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Effects of the proposed Financial Transaction Tax (FTT)

by

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Abstract

The EU Commission claims that the Financial Sector is under taxed and has proposed an EU-wide financial transaction tax (FTT) aiming to raise revenue and to reduce undesirable financial transactions. They claim that such a tax would not adversely affect ordinary citizens. We challenge the analysis and the conclusions made by the Commission. Experiences of imposed financial transaction taxes are reviewed. Basic features of the FTT, including its incidence and impact on cost of capital and therefore on business investment decisions are described. In the long run, it is clear that companies as such do not pay the tax, but rather their customers, employees and shareholders. The claim that tax revenue will increase and that financial stability will be enhanced is challenged. Finally, additional issues are discussed, such as the need for sound public finance, marginal cost of public funds for the FTT, its negative effects on pension's savings and its negative implications by its design as an extraterritorial regulation.

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1. Introduction

A proposed Financial Transaction Tax (FTT) has received a lot of attention in Europe in recent time. The issue has considerable importance for European integration in terms of the banking and financial system, competitiveness of the European area and the impact on economic activity through the transmission mechanism. A lot of effort has been made to analyse different aspects of taxation of financial transactions, including the extensive impact assessment by the EU Commission. In several important aspects regarding such a tax, a remarkable consensus seems to have been reached. The EU Commission and governments seem to agree that the FTT would adversely affect investment and growth prospects. Nevertheless, the debate is still vigorous. During the spring of 2012, alternatives to the FTT have been discussed, such as a levy on the issue of new share issues or other more limited forms of a transaction tax. The alternative of imposing a levy on certain components on the balance sheets of financial institutions and banks has also been discussed.[2] Such a levy already exists in some Member States (e.g. in Denmark) and is often referred to as a Financial Activities Tax (FAT). The FAT is said to mimic a VAT for the Financial Sector, without yielding the integration benefits of including that sector in the VAT system. These aspects are clearly very interesting and relevant, but the aim of this paper is to elaborate on some of the key aspects of the FTT.

The idea of taxing of financial transactions emerged some thirty years ago. The Nobel laureate James Tobin suggested a currency transaction tax in 1972 in his Janeway Lectures at Princeton.[3] Ever since, a great variety of variations on similar proposals have been put forward. Especially in times of financial disturbance, discussions on the topic have become intense. Proponents have often used arguments

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[2] "EU looks at stamp duty to settle tax impasse" (2012), retrieved from http://on.ft.com/IydwkL and "Germany makes last-ditch attempt to save transaction tax" (2012), retrieved from http://reut.rs/HznHEx.

[3] Tobin, J. (1978) "A Proposal for International Monetary Reform", Eastern Economic Journal, Eastern Economic Association. In fact, Tobin also referred to thoughts expressed by Keynes in his "General Theory of Employment, Interest Rates and Money" (1936).

not fully in line with Tobin's initial proposal.[4] Opponents have on the other hand argued from an efficiency point of view and referred to fundamental obstacles and distortions from such a tax.

The Commission has launched its proposal for a FTT to fulfil multiple purposes. Two of these have gained most attention. The proposal aims to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets, and to ensure that financial institutions make a fair contribution to raise government revenues. In this paper, we will challenge these purposes and elaborate on various additional aspects of a FTT, such as how it would affect pensions, cost of capital and growth prospects. The paper will also address the extra territorial tax aspects of the FTT.

2. The European Commission's Proposal

In September 2011, the European Commission presented a proposal for a FTT.[5] The Commission already explored the idea of a FTT in October 2010, in its Communication on Taxation of the Financial Sector.[6] The approach in 2010 was broader as the Commission discussed a wider range of measures regarding taxation of the financial sector. VAT exemptions of financial services were highlighted and some emphasis was made on distortion problems emanating from these exemptions. At this stage the Commission considered that there was greater potential for a Financial Activities Tax (FAT) at the EU-level. Important arguments for this assessment were that the FAT option could deal with the current VAT exemption of the financial sector and raise substantial revenues.

During the annual Brussels Tax Forum conference in March/April 2011, there was broad consensus that a tax should be levied on the Financial Sector, but that a Tobin type of tax, the FTT, would be undesirable for the EU. Much of the debate focused

[4] Der Spiegel 36/2001 "Die missbrauchen meinen Namen".
[5] EU Commission "Proposal for a council directive on a common system of financial transaction tax and amending Directive" 2008/7/EC, COM (2011) 594 final.
[6] EU Commission "Communication on Taxation of the Financial Sector", COM(2010) 549 final.

on the effects of the financial crisis and the financial sector was, by many, seen as the cause of the financial crisis and therefore that sector should pay for the burden it had inflicted on the rest of the economy and on ordinary citizens. Only a few conference participants raised the issue of government and central bank policies, allowing and promoting proliferation of debt issuing, or the inadequate exercise of financial regulation by regulatory authorities. At the conference, there seemed to be a consensus that even though the growth prospects of the European economy would suffer from taxation of the financial sector and that everyone would be worse off, it was still desirable to proceed with an appropriate levy or tax on the financial sector.

The proposal of September 2011 is to some extent contradictory to the Commissions previous reasoning. This may have political rather than economic efficiency explanations. The economic downturn during 2011 increased the urgency for policy actions, to handle financial disturbances, to avoid fiscal deficits and to finance stimulus incentives to maintain economic activity. To some extent it could be argued that the financial sector has become an easy scape goat for politicians, even though there are indeed room for criticising banks and similar actors for being a part of the cause. However, as will be addressed further in this paper, a FTT is probably not such a quick fix solution and it would entail many negative consequences.

The current proposal for a FTT has been heavily discussed. At the informal ECOFIN meeting of March 30th, 2012 ministers and governors discussed taxes on the financial sector. Member States agreed that alternatives to the proposal of the Commission should be explored.[7] Based on this information, it is reasonable to believe that further amendments to the proposal are likely to occur. However, it is currently unknown in what areas and to what extent this might happen, or if the proposal will survive at all. In this paper we mainly base our analysis of the proposed tax design as laid out in the Communication from September 2011.

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[7] The Danish Minister for Economic Affairs and the Interior, Margrethe Vestager, hosted the meeting and said: "Some countries support a financial transaction tax, others don't and would rather explore alternatives. Moving forward, I find it sensible to look at alternative models for taxing the banks." Retrieved from http://eu2012.dk/en/NewsList/Marts/Uge-13/informal-ecofin.

The basic features of the proposal are the following. The scope of the tax is wide, as it aims to cover transactions relating to all types of financial instruments. Furthermore, the scope of the tax is not limited to trade in organised markets, but does also include other types of trades, including over-the-counter trade.

The tax is focused on financial transactions carried out by financial institutions. The definition of financial institutions is broad and includes anyone acting as party to a financial transaction, either for their own account or for the account of other persons, or acting in the name of a party to the transaction. Central banks are excluded from the tax.

The territorial application of the proposed FTT and the Member States' taxing rights are defined on the basis of the residence principle. A financial transaction is taxable in the EU as soon as *one* of the parties to the transaction is established in the territory of a Member State. Where transactions are carried out on trade venues outside the EU, they will be subject to tax if at least *one* of the establishments carrying out or intervening in the transaction is located in the EU. It may be worth noting that the European parliament has advocated that both parties should be established in the territory of Member States. This would eliminate the extraterritorial aspect of the FTT. In general, OECD countries have expressed a concern if taxation entails extraterritorial taxation. However, even though such taxes are highly undesirable and impose on the taxation of other sovereign states, it has not prevented countries like the US to enact Foreign Account Tax Compliance Act (FATCA)[8] and impose obligations of banks and financial institutions to sign agreements with IRS, the US tax authority, to prevent withholding taxes of 30 per cent to be imposed. However, any form of extraterritorial taxation impedes the sovereign right of states to tax and we think it should attract the criticism it deserves.

The tax rates should be differentiated between the two categories and rates are proposed at 0.1 per cent for regular instruments and 0.01 per cent for derivatives.

[8] Subtitle A of Title V of the Hiring Incentives to Restore Employment Act (HIRE) which enacts Chapter 4 of, and makes modifications to, the Internal Revenue Code, the tax law of the United States.

According to the proposal, member countries are free to charge higher tax rates. Since each party of a transaction is to be taxed, a regular transaction between two financial institutions within the EU will be exposed to a tax rate of at least 0.2 per cent. Measures to avoid cascading effects are not explored further in the proposal.

3. Tax Incidence, Cost of Capital and Macroeconomic Impact

The FTT will inevitably create a tax wedge, i.e. an extra cost on top of the transaction the tax is supposed to be levied upon. This tax wedge may be seen as the starting point for analysing the effects of a tax on financial transactions. Through the transmission mechanism, the incidence of the FTT is far reaching and affects prices, quantities, behaviour and evidently welfare, beyond the parties carrying out the transaction to be taxed.

It is indeed the financial institutions, providing financial services to customers, who carry out the transactions that are subject to tax. This does not however mean that the institutions will bear the burden of the tax. One could say that there is a difference between the legal and economic burden of the tax. For a tax applied to all suppliers in a market there may be room to pass on the tax to the customers, since the tax hits all providers equally. The degree of competition, the character of the products or services being taxed and other market conditions will determine to what extent this will happen. In the long run, it is clear that companies as such do not pay taxes, but rather their customers, employees and shareholders.

Moreover, a tax wedge emanating from the FTT will increase the cost of capital in the economy. Once the tax is introduced, investors will face a lower rate of return (after tax). Therefore, they will demand a higher rate of return (before tax) from the companies they have invested in. The burden of the tax will be shared between the two and will affect the cost of capital. Applying a broader view and considering the consequences of an open economy, it should be recognised that there will be untaxed actors and untaxed investments, keeping the post-tax required rate of return unchanged. Hence, the tax will increase the pre-tax cost of capital, which in turn will influence the economy in various ways, including higher prices and a reduced number of economically viable investments.

The macroeconomic impact of a FTT has been assessed by the EU Commission in its impact assessment, published along with the proposal for the FTT. In short, a GDP reduction of 1.76 per cent as compared to a base line scenario is estimated. The effect is mainly triggered by a decrease in investment induced from higher cost of capital. This will reduce tax bases and dampen overall economic activity. In such a scenario, the revenue collection is estimated by the Commission to be 0.08 per cent of GDP.[9]

The deterioration of the tax base also follows from relocation and product substitution and might have effects such as, for instance, the misallocation of financial funds and in some cases that efficiency-enhancing market segments and/or products might disappear. This could also have impact on the financing of investment projects. At the same time, the Commission's impact assessment elaborates on various measures to mitigate undesired effects from the FTT. A number of such effects are listed, and under the assumption that all these effects simply cumulate, the negative effect on GDP could, in the best case scenario, be decreased to about -0.53% (instead of -1.76%).[10] A tax revenue estimate in such a scenario is ambiguous, however the Commission's most frequently referred tax revenue estimate is 57 Bn EUR[11], equal to slightly more than 0.4 per cent of GDP.[12]

While the Commission's impact assessment is very extensive, the many different assumptions, scenarios and estimates submitted are not always easy to evaluate or relate to, neither to understand the interaction between them. Criticism has been

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[9] Impact Assessment Vol. 17, p. 6, Commission Staff Working Paper, accompanying COM 2011(594).
[10] Impact Assessment Vol. 1, p. 52, Commission Staff Working Paper, accompanying COM 2011(594).
[11] , EU Commission "Proposal for a council directive on a common system of financial transaction tax and amending Directive" 2008/7/EC, COM (2011) 594 final, recently repeated e.g. in the ECOFIN press release, 3153rd Council meeting, Brussels 13 March 2012.
[12] Based on a total GDP for all 27 EU Member States of roughly 13,000 Bn EUR.

expressed against assumptions and model specifications, e.g. in a review by Oxera.[13] Questioned assumptions are i.a. the Commission usage of different (lower) burden of FTT when calculating GDP impact rather than calculating revenue prospects. Also, Oxera finds it likely that the Commission has exaggerated the possibilities to "protect" financing of business investment, resulting in an underestimation of the negative economic impact. Moreover, the Commission's assumption that ending of high-frequency trading would mitigate economic impact is not supported by evidence and appears inconsistent with the modelling of the economic impact.

In order to achieve more realistic scenarios, Oxera has adjusted some of the Commission's assumptions. The results suggest a negative impact in excess of 2 per cent of GDP and a loss of general tax revenue of nearly 1 per cent of GDP. Thus, Oxera concludes that there is a risk that the imposition of the FTT actually reduces total tax revenues from the economy.

Combining the evidence brought forward by the Commission in its impact assessment and additional analysis from others, the picture is quite clear that a FTT will reduce GDP and thereby welfare. Despite the fact that the financial institutions will be directly chargeable for the FTT, in the end the burden of the proposed tax will fall on consumers, employees and shareholders and total government tax revenue may well decrease. It appears that the FTT's initial purpose of revenue-raising is not likely to be fulfilled.

4. Efficiency of Financial Markets and Financial Stability

It is indeed important to deal with the issue of financial stability, including of course possible sources for lack of stability. The last decades, the world economy has gone through a number of troublesome periods 1997 (Asia), 2000 (IT-bubble), 2008 (Lehman Brothers) and 2011 (Greece). It is beyond this paper to explore the complex and difficult reasons behind these problems. However, it is far from clear that lack of

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[13] Oxera (2011) "What would be the economic impact of the proposed financial transaction tax on the EU?".

a FTT would explain why e.g. Greece tampered with its official public finance statistics. On the contrary, there is reason to believe that other interventions than tax measures would be better suited to avoid future financial crises. Appropriate regulatory standards and supervision regarding e.g. capital requirements, stress tests and similar monitoring and risk management accompanied by sufficient financial reporting standards to ensure transparency, accuracy and reliability are probably important areas to look into.

A sometimes proposed criticism of frequent short lasting transactions, often described as speculative, is that such transactions would be harmful to the functioning of financial markets. The critics suggest that such speculative transactions induce excess volatility and are therefore harmful. Proponents for a FTT suggest that such a tax would reduce transaction volumes in a way that would hit the speculative transactions. However, the difference between such “harmful” transactions and other transactions is not easily spotted. Under some assumptions a transaction tax is not likely to stabilise financial markets since a reduction in market liquidity amplifies the price impact and there seems to be no consensus among whether it could be possible to reach desired results by applying a transaction tax.[14]

A more fundamental problem of trying to control transaction volumes is that financial markets are borderless. Even if the FTT proposal is far reaching, there will be a lot of instruments and actors out of reach of the tax. It could be argued that transaction volumes will shift away to other territories to avoid being hit by a FTT. This is likely to increase, not reduce, volatility. Such conclusions are also made in the impact assessment by the Commission. This has been confirmed in other studies, e.g. by the IMF.[15] A general remark in this context is that large trading volumes facilitate sufficient liquidity in the financial markets and thereby increase efficiency, put pressure on trading spreads and contribute to minimizing financing costs for investments.

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[14] Pellizzari, P. and F. Westerhoff (2009), ”Some effects of transaction taxes under different micro structures”, Journal of Economic Behaviour and Organization.
[15] IMF (2011) “Taxing Financial Transactions: Issues and Evidence” Working Paper 11/54.

From a government revenue point of view, there is a contradiction between the purposes on the one hand to reduce transaction volumes and on the other hand to find additional tax base. The more successful a tax would be in reducing transactions, the less revenue a tax would raise. It is an empirical question to find out where these counteracting effects balance. As pointed out in part 3 of this paper, estimations suggest that an introduction of a FTT could in fact decrease overall tax revenue. To some extent this estimate includes an effect on trading volumes, even though the transmission mechanism is more complex and probably more importantly, works through the negative impact from the FTT on business investments.

The FTT proposal has exempted primary markets from tax, aiming to shield initial procurement of financing. The intensions behind this exemption are of course honourable. However, in practice there will remain a negative impact from a FTT, since the negative effects imposed by the tax on the secondary markets will interact with the primary market and in the end affect the costs of financing of government issues. It could be considered as common knowledge that high efficiency in the secondary market will have positive effects on the primary market and vice versa.

To finalise this section, in conclusion, there is reason to pose a question as to the underlying rationale of the proposal, which seems to be that transactions as such may be a source to financial instability. On the contrary, some transactions are a guarantee for stability. As shown in this section, in practice it is not possible to reduce volatility or instability through a FTT. Therefore, the FTT’s initial aim to create appropriate disincentives for undesired transactions is not likely to be fulfilled.

5. International Experience

Financial transaction taxes have been applied in several countries. However, the structure of the current proposal has not been implemented in practice. Within the EU there is a stamp duty in the UK and a similar tax is proposed to be introduced in France by the second half of 2012. Other countries such as Hong Kong, Taiwan, Singapore, Brazil and Switzerland pose alternatively designed taxes in this area. Within these systems, there are exemptions for various actors, e.g. market makers, or certain activities, e.g. hedging or borrowing and lending of stock. In addition, other restrictions apply to limit cascading effects. According to surveys, including reviews of the Commission's impact assessment, there are, despite the efforts to accommodate the tax design through numerous exemptions and limitations, difficulties e.g. regarding definitions and more important undesired behaviour among tax payers to avoid taxation. Moreover, there is recurring experience that transactions are shifted away and that it could be questioned if the tax has reduced speculation.[16]

The Swedish experience is worth some more extensive description. A transaction tax was applied from the mid 1980's to early 1990's and the design was to some extent closer to the Commission's proposal in terms of transactions exposed for the tax. However, the tax was geographically limited to transactions carried out in Sweden. The magnitude of financial markets was considerably smaller and the level of sophistication of financial instruments as well. Nevertheless, relocation became a serious problem and estimations have been made that 50 per cent of all Swedish trading moved to London, the volume of bond trading fell by 85% (even though the tax rate on five-year bonds was only three basis points), the volume of futures trading fell by 98% and the options trading market disappeared. The revenues from the tax on fixed-income securities were expected to amount to 1,500 million SEK per year, but the average was only around 50 million a year.[17]

To conclude, the international experience from taxing financial transactions leaves us with quite a lot of concerns and doubt. Besides small (and smaller than expected) government revenue, one finds problems such as complex rules, uncertainty and undesired behavioural effects.

[16] Almenberg, J. and M. Wiberg (2012) "Skatt på finansiella transaktioner" Sveriges Riksbank.
[17] Campbell, J. and K. Froot (1994) "International Experiences with Securities Transaction Taxes" in "The Internationalization of Equity Markets" NBER, Frankel, J. ed.

6. Cost of capital – Possible Impact on Pensions Savings

A general overview of the FTT and its implications for cost of capital has briefly been discussed in section 3. Among several applications, one area of interest to look further into is the effect on pension savings. To illustrate the FTT's cost of capital effects on pension's savings, this section will provide results from a stylised model.

The following assumptions can be made regarding pensions savings for an average worker. He starts his savings at the age of 30 and retires at 65, the monthly salary is 5,000 EUR, the yearly pension savings deposition is 10 per cent of the income and the average nominal yield is 5 per cent. To calculate the effect from a FTT, the turnover of the pension savings portfolio needs to be implemented in the model. The literature provides for a wide range of estimates on portfolio turnover. We have not found it feasible to find an average turnover for an average portfolio. Rather, we find it interesting to point out the great variety. Portfolios operating at a passive strategy may show low turnover ratios, slightly (or even far) below 100 per cent per year, while portfolios following more active strategies have high multiple turn over ratios exceeding 300 per cent per year.[18] Our sample calculation is based on a turnover rate of 150 per cent, or differently expressed that the average holding period of an individual investment is 8 months. This measure captures relocation due to changing economic conditions, age of the holder and individual preference for relocation.

When pension savings depositions are set aside, tax will be levied and the initial investment will be reduced. Furthermore, every time reallocation of the pension fund is done, the tax will be due. A reallocation will trigger the tax both when the assets are disposed of and when new ones are acquired in the same fund (or in any other pension fund or similar form of saving). The proposed tax rate of 0.1 per cent is applied on buyer and seller of each transaction. Since the tax is compounding, the overall impact on the pension is substantial. Based on the assumptions lined out above, the worker will see his pension reduced by close to 5 per cent due to the FTT. The sensitivity of this result to the portfolio turnover assumption is that a turnover of

[18] Day, T. et al (2001) "Investigating Underperformance by Mutual Fund Portfolios", table 5, mimeo University of Texas.

100 per cent would reduce the pension by close to 3.5 per cent, while a turnover of 200 per cent would result in a pension reduction of 6.5 per cent. The results are less sensitive to changes in the assumption on yield; an increase or reduction of this assumption by 2 percentage points would change the effect on final pension by less than 0.1 per cent.

7. Sound Public Finances and Marginal Cost of Public Funds

Sustainable public finances are indisputable. The first thing to do to ensure this is to improve long term growth perspectives. Growing tax bases provide a solid ground for sound fiscal stance. Second on the list is to scrutinise public spending and if necessary cut costs to meet budget balance. After that, there might be additional need to also consider tax measures. Such measures should be carried out primarily through eliminating existing inefficiencies, such as tax breaks in arbitrary areas e.g. for regional, sector or for other economically non-efficient policy reasons. If further tax measures should be required, after taking into account what has been said about growth, public spending etc., any increases should be as little distortive as possible.

To assess policy options among tax measures, it can be helpful to look into the marginal cost of public funds (MCF). In short, the MCF measures the loss incurred by society in raising additional tax revenues. The higher the MCF is for a tax measure, the more harmful the measure is. The MCF, or similar measures such as marginal excess burden, could be employed to evaluate not only tax reforms, but also public spending programs or other public policies. Theoretic framework, modelling design and empirical application may be complex and empirical results should, as always be looked upon with caution. MCF estimates may typically exceed one and stretch up to several multiples. Conclusions may be drawn from comparisons between the MCF for different measures, preferably within a consistent set of model specifications, assumptions etc. [19]

[19] Dahlby, B. (2008) “The Marginal Cost of Public Funds” MIT Press.

Hansson (2007) provides an overview and some applications of the MCF framework. She also calculates deadweight loss of taxation and uses broader measures of elasticity and finds larger estimates than previous studies, which in turn has used more narrow defined elasticities.[20] Similar results are found in other modern studies, focusing on labour market mechanisms.[21] An extensive study of marginal excess burden compares different types of taxation and finds that the highest costs are associated with capital taxation, while lower cost estimates are found for sales tax on capital goods and corporate taxation.[22] The MCF framework also provides room for analysis of the importance of country size. Based on the theory of asymmetric tax competition it could be expected that small jurisdictions which host only a small share of a country's resources will face a high MCF. There are also empirical results to support this hypothesis.[23]

In general, most of the mentioned studies report MCF-estimates ranging from 1 to 5. There are differences between studies, type of taxation studied and model specifications. Comparisons of estimates should, as mentioned, be made with caution. Still it is interesting that the MCF for a FTT has been estimated by the EU Commission at levels beyond 20.[24]

The general issue of sound public finances covers, as initially mentioned in this section, many aspects and it is highly doubtful whether a FTT at all is qualified in the discussion. Adjacent to this, there is also a discussion of under taxation of the financial sector. There is a considerable interdependence between business sectors, pronounced by e.g. increased outsourcing and joint venture structures etc. Therefore, it is hard to strike the difference between sectors implying equal or even larger difficulties to assess their different tax burdens. As pointed out in section 3, tax

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[20] Hansson, Å,(2007) "Taxpayers responsiveness to tax rate changes and implications for the cost of taxation" International Tax and Public Finance.
[21] Kleven, H. J. & C. T. Kreiner, (2006), "The marginal cost of public funds: Hours of work versus labor force participation", Journal of Public Economics 90.
[22] Baylor, M. and L, Beauséjour (2004) "Taxation and Economic Efficiency: Results from a Canadian CGE Model" Working Paper 2004-10, Canadian Ministry of Finance.
[23] Büttner, T. and N. Fabritz (2011) "Responses to Grants and the Marginal Cost of Public Funds" preliminary paper.
[24] Impact Assessment Vol. 17, p. 6, Commission Staff WP, accompanying COM 2011(594).

incidence is likely to alter the burden, blurring the picture even more. A more comprehensive analysis of this is beyond this paper.[25] Moreover, taxation may not be the best way to handle anomalies in specific sectors. Other possible measures would be e.g. to ensure sufficient competition.

8. Extraterritorial Taxation

Implications of extraterritorial taxation could be far reaching in a longer term perspective. A more thorough analysis is beyond the scope of this paper and may benefit from applying a game theory model. Aggressive moves from EU could in a short term perspective insert some additional taxing power to the Union. However, reactions from both other confederations of countries and single countries should be expected. The prospects of reaching a consensus on a global financial transaction tax are not likely to increase by such a tax design. On the contrary, single countries may find it even more interesting to provide attractive alternatives to financial market actors. Moreover, it could be expected that legal constituencies and sovereign countries with strong economic power and large domestic market may react by rising various walls and obstacles. This could in fact be a severe blow to free trade and efforts made to enhance trade and investment to the detriment of everyone. We note that the efforts by the EU to tax the airlines have been met by surprise and very negative responses from the US and China. They do not accept the effects on airlines costs on routes outside the EU, implied by the proposed legislation.[26]

At the same time, a number of countries are, under the premises of "protecting their tax base" imposing requirements on exchange of information. Such measures can be very far reaching and often also entail a threat of imposing withholding taxes for non-compliant countries or institutions. The US law on FATCA, mentioned in

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[25] It is of course questionable whether it is optimal that no sector has a lower tax burden than any other sector. It would imply that all sectors must face the same relative tax burden, irrespective of their sectoral differences. If this argument was used consistently, progressive tax rates or earned income tax credits etc would all be seen as anomalies that should be rectified by increased taxation of those below the average.

[26] "Europe Won't Back Down on Aviation Carbon Trading" (2012) from http://bloom.bg/xUZ5DO and "Trade war looms over EU's airline tax", China Daily (2012), retrieved from http://www.chinadaily.com.cn/opinion/2012-02/21/content_14653548.htm.

section 2, is a recent example, where the US would impose a 30 per cent withholding tax on all financial payments (also business to business within a business group) in the case the foreign financial institution has not signed an exchange of information contract with the US tax authority. It is our view that such legislation is a form of trade barrier but it would not merit a response by the EU Member States to act in a similar way. On the contrary, it would fuel protectionism to the detriment to all of us. The FTT proposal, to the extent it should be considered at all, must require both parties of the transaction to be residents of Member States. It is not sufficient to impose such a tax with only one party residing in a Member State introducing taxes on financial transactions.

9. Conclusions

The Commission's proposal for a FTT aims at raising revenue and reducing undesired, so called speculative, financial transactions. As shown in this paper, the FTT is not likely to fulfil any of these purposes. On the contrary, estimates point at lower total tax revenue and financial transactions shifting away from Europe, resulting in remaining or even deeper problems regarding financial instability. The Commission's proposal is contrary to its previous analysis. Recent development (informal ECOFIN of March 30th, 2012) indicates that rethinking may be under way. It is currently unknown in what areas and to what extent this might happen or if the proposal will survive at all.

Alternative measures, formerly discussed by the Commission, could be to extend the VAT system to include financial services or to further explore the proposals on a FAT. There are certainly several severe problems connected to both these alternatives. A FAT would also increase the burden on banks and the there is an obvious risk that margins will increase also in this situation, to the detriment of the private sector investments and growth. In the end, it may well be found that tax measures are not best suited to manage the initial problems of budget deficits and financial fragility that indeed need to be addressed. Structural reform to improve growth prospects is crucial to tackle high debt and budget imbalances in public finances. Reduced spending is likely to better promote growth and investments than substantially increased levels of taxation. Financial instability risks could probably better be mitigated by appropriate regulatory standards, capital requirements and sufficient financial reporting standards to ensure transparency.

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