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The EU-11: The Global Avant-Garde?

The negotiations on a financial transaction tax

Hubert Zimmermann

In the coalition agreement adopted in late 2013, the CDU/CSU and SPD agreed to push for the introduction of a financial transaction tax (FTT) as a priority project within the EU. This has increased the prospects that this concept, which has been promoted by numerous political and civil society actors for decades with the aim of curbing speculative transactions in the financial markets, will finally come to fruition. A supranational FTT long seemed to be no more than a utopian ideal, but for the past three years, it has been a topic of negotiations at EU level, with realistic prospects of success. The 11 Member States involved in the talks could thus become a kind of "global avant-garde". However, the negotiations are proving difficult, due to the divergent interests of the negotiating parties, objections from non-participating EU countries and massive lobbying by the financial industry. It therefore seems likely that the FTT that is ultimately adopted will be a watered-down version. Dwindling political impetus could also result in patchy implementation of the FTT, meaning that it ultimately fails to fulfil its original purpose.

A concept whose time is ripe?

The idea of a tax on financial transactions was mentioned as early as 1936 by John Maynard Keynes in his General Theory of Employment, Interest and Money. However, it is mainly associated with the name of the US economist and Nobel laureate James Tobin. In 1972, in response to the currency speculation which led to the collapse of the Bretton Woods system, Tobin proposed that a tax be imposed on foreign exchange transactions in order to curb volatility. However, the proposal conflicted with the neoliberal view – which was becoming increasingly prevalent in the 1970s – that deregulated capital markets promote prosperity and efficiency. This paradigm led to ever greater liberalisation of capital markets in the OECD states and resulted in the massive expansion of international financial flows, which continued despite the financial crisis. Events such as the Asian crisis in 1997/98 and the Russian crisis in 1998/99 gave fresh impetus to the concept of an FTT, with anti-globalisation organisations proving to be particularly fervent advocates of the tax. However, the US and the United Kingdom – profiting from the world's largest financial centres, New York and London – remained resolutely opposed to the tax. A financial transaction tax thus seemed to be a utopian ideal, especially given that international cooperation is essential for its introduction. This is the only way to ensure that financial market players do not circumvent the tax by resorting to arbitrage (conducting business in a market without an FTT). Sweden is often mentioned as a negative example in this context: it introduced an FTT from 1985 to 1992 but the tax only applied to brokerage services based in Sweden. As a consequence, a substantial proportion of Swedish financial transactions moved offshore and the volume of securities trading fell dramatically, reducing revenue from the new tax to a minimum and resulting in the failure of the experiment. It is only since the global financial crisis in 2007 that the implementation of this type of tax has appeared feasible once more. Some countries, such as France and Italy, have introduced a limited form of the tax at national level. However, the introduction of a supranational FTT, which many of its advocates describe as the only reliable way to rein in the financial markets, is essential in order to establish the concept on a firm footing. In the long term, the current EU negotiations involving 11 eurozone countries are likely to be the last chance to implement the tax in an internationally coordinated format.

Arguments in favour of the FTT

The basic objective of a financial transaction tax is to bring the financial markets back into line with the real economy. With that aim in mind, a small tax on financial transactions is intended to rein in trading to an appropriate level and extend the holding period of financial securities. It also aims to curb excessive leveraging, transactions with derivatives and other forms of speculative investment, and high-frequency trade (HFT). An additional attraction of the FTT is the revenue that it would generate, which could be used to ensure that the costs of managing financial crises are borne by the financial sector itself, first and foremost, and not by the taxpayer. The progressive effect of the tax, which would mainly be paid by high earners, also has the potential to minimise the growing inequalities in income distribution in many countries, which are largely the result of capital gains in sophisticated financial markets. Many non-governmental organisations (NGOs) are calling for the tax revenue to be spent on development. As a result, the FTT has been dubbed the “Robin Hood tax” in the UK and the US.

After the onset of the financial crisis in 2007, the FTT was therefore one of the most intensively discussed options for regulating the global financial markets through taxation, with the aim of restoring government control over the financial sector. Political parties, the churches, anti-globalisation NGOs and leading figures such as Bill Gates all called for the introduction of the tax. At intergovernmental level, this option was initially discussed from mid 2009 onwards by the G20, which tasked the International Monetary Fund (IMF) with producing a feasibility study. At subsequent G20 summits, however, it soon became apparent that most participants and, indeed, the IMF itself were opposed to the tax. At the G20 summit in Toronto in June 2010, Germany and France announced plans to work towards an EU-wide FTT. After the failure of a last-ditch effort by French President Nicolas Sarkozy in advance of the G20 summit in Cannes, the introduction of a global tax appeared to be out of reach, at least for the time being. The US, the United Kingdom and many emerging economies remain hostile to the tax for a variety of reasons.

Arguments against the FTT

The steadily diminishing prospect of an FTT that encompasses all the major financial centres and the entire spectrum of global financial flows is the argument most frequently advanced against an FTT. However, its opponents also highlight the difficulty of distinguishing between “harmful” speculation and “beneficial” transactions and point out that the tax could also affect small savers and ordinary investors, largely because financial institutions would pass on the ensuing costs to these customers. Opponents of the tax also argue that it could have unintended consequences: for example, the European Central Bank (ECB) warns that the FTT could cause considerable harm to the repo market, where banks can access short-term funding through inter-bank lending, resulting in another credit crunch like the one which occurred in 2008. The FTT’s potential to avert new financial crises is also viewed sceptically in most studies. The administrative costs of monitoring and collecting the tax and the unresolved problem of distributing the revenue if a larger number of countries participate are often mentioned as well. Another argument presented against the tax is that financial market players are likely to start trading elsewhere, with geographical relocation of transactions, meaning that financial centres in countries that have introduced the FTT will become less competitive – a problem which is particularly likely to affect the EU’s single market unless all the EU Member States participate.

The debate in the EU

For this reason, the plans for a European FTT initially aimed to introduce the tax in all the EU Member States. The escalation of the sovereign debt crisis in the eurozone gave fresh impetus to the previously non-committal debate within the EU. During the negotiations on the euro rescue package in May 2010, EU finance ministers agreed to consider in detail a tax on financial transactions. However, at this point, very few Member States were firmly in favour of the tax. Countries such as the United Kingdom, Luxembourg and Sweden vigorously opposed the FTT. The European Commission, too, was initially sceptical about the feasibility of an FTT, but subsequently revised its negative position. On 28 September 2011, it presented a proposal for a financial transaction tax in all Member States of the European Union. Under the proposal, the exchange of shares and bonds would be taxed at a rate of 0.1% and derivative contracts at a rate of 0.01%. Government bonds and the trade on primary markets (which deals with the issuance of new stocks or bonds) were to be excluded from the scope of the FTT. According to the Commission, the tax could raise approximately €57 billion every year, with the revenues to be shared between the

EU and the Member States. The most contentious issue proved to be the tax's scope of application: in accordance with the principle of establishment (or "residence principle") in the Commission's original proposal, the tax is payable if one party to the transaction is established in a participating Member State – even if the transaction takes place in another territory. This creates a risk that financial market players will simply relocate their registered office. A second draft, published in February 2013, therefore introduced the "issuance principle", whereby financial instruments issued in the participating Member States will be taxed when traded, even if the parties trading them are not established in FTT Member States.

During the course of 2011, it became apparent that an EU-wide FTT was not a realistic prospect. The focus of the debate therefore shifted to the eurozone, whose members include the staunchest advocates of the FTT, such as Germany, France, Belgium and Austria.

Enhanced cooperation

In June 2012, eurozone finance ministers announced their intention to press ahead with the introduction of a financial transaction tax through the procedure known as "enhanced cooperation". A minimum of nine Member States is required for enhanced cooperation to go ahead. However, the strict legal criteria applicable to enhanced cooperation mean that it is open to legal challenge. For example, it must not undermine the internal market, constitute a barrier to trade between Member States, or distort competition. Nonetheless, in January 2013, the EU finance ministers gave the go-ahead for negotiations on a financial transaction tax. The European Parliament also gave its seal of approval, with a large majority in favour of the tax.

Finally, 11 Member States – Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain – decided to press ahead with negotiations. In some of these countries, including Belgium, France and Italy, a limited form of FTT already exists. These countries are keen to align an EU-wide FTT with their own model in order to minimise their adaptation costs. In February 2013, the European Commission tabled a new proposal for legislation implementing enhanced cooperation among the participating States. This proposal strengthened the rules compared with the previous draft, primarily through the introduction of the issuance principle. The United Kingdom then launched a legal challenge against the tax in the Court of Justice. In mid 2013, the negotiations stalled. This was partly caused by an opinion issued by the European Council Legal Service which found that the extraterritorial application of the proposed FTT was contrary to European Union law. The Commission and the EU-11 disagreed, but the legal uncertainty has overshadowed the negotiations. Differences of opinion between the negotiating countries and uncertainty over the outcome of the Bundestag elections in Germany have made matters worse.

Current status of negotiations

The Commission's proposals and the EU-11 negotiations have been accompanied by massive lobbying by the financial industry against the proposed tax. As a consequence, the already divergent positions of the negotiating partners have drifted further apart. The Commission's comprehensive proposal is no longer viable. The exclusion of the repo market, for example, means that the expected revenue will be very much lower than the Commission's original forecast. Countries such as Italy and Spain also oppose any levying of the tax on the sale of government bonds, due to concerns about falling demand. France is in favour of an exemption for certain derivates in order to protect the major French banks engaged in this business.
In Germany, the FTT formed part of the coalition agreement between the CDU/CSU and the SPD – the outcome of a concession wrung from an initially sceptical CDU/CSU in exchange for the SPD's endorsement of the Fiscal Pact adopted in response to the euro crisis. Unlike the Commission's proposal, Germany's ruling coalition is in favour of taxing foreign exchange transactions as well. The SPD is also firmly opposed to the exemptions for financial instruments such as derivates, demanded by France.
In order to save face but also to salvage the comprehensive approach set out in the coalition agreement, the German government, at the latest talks, therefore called for a stepwise introduction of the FTT. The tax would initially apply solely to shares but would gradually be extended to all types of securities. This progressive approach is also reflected in the general tenor of the most recent Franco-German discussions on this issue on 18 February 2014. An agreement in principle in this spirit prior to the European elections in June seems feasible, but more far-reaching agreements will probably have to wait.

Recommendations

Civil society organisations have described the current EU negotiations as a breakthrough for a concept whose implementation long seemed unrealistic. However, even if the FTT is indeed introduced in the EU-11, optimistic hopes that this will mark the beginning of the end of hyperglobalised financial markets worldwide are likely to be dashed. One outcome of the financial crisis is that a tax on financial transactions and on profits in the financial sector is now regarded as politically legitimate in most countries, but genuine global governance in the field of tax harmonisation is still utopian due to the highly divergent positions within the international community. Regional cooperation in the form of "coalitions of the willing" beyond the EU-11 therefore seems to be the most promising approach.

The selective introduction of the FTT in 11 countries, initially limited to certain types of securities, would reflect the lowest common denominator. However, this may well cause problems with implementation. Without a binding roadmap for the integration of financial products initially exempt from the tax, as demanded by the SPD in Germany, the scheme is likely to remain patchy. For example, a tax on shares alone could well result in a shift towards alternative forms of investment. Furthermore, stepwise introduction of the tax would not be in line with the original mandate of the enhanced cooperation. Advocates of the FTT also criticise limited introduction of the FTT as conflicting with its basic philosophy. As they point out, it is the highly speculative financial instruments, in particular, which would then be exempt from the tax.

It is therefore highly likely that the outcome of the EU-11's negotiations will not fulfil the hopes of advocates of the tax or provide effective curbs on the global financial markets.

Due to the complex interactions between the financial markets and sectors of the real economy, such as corporate finance and individual financial security provision – interactions whose impacts are often almost impossible to predict – the FTT, despite its compelling logic, is too inflexible an instrument to achieve effective governance of the financial markets. Other instruments, applied in a more targeted manner, are better suited to achieve the desired governance effect. They include the abolition of undesirable financial transactions, especially high-frequency trading, e.g. through appropriate taxation as in France, a clear separation between banks' proprietary trading and retail banking, and regulation of the holding period of financial securities in portfolio management.

These measures lack the radical characteristics of a comprehensive FTT. However, it is already apparent from the EU-11 negotiations that the hopes of a universal remedy for global financial market regulation are misplaced.

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Further information

The texts of the Commission's proposals on the FTT and other information about the functioning, impacts and legal background can be accessed on the European Commission's website (**http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm**).

The Steuer gegen Armut (Tax Against Poverty) initiative brings together a number of NGOs which support the introduction of the FTT. Their website provides comprehensive and regularly updated documentation, with relevant links, on the evolution of the tax over the last 20 years (**http://www.steuer-gegen-armut.org/**).

There are also numerous studies which analyse the economic benefits and disadvantages of an FTT. A positive assessment is provided, for example, in the study published in 2012 by the German Institute for Economic Research (DIW Berlin), entitled *Finanztransaktionssteuer. Ökonomische und fiskalische Effekte der Einführung einer Finanztransaktionssteuer für Deutschland* (**http://www.diw.de/documents/publikationen/73/diw_01.c.405812.de/diwkompakt_2012-064.pdf**).

One of the many critical analyses by institutes close to the financial industry is the study published in May 2013 by the German Banking Industry Committee (DK), entitled *Auswirkungen einer Finanztransaktionssteuer aus Sicht von Marktteilnehmern* (**http://www.die-deutsche-kreditwirtschaft.de/uploads/media/130515_Stn_DK_FTS_Marktfolgen_V_2.2.pdf**).

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