Irish Congress of Trade Unions

# The Case for a Financial Transaction Tax

## A Fair and Substantial Contribution from the Financial Sector

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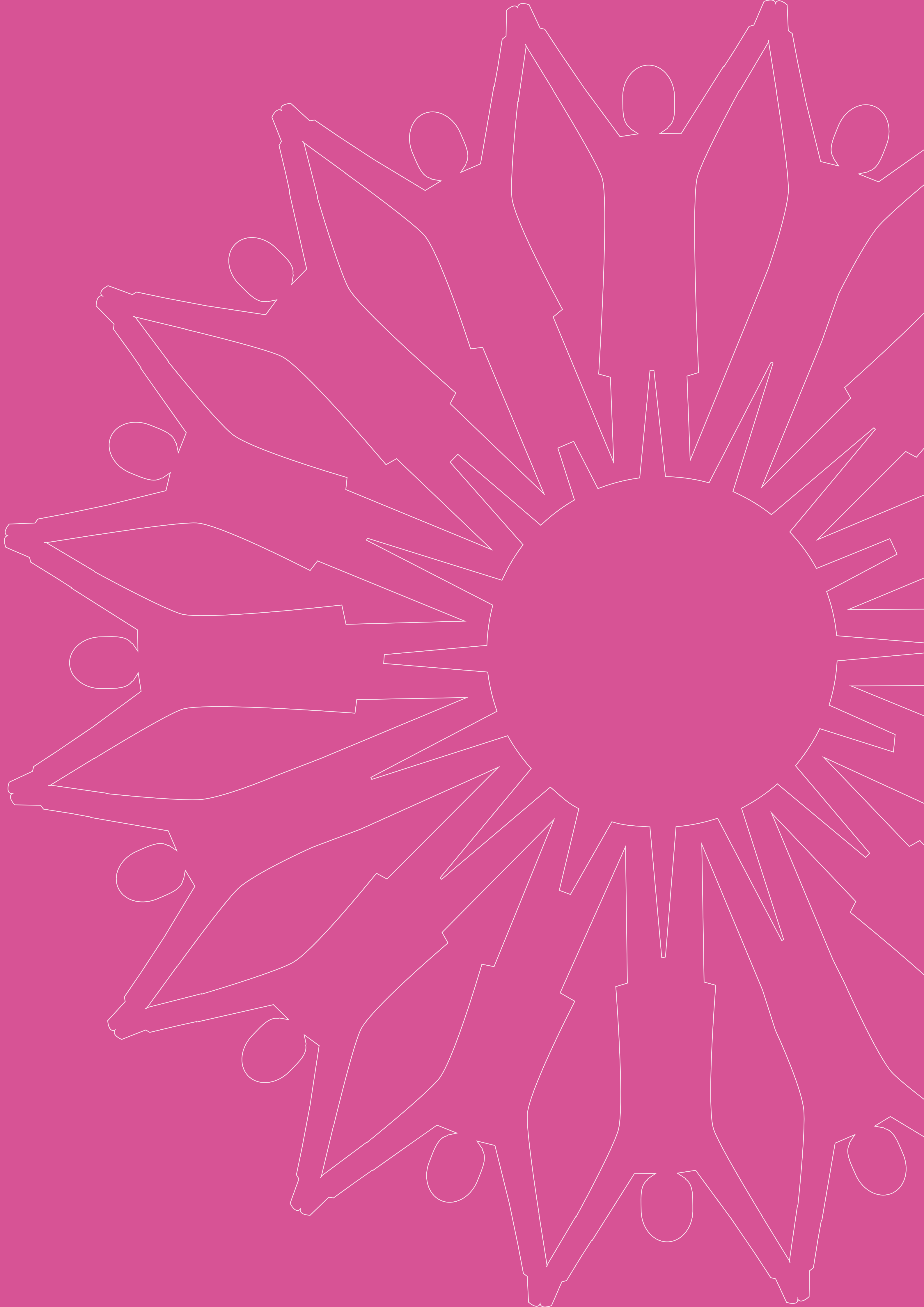

**There is a strong consensus across Europe and beyond that the financial sector must not only contribute more, but that it must also be subject to greater legislative oversight.**

# Financial Transaction Tax - a Fair and Substantial Contribution from the financial sector.

The current crisis emanated from within the global financial sector. Yet, it is citizens and governments that have borne the bulk of the cost to date.

Financial sector support – state support for failed or ailing banks – has cost about €4.6 trillion or 39% of EU27 GDP, in 2009.[1]

The European Commission has proposed measures to ensure a common European approach in averting a repetition of past practices in the financial sector, particularly with regard to risky behaviour of some segments of financial markets.[2]

There is a strong consensus across Europe and beyond that the financial sector must not only contribute more, but that it must also be subject to greater legislative oversight. In June 2010 the European Parliament asked the Commission:

> *"To prepare a report considering as to how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system".*[3]

1 European Commission Staff Working Paper. Impact Assessment Accompanying the *Proposal for a Council Directive on a common system of financial tax and amending Directive 2008/7/EU* (hereafter EU Impact assessment)

2 European Commission Proposals for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC ( Hereafter EC proposal)

3 EU Impact Assessment

The Commission proposed a Financial Transaction Tax (FTT) of 0.1% on transactions in bonds and equities, and 0.01% on derivatives transactions. The Commission argued that: 'Given the absence of a legally binding international agreement, the Union, representing the world's largest financial services market, has to assume a leading role by the coordinating, the establishment and the implementation of a taxation of a well-designed FTT, that will create a stronger momentum in the process towards concluding an international agreement'

The aim of the FTT was twofold: to raise revenue to ensure the financial sector pays a 'fair share' of the cost of the crisis and to reduce the speculative trading that allows the financial sector too much power over the productive economy.

While this proposal did not secure the necessary unanimous support from member states, it was not consigned to the political limbo. At the June 2012 ECOFIN meeting the proposal was withdrawn to allow a number of countries to proceed with an FTT proposal under the procedure of 'enhanced co-operation, whereby at least nine countries can initiate a proposal for a directive covering these countries.

Eleven EU countries are pushing ahead with an FTT tax to be introduced in their 1st January, 2014. At the October ECOFIN meeting in Commissioner Algirdas Semeta said that Belgium, Slovenia, Slovakia, Greece, Italy, Spain, Portugal, Estonia and Finland could make the leap together with France and Germany.[4]

A form of FTT will apply in at least nine countries from January 2014. While others may join at a later stage, the later a country joins the less of a chance they have to shape the final proposal. The question has now changed from 'will it work?' to 'how will Ireland be affected when other countries move towards an FTT?'

4 http://www.reuters.com/article/2012/10/09/us-eu-ftt-support-idUSBRE8980IE20121009

The financial sector does not want to pay this tax and has issued dire warnings of the flight of capital and jobs. The *Financial Times* has suggested that any threats of an exodus "should be faced down, not just because they are unreasonable but because they are of questionable credibility."

A London-based banker Avinish Persaud,[5] previously head of the world's largest institutional investors - State Street Bank, commenting on the torrent of abuse directed at the FTT said that what draws him to this subject is the "disproportionate, inconsistent and disingenuous arguments used by my fellow bankers against this proposal." [6]

The triumph of the 'new-classical' economics from the 1970's onwards has been described as an 'opium of the intellectuals, which captured first the economics profession, then opinion-formers, media and politicians; first the traditional right, then liberals and even much of social democracy".[7]

Changes in political power which accompanied this ideology coincided with changes in taxation objectives. The past two decades witnessed the elimination of taxes on financial transactions in quite a number of countries, resulting in less and less control of the financial sector.

There is a strong political lobby across Europe and beyond in favour of an FTT and there is a strong intellectual lobby - with inside knowledge of the financial markets - which contends that many of the arguments against the tax are "part of the obfuscation strategy of invoking the fear of the unknown."[8]

5 Persaud is Chairman of Intelligence Capital Ltd. He was previously head of the world's largest institutional investor, State Street Bank, and before that head of JP Morgan's Commodity and Currency. He was listed second on Prospect Magazine's panel of "best contributors in the public conversation on the financial crisis".

6 Avinash Persaud' The Economic Consequences of the EU Proposal for a Financial Transaction Tax ' March 2012.

7 Lipton, M, Griffith-Jones S and Wade R., 'A Three Step Programme to re-civilise capitalism'. *The Guardian*. 7 December 2011

8 Persaud. op cit

There is plenty of evidence that small transaction taxes will not only make this sector pay its contribution, but will reduce the risk of the recurrence of economic crises based on speculative bubbles. At the heart of the argument is the power the financial sector has to ruin the productive sector of our economy; casino capitalism versus productive capitalism.

The FTT is opposed by some very powerful and influential vested interests. Conventional economists who completely overlooked the largest asset bubbles in the history of the world contend that an FTT will cause a loss of liquidity, will have no impact on the volatility it seeks to curb and will raise the cost of capital and slow growth.

The most obvious reason for scepticism about these criticisms is that with computerisation and deregulation there has been a sharp decline in transactions costs and an "increase in transactions costs implied by the tax would just raise them back to the levels of early or even mid-90's".[9]

Markets were healthier then than they are now and there was no loss of liquidity.

Despite promises of by governments since 2008, there has been very little reform of the financial sector. Despite its culpability in this crisis the influence of the financial sector lobby remains hugely influential.

It is our view that there is now sufficient evidence to show that transaction costs will bring both economic costs and benefits but that, on balance, we are likely to see a net economic gain.[10]

9 Baker, Dean. Centre For Economic and Policy Research, Washington. 'Ken Rogoff Misses the Boat on Financial Speculation Taxes' October 4, 2011

10 Schulmeister draws attention to the flaw in the model used by the European Commission in that it pays insufficient attention and analysis of the positive outcomes emanating from this tax.

# Financial Transaction Tax: the details

The proposed tax rates would range from 0.1 to 0.01%. The rate is set to ensure that:

a) it is not too large to encourage tax evasion,

b) it is not too small that there are no longer any hindrance to reckless, speculative activities and

c) it will not induce any considerable 'emigration' of transactions to other 'FTT-free' marketplaces .

There are a number of compelling reasons behind the introduction of a Financial Transactions Tax by the European Union:

1. **The sector has cost citizens and future generations massive sums in Bailout costs.** A Financial Transaction Tax ensures that the financial sector contributes to covering the costs of the crisis. The EU has committed €4.6 trillion euro in bailout funds. These rescue packages placed a heavy burden on the present and future generations of citizens.

2. **The sector is exempt from VAT and is not therefore paying its fair share of taxes.** This will come as a surprise to many SME owners for whom VAT returns are a regular chore. From an economic perspective it gives the financial sector an unfair advantage over other sectors of the economy. Revenue losses from the VAT exemption are estimated by the EU to be circa 0.15% of GDP, which for the EU27 translates into approx €18 billion.[11] The opponents of an FTT often claim that the VAT exemption is balanced by an inability of the sector to reclaim VAT on inputs. However, Hemmelgarn et al conclude that, even after taking the returnable VAT into consideration, most studies point to a net revenue loss.[12] This exemption has inflated the profits of the financial sector.

3. **Much Financial sector trading behaviour involves excessive risk taking and has destabilising effects on the real economy** This is particularly true of derivatives trading. The use of derivative trading by Anglo Irish is a major cause of our financial crisis. The FTT tax aims to de-incentivise excessively risky activities, thereby stabilising markets.

4. **There is too little regulation and supervision of the sector.** This tax is to complement the 'far reaching reforms' the EU is proposing, to bring the financial services sector to the service of the real economy, in particular to finance growth.

5. **To generate additional revenue for general budgets.** There will be a new revenue stream with the objective of gradually displacing national contributions to the EU budget.[13] This additional revenue could be used to reduce debt or to boost growth in the economy.

6. **Excessive management remuneration packages.** Fuelled by bonus schemes these encourage irresponsible risk.

7. **Implicit 'guaranteeism'.** This is the argument that 'knowing' that the state will always bail out the banks – 'too big to fail' - out leads to excessive risk-taking.[14]

11 European Commission Press Release September 2011 http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1085&format=HTML&aged=0&language=en&guiLanguage=en

12 Hemmelgarn T, &Gaetan & Zangari Ernesto, Cpt 4 'Can Tax Policy Help to Prevent Financial Crisis?' in Alworth JS and Arachi G (ed) *Taxation and the Financial Crisis*, 2012

13 EC proposal

14 EC Proposals

The European Commission produced an Impact Statement which analysed two options: a financial transaction tax (FTT) and a financial activities tax (FAT), and concluded that the FTT was the preferred option. FAT is a tax on excessive profits and remuneration. These concepts can be made nebulous by accountants and are thus open to evasion. While the FAT but has a number of limitations it is, to the banking lobby, the lesser of two evils. Endless discussions as to FTT versus FAT only serve the interests of the banking lobby.

A FTT is the strongest option, because it would discourage high-frequency trading and help reduce excessive volatility; FAT would not have the same direct impact on trading behaviour. A FTT would also raise a greater amount of income; due to the enormous volume of the tax base, the tax rate could be very small while the tax receipts might be considerable. Avoidance of the FTT would be more difficult because it is collected automatically when a deal is settled, thus avoiding the use of tax management strategies employed by the wealthy. It is also much cheaper to collect FTT, than either income tax or VAT.[15]

The European Commission proposals involve taxing the 85% of *financial transactions* that take place between financial institutions. In the current debate its remit covers currency markets and includes trading in shares, bonds and derivatives. If you were buying shares at €10,000 you would be liable for a €10 tax.[16]

The proposed FTT is not to be imposed on house mortgages, bank loans, insurance contracts and other 'normal' financial activities carried out by individuals or small businesses. Private households and SME's are therefore effectively exempted.

15 Schulmeister S., Schratzenestaller M., Picek O, 'A General Financial Transaction Tax - Motives, Revenues, Feasibility and Effects'. Austrian Economic Institute

16 European Commission http://europa.eu/rapid/pressReleasesAction

Primary markets are also excluded from the scope of the tax so as not to undermine the raising of capital by governments and companies, as are transactions with the European Central Bank and national central banks.

A FTT is a progressive tax and will fall mainly on the richest institutions and individuals - short term speculators, hedge funds and high frequency traders who will pay more than long term investors such as pension and insurance funds. Not all consumers of financial products will pay equally, as most don't trade in bonds, derivatives or hedge funds.

The EU Impact Statement concludes that it will have a progressive distributional effect; its impact will increase proportionally with income, as higher income groups benefit more from the service provided by the financial sector.[17]

At a rate of 0.1% for bonds and shares and 0.01% for other kinds of transactions such as derivatives, the tax could raise approximately € 57 billion per year, assuming all 27 EU countries introduced the tax[18] Levied across the nine countries that have announced their willingness to proceed on their own, including the largest economies on the continent - Germany, France and Italy - the tax will raise €18 bn.[19]

However, this should be considered a first stage. Schulmeister *et al* contend that "the amount of potential revenues from a general FTT are so big that they could substantially finance truly great projects like "a Global Marshall Plan, or projects to improve the infrastructure within the EU, in particular with respect to the challenges posed by climate change."[20]

17 Impact Statement

18 http://europa.eu/rapid/pressReleasesAction.

19 Persaud, A., 'The Economic Consequences of the EU Proposal for a Financial Transaction Tax' March 2012.

20 Schulmeister S, et al General Financial Transaction Tax - Motives

In an ideal world this would be a global tax but it is not true that it has to be global to work. The authors of the Austrian Economic Institute research on the revenues, feasibility and effects of a general FTT argue that "an FTT need not be introduced globally, there do exist options which would allow 'forerunner countries' to introduce such a tax without doing much harm to their financial markets."[21]

If it is not feasible to include all countries, the report recommends a number of other actions that could also be taken including:

- special higher exit taxes
- intelligent tax design
- political pressure on tax havens
- bilateral contracts over the treatment of securities[22]

In a review of the main characteristics and impact of FTT's around the world, Beitler[23] concluded that while the size, scope and design of FTT's varied greatly, some key lessons and best practices could be elicited from these diverse experiences, namely:

- The lower the rate and the simpler the design, the more revenue is collected.
- Their successful introduction and maintenance depend on the government's ability to resist vested interests. In Brazil, Japan and India where FTT were successful in raising high revenue and stabilising markets, they were removed or diluted as a result of the lobbying effects of the financial sector.
- Their success also depends on the manner in which the tax is implemented as well as the rate at which it is set. Much of the literature reviewed shows that FTT both increase and decrease volatility in different situations.
- They are a significant source of revenue for both developed and developing countries, oscillating around 1% of GDP, but in the case of Argentina have risen to as high as 11%.
- They can be 'plumbed in' to existing tax collection mechanisms, making implementation simple and collection costs small.
- In terms of regulatory effect in reducing short term speculative trading without affecting the functioning of their financial markets, we can look for best practice at Taiwan, Chile and India's multi-tiered tax regimes.
- The UK's model is an example of a well designed tax that avoids both substitution and migration.
- The Swedish model was badly designed and as a result its effects were damaging; it can however provide useful insights into what not to do.[24]

## The Swedish Model

The next section compares the Swedish FTT to the UK stamp duty tax. The arguments are largely informed by the work of Schulmeister and Picek. There is general agreement that the Swedish tax is an example of a badly designed tax, while the UK is of a well-designed tax.

Opponents of the tax frequently cite the case of Sweden which resulted in "significant migration of trading in Swedish stocks from Stockholm to London."[25]

21 Schulmeister S Visiting Scholar at IMF/Fiscal Advisory Department . ‚Short-term Asset Trading, long-term Price Swings, and the Stabilizing Potential of a Transactions Tax' - October 2010. Paper presented at an IMF seminar on November 2012.

22 Schulmeister et al.'A General Financial Transaction Tax – Motives'

23 Beitler did a case study analysis of eight countries, Taiwan, Brazil, Argentina, Japan, Peru, China, the UK and Sweden.

24 Beitler, Daiana. Raising Revenue, A review of Financial Transaction Taxes throughout the world. A report for Health Poverty Action and Stamp Out Poverty September 2010

25 FitzGerald, John/with Central Bank of Ireland Staff. The EU Financial Transactions Tax Proposal: A Preliminary Evaluation

In 1984 Sweden introduced a tax of 0.5%, on the purchase and sale of equities. There is general agreement that the Swedish Tax was flawed in its design, one only had to pay when the transaction was carried out by a Swedish broker, which made tax avoidance relatively easy. The Swedish experience merely reminds us to be vigilant in the design and implementation of the tax. For example, the tax, which was levied only on Swedish brokers, facilitated tax avoidance by simply allowing local brokers to switch to using foreign broker services.

The UK stamp duty is a:

> *worldwide tax on ownership transfer of companies incorporated in the UK, independently of where the transaction takes place and whether the trader is foreign or domestic...foreign incorporated companies issued or listed on the London Stock Exchange are not subject to the tax.*

The UK levies stamp duties on any purchase of shares at the rate of 0.5%, with a special 1.5% 'exit charge'. The latter is an anti-avoidance measure.

In 1986 the UK levied a 'stamp duty reserve tax' (SDRT) to properly levy stamp duty on the stock exchange. This was levied not only on the registration of documents of transfer but also on agreements to do so. Prior to this it had been possible to avoid the tax by buying and selling a stock between ownership registration dates every two weeks on the London Stock Exchange.

SDRI is paid on all agreements to transfer, while any transfer where a formal document is produced falls under 'ordinary' stamp duty. The tax is paid, irrespective of where the trading takes place, if it is a company incorporated in the UK.

This is a successful tax, with low collection costs and which brought in £3.46 billion - €5billion - which was 0.7% of total UK tax revenues, in 2005/6.[26]

26 Schulmeister et al., 'General Financial Transaction Tax – Motives',

Although only 20% of UK share trades are covered by the tax, it has an inbuilt anti-avoidance mechanism in the form of the issuance principle. This tax has not driven share transactions off shore - and the UK would be uniquely vulnerable to such a process given the number of grey jurisdictions within its sovereignty such as the Isle of Man, the Channel Islands, and the British Virgin Islands.[27]

The European Commission borrowed the issuance principle from British tax law in designing the FTT proposals. The ownership of an instrument is only legally established when stamp duty is paid, those engaging in tax avoidance schemes involving the 'lending' of shares are involving themselves in a risky business which could involve loss of the share concerned.

While the UK stamp duty on shares provided part of the template for the FTT it was seen by the Commissioner as being inadequate to the requirements of an effective FTT:

> *"I do not believe this should be modelled on the UK stamp duty. That tax has too limited a scope and leaves most transactions - and notably those of professional dealers – untaxed. With such an approach, we would not meet our policy objectives."*[28]

One of the main fears about introducing FTT's is that share transactions would 'move offshore'; Schulmeister *et al* make a number of important points in this regard.

Firstly avoiding duty by moving share transaction moving offshore is impossible since stamp duty also applies to overseas transactions of UK shares.

27 'Crown dependencies: the Loophole Islands'. *Guardian* 28 June 2012

28 Commissioner Algirdas ŠemetaEuropean Parliament Plenary Debate: Brussels, 23 May 2012

If in practice, this wasn't happening, they suggest another couple of steps the UK authorities could take, such as

- charging interest on the stamp duty on share transactions that take place overseas, which becomes payable with the original charge when the relevant legal documents are returned to the UK, or
- levying an exit-charge on initial public offerings on overseas stock markets.[29]

The main lesson from the British tax regime is that FTT can work well "if legislators are willing to ensure that financial innovations or other tax avoidance measures threatening the tax base are included or charged with a higher rate upon leaving the tax regime."[30]

## The Issuance Principle & the Residence Principle.

The Commission proposal contained what was termed the 'residence principle' under which the tax would apply to all financial transactions subject to the following conditions:

1. At least one party to the transaction is established in a Member State and a financial institution established in the territory of a Member State is party to the transaction, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction; or
2. The transaction involves a financial instrument issued by legal entities registered in the Union.

In May 2012 the European Parliament introduced the concept of the 'issuance principle' into the directive on the basis that: "A combination of both the residence and the issuance principles would ensure that the FTT covers all transactions and all actors."

**Residence principal:** Any firm involved in a transaction located in the FTT-zone will have to pay the tax, and also any firm in the world acting on behalf of any firm located in the FTT-zone. In addition and crucially if a FTT-zone firm (e.g. in Germany/France) and non-FTT-zone firm (e.g. London) complete a transaction, then both firms must pay the tax to the FTT-zone member state.

Example: If a German bank carries out a financial transaction with an insurance company in London, the tax is due twice to the German tax authorities. The UK tax authorities do not receive any revenue, but the UK firm still pays the tax.

**Issuance principal:** Any firm anywhere in the world involved in a transaction of a security originally issued in the FTT-zone must pay the tax.

Example, Siemens shares issued in Germany and traded between a Hong Kong institution and one in the US will pay the tax.

29 These suggestions were taken by Schulmeister from the work of Hawkins-McCrae, 2002.
30 Schulmeister. op cit

## Financial Transactions Tax - the theoretical background

The two economists most associated with proposals for such taxation are John Maynard Keynes and James Tobin. Keynes, writing during the Great Depression, was the first economist to propose such a tax, arguing that the real economy cannot be left to the casino gambling activities of stock exchanges. He proposed a transfer tax on all transactions to mitigate "the predominance of speculation over enterprise."[31]

Keynes was referring solely to internal developments in the US.

The concept was internationalised by James Tobin in the 1970's when he argued for a tax which, by raising the cost of currency transactions, would reduce their volume and destabilising effects. Tobin famously referred to 'throwing sand in the wheels of financial markets' to enable national monetary policy to respond to domestic macroeconomic needs.

In the aftermath of the 1987 stock market crash, Summers and Summers proposed a FTT for the US arguing that "such a tax would have the beneficial effects of curbing instability introduced by speculation, reducing the diversion of resources into the financial sector of the economy, lengthening the horizons of corporate managers, concluding that the efficiency benefits from curbing speculation are likely to exceed any costs of liquidity or increased costs of capital that come from taxing financial transactions more heavily."[32]

Understanding why 'throwing sand into the wheels of financial markets' is necessary is key to understanding the root causes of the current crisis.

31 Keynes, J. M. The General Theory of Employment, Interest and Money, New York, 1935

32 Summers, L., and Summers V, 'When financial markets work too well: A cautious case for a securities transactions tax' . Journal of Financial Services Research, Volume 2 Numbers 2-3 1989

The period from the 1990's to the current crash of 2008 saw an enormous expansion of financial transactions, fuelled in part by financial innovations particularly in derivatives and automated trading, a process that many economists argue shifted economic activities from the "real economy" to financial investment and short-term speculation.

Schulmeister et al show in their research that:

> *"There is a remarkable discrepancy between the levels of financial transactions and the levels of the 'underlying' transactions in the 'real world'. e.g., the volume of foreign exchange transactions is almost 70 times higher than world trade of goods and services. In Germany, the UK and the US, the volume of stock trading is almost 100 times bigger than business investment, and the trading volume of interest rate securities is even several 100 times greater than overall investment."*

These discrepancies have risen tremendously since the late 1990's with financial transactions expanding several times faster than transactions in the 'underlying' market for goods and services – 'real-world-transactions.'

Trading in derivatives markets has expanded significantly more than trading in spot markets. Globally, derivatives trading volume is about 50 times higher than world GDP, whereas spot trading is 'only' 7.5 times world GDP. In Europe and the USA, these ratios are significantly higher. [33]

It is difficult to disagree with the authors when they conclude that these massive increases in financial-transaction volumes constitute a danger to the real economy and that the power of finance has to be curbed. It is "like a giant combine harvester, destroying too much of the grain, leaving only too little to consume, or to store and sow."[34]

33 Schulmeister et al. 'A General Financial Transaction Tax' -

34 Patomaki H., 'Democratising Globalisation - The Leverage of the Tobin Tax', 2001.

# Derivatives

Derivatives call for money to change hands at some future dates. In the context of Ireland's banking crisis everyone will understand Warren Buffet's[35] explanation of how new derivatives used by a capital management company caused a major crisis in the US in 1998.

> *"The particular derivative used was known as total-return swaps - for example, Party A to a contract, usually a bank, puts up all of the money for the purchase of a stock while Party B, without putting up any capital agrees that at a future date it will receive any gain or pay any loss that the bank realizes."*

Buffet said on reading about the derivatives activities of major banks, "the only thing we understand is that we *don't* understand how much risk the institution is running."

Speaking to his company's AGM in 2002, he presciently warned that the "derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some even makes their toxicity clear."

Buffet described the attractions of derivatives as follows:

> *"Almost invariably they are favoured either by the trader who was eyeing a multi-million dollar bonus or the CEO who wanted to report impressive 'earnings' (or both). The bonuses were paid, and the CEO profited from his options. Only later did shareholders learn that the reported earnings were a sham."*

He went on to point out that Governments and Central banks have, to date, found no effective way to control, or even monitor the risks posed by these contracts.[36]

Dean Baker, Co-Director at the Centre for Economic and Policy Research, Washington, had this to say about the huge increase of the economy's resources being used in the creation and trading of financial assets:

> *"Finance is an intermediate good, like trucking. Unless this enormous expansion of the financial sector was associated with a better end result (e.g. more effective allocation of capital or more secure savings) then it is difficult to see any economic benefit from the increased resources being consumed by this sector. It is as though we had five times as many people and trucks used in the trucking sector, but no improvement in delivery times or other identifiable service benefit."*

The resources, he goes on to argue, that would have otherwise been committed to the financial sector can instead be employed in a sector where they can have measurable economic benefit - an important and often overlooked benefit. In principle at least financial markets in turn will "allocate capital in ways that support growth if major actors focus on seeking long-term investment opportunities."[37]

35 Buffet is CEO and primary shareholder of Berkshire Hathaway. He is frequently referred to as the most successful investor of the 20th c. He famously referred to derivates in 2002 as potential weapons of mass destruction.

36 Berkshire Hathaway Inc. 2002 Annual Report. Feb 21 2003

37 Baker Dean, Centre for Economic and Policy Research, Washington.' The Benefits of Financial Transactions Taxes'. Statement to the Bundestag, May 17, 2010.

## The Effects of a Financial Transaction Tax

The European Commission's initial Impact Assessment reckoned that with a tax rate of 0.1% there would be a drop in GDP of -1.76% in the long run.[38] This figure was later modified by the EC to -0.5% and then down to -0.2%, 'the worse possible scenario'.[39]

However, the flaw in the economic model used by the Commission is that it primarily analyses the negative effects of the tax and underestimates the positive contributions of a FTT to macroeconomics. Jones and Persaud examined the effects of a FTT on three levels of GDP, starting with the European Commission estimates, and then modifying them to include important elements that are omitted.

They conclude that the positive effects are more likely to compensate the negative effects and that the impact on GDP of an FTT is likely to be positive, at around a minimum of +0.25%.[40] Their work shows that the overall positive impact on growth could be even higher and they identify a number of channels through which the FTT could support sustained growth and further increase GDP:

- The effects of the FTT on consumption could lead to an it expansion of total aggregate demand which would have a positive effect on the level of GDP (an aspect that is entirely neglected by the commission)
- Using the increase in tax income for fiscal consolidation could reduce the cost of government debt, which could in turn crowd-in private investment
- Using the increase in tax revenue to increase government investment could have both short term and long term positive effects on growth. [41]

Factoring in the positive as well as the negative effects of the tax on growth produces a very different picture from the initial gloomy estimate of the Commission.

A further possibility for increasing the positive effects on GDP comes from the possibility of a more efficient functioning of the labour market if there were more science and engineering graduates for real engineering, than for financial engineering. This point was made recently by Martin Naughton of Glen Dimplex who, in an interview the Irish Times said that "we should concentrate more on making things and less on financial engineering."

The unfair advantage that VAT exemption gives the financial sector means that shareholders get higher profits or managers can get higher pay, such as bonuses or stock options. The 'earnings premium' at director level in the financial services sector is estimated to be 40%.[42]

Should, as a result of the FTT, the relative income of some of the highest paid employees in the financial sector be relatively lowered, then it could encourage some of these very bright minds to move to activities that could enhance the present and future competitiveness in Europe. This should lead to another qualitative positive impact on GDP by allocating human resources into the more productive sector of the economy.[43]

38 Impact Assessment
39 Griffith-Jones S., and Persaud, A Financial Transaction Taxes
40 Should the FTT, for example, decrease the probability of crises by 5%, (which is a very low assumption) , and the cost of GDP lower growth in the long term due to crises were around 7%, ...then the positive impact of the FTT on the level of GDP, due to crisis avoidance, could be a 0.35% of GDP. In that case, the net effect of the FTT on the level of GDP would be +0.25 % (if we combine the negative impact estimated by the Commission model of -0.1%, with the positive one just estimated of +0.35%). Jones and Persaud

41 Jones and Persaud op. cit
42 European Commission Technical Fiche, Tax contribution to the Financial sector http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_ sector/fact_sheet/tax-contribution-fin-sector.pdf
43 Jones and Persaud op cit

The first cry of opponents of any reform in the financial sector is that 'pensioners will pay for this'. Pensions exist in the real economy which would benefit from restricting speculative trading in financial products. Existing private pension funds have been casualties of the speculative financial bubble of the early years of this century, with many private pension funds in trouble. One of the main purposes of a FTT is to reduce the incidence of financial crashes and pension funds can only gain from this.

Even accepting this as a cost of the tax, it would be marginal compared with benefits brought about by financial stability, which are more likely to boost pensions.

Jones and Persaud's research demonstrate that the positives from a FTT will more than offset the passing on of the tax to the consumer, for of the following reasons:[44]

**Firstly,** the existing instability in markets is costing pension funds. If the tax brought an increase in financial stability, the benefits are likely to offset the slight costs, boosting pension pots. If a 0.1% FTT reduced the incidence of financial crashes by just 5%, then the increased expected return on pension funds would be higher than the cost of the tax.[45]

**Secondly,** the tax will therefore fall heaviest on short term speculative trading and less on long term investments generally preferred by fund managers. Most pension fund investments are in the "buy and hold", long term category, so it is the turnover period that is crucial when calculating the costs.

**Thirdly,** the FTT tax compares favourably with annual pension management costs, as shown by Persaud. In the case of a turnover of 50% of its funds, every 3.5 years the average pension fund would pay 0.03%.

This compares with annual management and transaction costs of pension fund assets of over 0.69%, which are 23 times the incident of the tax.[46]

All proposals involving change will provoke opposition from those who have an interest in the status quo. This opposition will be grounded in self interest but will be cloaked in a concern for the public good, often expressed as a concern for the welfare of pensioners or employment levels. The issue of pensions and the FTT has been dealt with. On the issue of jobs, it is notable that even the Central Bank/ ESRI review is quite tentative on the possible levels of job changes which would arise from an FTT. It states:

> *"… it is possible that some firms could choose to leave Ireland in response to the tax which would result in a reduction in financial sector output, employment, and existing corporation tax revenue."*[47]

The analysis suggests that the firms with the highest propensity to migrate following the introduction of the tax are likely to be in the non-banking sectors which account for the smallest share of gross value added. This clear statement of analysis is elided by the following piece of speculation:

> *"Nevertheless, the relocation of even a small number of large IFSC banks or fund administration firms which would result in a loss of corporation tax revenue and an increase in unemployment could offset the initial increase in revenue from the FTT."*[48]

Industrial policy in advanced economies involves making choices about where jobs are. As far back as our accession to the EEC in the early 70s, we decided that certain jobs would disappear to be replaced by other ones.

44 Griffith-Jones S. and Persaud A., 'Financial Transaction Taxes', February 2012
45 Persaud, A. The Economic Consequences of the EU Proposal for a Financial Transaction Tax March 2012.t

46 Persaud op. cit.
47 Fitzgerald, John & Central Bank of Ireland. EU financial transactions tax proposal: a preliminary evaluation ESRI
48 Fitzgerald, op cit

This is the underlying assumption in IDA policy. It is interesting how the debate on Irish education and our shortages of maths and science graduates does not connect on the role of the financial sector.

The 12.5 % Corporation Tax is rightly considered a cornerstone of Irish jobs policy. To the extent that Irish isolationism on an FTT may make it difficult to maintain the rate it is potentially destructive of jobs in other sectors of the Irish economy.

Minister Noonan explained to the Dáil in May of this year why the Irish Government would be opposing a FTT and based his arguments on the ESRI/ Central Bank research report.[49]

a) the "net revenue gain for Ireland from the introduction of a FTT is likely to be modest... between €490 million and €730 million."

b) Two-thirds of this yield would have gone directly to the EU to fund its budget.

c) A FTT would displace financial sector activity, especially when alternative locations - London - are readily available

d) The macro-economic impact of a financial transactions tax would be that it would lead to a lower level of economic activity in the financial sector, which might result in lower receipts from income tax and corporation tax.

e) There would also be an impact on the Exchequer. A 1% rate of stamp duty applies to transfers of shares in Irish companies. The Commission's proposal would involve the abolition of this tax and the loss of existing stamp duty revenue which was €180 million in 2010 and €195 million in 2011.

f) the important matter is to preserve the financial services industry in Ireland, especially in Dublin, because it is one of the sectors expanding at present.

g) Ireland is not signing up to enhanced cooperation and while it states that it will continue to monitor the discussions *"whatever measure is introduced should not interfere with the common market."* [50]

The report concluded that more detail was needed before a definitive conclusion could be reached about its impact on the Irish financial system and taxation revenue.

Each of these arguments can be countered as follows:

a) Between half and three quarters of a billion is not modest. The government has committed to the Troika that increased taxes of €1.25 billion and expenditure cuts of €2.5billion will be imposed in Budget, 2013.

b) The economic model used in the calculation of this net revenue gain is based on an analysis of the negatives and doesn't take into account the expected positive outcomes.

   The model didn't factor in the many ways through which the FTT could be used, be it to support sustained growth - for example, investment in productive jobs and infrastructure, or to reduce government debt.

c) This displacement argument - that we would lose jobs to London - is highly debatable. Firstly, our current stamp duty on financial transactions covers the transfer of stocks or marketable securities of an Irish incorporated company and is charged mostly at the rate of 1%. In the UK, the rate is 0.5%, so our current rate is double the UK rate. This would suggest that the reason financial companies locate to Ireland is not based on the stamp duty rate but more likely on our corporation tax rate.

49 Fitzgerald, op cit

50 Oireachtas Debates Dáil Éireann 5th July, 2012

The UK and Ireland's stamp duty rate are quoted throughout the economic research literature as examples of a successful FTT and both countries support a significant financial sector, yet there has not been a relocation or displacement to other countries in Europe on a scale that either country wants to reduce its stamp duty.

d) The macroeconomic effect has to be just that - the effect on the whole economy. The ESRI/ Central Bank study deals with its effects on the financial sector only.

e) Of course, the loss of stamp duty has to be factored into the analysis. It will be subsumed into the new tax. We should still end up with a significant net gain.

f) Preserving the financial services sector should not be at the expense of the productive sector of Ireland's economy.

In terms of the growth of the financial services sector in Ireland we should tread carefully. This sector is capable of repeating the same mistakes, taking the same risks and operating from the same comfort blanket of the 'moral hazard' that ultimately the state will bail them out again. The potential for this to happen again is unchanged. With an FTT it is at least diminished somewhat.

(g) It is somewhat ironic that the Minister insists that Ireland will be vigilant in watching that the FTT does not interfere with the common market, given Ireland's policy on corporation tax. The French are at the forefront of promoting the FTT, despite Ireland's opposition, have frequently criticised our special corporate rate as being in breach of the single market. Let's hope that our opposition to an FTT is not a foreign policy own goal.

Few Irish citizens know how narrowly we escaped having a second Anglo bailout. Depfa was based in the IFSC and was initially 'regulated' by the Irish Financial Regulator. The perception in Germany is that the bank had moved to Dublin to avail of our lower corporation tax and our light-touch regulatory system. Depfa was taken over by Hypo in 2007, and returned to the supervision of the German regulator, Bafin. This meant that the enormous bill of €150 billion for rescuing Depfa landed at the door of Germany's taxpayers, whereas it might otherwise have landed at ours.

A programme broadcast on Germany's ZDF channel told viewers that Depfa was one of several German banks that had moved to Ireland to take advantage of low taxes and lax regulation. The reporter noted that it "is an open secret that the rules here are not exactly strict. 'The cameras zoomed in on Depfa's offices at the IFSC and on the National Convention Centre, which was funded with the help of a €280 million Depfa loan to the Irish government.[51]

The lack of sympathy in German circles for Ireland's financial plight in recent years has been widely discussed in the Irish media. This lack of sympathy is seldom, if ever linked to the ludicrously weak role of our financial 'regulator' in causing substantial losses to the German taxpayer and to the German perception that Dublin's IFSC was the 'wild west' of Europe's financial industry. The behaviour of institutions based in the IFSC was central to the boom and the image of the IFSC and what it stood for was central to shredding Ireland's reputation in mainland Europe.

Dr Elaine Byrne of TCD, one of Ireland's foremost authorities on political corruption, has written on the disproportionate influence exercised by the IFSC elite on policy formulation.[52]

51 http://kathleenbarrington.blogspot.ie/2010/09/unwelcome-attention-for-ifsc.html consulted 13 7 2012

52 Elaine Byrne:' IFSC living by its own rules and not in the real world' Irish Independent May 06 2012

This is exercised through the clearing house group, located within the Department of the Taoiseach, and is chaired by IFSC executives. It has become a mechanism by which aspects of fiscal policy are outsourced to the financial services industry. A group such is of obvious benefit to the industry it serves and to the national objective of establishing a financial services industry. But when it is composed solely of industry insiders there is a danger that it will be dominated by special pleading and sectoral self-interest.

There is a perception in Financial Services circles that if Ireland does not join the FTT it will be business as usual. This is unlikely to remain the case in the medium term as citizens see the effects of the FTT in other member states and demand that the financial services industry make some contribution to repairing the economy which that industry did so much to break. The industry enjoys the 12.5% corporation tax, in common with all other industries but unlike other industries it enjoys an exemption from VAT.

It seems strange, in the face of these exemptions, and sacrifices faced by citizens, that there is a blanket refusal by the financial services industry to contemplate any increase in its tax contribution to the Irish state. Ireland's best interests do not necessarily coincide with those of the IFSC, nor do the best interests of the IFSC necessarily coincide with the City of London. The French FTT(described by the ESRI as being equivalent to the Irish stamp duty on shares),which came into force in August of this year, imposes a 0.1% levy on trades in firms headquartered in France, with a market capitalisation of over €1 billion.

Proposals for an FTT covering most of the major states of the Euro zone are gathering momentum. The Irish government is constitutionally entitled to stay aloof from this process but it is not without risk. If Ireland remains aloof there is a real danger that the FTT proposal will be shaped without any regard to Ireland's interests.

This could leave us at a later stage entering an FTT system which we had no influence in shaping. Our absence from the founding negotiations of an FTT could be costly at a later stage. It is consistently stated by opponents of an FTT that financial activities will be displaced by the FTT. One way of minimising this risk would be by adopting a more aggressive stance on tax havens, including the Isle of Man and the Channel Islands.

The position of the Irish government is not to support such a tax until it is applicable across all twenty seven member states. In practice, this means we oppose the tax. Given the current political situation in England, it is unlikely that the Conservative party would accept such a tax, even if it was demonstrably in Britain's favour. Paradoxically Ireland (like Britain) has a form of FTT through stamp duty on share transactions and both countries are frequently cited in academic literature on Financial Transaction Taxes. From an Irish point of view we must ask ourselves if following the British lead is in our interest. At the time of our bailout in 2010, Morgan Kelly, the UCD economist wrote that "from now on we must depend on the kindness of strangers'.[53] Most of these 'strangers' are on Continental Europe, not the other island. A majority of the original six member states will move together on the FTT proposal.

53 Irish Times November 8th, 2010

# Conclusion

The Irish government is now involved in negotiations on our banking debt which are as important as those leading to our accession to the EU and the treaty negotiations of 1921. We enter into these negotiations in a position of relative isolation because of our government's attitude to the FTT. If the government underperforms in these negotiations Irish citizens will have to pay for this for decades to come. It is ironic that this should be the case given that a cornerstone of Irish Foreign policy since the 1970s has been to maximise our influence in mainland Europe, keeping Ireland strong in Europe. Our stance on FTT undermines this long standing goal.

The main bone of contention between Ireland and mainland European countries is our corporate tax rate. The experience of the current government in the period immediately after it resumed office shows the depth of hostility to Ireland on this issue.

Despite the departure of Nicolas Sarkozy, one of the most vocal critics of our corporation tax policy, political developments in Europe in the near future will produce an environment even more hostile to our corporate tax regime. Ever since its introduction by the rainbow coalition in 1995, the 12.5% corporate tax rate has become a central part of the state's industrial policy and its maintenance is an article of faith. In this situation, the wisdom of opening up another example of Irish 'exceptionalism' is open to serious question. Any more Irish 'exceptionalism' will simply make the future defence of our corporate tax regime more difficult at European level. If this occurs it in effect means the transfer of political resources from productive sectors such as agri-food, pharmaceuticals, and ICT towards the financial services sector, in a manner reminiscent of the shift in financial resources described by Adair Turner, Chairman of the UK Financial Services authority.

'The financial system …tends to create volatility against which the non financial system then has to hedge, paying the financial system for the service: an initially zero sum activity…then becomes positive sum for the financial industry and negative sum for all the others'.[54]

As a core group of countries take the FTT proposal forward, we should beware of isolating ourselves. We should avoid making the foreign policy mistakes of Britain, which was present to the Messina conference in 1955 - effectively the founding conference of the EU - but did not participate in the negotiations which led to the treaty of Rome in 1957. Four years later the Macmillan government reversed policy and made application to join the EEC.

They were now outsiders, were rebuffed by General De Gaulle and spent the next ten years trying to negotiate membership of an institution having declined the invitation to be founding members. This is a troubling omen for our future.

The argument for the FTT can be made at a number of levels. It adds to state revenue at a time when the state finances are under unprecedented pressure and it shows citizens that the institutions which were the main culprits in our economic collapse are making some contribution towards a recovery. It will alter economic behaviour by making risky transactions more costly, while in turn allowing a more rational allocation of economic resources. It will minimize the threat to our corporation tax regime which is seen as the cornerstone of industrial policy, and therefore favour the productive sector. Finally it will prevent the country from being isolated from mainstream political and economic opinion in the Eurozone.

54 Turner, A. *After the crisis*, Cambridge 2012, p.58.

# Appendix 1 Summary of economic arguments for and against FTT.

The economic assertions of the proponents of FTT's are as follows:

1. There is excessive trading activity, in modern asset markets due to the predominance of short term speculation
2. Speculation is destabilizing - it moves prices often away from their fundamental equilibrium values (In the absence of consensus on fundamentals, the markets are dominated... by traders in the game of guessing what other traders are going to think) - Tobin 1978 p 158
3. The most pressing problem due to the predominance of short-term speculation is not so much the volatility of asset prices over the short run but over the medium and long run. This is so because short-term speculation causes long swings in assets prices and, hence, persistent deviations from their fundamental equilibrium - Tobin 1978, 154
4. The overshooting of exchange rates, but also of stock prices, interest rates and commodities prices fosters the "predominance of speculation over enterprise" (Keynes, 1936) and thereby dampens economic growth and employment
5. A uniform tax per transaction increases the cost of speculative trades the more the shorter their time horizon is. Hence, a transaction tax would have a stabilizing effect on asset prices and would thereby improve the overall macroeconomic performance.
6. A (currency) transaction tax would provide governments and/or supranational organizations with considerable revenues which could/should be used for achievement of policy goals.

The economic assertions of opponents of FTT's are as follows:

1. The high transaction volumes in modern financial markets stem mainly from the activities of market makers. The latter provide just the liquidity necessary for the price discovery process and, hence, for facilitating and smoothing the movements of asset prices towards their fundamental equilibria. Furthermore, "a large part (of short-term transactions) is related to hedging and distribution of risks" (ECB, 2004, p. 3).
2. Speculation is an indispensable component of both the price discovery process and the distribution of risks. As part of the former, speculation is essentially stabilizing, i.e., it moves asset prices smoothly and quickly to their equilibria (Friedman, 1953)
3. Any increase in transaction costs, e.g. due to an FTT, will cause liquidity to decline which in turn will increase the short-term volatility of asset prices ("To the extent that the functioning of financial markets might be hampered by the tax, the risk-sharing benefits of deep and liquid markets might be reduced . . ." – ECB, 2004, p. 3).
4. An endogenous overshooting caused by excessive speculation does not exist. Any deviation of asset prices from their fundamental equilibrium is due to exogenous shocks and, hence, is only a temporary phenomenon (within this perception of the world the persistent deviations of exchange rates from their fundamental equilibrium as well the slow speed at which exchange rates revert to PPP remains a puzzle: the so-called purchasing power parity puzzle – Rogoff, 1996; Taylor – Taylor, 2004).
5. Transaction taxes are hard to implement, in particular taxes on international transactions. Moreover, "financial market participants are likely to find ways to circumvent the tax" (ECB, 2004, p. 3).

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