Review of the economic impact of the European Commission proposals for a financial transaction tax

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Review of the Commission’s impact assessment

- model of GDP impact due to effect on the cost of capital
- relocation of transactions
- capital flight
- economic incidence
## Review of GDP impact numbers

<table>
<thead>
<tr>
<th>Economic model</th>
<th>Commission impact assessment</th>
<th>Adjusted assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1.76% of GDP</td>
<td>Tax both sides of transaction</td>
</tr>
<tr>
<td>Primary market</td>
<td>−2.2%</td>
<td>Accept</td>
</tr>
<tr>
<td>Non-FI transaction</td>
<td>−15%</td>
<td>Accept</td>
</tr>
<tr>
<td>HFT transactions</td>
<td>−40%</td>
<td>Reject</td>
</tr>
<tr>
<td>Company finance</td>
<td>−40%</td>
<td>Accept only bank lending assumption</td>
</tr>
<tr>
<td><strong>Final impact</strong></td>
<td>0.53% of GDP</td>
<td></td>
</tr>
</tbody>
</table>

These impact numbers are for the ‘closed-economy’
Two scenarios for the open economy

**Scenario 1: Relocation to avoid the tax**

- financial transactions relocate outside EU to avoid the tax
  - both tax revenues and GDP impact would be lower than in the closed-economy
  - overall tax revenue impact could still be negative
  - significant loss of FS activity for major EU financial centres

**Scenario 2: Tax difficult to avoid, causing capital flight**

- difficult for EU companies and investors to avoid the tax
  - FTT revenue is closer to expectations
  - impact on wider EU economy is at least as severe as ‘closed-economy’ model
  - non-EU investors require higher pre-tax returns from EU companies
  - overall tax revenue impact could be negative
Economic incidence

- investors and companies would share the burden of the tax
  - either investors accept lower post-tax returns if they cannot avoid paying the tax
  - or companies have to pay higher pre-tax returns to compensate
- rates of return are determined by the ‘marginal’ investor
  - non-EU investors do not have to accept lower returns
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PROPOSED EU COMMISSION FINANCIAL TRANSACTION TAX IMPACT ANALYSIS ON FOREIGN EXCHANGE MARKETS

31 January 2012

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Overview & scope of the paper

• **Overview of the proposed Financial Transaction Tax (FTT)**
  – On 28th September 2011 European Commission President José Manuel Barroso, unveiled the EU Commission’s proposal for an EU wide financial transaction tax (FTT) which would take effect from 1\textsuperscript{st} January 2014
  – The current proposal states securities transactions are to be charged 0.1% on the purchase price and derivative transactions are to be charged at a minimum rate of 0.01% of the notional value traded
  – For FX, Forwards, Swaps, and Options are subject to the 0.01% of notional tax

• **Scope of the paper**
  – Oliver Wyman was asked by the Global FX Division of GFMA to conduct an independent review of the effects of the FTT within the EU on FX markets
  – We quantified, to the extent possible, how the proposed tax will impact direct transaction costs
  – We also analysed the secondary impacts and indirect cost implications
  – Taking these together we have quantified the total additional direct and indirect costs imposed by the FTT and the effects on the different users of FX products
Conclusions (1 / 2)

1. **The tax will dramatically increase the cost to transact with particular impact on the most liquid, most traded products (e.g. 1 week EUR/USD swaps)**
   - The most liquid products are impacted the most due to the tight bid/ask spreads, the resulting relative increase in transaction costs will be 9-18x
   - 75% of eligible volumes in the FX swap market are <1 week in duration and so the majority of the trading volumes will see a significant increase in direct transaction costs
   - Considering the entire tax eligible FX cash and derivatives market including products of all durations, we estimate the weighted average increase in transaction costs to be 3-7x

2. **The real economy (asset managers, pension funds, insurers, and corporates) may experience the largest increases in transactions costs**
   - These counterparties have a more limited ability to shift treasury operations outside the EU tax jurisdiction
   - Counterparties within the tax jurisdiction could experience an increase in costs due to likelihood of FTT being passed on to end users, including tax exempt corporates
   - Asset managers, pension funds, and insurers could be doubly hit due to both responsibility for their own tax liability as well as any portion of the tax passed through from the dealer
Conclusions (2 / 2)

3. Speculative trading is less impacted due to portability of booking location
   - High frequency trading accounts for ~10% of total traded tax eligible FX cash and derivative volumes conducted by hedge funds and the proprietary trading desks of banks
   - Oliver Wyman estimates that hedge funds able to relocate ~80% of total transactions outside the EU tax jurisdiction
   - Oliver Wyman notes that dealers are likely to shift booking of transactions to locations outside the EU tax jurisdiction; we estimate a net shift of 60-80% of volumes by dealers
   - Oliver Wyman estimates the impact of cessation of high frequency trading in the EU at ~1% of global FX cash and derivative turnover, this equates to a ~6% reduction in FX cash and derivative turnover involving at least one EU counterparty

4. The implementation of the tax costs the economy more than the tax burden
   - Versus today, there could be a 70-75% shift in volumes due to relocation of trading outside the EU tax jurisdiction and to a lesser extent a reduction in short-term speculative activity, reducing overall market volumes and impacting liquidity within the EU
   - Volume relocation outside and reduction of trading within the EU tax jurisdiction could lead to a widening bid/ask spreads by up to 110% depending on currency pair and product; this leads to the overall cost of tax to the economy being greater than the tax revenue generated