

Committee / Council:	ECOSOC
Issue:	Defining principles concerning the economic transaction taxation
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Note: After due deliberation with the secretariat, we have decided to focus on the financial nature of the 5th agenda item (as described above). Therefore, the term “financial transaction taxation” shall substitute the term “economic transaction taxation” for the purposes of this study guide.

Introduction

The earliest form of trade involved direct exchange of a good / commodity / product or service for another, the so called barter. With the invention of money, traders gained more mobility and interoperability, since money was used to represent the value of the traded objects and could therefore be exchanged for virtually anything. The trading of an item representing the value of real goods or services gave birth to the financial market. With time more complex forms of trade began to prevail, like trading pieces of paper, the so called “notes” which provided even more mobility and functioned as a claim to a certain amount of money (e.g. metal coins) deposited in a certain location, like a bank. Next came the invention of interest rates which were to be applied to loans, thus making loans a profitable business. The lender could then sell the payment (debt) obligation of the borrower to a third party, to whom the borrower would now owe the money. These debt obligations, so called liabilities, could also be sold in larger quantities and gradually became financial “packages” in the wake of the financial crisis of 2008, when hundreds of them were sold as one financial instrument (a (set of) certain financial asset(s), in this case called Mortgage-Backed Securities / MBS and Collateralized Debt Obligations / CDOs). However, the buyers of those liabilities soon realized that, if a large portion of the people owing to them proved unable to fulfill their obligation, they could lose a lot of money. Others, believing in the ability of the indebted to meet their obligations, offered so called Credit Default Swaps (CDS), financial instruments which were purchased by the owners of MBS as well as CDOs and obliged the sellers to remunerate the buyers, in case the MBS and CDOs covered by the CDS agreement lost their value, because the indebted people were unable to pay. Another example of complex financial instruments includes the so called options: Person A buying an option from person B, gives the former the right

to buy from or sell to the latter a certain asset at a certain point of time in the future and, potentially, at a certain price.

All of the above examples illustrate the complex ways in which participants of the financial market are able to interact financially. Since the outbreak of the 2008 crisis, the international community has come to realize that financial instruments such as the above cause great intransparency in the financial market and are able to spread the detrimental effects of economic breakdowns across the globe (e.g. liabilities like MBS & CDOs sold abroad). Indirectly, they also bring about market instability as a result from the lack of trust they cause. Imagine a renowned broker insuring all the bonds of a certain country in his possession with CDS. The effect? All other market participants owning bonds from that country will try to insure them as well or, even worse, sell them, which would force the country concerned to issue bonds with higher interest rates.

Aware of the above dangers associated with financial derivatives (CDS, options, etc.), which are financial instruments the price or the gain of which is dependent on or derived from another financial asset (like bonds or stocks), the international community needed to control and limit their use to a certain extent. At the same time, the ever growing financial market with all this betting and the speculation (basing financial actions, like buying and selling, on personal predictions of the average opinion of the market about a certain asset or derivative, the price of which is often decided by the trust of the market participants and not its true value) did not even lead to financial growth for the states, because there was no according tax applicable, which brings us to the financial transaction taxation.

The Financial Transaction Taxation (FTT) dates back as far as to the beginnings of the 19th century (1808), when stamp duties of official documents transferring property titles in England were calculated in proportion to the value of the property in question. FTT imposes taxes on financial transactions, which means that fees only apply upon the conduct of such a transaction, in every other case not. If person A owns a security and sells it to person B, both have to pay taxes to the government proportional to the value of the security and dependent upon a few other factors. However, if person A never sells his security, he is not going to be charged. There are numerous arguments in favor and many against FTT which are going to be listed below in the section entitled “Background Information”. There also exist similar alternatives to FTT, to which a short reference will be made, and, furthermore, the scope of factors to consider regarding the legal implementation of FTT will be presented.

Before all that, let us define a few key terms, with which we can then work more efficiently...

Definition of Key Terms

The following definitions all originate either from the European System of national and regional Accounts (ESA 1995 / Regulation (EC) No 2223/96 including all amendments: [consolidated version](#) - also to be found under: [ESA 1995](#)) or from a paper entitled “Definition of Economic Assets” by Anne Harrison ([unstats.un.org](#) – UN Statistics Division) from the 4th meeting of the UN Advisory Expert Group on National Accounts (30 January – 8 February 2006, Frankfurt).

Assets:

An asset is an entity from which the economic owner can derive a benefit or series of benefits in future accounting periods by holding or using the entity over a period of time, or from which the economic owner has derived a benefit in past periods and is still receiving a benefit in the current period. Because it represents a stock of future benefits, an asset can be regarded as a store of value.

Financial Liability:

A financial liability is established when one unit (the debtor) is obliged, under specific circumstances, to provide a payment or series of payments to another unit (the creditor). The most common circumstance in which a financial liability is established is a legally binding contract which specifies the terms and conditions of the payment(s) to be made and payment according to the contract is unconditional.

Institutional Unit:

Institutional units are economic entities that are capable of owning goods and assets, of incurring liabilities [and] of engaging in economic activities and transactions with other units in their own right.

Transactions:

A transaction is an economic flow that is an interaction between institutional units by mutual agreement or an action within an institutional unit that it is useful to treat as a transaction, often because the unit is operating in two different capacities.

Financial transactions:

Financial transactions are transactions in financial assets and liabilities between institutional units, and between them and the rest of the world.

Financial assets:

Financial assets are economic assets [All assets in the System are economic assets, except for (1) human capital, (2) natural assets that are not economic assets (e.g. air, river water) and (3) contingent assets, which are not financial assets], comprising means of payment, financial claims and economic assets which are close to financial claims in nature.

- ⇒ Means of payment consist of monetary gold [Monetary gold is gold owned by the authorities (or by others who are subject to the effective control of the authorities) and held as a reserve asset.], special drawing rights [[SDRs](#)], currency and transferable deposits [Deposits (in national or in foreign currency) which are immediately convertible into currency or which are transferable by cheque, banker's order, debit entry or the like, both without any kind of significant restriction or penalty].
- ⇒ Financial claims entitle their owners, the creditors, to receive a payment or series of payments without any counter-performance from other institutional units, the debtors, who have incurred the counterpart liabilities.
- ⇒ Examples of economic assets which are close to financial claims in nature are shares and other equity and partly contingent assets. The institutional unit issuing such a financial asset is considered to have incurred a counterpart liability.

Financial Derivatives:

Financial assets based on or derived from a different underlying instrument. The underlying instrument is usually another financial asset, but may also be a commodity or an index. [like futures, options, swaps, etc.]

Background Information

The idea of FTT gradually gained popularity during the 20th century. One of the earlier proposals involving FTT came from John Maynard Keynes, who, anticipating the existence of FTT on securities (STT – Securities Transaction Taxation) in England, argued that the US also needed STT. James Tobin, greatly influenced by Keynes, later proposed the so called Tobin Tax, which was FTT imposed only on spot conversions of currencies proportional to the value of the currencies traded. In their argumentation both believed that imposing FTT mitigated the danger of speculation on the financial markets.

The first of the following arguments in favor of FTT constituted the basis for Keynes' and Tobin's argumentation, the rest includes the most important ones for contemporary discussions on FTT:

1. Curbing volatility of financial markets:

Speculation leads to a great number of unpredictable speedy financial interactions which cause great mistrust on the financial markets. By applying taxes to each of these actions, speculators will be forced to reduce the number of transactions, which are undertaken simply because of a certain "feeling" and predictions, and devote more attention to the long term fundamental value of the traded financial asset instead of its apparent value in the eyes of the common market opinion. And most important of all, the number of financial transactions in general would decrease permitting more effective market observation as well as risk assessment based on more transparency.

2. A fair tax contribution of the financial markets:

Why should the monetary volume of certain types of financial transactions be 10 to 15 times larger than the world's GDP without even being taxed, especially when the financial markets spread the crisis around the globe? For comparison: The worldwide GDP (value of all goods and services produced in one year) of 2010 amounts to approximately \$63 trillion (US dollars), while global Over-the-Counter (OTC – transactions conducted directly between two parties without any intermediaries, like financial institutions) trade in financial derivatives amounts to \$601trillion and foreign currency transactions to \$955 trillion. Also in 2010, the general volume of traded derivatives was 70 times larger than the global GDP. Take a look:

<http://www.economicinpictures.com/2011/09/size-of-financial-markets.html>

http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/conferences/taxforum2011/schulmeister.pdf

(Page 8, Graph 1)

3. Raising funds for future bail-outs:

Together with the above key points, using revenue from FTT to strengthen bail-out mechanisms is brought forward by the European Commission (EC), when supporting the idea of a European FTT. In this way, the burden of providing financial assistance to the financial

markets is meant to be taken from the shoulders of taxpayers and other non-participants in those markets.

4. Addressing tax evasion:

Again an argument highlighted by the EC, addressing tax evasion is thought to be possible through a broad legal basis of as well as broad definitions of transactions falling under the FTT and stringent controls. FTT is believed to be less susceptible to tax evasion.

The above points summarize the prevalent reasons for the implementation of FTT. However compelling they may sound, there are also strong arguments against FTT:

1. The distributional aim of many taxes (like income taxes and value-added-taxes - VATs) is not accomplished:

FTT is calculated proportional to the gross proceeds of the transaction (the value of the traded financial asset) and not the net proceeds (the economic gain accomplished or the losses inferred). This means that, if person A buys and sells a security at the same price, he will pay the tax and infer losses, as opposed to person B who is taxed according to his economic gain and not the gross proceeds of his financial action. This discourages financial transactions much more than a tax based on the net proceeds, since the market participants will pay the tax regardless of the outcome of their financial action.

2. FTT is a cascading tax:

Simple example: With FTT in effect, person A sells a financial asset to person B for 10€ and the latter has to pay, let's say, 2€ more (for the 20% tax). Person B paid 12€ for the asset he bought and he decides to sell it to person C (in the meantime, the asset's value has remained steady). Person C now has to pay 12€ plus 20% of 12€ as tax, all in all 14,4€. Person D buying the asset from person C now pays 20% more, which leads to a price of $14,4€ + (20\% * 14,4€) = 17,28€$. All this is a vicious cycle increasing the asset's price, but not its value, as long as the persons A-Z don't want to infer losses of course. The more transactions a financial asset is subjected to, the more tax money the government earns. This is called a cascade / cascading tax.

Taxes like the VAT are calculated for the seller on the value he added to the object of transaction. Above example with VAT: Person A sells the object for 10€ plus 2 € to person B (12€). The latter sells it for 12€ and... he didn't add any value, so he doesn't pay taxes. If he had added a value of 2€, he would have sold it to person C for $12€ + 2€ + (2€ * 20\%) = 14,4€$ and paid the government tax for the added value of 2€, which would have amounted to $2€ * 20\% = 0,4€$ or $[14€ \text{ (already taxed value + added value, on which tax is calculated)} - 12€ \text{ (already taxed value)}] * 20\% = 0,4€$. This means that the government received taxes for 10€ (initial value) + 2€ (added value) as opposed to FTT, where the government would have received taxes for 10€ (initial value) + 12€ (initial + added value) (equaling 4,4€ instead of the 2,4€ under VAT).

As described above, FTT is a cascading form of taxation and, therefore, greatly decreases financial liquidity for those forms of assets subject to it.

3. Avoidability using financial derivatives:

Simple example: With FTT in effect, person A buys some shares, e.g. from Apple, with a value of 1000€ (paying 20% => 200€ tax). Then, after their value has increased to 1200€, he sells them again for 1200€ paying 240€ taxes. All in all, person A has paid 440€ to the government. However, certain financial derivatives allow him to speculate on the market value of 1000€ in shares of Apple avoiding the tax:

Person A signs a swap agreement with an investment bank with a notional principal amount (NPA) of 1000€ in Apple shares and one month duration. This means that they agree on the following: "At the ending date of the agreement person A owes the bank the interest rate which a 1000€ loan over a period of one month would have incurred while the bank owes person A the fluctuation of the value of 1000€ of Apple shares." (If the shares would have brought him a profit of 200€ upon resale at the ending date of the swap agreement, the bank now owes person A 200€) The result? The tax destined for the government now amounts only to:

$20\% * (\text{fluctuation of } 1000€ \text{ Apple shares under the circumstances described above} + \text{interest rate of loan as described above}) =$ most probably much less than the 440€ the government would have earned, if it wasn't for the swap...

⇒ The procedure described above is one of the most trivial financial interactions which could be used to avoid FTT. Of

course according legislation could dictate that the FTTax should be calculated based on the NPA (the 1000€), but there exist much more complicated financial instruments to consider. In this sense, the determination of the taxable amount could become almost impossible on a broad basis.

Having considered the above arguments in favor as well as against FTT, the revenues' aspect should be taken into account as well. By taxing the gross proceeds of a financial transaction much more income is generated for the government than by taxing the net proceeds and that at a very low tax rate. Further aspects concerning the implementation of FTT will be presented in the section "Possible Solutions".

Major countries and organizations involved

Germany:

Chancellor Angela Merkel's government has agreed to place additional pressure on the rest of the EU members for the implementation of FTT inside the EU (after having first proposed it) in exchange for support from the opposition for the timely ratification of the new EU treaty "compelling fiscal discipline".

UK, US, Canada & China:

Against FTT of any extensive form.

France, Italy & Spain:

After the latest meeting in Rome among Germany, France, Spain and Italy, an intention "to seek a euro-zone financial transaction tax, which could be used to pay for bank rescues without more government borrowing" was announced. Especially France's new president, Mr. Hollande, has committed himself to focusing on the enactment of FTT.

Brazil, South Korea, Hong Kong, South Africa, Switzerland, Taiwan, India, Argentina, Turkey & others:

Already enacted FTT.

IMF:

In response to the crisis and the request of the G20 nations addressing the IMF at the 2009 G20 summit "to prepare a report for our next meeting with regard to the range of options countries have adopted or are considering as

to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system”, the IMF prepared a report for the G20 entitled “A Fair and Substantial Contribution by the Financial Sector” outlining, amongst other things, three possible options for the contribution of the financial markets to state revenue and their own future bail-out:

- The FTT,
- The Financial Activities Tax (FAT), which would be based on the profits of financial institution (banks, but also others) and bankers’ remuneration packages and
- The Financial Stability Contribution (FSC) or “Bank Tax”, which would be based on the assets currently in possession of the financial institutions covered by the tax.

The IMF paper further stated that “While much detail remains, its potential merits are such that the combination of a FAT and a levy of the kind described above [FTT] offers a coherent package for addressing the objectives set out above. [Generating revenue, decreasing volatility, etc.]”

The IMF paper also stated that “Like an FTT, a FAT would tend to reduce the size of the financial sector—but with less uncertainty as to its impact on the structure of financial markets, effective implementation and, to some extent, incidence.”

Finally, the following statement from the IMF paper should be noted: “There may indeed be a case to supplement a levy of the kind described above with some other form of taxation, but an FTT does not appear well suited to the specific purposes set out in the mandate from G-20 leaders.”

Many NGOs support FTT.

Relevant UN Treaties, Resolutions and Events

- The NGO Committee on Financing for Development and the Working Group on Innovative Sources of Financing for Development of the UN have published a paper entitled “Innovative sources of Financing for Development” stating that: “We urge governments to implement an international FTT with an explicit development component.”

- UN News Center: “14 May 2012 – A group of United Nations independent experts today called on the European Union (EU) to take the lead in promoting the adoption of a global financial transaction tax that would offset the costs of the current economic crisis and protect basic human rights.”
- A “report of the activities in the framework of the 5th UN high level debate on financing for development” in New York from the 5th to the 9th of December 2011 made a few interesting statements:
 - o “The session focused on innovative mechanisms to finance development (mainly the role of the Financial Transaction Tax (FTT)) and how these mechanisms can address inequality and link the local and the global agendas.”
 - o “Unfortunately, as the last G20 meeting in Cannes proved, a clear consensus among governments is, however, still lacking. Neither within the EU, nor within the UN has consensus been reached. Although Norway and France have been pushing to introduce the FTT in the UN’s resolution on FfD, G77 countries have rejected such proposal.”
 - o “There was total consensus that different options of FTT are feasible mechanisms which, additionally to ODA commitments, could be crucial to fill the current financial development gap and to solve the “global solidarity dilemma” as many experts have highlighted. However, the real challenge nowadays is to gather the necessary political will to implement such mechanism.”

Possible Solutions

When it comes to the implementation of FTT, there are numerous factors to consider. At first the targeted financial assets and liabilities and, consequently, the types of taxable financial transactions have to be defined. FTTs having been proposed in the past include:

- The Keynes tax addressing securities, therefore called STT (as mentioned before).
- Currency transaction taxes like the Tobin tax (spot conversions of currencies), the Spahn tax (high tax rates apply to currency transactions deemed outside the admissible range by a central authority) and Special Drawing Rights (SDRs – foreign exchange reserve assets that establish a claim on non-gold foreign exchange reserve assets of IMF member nations).

- The bank transaction tax applying to entries on bank accounts.

Among the categories of financial assets which could be taxed, apart from the plain products issued in the primary market (dealing with the issue of new financial assets, like bonds securities, etc.) and further circulated in the secondary (resale of already existing financial assets), structured products and financial derivatives play an important role, in that the latter cannot only substitute many other financial assets and serve tax evasion, but also that they are complex and difficult to incorporate in tax-related legislation. Nevertheless, since FTT aims at taxing the financial sector and not taxpayers, certain categories like insurance contracts, mortgage lending, consumer credits, payment services and other financial transactions could or even should be exempted from the tax. Deciding on the taxable categories is the most crucial step in FTT implementation, as FTT, while generation revenue, functions as a discouraging factor to the markets of those financial assets covered by it. (Structured products are investment initiatives in which the profits from financial assets are used to purchase other financial assets, usually derivatives, which then generate the revenue produced by or lead to the loss inferred by the structured product. They are most commonly used to buy financial assets in the long run (years), which otherwise would be too expensive.)

Furthermore, the institutional units to whose financial transactions the FTTax applies have to be defined. The states of the EU discussing the implementation of FTT have given an extremely broad definition of the taxable institutional units (including all banks as well as “investment firms, organized markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, holding companies, financial leasing companies, special purpose entities [...] and other persons carrying out certain financial activities on a significant basis”. Central banks of member states and the European Central Bank (ECB) are exempted).

Another aspect of the implementation of FTT is the jurisdiction of the tax. Sweden lost a large portion of its financial market, which immigrated to England, after having imposed FTT on domestic financial transactions. In order to avoid the tax, everyone started to conduct their financial transactions abroad. In order to prevent the occurrence of such an effect, the EU FTT in discussion uses residence-based jurisdiction. All institutional units being “financial” residents of the EU would pay the tax. Residency includes branches of financial institutions, registration, authorization to act, headquarters and other “establishments” in EU member countries (and for people residency in an EU country, of course). Even financial transactions, which are conducted by institutional units not established in the EU, would be

taxed in case an institutional unit established in the EU participated in those transactions. However, residency does not extend to subsidiaries, affiliates and corporate parents. Therefore, EU FTT might result in less non-EU residents using EU residents for financial transactions and EU residents using their non-EU affiliates to conduct financial transactions. The above points clarify the importance of giving exact legal definitions concerning the jurisdiction of the tax.

Finally, as stated before, financial derivatives can be used to complicate things. Provisions like “Where more than one PNAs are identified, the highest shall determine the height of the tax.” can contribute to solving this problem. However, even a committee of experts would have a hard time trying to foresee and prevent all the different ways of avoiding the FTT. The development of more complicated financial instruments aiming to avoid FTT could even result in increased confusion and mistrust at the markets. Therefore, financial derivatives constitute a point of much controversy in international talks about FTT and should be devoted the attention they deserve.

FTT has not yet reached international recognition and international talks as well as ECOSOC debates about this taxing option aim to create agreement upon the question whether FTT should be implemented and, if so, to which scope as well as with which parameters.

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