Innovative financing at a global and European level

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PURPOSE: open a debate on the taxation of the financial sector.

BACKGROUND: the recent financial crisis stressed the need for a more robust financial system, given the cost of financial instability for the real economy. In addition, there are several key challenges in the areas of development, resource efficiency and climate change with significant budgetary implications. Against this background, could supplementary taxes on the financial sector be a potential revenue-generating solution?

The European Council concluded on 17 June 2010, in preparation for the G-20 Toronto Summit, that the EU should lead efforts to set a global approach for introducing systems for levies and taxes on financial institutions with a view to maintaining a world-wide level playing field and will strongly defend this position with its G-20 partners. The introduction of a global financial transaction tax should be explored and developed further in that context.

The European Parliament has also been debating issues related to the financial sector and taxation. In particular its Resolution of 10 March 2010 asks the Commission and Council to look at how a financial transaction tax could be used to finance development cooperation, help developing countries to combat climate change and contribute to the EU budget. Some Member States have already taken measures with regard to bank taxation.

Such debates are not limited to the European Union. These are indeed issues reflecting the global and systemic nature of the financial crisis and its consequences. There have been discussions in the G-20 on new forms of taxation. However, there is no global consensus on additional tax instruments.

Regardless of the tax instrument considered, is there a rationale for adapting the tax system to make the financial sector contribute in a fair and substantial way to public budgets? The Commission sees three main arguments for this.

(1) to complement the extensive financial sector reforms underway, taxes could contribute to enhancing the efficiency and stability of financial markets and reducing their volatility as well as the harmful effects of excessive risk-taking;

(2) the financial sector is seen to bear an important responsibility for the occurrence and scale of the crisis and its negative effects on government debt levels worldwide. Additional taxes could also be justified by the fact that some governments provided substantial support to the sector during the crisis and it should hence make a fair contribution in return;

(3) most financial services are exempt from value added taxation in the EU. The reason is that the major part of financial services' income is margin based and therefore not easily taxable under current VAT.

This Communication contributes to the debate by covering two instruments, a Financial Transactions Tax (FTT) and a Financial Activities Tax (FAT).

CONTENT: the Commission communication shows that innovative financing mechanisms in general and new financial sector taxes in particular could be an important element in responding to the current global and European challenges.

Financial Transactions Tax (FTT): the FTT is designed to tax the value of single transactions. For a wide coverage, it should be applied to a broad range of financial instruments (i.e. equities, bonds, currencies and derivatives), even if some current proposals envisage limiting the scope to a subset (e.g. currency transaction levy).

Globally, estimated tax revenues would have been around EUR 60 billion for 2006 for stocks and bonds transactions assuming a tax rate of 0.1 %. Some studies find ten times this amount if derivatives are included. However, there are technical problems for derivatives such as determining tax bases as well as doubts about the accuracy of revenue estimates. Past experiences have shown a substantial gap between expected and realised revenues. There are also open issues with currency transactions if levied only nationally.

The revenue generated would be largely collected in a limited number of countries where trading activities are concentrated. This uneven distribution would be even greater when derivatives are included. On the one hand, this could make an agreement on a tax more difficult given that all countries would have to implement the tax while only a few gain the revenue. On the other hand, one can argue that investors from all over the world use the central market places. Therefore, all users contribute to the tax revenue, giving it a global dimension.

Assessment: the Commission considers that globally, an FTT could be an appropriate option as a revenue raiser in particular to provide financing for global policy goals. For it to work effectively and fairly, participating countries should try to come to an agreement on global financing tools that can be acceptable to all. The Commission is committed to continuing to work with its international partners, in particular in the G20, to reach such an agreement.

A financial transaction tax could be considered at the EU level only. However, it must be borne in mind that the financial industry is a global and interconnected one. Financial activities are concentrated in a small number of financial centres both inside and outside the EU which compete on the world stage. Finance is also a complex and evolving area and the main players have a developed capacity to seek out new and innovative ways of doing business and of structuring financial transactions.

Financial Activities Tax (FAT): another potential instrument to improve taxation of the financial sector and reduce potential negative externalities is the Financial Activities Tax (FAT) as proposed by the IMF. In its most extensive form (addition-method FAT), the FAT falls on total profit and wages. It can also be designed to specifically target economic rents and/or risk. In contrast to an FTT, whereby each financial market participant is taxed according to his transactions, the FAT taxes corporations. The focus here is on the addition-method FAT.

For the 22 developed economies considered in the IMF report to the G-20, a 5 % rate of the addition-method FAT would create revenue corresponding to the average of 0.28 % of GDP. Using the country-level estimates for the share in GDP to calculate absolute figures, this would translate into total revenue for the 22 countries of roughly EUR 75 billion for the addition-method FAT. For the EU-27, the addition-method FAT could raise up to EUR 25 billion.

Assessment:at this stage the Commission considers that there is greater potential for a Financial Activities Tax at EU-level. This option could deal with the current VAT exemption of the financial sector and raise substantial revenues. Given the innovative nature of this tax there is a need for further technical work on how it might be implemented. The addition-method FAT can be interpreted as a tax on a proxy for total value added generated by a financial sector company. However, if designed as a complement to the current VAT, a number of technical issues must be resolved in order to align both taxes. The Commission believes that the FAT option is worth exploring in the EU context. This should include an assessment of its possible competitive implications and whether these are offset by possible disincentives for companies to relocate.

In the light of the conclusions above, the Commission will therefore without delay launch a comprehensive impact assessment, which will further examine each of these options, in order to be in a position to make appropriate proposals on policy actions by summer 2011.