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Research Briefing
Global financial markets

Financial Transaction Tax*

Counterproductive

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Author
David Folkerts-Landau
Group Chief Economist
+44 (20) 754-55502
david.folkerts-landau@db.com

Editor
Bernhard Speyer

Deutsche Bank AG
DB Research
Frankfurt am Main
Germany
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

www.dbresearch.com

DB Research Management
Ralf Hoffmann | Bernhard Speyer

The Financial Transaction Tax (FTT) that 11 EU members – including Germany, France, Italy and Spain – are planning to implement in January 2014 is misguided, counterproductive and badly designed. The proposal is targeted at the financial services sector but would impose direct and indirect costs to the real economy. Despite ambitions to grow their own financial centres, states have signed up to a tax that encourages off-shoring of activity. Most importantly, at a time when the cost and availability of capital in the EU is sometimes problematic, the FTT would raise it for households, firms and even states.

So why do it? In cash-strapped times, a tax of 0.1% on equity and debt and 0.01% tax on derivatives must seem like a gift to sovereign treasuries. The EU Commission says the FTT will yield EUR 30-35 bn a year. However, like any tax, it would also raise the cost of economic activity. One of the Commission's own research papers implies that a tax intake of, in this case 0.2% of GDP would result in a -0.4% impact to GDP. The official Commission impact study is more upbeat but still concedes the FTT would reduce, not increase, long-term economic output. Moreover, the tax revenues will likely be much smaller due to capital losses on existing securities, higher interest costs, and the migration of financial activities elsewhere.

Proponents of the FTT point to stamp duties in financial centres like Ireland and Britain as proof that an FTT can work without too many damaging side effects. Significantly, however, these stamp duties do not cascade, i.e. they do not tax intermediate transactions, only the end-user. By contrast, the FTT, with its explicit aim of curbing high frequency trading, would apply to all legs of the transaction – from broker to bank to end user – resulting in costs that are multiples of the 0.1%

The FTT would certainly be successful at diminishing Europe's financial heft. According to the Commission's own estimates, the derivatives business will shrink by 70-90%, a decline it appears quite sanguine about. Although the derivatives tax is much lower than that on securities, the large notional amounts involved means the impact on volumes is much higher. More generally, the FTT would penalise banks for being European. Non-European institutions trading with them will post a wider bid-ask to reflect the FTT. The tax incidence would, directly or indirectly, fall on the European institution.

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Most importantly, the FTT would hurt the real economy. Corporates account for about 10% of total FX derivatives turnover in the FTT tax area, mostly for hedging international trade and interest rates, and Oliver Wyman estimates transaction costs for them could increase by 300%. The tax would even apply to secondary transactions of sovereign debt, increasing the yield differential due to liquidity and therefore the price. For instance, the pre-crisis spread between German and Austrian sovereign debt, which could reasonably be assigned as a liquidity premium, was around 10 basis points. Assuming this same liquidity premium, and given that outstanding EU sovereign debt is EUR 8.5 trillion, EU sovereigns would eventually have to pay an additional EUR 8.5 bn of interest due to the FTT. This alone would reduce by a quarter the supposed revenue gain from the tax.

Finance does need reform, but the FTT is the wrong solution. The rules on liquidity, capital and derivatives that have been introduced since 2007 and which are still being implemented, are more sensible. This is a bad law and should be scrapped.

David Folkerts-Landau, Group Chief Economist
(+44 (20) 754-55502, david.folkerts-landau@db.com)

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