



Taxation of the Financial Sector

**Kangaroo Group
Working Group "Taxation"
Brussels, 2 June 2010**

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The views expressed are solely those of the speaker and do not necessarily reflect the views of the European Commission.



Plan of presentation

- Why additional taxes on financial sector?
- Assessment Criteria
- Selected Instruments
- Conclusions



Why additional taxes for the financial sector?

- Two reasons for a specific contribution:
 - Backward looking – How to retrieve the cost of govt bail-out
 - Forward looking – Which mechanisms to reduce risk of future crisis and ensure that tax payer is not taking the bill
- In addition, international debate on possible (new) sources of finance to support fiscal consolidation, development aid and global public goods.
- Commission Staff Working Document on “Innovative Finance at global level” and IMF interim report to G-20 analyzed – inter alia - different options for taxes on financial sector.



Why additional taxes for the financial sector?

- Fiscal cost of direct support: 2.7% for advanced G-20 countries (net of amounts recovered so far). In most affected countries up to 4-5%.
- Amounts pledged: on average 25% of GDP in G20.
- Overall effect of crisis on budget deficits and debt:
 - EU-wide general govt headline deficit expected to reach 6.9% of GDP (2009) and 7.5% (2010).
 - Government debt in advanced G-20 is expected to rise by on average 40 pct points of GDP from 2008 – 2015.
- Contraction of overall economic activity: -4.2% GDP decrease in EU-27 in 2009, recovery still fragile with 1% GDP growth in 2010, 1½% in 2011 (Commission Spring Forecast)



Overview of selected instruments

- 1. Financial transactions tax**
- 2. Pricing of leverage and risk-taking (bank levy)**
- 3. Bonus tax**
- 4. Additional profit tax**
- 5. Financial activities tax (combination of 3 and 4)**



Assessment Criteria

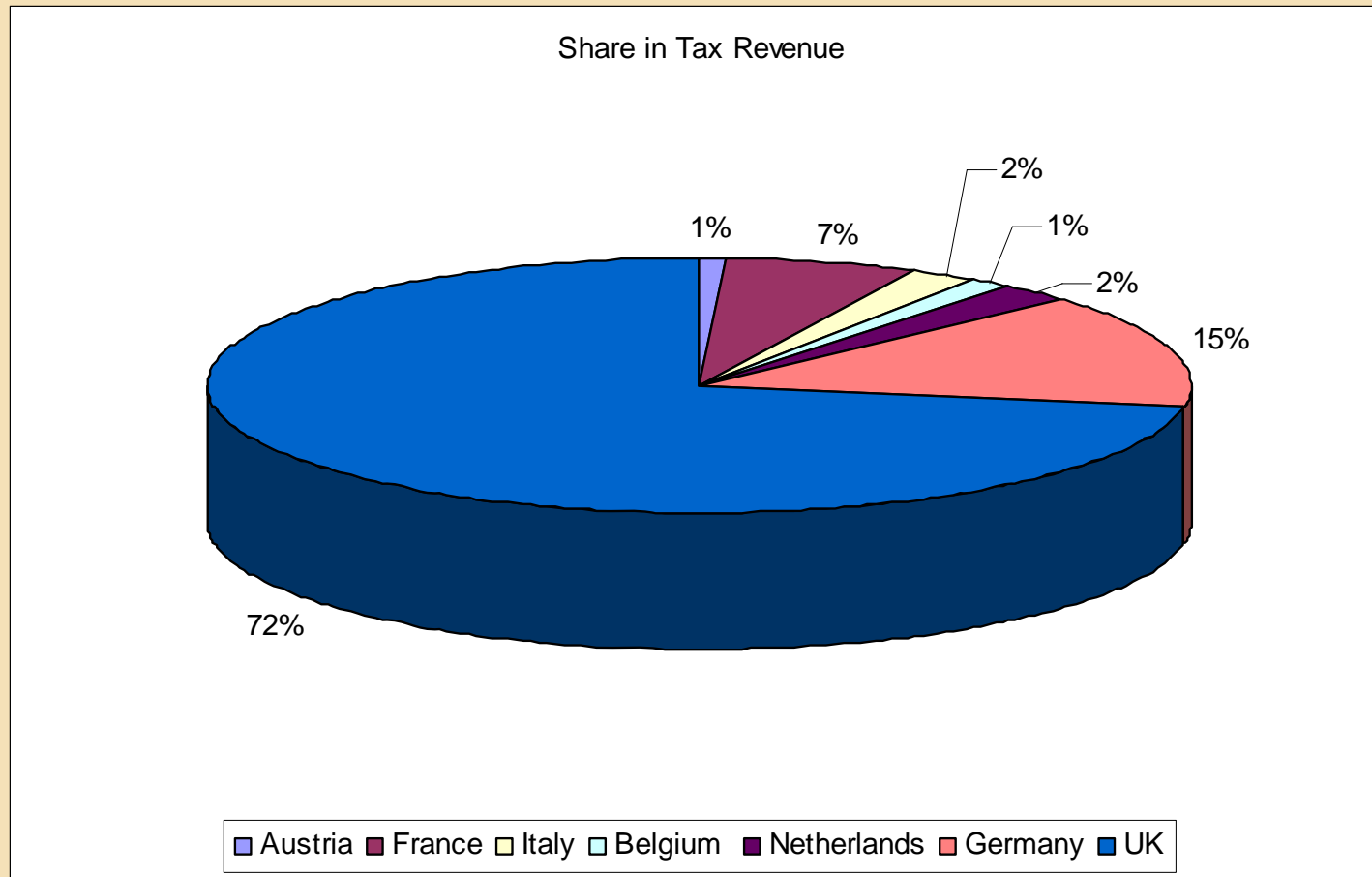
- 1. Potential to raise revenue**
- 2. Effects on market efficiency**
- 3. Tax Incidence: on whom falls the tax burden in the end – effects on equity and income distribution**



- **Rationale:** increase cost of financial transactions, stabilise financial markets, raise revenue.
- **Revenue** estimates of more than €50 billion worldwide and of about €20 billion for Europe (estimate without derivatives and 0.1% tax rate); geographical concentration.
- **Efficiency:** uncertain, FTT may increase price volatility; cumulative effect of tax;
tax avoidance: transactions to be relocated and substituted if tax not general and global.
- **Incidence:** unclear, likely to be partly borne by customers and economic operators via higher costs of capital and risk hedging;



Hypothetical revenue distribution 2007 for selected EU countries



Source: Wifo (2008)



Pricing of leverage and risk taking – bank levy

- **Rationale:** Levy/ tax on certain balance sheets positions of financial institutions, with the revenues being channelled either into a crisis resolution fund (Commission proposal) or the general govt budget (U.S.); tackle excessive risk-taking
- **Revenue:** Depending on rate and base, e.g. extrapolation of Swedish proposal with 0.036% tax rate: €13 bn
- **Efficiency:** can foster financial stability by slowing the build up of excessive risk positions in balance sheets, esp. if risk-adjusted; risk of tax avoidance: less prone to re-location
- **Incidence:** tax might be partly shifted to clients. (depends on concrete design and level of competition in markets)



Taxation of bonus payments

- **Rationale:** reduce managers' or traders' incentives to take excessive risks (UK, France -> one-off tax)
- **Revenue:** Around €4 billion for EU
- **Efficiency:** in long-run tax might have some positive effect on risk taking; but: possibly some relocation of activities to non-taxing countries or areas and to quasi-financial sector and other tax avoidance effects.
- **Incidence:** uncertain; probably some redistribution effects, when born by high-income earners and bank shareholders.



Increase in profit taxation

- **Rationale:** Higher rate or surcharge on corporate income tax; idea: taxation of extra profits from implicit state guarantees.
- **Revenue:** around €4 billion in EU depending on level and design of surcharge.
- **Efficiency:** Partly taxing pure rents; could raise the required pre-tax profit and thereby increase risk taking;
- **Incidence:** might be partly rolled to clients, some redistribution effects from impact on bank shareholders.



Financial Activities Tax (FAT)

- **Rationale** similar to bonus and profit tax: Tax on profits and remuneration paid to staff. Similar to combination of bonus and profit tax.
- **Revenue:** Example UK: 2% FAT rate; Revenue: up to 0.2% of GDP (€3.2 bn)
- **Efficiency:** similar to extra-profit tax as it may be designed to fall on pure rents of financial sector; could also reduce size of the sector; tax avoidance: perimeter and relocation issues
- **Incidence:** depends on definition of tax base, if solely pure rents are taxed incentives to shift to consumers is reduced. Otherwise parts of the burden might be shifted to purchasers of financial services.



- Different objectives – different instruments
 - ➔ Financing of resolution of failing banks - Bank Levy
 - ➔ Contributing to crisis cost/ fiscal consolidation – FTT or FAT (or components); Further analysis needed, search for “double dividend”
- Better regulation and supervision remains paramount
- Exit strategies need balanced mix of instruments:
Expenditure cuts; Revenue side: not only new sources, review quality of existing tax systems (tax gaps, distortions)
- Global coordination (G-20) essential as isolated action is less effective, risk of tax avoidance



Thank you!



Stocks and Bonds (spot transactions)

- Tax base for a transaction tax is the price of the assets as valued in the transaction.
- Example: Investor sells 1,000 stocks of a company for 1,000 Euro each, tax base would be 1,000,000 Euro. A tax rate of 0.1% would lead to a tax payment of 1,000 Euro.
- Effective tax rate (tax payment divided by cash-flow) is indeed 0.1%. Similar examples can be made for government or company bonds.



Despite current focus on “new” taxes, reform options of existing fiscal systems should be high on the agenda, too.

- **Expenditure**
Reduction in non-productive spending tends to have more long-lasting effects if linked to structural reforms
- **Traditional additional tax revenues**
Increases in rates, in tax bases and in efforts to fight tax fraud and tax evasion
- **Review quality of revenue side of the budget**
Reduce existing distortions and improve efficiency. Notably distortion between debt and equity in CIT systems.
- **New taxes on financial sector**
Analysis of economic effects and revenue potential



Risk-hedging (use of derivatives)

- EU-based company has to pay a bill of 11m USD in 3 months and fears further decrease of Euro.
- Hedge risk that Euro falls below 1.10 USD. Option to buy USD at this price in 3 months. Premium for this is currently ca. 30,000 EUR.
- Value of the underlying: 11m USD = 10m EUR), tax rate 0.01%, tax payment 1,000 EUR,
- Tax payment (1,000 EUR) to real Cash-flow (30,000 EUR): 3.3% (effective tax rate).
- If company wants to hedge an extreme case (Euro drops below parity), premium is only 5,000 EUR. Tax base (11m USD = 11m EUR), Tax payment 1100 EUR, effective tax rate 22%!
- “Effective Tax Rate” can be very different depending on contract.