



TOWARDS A FINANCIAL TRANSACTIONS TAX

The case for feasibility¹

The financial transactions tax is often questioned on the basis of its lack of feasibility. Not only political, but also technical arguments are used to oppose the tax. This note seeks to clarify the debate surrounding the feasibility issue and indicates that technical issues or obstacles can be resolved or overcome. The argument of the paper, therefore, is that the implementation of such a tax is a political matter.

1. Transparency in the OTC derivatives market and the taxable basis for derivative instruments

Derivative instruments can be divided in three broad categories: futures, options and swaps related to stocks or stock indices, interest rates, foreign exchange, commodities or credits. Derivatives are traded either on organized exchanges or “over the counter” (i.e. bilateral OTC transactions); a large majority of derivatives are traded OTC: the latest estimates of the Bank for International Settlement are 85% traded on OTC and 15% traded on exchanges. However, at the G20 Pittsburgh summit in September 2009, the G20 members agreed in their leaders' statement that “all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate”. This should reduce the size of the OTC market which in the future could look more like a 'niche market' where only ad-hoc and non standardisable derivative contracts are traded. The main difference between contracts traded on-exchange and traded OTC is not the type of instruments traded (futures, options and swaps are traded both on- and off-exchange) but the characteristics of the instrument that, if traded OTC, is customized ad hoc to the desires of the buyer.

In order to be able to collect the tax what really matters is the information on the derivative contract. In order to have this information, the derivative instrument must be cleared by a central clearing counterparty (CCP). If this is already the case for derivatives traded on exchanges, there are not yet binding rules for derivative contracts traded OTC. However, the Commission's proposed Regulation on OTC derivatives and clearing counterparties (EMIR) foresees that standardised OTC derivative contracts should be cleared by a CCP. EMIR also foresees that all derivatives must be reported to Trade Repositories. The content of these reports must contain at least the main characteristics of the contract, including the type, underlying, maturity/exercise/delivery date, price data and notional value. Therefore, as a result, competent

¹ This note has been produced by the S&D Group Secretariat Unit C for the S&D Group as a background to its political work. It does not necessarily represent the official views of the S&D Group. We would especially like to thank Dr. Stephan Schulmeister, Austrian Institute of Economic Research, Sony Kapoor, Managing Director of Re-Define, and Dr. Maria Cecilia Guerra, Università degli Studi di Modena e Reggio Emilia for their valuable input. For further information about this paper, please contact Luca Fossati in the S&D Group Secretariat.

authorities will have a full picture of both the trading happening on organised exchanges and the trading happening off-exchange. In other words, it will be technically possible to collect the FTT not only for spot instruments (i.e. standard stocks) and derivatives traded on exchange, but also for the huge market of the OTC derivatives.

An important point raised for derivative instruments concerns their taxable basis. The possibility of taxing the notional value of a derivative contract was considered. The notional value of a derivative contract is the value of the asset, i.e. the value of a futures contract at the current futures price, the notional principle of a swap and the spot value of the underlying asset in the case of options. The notional value is also known when a contract is entered (and it will from now on be reported to Trade Repositories for all derivative transactions). A tax on the notional value ensures that an FTT specifically targets short-term speculation with high leverage/risk; that is, the FTT would impact the more upon the costs of derivatives trading the higher is the leverage ratio.

Another possibility would be to tax the delta (Δ) of a derivative instrument. The delta represents the sensitivity of the instrument price to a change in the value of its underlying. In case of an interest rate swap, for instance, the delta risk measures accurately the risk associated with the shift of the interest rate curve.

The tax burden of the FTT would be divided between the buyer and the seller; hence, each side of a financial transaction would just pay 0.025% of the asset value if the FTT was set at 0,05. For example, in the case of a standard future traded on an organised venue, the transaction is cleared by a CCP. The information concerning the characteristics of the contract (among which its notional value and the counterparties) are accessible and the tax would be impossible to avoid. This is obviously true for on-exchange stock transactions.

If the transaction takes place OTC - where the majority of derivative transactions take place - it is of the utmost importance to ensure that a reliable system of collection exists also for OTC transactions. EMIR generally foresees that OTC derivative transactions must be cleared by a CCP. Therefore, the same system of collection can be used for both on- and off-exchange transactions. Concerning those derivative transactions which would be exempted from the EMIR clearing obligations (derivative contracts below a certain threshold used by non-financials to hedge against risk), information on the transaction must in any case be reported to a Trade Repository. Therefore, the relevant information on the contract is accessible and the tax would be theoretically impossible to avoid.

2. Financial and non-financial counterparties

One of the criticisms concerning the FTT refers to how targeted the FTT would be and which subjects would the FTT actually tax. In order to ensure that the FTT targets financial players only the FTT should not tax those transactions which are the financial equivalent to "real-world-transactions" e.g. payments related to the commodities and labour markets. For instance, operations carried out in primary markets (e.g. underwritings and IPOs), and bank credit operations would fall outside the scope of the FTT. Given that it is practically impossible to set rules that make a distinction between transactions made for profit and those made to hedge against risk, an exemption based on *who* does the transaction instead of *what* kind of transaction is made does not seem to be a feasible way forward.

This concept would ensure that all financial transactions aimed at holding a financial asset will not be affected in a noticeable manner by the FTT given the very low rate of 0,05%. Importantly, however, the costs of those speculative transactions which are unrelated to market fundamentals would significantly increase. The more short-term oriented a transaction is (the faster open positions are changed) and the riskier a transaction is (the higher the leverage ratio is), the bigger the cost.

3. The FTT and high frequency trading

The FTT would specifically tackle purely speculative trading which creates and exploits excessive liquidity and it would leave longer term investments virtually untouched. The aim of the FTT is to mitigating very short-term and destabilizing speculation (i.e., unrelated to fundamentals). High frequency, electronic trading is unrelated to market fundamentals and it is not beneficial to price discovery. The higher the speed of trading, the less does the trading support the price discovery process. The reason is simple: investors do not have enough time to form rational expectations of market fundamentals. This type of excessive liquidity would be considerably reduced by implementing an FTT. HFT is one of the reasons behind the growth of dark trading. Firms engaging in high frequency trading are often denied access to dark pools on the grounds that dark pools do not want their clients' orders to be identified by HFT firms.

The two main criticisms concerning the effects of the FTT on HFT are that a) HFT would be reduced as an effect of the FTT and therefore the revenues of the FTT would also diminish, and b) if HFT moved out of the EU its effects would still be felt on European markets due to the globalisation of financial markets.

With regard to the first point, if HFT activity diminished in the EU that would mean that the tax had a positive effect in reducing extremely short-term speculating activities. The revenues from the tax would change with the passing of time; this is a characteristic of any tax. Secondly, HFT needs immediate proximity to the servers to get the lowest possible latency. Electronic trading could not happen in Europe if HFT firms' servers were not located in Europe. The effects of HFT trading in third countries on European markets are impossible to foresee, it does seem very unlikely however that HFT trading happening outside the EU would have any significant effect on EU -traded instruments.

4. The effect of an FTT on third countries' EU currency holdings

With regard to the criticism concerning third countries' reserves in EU currencies, it does not seem to be realistic that the FTT would have a negative impact on capital holding since the FTT is on transactions, not on holdings. Provided that Central Banks do not behave like professional investors, e.g. hedge funds, and therefore they do not make several transactions every day, an FTT - even if limited to EU currency denominated instruments - would not have an impact on third countries' currency holdings.

From a technical point of view there is no real problem in collecting an FTT even if the FTT would be applied in EU countries only. For instance, in a transaction based on euro/dollar currency rates, the FTT would apply to a bank based in France and to its counterparty in a third country. The tax burden in fact is divided between the buyer and the seller; hence, each side of a financial transaction would just pay 0.025% of the asset value (2.5 basis points).

5. The competitiveness of the EU

Another criticism is that a European-only FTT will trigger an exodus of financial activity outside the EU. This possibility does not seem to be likely. Europe is a key economic power and a well designed FTT - given its very limited size - will not have a significant impact on non-speculative trading. Examples of financial transaction taxes at the national level, such as the stamp duty collected in the UK, the financial transaction taxes in Austria, Ireland, France, and the taxes on bond transactions of Belgium, Austria and Greece, show that a tax does not make investors flee. A very small levy like the 0,05% FTT proposed by some will not have a negative impact on European competitiveness. A global tax would definitely be the best solution but if Europe takes the lead this will create strong political incentive for others to take the same road.

31 May 2011

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