The Real Economic Impact of a European Financial Transactions Tax

July 2013
About Red Tape Watch!

Analysing the economic impact of European Union regulation

Red Tape Watch! is a series of studies measuring the real impact of European Union regulation of business and the economy. It applies EU modelling techniques to data drawn from EU sources to analyse the cost of EU red tape in terms of jobs and output across the EU and in member states. In other words the EU has already provided some of the numbers, but has not added them together. Red Tape Watch! reveals the true cost of EU red tape.

This report was produced by New Direction – The Foundation for European Reform, a free market, euro-realist think-tank established in 2010 in Brussels. It is affiliated to the Alliance of European Conservatives and Reformists (AECR). New Direction seeks to promote policies and values consistent with the 2009 Prague Declaration to help steer the European Union on a different course and to shape the views of governments and key opinion formers in EU member states and beyond.

The views expressed in New Direction’s reports are those of the authors and do not necessarily reflect the views of all members of New Direction.

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In Brief

- The European Commission has adopted a proposal to implement a common European tax on financial transactions through the enhanced co-operation of eleven member states.
- The aim is to seek a contribution from the financial sector to repair public finances damaged by the financial crisis.
- But applying Eurostat modelling shows that the loss of output in the financial services industry will have knock-on or multiplier effects throughout Europe’s economy, inflicting a loss of around 641,000 jobs:

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- The Commission’s impact assessment of the FTT fails to take this into account and relies on unsubstantiated assumptions about how revenue from FTT would be used.
- Even so, the European Commission describes the tax as “the third-best solution” and enhanced co-operation as a “last resort solution”.
- In recent weeks and months the FTT proposals have been subjected to increasing criticism, not least from governments previously committed to the scheme.
- The Commission estimates that the annual revenues raised are likely to be in the order of €34 billion across the EU11 (around 0.4% of GDP).
- It is likely the proposed tax would double current taxes on capital. The tax is projected significantly to influence the structure of the financial services industry with activity in some markets expected to fall by around 75%.
- Additionally, as the tax will fall on government bonds, this implies an increase in costs for public budgets of around €3.8 billion for the EU11. The current proposals are also seeking to cover regional development banks, increasing the cost of public finance yet further.
- The Commission admits that taxing transactions that raise capital for investment “... could have negative knock-on effects on growth and jobs and the overall competitiveness of the economy.”
- However, the impact assessment suggests that if the revenues were used for debt reduction, tax cuts or productive public investment the net impact of the tax would be neutral or even positive.
• But raising taxes on the productive economy is not an appropriate policy for deficit reduction.
• Tax cuts on labour or corporates are unlikely given the circumstances, and capital flight from the FTT would undermine their effectiveness.
• Policies raising taxes to increase public investment do not have a strong record.
• The impact assessment also attempts to justify the tax by closing the “fairness gap”, citing the economic cost of social tension and political instability. However, a wide range of economic policies could be justified or discredited on the likelihood of social unrest.
• The employment impact of the FTT cannot be ignored. This includes job losses within the financial services industry and also suppliers within computer services, legal and accounting services.

In summary the costs of implementing this policy will reduce economic growth, investment and job creation. It will be difficult to repair public finances when the additional sources of income include government bonds and regional development banks. This involves governments effectively taxing themselves. The tax revenues are uncertain and may be undermined by activities relocating outside of the EU11 or outside of Europe altogether.

The Commission needs to do much more work justifying a potentially disastrous loss of employment and output from the FTT.
1 Europe's Financial Transaction Tax

The European Commission has adopted a proposal to implement a common European tax on financial transactions, the Financial Transaction Tax (FTT). The full range of proposals is described in the European Commission’s report assessing the costs and benefits of the tax. Eleven member states have indicated they wish to develop “enhanced co-operation” to implement the tax – Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain.

1.1 Why a new tax?

In response to the global economic downturn, governments across Europe committed significant resources to prevent the collapse of their financial systems. The European Commission argues that the stabilisation of financial markets has been relatively successful but at a high cost to tax payers.

Governments are now turning their attention to bringing public finances back onto a sustainable path. The European Commission argues that in light of the significant resources committed by the public sector, there is an “absence of a fair and substantial contribution from the financial sector,” and this is the prime justification for the FTT.

The Commission describes the tax as “the third-best solution” and enhanced co-operation as a “last resort solution”. Nonetheless, its impact assessment of the tax detects no net negative economic consequences from the FTT and indeed argues that it might benefit the economies of the FTT eleven. In other words, the FTT is not only ‘fair’, but economically benign.

This paper examines these claims and exposes contradictions at the heart of the tax plans. It applies Eurostat modelling techniques to assess the possible impact of the tax in terms of job losses.

1.2 Revenues from taxing financial transactions

The Commission argues that the tax should cover all financial instruments including shares, government bonds, derivatives and structured products. The Financial Transaction Tax will cover all financial institutions and all markets (organised and non-organised). The proposed tax rates are 0.1% of the consideration paid for trading in securities and 0.01% of the notional value of the underlying for derivatives. Taxes are to be paid immediately to member states where the taxable financial institution is based.

The European Commission estimates that the annual revenues raised by the FTT will be in the order of between 0.3% and 0.5% of GDP. A less ambitious tax introduced by France in the summer of 2012 is expected to generate around €1.1 billion, around 0.06% of GDP. The Commission states that this is “far below” a fair and substantial contribution from the financial sector.

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2 Enhanced co-operation is a mechanism that allows a group of EU member states to pursue further integration within EU institutions without the others being involved. There must be a minimum of nine states in the group.
3 The Commission describes the first-best solution as the introduction of global tax and the second-best solution as a tax across all EU members.
Based on the initial tax rates proposed, revenue estimates are around €57 billion annually for the entire European Union if it were implemented by every member state. These initial estimates allow for market reactions which are assumed to be significant - a 15% fall in securities trading and a 75% fall for the derivatives markets from activity moving outside the taxed jurisdiction or ceasing altogether.

Initial proposals to establish an FTT covering the EU27 failed, and the enhanced co-operation approach was adopted by the eleven states listed above. These account for around two thirds (66.4%) of EU27 GDP, implying total revenue of around €38 billion (€57 billion x 66.4%).

A more accurate measure of revenues was based on the net operating income of the EU banking sector of which the EU11 accounted for 59.8% of the EU27. So the European Commission estimates total EU11 revenues of around €34 billion based on this measure (€57 billion x 59.8%). This suggests FTT revenues would be around 0.4% of GDP.

According to the Commission’s assessment, the proposed FTT is modest and will result in a “rather tiny” increase in the cost of capital. However, the latest data available from Eurostat shows that capital taxes are currently 0.3% of GDP for the EU27. This suggests the proposed FTT would double current taxes on capital in affected countries.

1.3 Implementing the new tax

The European Commission has proposed a “big bang” approach to implementing the new tax. This will involve implementing the proposed common FTT regime at the same time at the EU11 level for all organisations, products and markets. However, implementation of the tax has been delayed, and is not now expected until mid-2014.

2 Unanswered questions and contradictions

The Commission’s proposals and impact analysis paint a sunny picture of the FTT raising higher income for government while enhancing Europe’s economic prospects. The new tax is a ‘win-win’, improving ‘fairness’ and prosperity at the same time for those states implementing it. Such a benign prognosis for a major new tax should of itself raise suspicions, and indeed on a more careful analysis the tax is fraught with problems and contradictions that the Commission has not addressed.

2.1 Taxing themselves

The European Commission points out that institutional investors including pension funds, banks and insurance companies make regular use of some of the financial instruments that will be covered by the FTT. Allowing exemptions to the tax will be challenging as it is difficult to establish what is “... actually linked to the (non-taxable) raising of capital or to the (taxable) trading on secondary markets.” Its preference is for an FTT that has no exemptions, either by product or sector.

Yet the European Commission’s economic impact assessment highlights that the tax will fall on government bonds, implying an increased cost for public budgets. In other words participating governments will effectively be taxing their own public borrowing activities. The increase in the cost
of capital following the introduction of the tax could be about 0.07% (7 basis points). The economic impact assessment provides estimates of an additional cost of public debt of around €3.8 billion for the EU11.

Similarly, the proposals recommend that regional development banks should not be excluded from the FTT. Regional development banks are an important source of funding for public projects, but the Commission suggests an exemption “... might raise the issue of also totally or partially exempting other actors that also provide financing for private or public investment projects ...” Again, governments implementing the FTT will in effect be taxing themselves in a wasteful merry-go-round of higher public borrowing costs.

These problems have recently been raised by the French Government, which is reportedly now arguing for wholesale changes to the FTT⁴.

2.2 The wider impact on the economy

The European Commission’s proposals reference General-Equilibrium modelling undertaken by the DG Economic and Financial Affairs (ECFIN). This modelling investigated the economy-wide impacts of introducing an FTT. The main results from the exercise are that a transaction tax would increase the cost of capital resulting in a decline in the capital stock, a contraction in the economy and a lower level of employment.

The assessment also states that taxing transactions that raise capital for investment “… could have negative knock-on effects on growth and jobs and the overall competitiveness of the economy.” The modelled results are reflected in the impact assessment report which cites a “… negative impact of the tax on economic efficiency and, thus, on GDP.”

However, the impact assessment goes on to describe a number of ways in which the FTT will in practice have no net negative impact on economic performance. In particular it suggests that the proceeds of the FTT could be used either to reduce public debt, to reduce other taxes or for “productive public investment”, eliminating the net impact of the tax. Indeed it asserts that “a positive effect on jobs and growth in participating Member States is not unlikely”.

Taking these three alternatives in turn, reducing debt may seem an appropriate conclusion for many countries with high levels of debt. Indeed, the FTT proposal is originally based on the need to repair the public sector’s finances, on the premise that high public debt resulted in part from the rescue of the banking sector, and the banking sector should therefore pay its share of that cost.

However, while governments have been forced to raise some taxes in response to the deficit crisis, this is usually regarded as a temporary measure, with the risks of harming growth widely recognised. Instead, the economic debate has revolved around whether to reduce deficits by cutting spending or to encourage growth by allowing debt to rise. The idea that governments could reduce deficits by increasing taxes and so promote growth contradicts not just the policy of key member states such as Germany but also those who favour a Keynesian approach to the crisis.

⁴ See http://uk.reuters.com/article/2013/07/11/uk-france-tax-eu-idUKBRE96A0GH20130711
A better option might be one that lowers labour or corporate taxes, and the impact assessment predicts higher growth under this scenario. But the idea that highly indebted governments would use FTT in this way when its specific purpose is to reduce debt seems implausible. Besides, if this were such a good idea, why has it not been attempted long ago? The answer is clear: taxes on capital are relatively low because capital is much more mobile than labour or even companies, and doubling taxes on capital is likely to lead to capital flight\(^5\).

In other words any revenue from the FTT would not generate enough for compensatory tax cuts on other areas of economic activity to prevent a fall in output.

Besides, the impact assessment implicitly dismisses this possibility. While it states that, due to its size and attractiveness, no negative effect should be expected on the financial capacity of the EU11+ and the EU27 market. But this conclusion is contradictory. If the taxed area is large enough not to drive business elsewhere, why is the EU11 option only ‘third best’ after a global-wide and an EU27-wide tax?

The third scenario offered by the Commission’s impact assessment is that the proceeds of the FTT were spent “on growth enhancing public investment”, in which case GDP would increase by 0.2% to 0.4%.

Again, such an analysis seems wilfully naïve. The general record of government spending is the opposite of “growth enhancing”, and to assume that the proceeds of the FTT would be spent more efficiently by governments than by the private sector is excessively optimistic to say the least. Following this logic contradicts the lessons of history, particularly in Europe.

Finally, the impact assessment offers a justification for the FTT in closing the “fairness gap”. It claims that, without addressing the fairness gap, Europe risks “… social tensions, general strikes and political instability.” The impact assessment estimates the cost of a one day general strike of up to 0.2% of GDP. However, throwing such a number into the ledger is an absurd piece of wishful thinking, and has no place in a serious analysis. Any number of economic policies could be justified or discredited on the possibility of social unrest.

### 2.3 The impact of FTT on employment

The impact assessment suggests that on balance there will be no negative employment effects from the FTT. The European Commission makes this claim based on the recycling of FTT revenues and the triggering of demand in sectors outside of the financial services industry.

But notwithstanding the key purpose of the FTT to restore public finances, the employment impact of the FTT cannot be ignored. The loss of output in the financial services industry will have knock-on or multiplier effects throughout Europe’s economy.

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\(^5\) As the experience of Sweden, which introduced an FTT between 1984-1991, showed. See for example *EU Direct Taxes*, New Direction, 2012.
Eurostat has published an Input-Output model which allows wider economic impacts to be modelled across the EU27 economies. In other words it is possible to measure the impact of the loss of output based on the Commissions’ own assessment of €34 billion revenues raised from the FTT\(^6\).

If we model the wider impacts across the EU27 economy using the macroeconomic impact (Input-Output) model as outlined above, we find a loss of around 641,000 jobs. This includes job losses within financial services and also suppliers within computer services, legal and accounting services.

It is possible to estimate how the FTT might impact on specific member states within the EU11 and the remaining sixteen states. The estimated employment impact of the FTT imposed in each Member State is set out below\(^7\).

The overall impact of 641,000 job losses includes employment losses among Member States outside of the EU11 and this is likely to be in the order of 65,000 job losses\(^8\). The majority of these job losses, outside of the EU11, are likely to arise in the UK, particularly in London, where a large proportion of service providers to the EU’s financial sector are located.

Within the EU11 the FTT in Germany is likely to result in the largest loss of jobs, nearly 180,000.

**Estimated impacts of FTT imposed in each Member State**

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*Source: Eurostat modelling*

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\(^6\) Equivalent to €33.7 billion in 2008 prices, the base year of the impact model.

\(^7\) The value of the FTT in each EU11 member state is based on the GDP share measures shown in the European Commission’s economic impact assessment.

\(^8\) Based on the difference between financial sector linkages across the whole of the EU27 and financial sector linkages with each individual Member State and the rest of the EU27.
3 Conclusion

The FTT’s potential impact on jobs gives serious cause for concern. Some of this impact might be offset, depending on how effectively the revenue eventually raised is used. But given the massive negative impact of the tax, the Commission needs to do a much better job of analysing the true net costs involved, rather than wishing them away with assumptions about government spending and social stability.

In recent weeks and months the FTT has been questioned not just by the financial services sector and those countries opting out of the tax (the UK Government has launched a legal challenge to it) but even by the governments who initially signed up to it.

European officials now think that the tax will not be implemented until mid-2014, and that there may well be significant changes to how it is implemented.

The evidence outlined in this report shows that the downside risks of the Financial Transaction Tax are significant. The potential loss of hundreds of thousands of skilled jobs at a time of economic weakness should not be risked.

It is surely time to bury this tax once and for all.

4 References

European Commission (ECFIN), Macroeconomic Implications of Securities Transaction Taxes

European Commission, Impact Assessment

Eurostat Input-Output database
http://epp.eurostat.ec.europa.eu/portal/page/portal/esa95_supply_use_input_tables/introduction

Eurostat Tax Revenue Database

Impact modelling

Eurostat has published an Input-Output model which allows wider economic impacts to be modelled across the EU27 economies. The model shows transactions between 65 industrial sectors and final demand markets (exports, investment, government expenditure and household consumption). The model was used to develop “Type II” employment, output, GVA and income multipliers for the EU27 economy. Type II multipliers treat households as an endogenous sector (allowing induced effects to be captured).