FINANCIAL TRANSACTION TAX – Pros and Cons

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Overview

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Starting Points

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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.

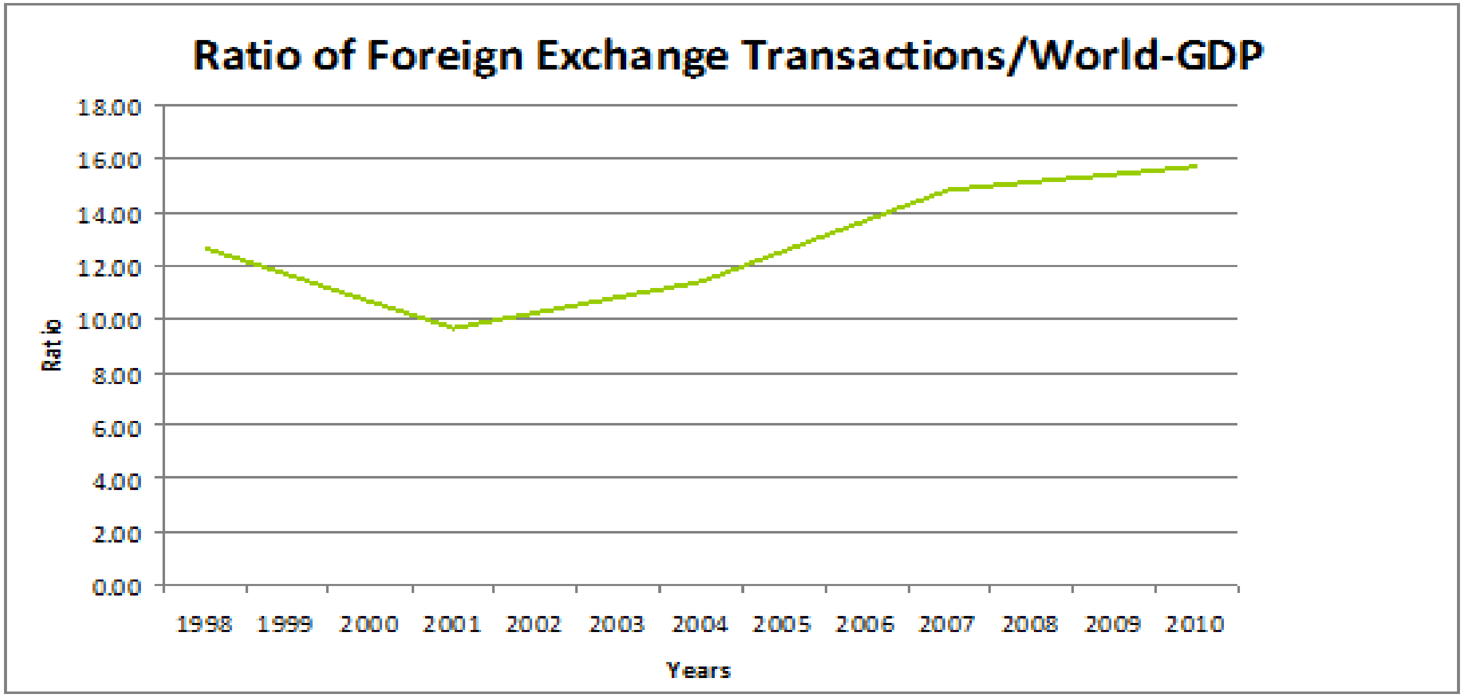
Stability in the financial markets is a public good

No exclusion, no rivalry in consumption

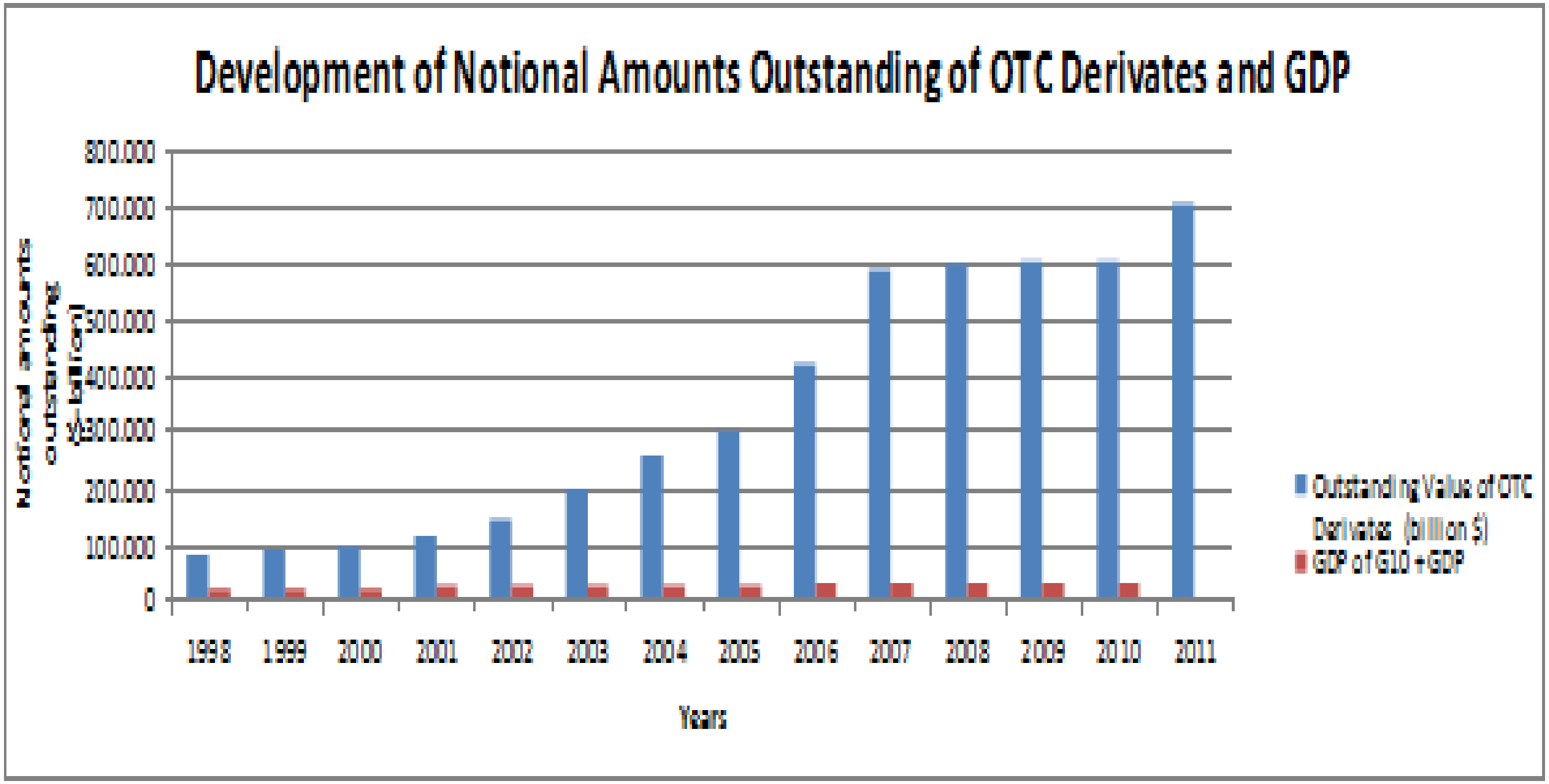
Financial markets driven by self-interested parties tend to overuse *financial stability* and are unable to provide stability by themselves. Only the state can provide financial stability. Trading can be interpreted as using the public good “financial markets’ stability”. Against this background FTT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

Decoupling of Real and Financial Economy

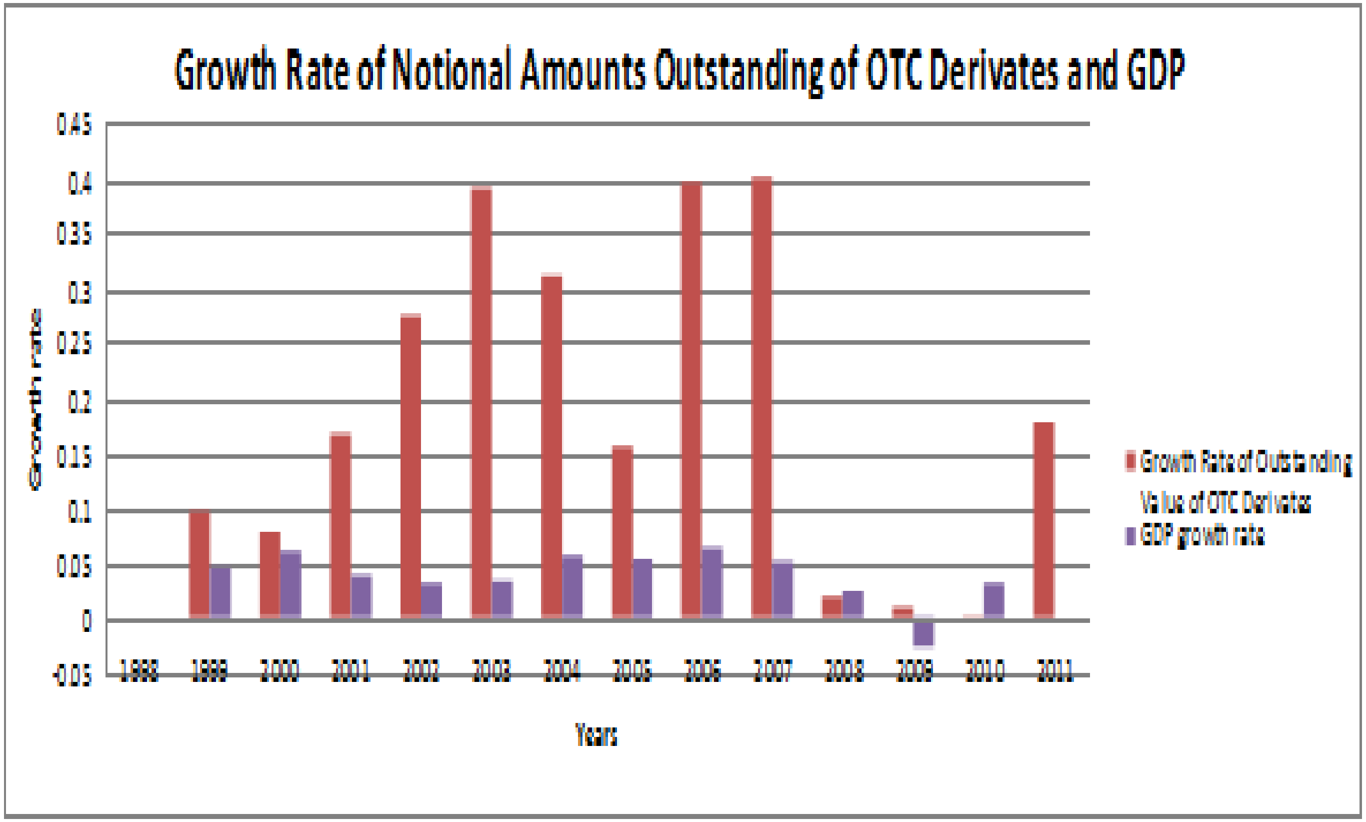
Foreign Exchange Transactions have increased more than GDP (Trade Volume) despite the financial and sovereign debt crisis.



Explosion of Outstanding Value of OTC



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 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

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

FTT helps to avoid detrimental activities

Speculation with derivatives like naked short selling and credit default swaps 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.

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.

5 Revenue Estimate for 11 countries

	Distribution of tax revenue according to	BIP (EU Commission 2013)	Profits + Salaries (DIW 2012)	Assets of credit institutions (DIW 2012)
		in billion Euro		
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

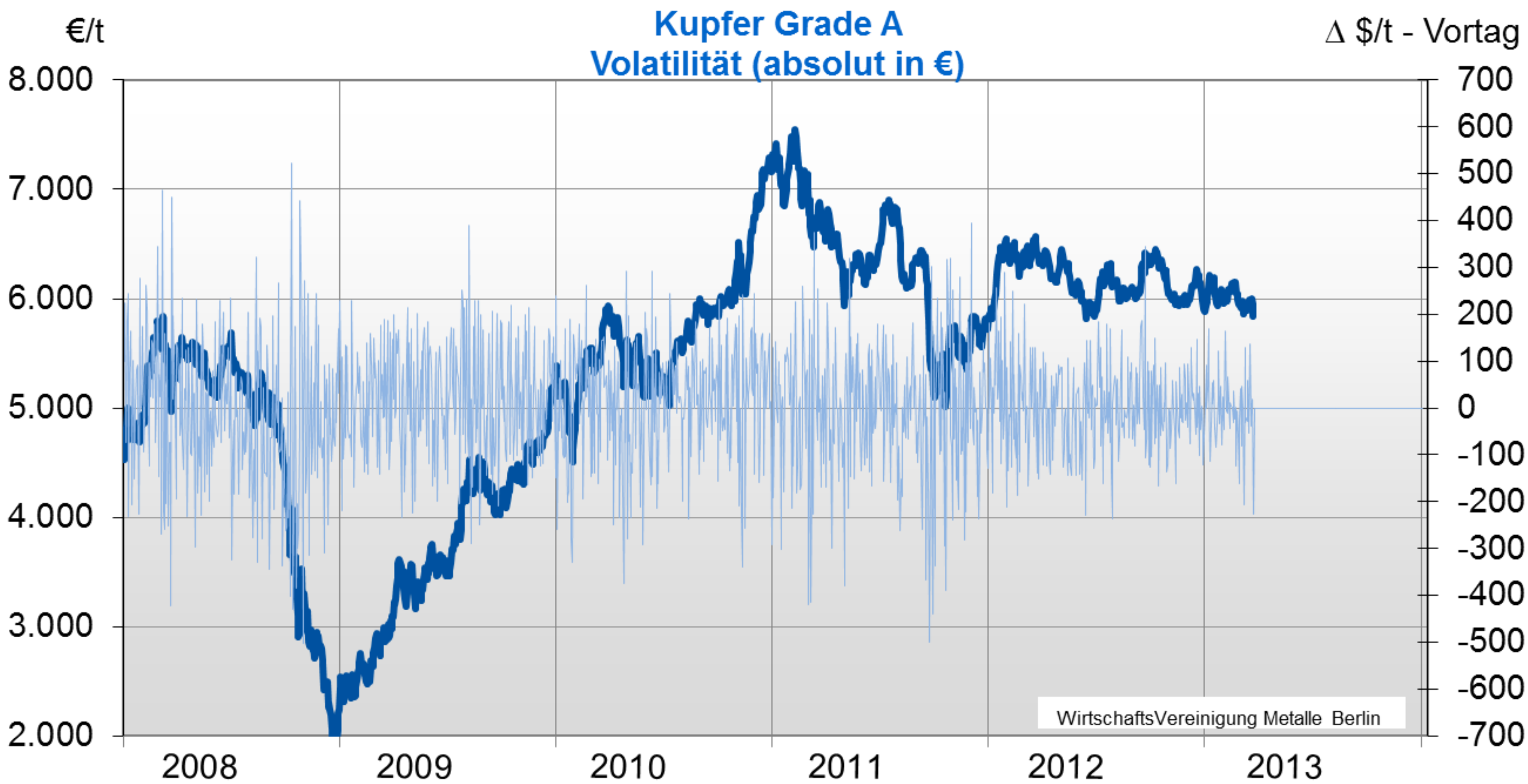
6 Main Con of FTT

Pure hedging activities are not identifyable

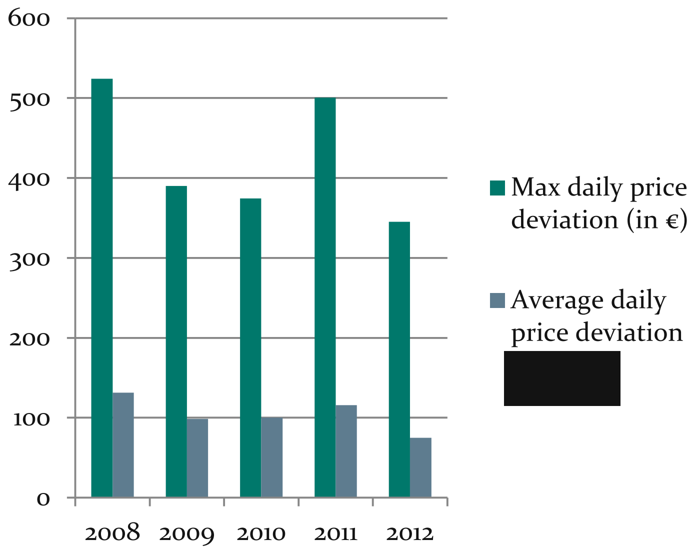
Hedging for the real economy is subject to taxation

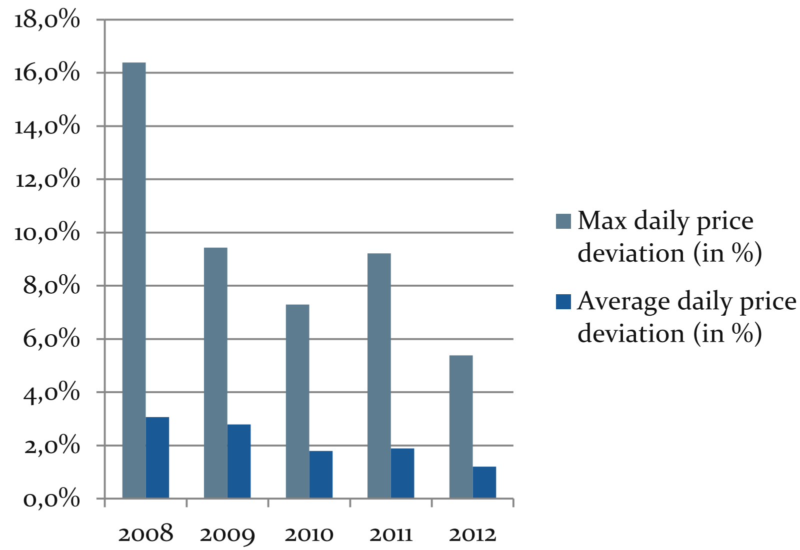
Real economy „will be punished“ for seeking security against excessive price fluctuations

Volatility Example: Copper



6 Volatilität Copper





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

Handelsvolumen und Produktion

LME-trade volume: share of the world production of several metals

	Aluminum	Copper	Zinc
World production	53	20	13
Trade Volume	1.570	948	575

Quellen: Quellen: raffiniertes Aluminium, World Metal Statistics, World Bureau of Metal Statistics, Ware, Großbritannien, Stand: 14. März 2012; raffiniertes Kupfer, International Copper Study Group, Lissabon, Portugal; Zinkblöcke, International Lead and Zinc Study Group, Lissabon, Portugal; London Metal Exchange; eigene Berechnungen.

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 natural resources not be 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