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# The EU Financial Transactions Tax: Antecedents and Current Debate

**Summary:** The paper deals with the development of the Financial Transactions Tax (FTT) policy idea and its feasibility in the absence of global coordination. New taxes are evaluated in terms of how they fit into existing national tax systems. Increasingly, however, cross-border issues assume greater significance in tax design and this is particularly pertinent in the case of FTT which has a long history. The various changes in tax systems and the economic environments within which they operate since the original “Tobin Tax” proposal are noted and the way they affect the debate on FTT are discussed. The proposal to introduce a unilateral FTT in the EU and its feasibility are examined. In terms of achieving its fundamental objectives the feasibility of the tax is crucial unless, as may be the case in the UK, the need to rebalance the economy away from the financial sector is a more urgent priority.

**Key words:** Financial transactions tax, Tobin tax, Computerised financial trading, Global tax coordination.

**JEL:** F31, G15.

The issue of global tax coordination is particularly pertinent in the case of the Financial Transactions Tax (FTT) which has a long history going back to John M. Keynes (1936, 1980) and James Tobin (1972, 1978). When Tobin (op.cit) revived Keynes’s (op.cit) idea of a “government transfer tax” on financial transactions it was intended to be a global tax. Its primary purpose was to curb speculation in foreign exchange markets in the context of the Bretton Woods system that in the early 1970s was on its way out. The revenue raising potential of the tax to be used for aid to developing countries was an additional but secondary objective. Nowadays, although curbing speculation and revenue raising still remain the principal justifications for the introduction of an FTT the debate is conducted in an environment in which tax systems and global economic conditions have changed significantly since the original “Tobin Tax” proposal.

The main aim of this paper is to assess the development of the FTT policy proposal in the light of the various changes in taxation and economic environments that have occurred in the past forty years. Section 1 examines some of the most significant changes since the original “Tobin Tax” proposal and Section 2 outlines the main elements of the current EU FTT proposal. Section 3 evaluates the feasibility of the EU proposal. Section 4 draws some conclusions.

## 1. Changes in Tax Systems and Economic Environment since the 1970s

Most industrial countries raise the bulk of their revenue from taxes on income, spending, corporate profits and local property taxes. This general picture has not changed significantly since the 1970s (for information about taxation in the EU Members see European Commission 2007). However, there have been some important changes. With regard to direct taxes there have been some dramatic reductions in tax rates for both income and corporation taxes. In the UK the top marginal tax rates of 83% on earned and 98% on unearned income were reduced to 40% for most of the period while the basic income tax rate declined from 33% to 20%. Corporation tax declined from 52% to a projected 23% in 2014. Similar trends are observed internationally (Institute of Fiscal Studies 2011). With regard to indirect taxation the composition of indirect taxes also changed significantly during the period. Between 1975 and 2008, the proportion of Organisation for Economic Co-operation and Development (OECD) tax revenues coming from “general” consumption taxes like Value-Added-Tax (VAT) rose from 13% to 20% while the proportion coming from “specific” consumption taxes like excise duties fell from 18% to 10 (OECD 2011)<sup>1</sup>. Despite the increased importance of VAT as a source of tax revenue the financial sector is almost universally exempt from VAT.<sup>2</sup> This is the case in more than 150 countries that use VAT, including all OECD countries (excluding the US) and the whole of the European Union. This represents serious under-taxation of the financial services sector, the degree of which has increased as the standard VAT rate increased over time. Although the dramatic reduction of tax rates in direct taxation and the expansion of “general” consumption taxes like VAT (from which the financial services sector is excluded) are the most significant changes in tax systems since the original “Tobin Tax” proposal, there have been some notable additional new taxes particularly on financial transactions. In the 1970s there were hardly any taxes on financial transactions. Currently some 40 countries use some sort of FTT (Daiana Beitler 2010; Thornton Matheson 2011).<sup>3</sup>

At the same time there have been equally striking changes in the technological and economic environment in which tax systems operate during the same period. At the technological level the most significant development has been the emergence of computerised trading in financial markets and computerised tax collection systems. With regard to the economic environment, three changes are of particular importance in a debate on tax policy in general and the FTT in particular. First, inequalities in income and wealth have increased considerably (Branko Milanovic 2011). Second, the role of the financial services sector in the economy also increased in many signif-

<sup>1</sup> OECD. 2011. <http://stats.oecd.org/Index.aspx?DataSetCode=REV>.

<sup>2</sup> The standard argument for exemption is that the charges for many of the services provided by the financial services sector, particularly banking services, are implicit rather than explicit.

<sup>3</sup> The countries which have implemented this kind of tax are: Argentina, Australia, Austria, Belgium, Brazil, Chile, China, Colombia, Denmark, Ecuador, Finland, France, Germany, Greece, Guatemala, Hong Kong, India, Indonesia, Ireland, Italy, Japan, Malaysia, Morocco, the Netherlands, New Zealand, Pakistan, Panama, Peru, Philippines, Portugal, Russia, Singapore, South Korea, Sweden, Switzerland, Taiwan, the United Kingdom, the United States, Venezuela and Zimbabwe.

icant ways.<sup>4</sup> Third, due to increased globalisation and increased international mobility of individuals and companies cross-border issues in taxation are now far more important than forty years ago (for a discussion about globalization and tax design see James R. Hines and Lawrence H. Summers 2009).

How do these changes affect the current debate concerning the introduction of a “Tobin Tax”?<sup>5</sup> First, following the global financial crisis of 2008, a FTT is no longer seen as primarily an instrument of curbing foreign exchange speculation. The tax is now seen as a means of reducing market volatility and excessive speculation in financial markets and as a safeguard against future financial crises. The revenue collected by a FTT is now seen more as a means of compensating the public sector for the post 2008 public sector bail-out of the financial sector and as an insurance premium in case of any need to deal with systemic risk problems in the banking sector. Second, the changes in direct taxation involving dramatic reductions in income and corporation tax rates combined with the unprecedented rise in inequalities in income and wealth have introduced a new justification for the FTT. Third, the change in the composition of indirect taxation and the expansion of “general” consumption taxes like VAT combined with the secular increase in the size of the financial services sector has strengthened the case for a FTT given the under-taxation of the sector by its exclusion from VAT. It has also re-ignited the debate of whether the removal of this favourable treatment might be one of the options to be considered in any rethinking of the way the financial services sector is being taxed. Fourth, changes in technology have had a radical impact on financial market organisation, market operation and tax administration. In the past forty years financial market transactions have been supported by clearance and settlement systems which have become highly automated, centralised, and integrated thus greatly facilitating tax administration (see John D. Brondolo 2011).

The revolutionary changes in information technology have both strengthened and weakened the case for a FTT. To the extent that technology has improved the cost-effectiveness and ease of administration of the tax, the case for a FTT has been strengthened. Moreover, if computerised trading, especially high-frequency trading (HFT), is considered to be a significant factor in contributing to market volatility and excessive speculative activity, a FTT would be desirable if it can limit such socially useless and risky speculative activity (see also Carsten Sieling 2012). On the other hand to the extent that technology has transformed financial markets by moving trades away from physical trading floors to cyber space, the case for a FTT that is not global has weakened considerably if trades can be diverted in a matter of seconds to financial centres with the lowest transaction costs, taxes and regulation.

Finally, a dramatic change since the original “Tobin Tax” proposal has been the proliferation of FTT of different varieties and in different countries and financial centres. This has some important ramifications with regard to Tobin’s original insistence that the transfer tax needed to be a global tax. In the 1970s none of the current

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<sup>4</sup> Fundación Ideas (2010) reports that the volume of financial transactions is 70 times greater than the current world GDP while in 1995 it was around 25 times.

<sup>5</sup> Phillip A. O’Hara (2011) suggests the Tobin tax as another “tool” to balance the economy in the current context.

40 “unilateral” FTTs were in existence (for examples and discussion of existing varieties of FTT see Brondolo 2011).

## 2. The EU FTT Proposal

Given the difficulties involved in reaching a global agreement on a global FTT, the focus of attention has shifted towards the European proposal for a FTT within the EU. According to the EC draft directive (European Commission 2011a) the EU FTT proposal will contribute significantly “to the on-going international debate on financial sector taxation and in particular to the development of a FTT at global level. In order to best minimise risks, a coordinated approach at international level is the best option. The present proposal demonstrates how an effective FTT can be designed and implemented, generating significant revenue. This should pave the way towards a coordinated approach with the most relevant international partners.”

Although a coordinated global approach to the introduction of FTT is desirable it is not a pre-condition for the coordinated adoption of a FTT in the EU. Given, however, the UK’s stated opposition to the introduction of a FTT in the EU unless it is part of a global agreement and the continued objection to the tax by several other EU member states, the adoption of an EU-wide tax seems highly unlikely. Even though the FTT may not be implemented in all 27 member states of the EU, given the strong support for the tax in Germany and France, it may still be introduced under enhanced cooperation to a sub-set of mainly eurozone countries. The greater the participation in a harmonised FTT the greater the benefits of membership of the scheme will be. This is because if uncoordinated tax measures are put in place it may lead to fragmentation in the internal market for financial services.

What are the main features of the Commission’s FTT proposal? There are four principal policy goals:

*i. A fairer contribution of the financial sector.* Given the current under-taxation of the sector and its role in causing the Great Recession the tax is seen as a fair contribution by the sector towards the 4.6 trillion euros cost of dealing with the crisis (Yaldaz Sadakova 2012).

*ii. Financing the EU Budget.* The FTT is seen by the Commission as an independent source of “own resources” means of financing the EU Budget replacing national contributions (Stephan Schulmeister 2009).

*iii. A complement to regulatory reform in the EU.* The FTT is not considered as a substitute for a reformed regulatory framework but it can contribute to the establishment of a safer financial sector by “addressing particularly risky behaviour in some segments of financial markets” and by creating “appropriate disincentives for transactions that do not enhance the efficiency of financial markets” (European Commission 2011b).

*iv. Proving a lead for the development of FTT at the global level.* The Commission believes that a “unilateral” EU tax can “pave the way towards a coordinated approach with the most relevant international partners” (European Commission 2011b).

The tax will be applied to all transactions on financial instruments between financial institutions broadly defined to include “investment firms, organised markets,

credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, holding companies, financial leasing companies, special purpose entities” (European Commission 2011b). Transactions within the European Central Bank and National Central Banks are excluded.

The tax will have a wide scope, covering transactions relating to a variety of financial instruments including derivatives agreements. Moreover, the tax will be applied not only to transactions in organised regulated markets but it will also cover other types of trades including over-the-counter trade. Most day-to-day financial activities relevant for citizens and businesses remain outside the scope of FTT. This is the case for the conclusion of insurance contracts, mortgage lending, consumer credits, payment services etc. (although the subsequent trading of these via structured products is included). Also, currency transactions on spot markets are outside the scope FTT, which preserves the free movement of capital. However, derivatives agreements based on currency transactions are covered by FTT since they are not as such currency transactions.

The tax will be applied where at least one of the parties is EU based. The proposed minimum tax rates will be 0.1% for bond and equity transactions and 0.01% for derivative transactions between financial firms (European Commission 2011b).<sup>6</sup> Individual member states may apply higher rates.

### 3. The Feasibility of the EU Proposal in the Absence of Global Agreement

The crucial factor in determining the feasibility of a FTT is the extent to which the tax could be avoided if imposed unilaterally. A FTT is feasible if it does not create opportunities for tax avoidance through mass migration of trade to other financial centres; and it is not feasible if it does cause migration and tax avoidance. If trading can migrate globally “at the click of a button” is it not pointless to introduce a unilateral tax? This in itself constitutes sufficient reason for rejecting a unilateral FTT proposal. A FTT, however, may be considered undesirable for a number of additional reasons, in which case the question of its feasibility or effectiveness is largely irrelevant. The issue of feasibility and effectiveness only becomes important if it is assumed that the tax is on balance desirable. In that case the tax can either be accepted as desirable and feasible or rejected as desirable but not feasible. On this basis supporters and opponents of the FTT could fall into one of three categories. First, the tax may be rejected as undesirable regardless of feasibility. Second, the tax may be accepted as both desirable and feasible. Third, the tax may be rejected because although desirable it is not feasible.

The debate concerning the desirability of the tax, therefore, must precede any discussion of feasibility (see David Hillman and Christina Ashford 2012). However, the two issues are not always kept separate. The position of the UK government is a case in point: it supports the introduction of a FTT but only if it is implemented globally. The dramatic rejection by the British Prime Minister Mr Cameron of the EU

<sup>6</sup> Moreover, the Leading Group (LG) proposes a 0.005% tax on foreign exchange (Leading Group 2010).

FTT proposal was on the basis that in the absence of a global agreement the tax will harm the position of the City of London as a leading global financial centre. Does this mean that if global coordination can be achieved the introduction of a global FTT is a good idea? Judging from the pronouncements of the Chancellor of the Exchequer, Mr Osborne and the governor of the Bank of England, Sir Mervin King, the answer is no. Both have expressed serious reservations in principle about the introduction of a FTT.<sup>7</sup>

There are several arguments supporting this view that the FTT is a bad idea in principle and it should be rejected regardless of feasibility considerations (see Rafal Raciborski, Julia Lendvai, and Lukas Vogel 2012). First, a FTT could lead to a reduction in output and growth in the economy. There are theoretical and empirical arguments supporting this conclusion.<sup>8</sup> By increasing the cost of capital the FTT could lead to lower investment, lower capital stock and ultimately lower growth (European Commission 2011b).<sup>9</sup> Second, there may be serious adverse consequences on the workings of financial markets. With fewer trades liquidity could be reduced and the information content of prices could also be reduced. A decrease in the size of financial markets could in fact result in an increase rather than a decline in volatility which was one of the main objectives of a Tobin Tax. In any case there is no conclusive evidence that a FTT results in a definite decline in market volatility (see also Neil McCulloch and Grazia Pacillo 2010). Third, a FTT is not well suited as a means of reducing risk and making finance safer. Its main impact is on short maturity transactions which are not necessarily the main source of risk and instability in the financial system. Arguably there are merits in curbing ultra-short maturities such as HFT which a FTT will undoubtedly achieve. There are, however, alternative ways of curbing HFT, such as requiring a minimum period in which bids and offers must stand, without a tax that affects the entire spectrum of financial transactions. Finally, the burden of a FTT, like any tax, could in the long run be shifted either forward in the form of higher prices or backwards in the form of lower wages. Given the expectation that with higher cost of capital, following the introduction of the tax, will lead to lower capital stock and growth, in the long run the tax will be borne partly by workers in the form of lower wages. For the same reason the revenue raising potential of

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<sup>7</sup> Mr Osborne is reported to have expressed these additional reservations after the EU Finance Ministers meeting of 8 November 2011 (see Ralitzia Kovacheva 2011). Sir Mervin King dismissed the idea of a “Tobin Tax” at a hearing in the House of Commons (see Emma Saunders 2010).

<sup>8</sup> According to Peter A. Diamond and James A. Mirrlees (1971) taxation of intermediate inputs is inefficient because it produces “cascade effects” throughout the economy which should be avoided. Steve Bond, Mike Hawkins, and Alexander Klemm (2004) in their empirical study concerning the effects of the UK stamp duty on share prices show that the tax depresses share prices especially of those shares which are frequently traded.

<sup>9</sup> There is a controversy regarding the impact of the FTT in terms of GDP since more recent work has lowered those output losses close to zero. The empirical arguments are conducted in the context of Dynamic General Stochastic Equilibrium (DGSE) model where it is inevitable that a tax is found to be “distorting” and reduce output: but then the evaluation should take into account whether the FTT replaces another tax (in which case there is the question of which tax is the more “distorting”) and its effects on aggregate demand. Stephany Griffith-Jones and Avinash Persaud (2012) point to an expansionary effect of this kind of tax if the obtained funds are reinvested in the economy.

the FTT must be adjusted downwards to account for the fall in overall tax revenue resulting from lower growth.

We must now consider objections to the FTT based on the absence of global coordination and agreement which renders the tax not feasible. Tobin (1972, 1978) believed that for his tax to work effectively it was necessary to impose an internationally-agreed uniform tax. However, the position today with regard to FTTs is quite different from the 1970s. As Persaud (2011, 2012) points out since most leading financial centres in the world today, including some of the most rapidly growing financial centres, impose taxes on financial transactions, the objection to the “unilateral” FTT on the grounds of feasibility is no longer convincing. These taxes have been introduced “unilaterally” over the years without any loss of competitiveness by the country introducing the tax. The one notable exception was Sweden (John Y. Campbell and Kenneth A. Froot 1993; Steven R. Umlauf 1993). The spectacular failure of the Swedish experience with a “unilateral” FTT was mainly because it was based on residence rather than on the transfer of ownership which is the basis of the UK stamp duty. The UK government “unilaterally” introduced the current version of stamp duty on financial transactions in 1986 without waiting for an international agreement. It has been in operation all this period without modifications or a mass exodus of trading away from the UK. Persaud (op.cit) maintains that if a similar principle is applied to the EU FTT it would remove any objection to the FTT on feasibility grounds. Indeed according to the EC draft directive mechanisms will be created to ensure that EU residents pay the tax regardless of where trade takes place.

Barry Eichengreen (2012, p. 1) on the other hand is not so optimistic about the feasibility of a unilateral FTT. He predicts that “if France imposes the tax unilaterally trading in equities and derivatives will simply migrate to Frankfurt. If it is limited to the eurozone, transactions will move to London. And if it is adopted by all EU member states—a fanciful scenario, given British resistance—the market will simply migrate to New York and Singapore”. However well designed the EU tax promises to be, Eichengreen claims that the banks will be devising new tax avoidance instruments. A unilateral EU FTT may or may not be feasible in the sense that it can be avoided through migration of companies or trade. The acceptance or rejection of the proposed tax, however, does not hinge entirely on the issue of feasibility. Given the multiplicity of targets it would indeed have been very surprising if the question of feasibility was the only objection to the implementation of the tax.

Like the original “Tobin Tax” proposal the modern version has two aims: market stabilisation and revenue raising. The latter aim has several new dimensions. First, the revenue raised is seen by the European Commission as an “own resource”, increasing the Commission’s budget without the need for additional contributions from member governments. Second, it can be seen as “a contribution back to society” from the financial sector in the light of the recent bail-outs. Third, many supporters of the FTT see it as a redistributive measure. Fourth, the proceeds of a FTT can be seen as a means of supporting global developmental and green environmental objectives. A new dimension has been added by the announcement of the “big four” eurozone countries (Germany, France, Italy and Spain) following their meeting in Rome (on June 22, 2012) that the revenue raised by a future FTT will be

used to stimulate growth thereby contributing to deficit reduction and total indebtedness in the eurozone. Clearly the achievement of this objective depends a great deal on the feasibility of the tax (for alternative views see Persaud 2011, 2012; and Eichengreen 2012).

A FTT may be the wrong tool for raising revenue, especially if its feasibility is questioned, but is it an ideal instrument for stabilising financial markets? This goes at the heart of the Keynes/Tobin argument that a FTT can limit wasteful and potentially harmful speculation without affecting liquidity in financial markets (Keynes 1936, 1980; Tobin 1972, 1978). Would a comprehensive tax on transactions dampen financial volatility? We are not any way nearer at resolving this issue now and therefore establishing the desirability or otherwise of the FTT as an instrument of regulation and stabilisation of the financial sector. An important new dimension, however, has been added to the debate. As noted in Section 2 the most important technological change, especially in the last ten years, has been the development of computerised trading. There is little doubt that a tax on financial transactions will limit transactions but the effect will be felt much more acutely by HFT than by traditional institutional investors who turn their portfolios less frequently. The crucial question is this: would the reduction of HFT improve financial stability? According to Persaud (2011) there is little doubt that if a transaction tax limits high-frequency trading it may improve systemic resilience. On the other hand, Eichengreen (2012) considers that a unilateral FTT in Europe is a distraction which may perversely increase systemic risks and instability.

How is the achievement of this objective affected by feasibility considerations? If the tax is feasible, which means that it can be implemented unilaterally without significant migration of trading activity, then its desirability as a tool of preventing future financial crises depends on the view taken with regard to its principal victims, HFT and other short maturity transactions. If the tax is not feasible in the sense that if applied unilaterally there will be migration of trading, then there are some very interesting implications. An EU-wide FTT will shift trading including HFT to other global financial centres. This is no guarantee of global financial stability. If the FTT is adopted by some eurozone countries only then there is an interesting twist about the effects of this decision on the UK economy, noted recently by Larry Elliot (2012). Paradoxically by opting out of the EU FTT the UK government is making this imbalance in the economy worse. The absence of a global agreement on a FTT could, therefore, be seen as assisting the UK to rebalance its economy and could even provide a justification for the UK joining forces with other European partners in supporting the “unilateral” introduction of an EU FTT.



## 4. Conclusions

The debate on a FTT was initiated by Keynes in the 1930s, revived by Tobin in the 1970s and now in 2012 we are on the verge of the tax being adopted unilaterally in parts of the EU.<sup>10</sup> Tax systems and the economic environments in which tax systems operate changed significantly since the original “Tobin Tax” proposal. With regards to tax systems, direct taxes have lower tax rates, indirect taxes rely more on VAT-type taxes from which the financial sector is still excluded and new FTTs are now operating in some 40 countries. With regard to the economic environment, globalisation has elevated the importance of cross-border issues in taxation and technology has revolutionised market trading and tax collection systems. Following the Great Recession of 2008, the debate now incorporates issues like redistribution of income and wealth, what constitutes a fair taxation of the financial sector and whether a FTT can improve systemic stability.

One important difference between the old debate and the current one concerns the question of global cooperation and coordination. Can a FTT operate effectively without a global agreement? Tobin thought that the tax needed to be global. Opinion on this issue is now more divided. Supporters of the EU FTT argue that the risk of migration is now much less than forty years ago since transaction taxes are already in place in most major financial centres. Sceptics point out that the comprehensive nature of the unilateral EU tax which includes derivatives and over-the-counter transactions might lead to migration of trade in which case most of the major objectives of the tax would not be achieved. Revenue would be much less and systemic risk will be exported to other centres without a reduction of global financial instability. The UK’s opposition to the FTT which led to the use of its *veto* in 2011 is producing a curious paradox: if it is important that the British economy is rebalanced then the UK should support the introduction of a Europe-wide FTT.

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<sup>10</sup> There was, of course, considerable discussion of financial transaction taxes in the 1980s, 1990s and 2000s (Lawrence H. Summers and Victoria P. Summers 1989; Mahbub Ul Haq, Inge Kaul, and Isabelle Grunberg 1996; Philip Arestis and Malcolm Sawyer 1997; John Grahl and Phothis Lysandrou 2003).

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