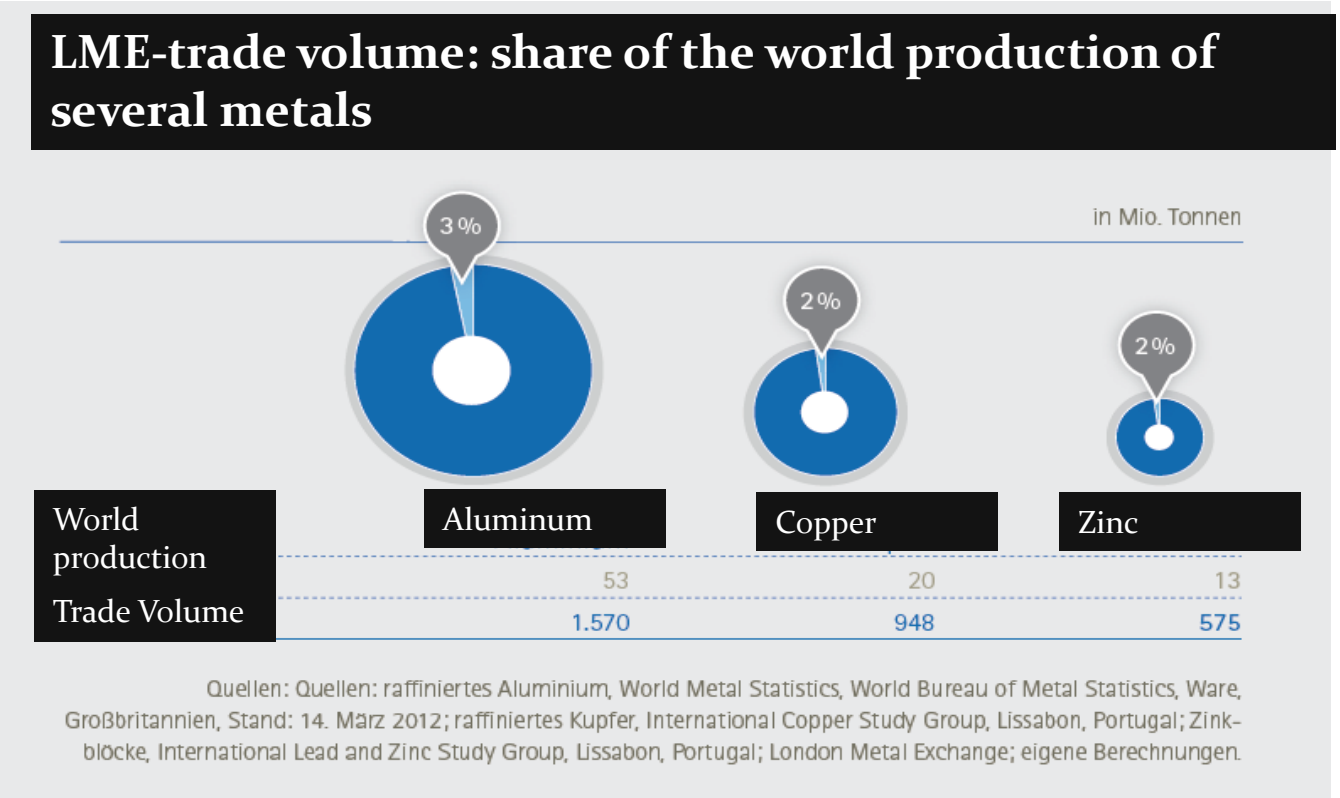
6 Volatilität Copper





However, presumably, only a small part of the complete trade volume is caused by pure hedging

6 Handelsvolumen und Produktion



Source: Annual report 2011 of the German association „Wirtschaftsvereinigung Metalle

Trade volume: production volume multiplied by 33, multiplied by 20 and multiplied by 50.

Pure Hedging?

6 Con of FTT

What to do?

Exemptions?

Should derivatives based on commodities exempt from being taxed?

Likely outcome: Arbitrage between financial instruments

Better alternative: refunding

6 Summary and Conclusion

FTT is important for stopping the decoupling of financial markets from the real economy.

- Self-interested parties tend to overuse the public good financial stability.
- Need of new tools that promise improvement in the crisis and complement the regulatory steps

FTT increases transaction costs and offers the prospect of slowing down the mutually reinforcing trend of more and more derivative products and shorter holding periods.

Vielen Dank für Ihre Aufmerksamkeit.

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Thank you very much for your attention