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A European Tax on Foreign Exchange Transactions?

*Sandor Richter**

Introduction

The financing of the redistribution of resources across member states of the European Union (EU), the EU's »own resources«, currently consists of three main components: customs duties collected at the common external border of the customs union, part of the value added tax (VAT) revenues in the individual member states calculated by statistical methods (VAT-based own resources) and, as the biggest part, the component proportional with the member states' gross national income (GNI) (GNI-based own resources) calculated by a unified rate. This system lends decisive leverage to the national treasuries in negotiations about the size and, to a lesser extent, the ways of the allocation of funds earmarked for cross member state redistribution by the EU. The periodically returning debates and the disappointing bargaining about the financial perspectives for 2007 to 2013 have led to the proposal for a comprehensive review of the EU budget in 2008/2009. The forthcoming review provides an opportunity for initiating fundamental reforms which may take two different courses. The first one is the extension of the GNI-based component of the

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current system, with member state contributions reflecting as closely as possible the differences in the individual member states' economic strength. This would be a transparent, simple, efficient and fair system in terms of burden sharing at member state level. The alternative course of reform relies on the principle that the EU should increasingly become a »Union of the citizens«, therefore the »own resources« should be collected through the introduction of a European tax. In the past decade several options for a European tax were discussed: income taxes (personal income tax, corporate income tax, withholding tax on interest income, and transfer of seigniorage revenue); taxes on real transactions (genuine VAT, taxation of energy, communication taxation, climate charge on aviation, and excise duties on tobacco and alcohol); and finally a tax on financial transactions (tax on stock exchange transactions in shares and bonds). This latter group has recently been extended by proposals for a tax on foreign exchange transactions. This paper addresses the pros and cons of a European tax on foreign exchange transactions.

The Idea

The original idea of a global tax on foreign exchange transactions was first raised by the US economist James Tobin in 1972.¹ The tax (often referred to as the Tobin tax) was intended to »throw sand into the wheels of international speculation«. The essential property of the transactions tax, as Tobin formulates it, is

»that this simple, one-parameter tax would automatically penalize short-horizon round trips, while negligibly affecting the incentives for a commodity trade and long term capital investments. [...] It handles, with built in flexibility, problems that were formerly tackled by rigid quantitative exchange controls or financial regulations.« (Tobin 1996a: xi)

The world economy background of the proposal for a transactions tax on foreign exchanges has been the diverging development of foreign exchange transactions related to the real economy and of speculation, respectively. According to data from the latest Triennial Bank Survey published by the Bank for International Settlements (BIS), the average global daily turnover in April 2004 (»traditional« foreign exchange transactions² only) amounted to USD 1.9 trillion (BIS 2005: 5). On the basis of 245 business days this is an annual turnover of USD 461 trillion. In the same year USD 11,069 billion global exports of goods and services and USD 730 billion global foreign direct investment (FDI) outflows were reported. The former amounted to 2.4 percent, the latter to 0.16 percent of the annual value of foreign exchange transactions in 2004.³

1 James Tobin put forward the idea at his Janeway Lectures at Princeton in 1972 (Tobin 1974).

2 Spot and outright forwards transactions, foreign exchange swaps. Not included in this figure are transactions in the form of derivatives.

3 The world gross domestic product (GDP) in that year (USD 40,671 billion) made up less than ten percent (8.8 percent) of the foreign exchange transactions (World Investment Report 2005: 14)

What concerns Europe, close to half of the global turnover falls on the EU members (USD 224,000 billion) and a further over five percent share of the total turnover (USD 24,000 billion) on non-EU Europe, primarily Switzerland (see table 1). As the above figures indicate, only a small fragment of foreign exchange transactions is directly related to real economy transactions such as trade and FDI. A considerable, though not exactly known part of the transactions concerned is of indirect relevance for the real economy: these consist of insurance, hedging and arbitrage. What remains is speculation.

In the original Tobin proposal the revenue-raising capacity of a tax on foreign exchange transactions was seen as a by-product of an economic policy measure whose primary role would be to put an efficient brake on the growth of international speculation in a world economy where traditional restrictions on cross-border capital movement have been practically removed completely.⁴ The revenue-generating capacity was rediscovered and became increasingly popular in the middle of the 1990s.

Table 1: Geographical Distribution of Reported Foreign Exchange Market Turnover¹, Daily averages in April 1995 and 2004

	1995	2004
	% share	
EU-15 Eurozone	17.5	13.6
EU-15 national currencies (UK, Sweden, Denmark)	32.8	34.3
EU-8 new member states	...	0.7
Non-EU Europe ²	6.0	5.2
Global players ³	42.5	42.5
Rest of the world	1.2	3.7
Total	100.0	100.0

1 Adjusted for local double-counting (net-gross).

2 Switzerland, Norway, Turkey, Russia.

3 Japan, USA, Hong Kong, Singapore, Australia, Canada.

Source: BIS 2005, Table B.6

Heavy Weights and Light Weights – The Actors in Foreign Exchange Transactions

The potential payers of a tax on foreign exchange transactions would be the economic agents participating in foreign exchange trade – reporting dealers, other financial institutions, and non-financial customers:⁵

4 »Raising revenue has never been my main motivation« (Tobin 1996a: xvi). »In any case, the principal purpose of the tax is to expand the autonomy of national monetary policies« (Tobin 1996b: 496).

5 Definitions according to Bank for International Settlements (BIS) (2005: 36).

- *Reporting dealers*: Financial institutions that actively participate in local and global foreign exchange and derivatives markets. Mainly large commercial and investment banks and securities houses trading in currencies both for their own account and/or meeting customer demand. They typically deal through electronic platforms, EBS or Reuters.
- *Other financial institutions*: Financial institutions that are not classified as reporting dealers, including smaller commercial and investment banks and securities houses plus pension funds, insurance and leasing companies, hedge funds, mutual funds, money market funds, currency funds, building societies, financial subsidiaries of corporate firms and central banks.
- *Non-financial customers*: Any counterparty in a deal other than those described above; mainly end users such as corporations and governments.

In 2004 slightly more than half of the total foreign exchange turnover fell on reporting dealers. Other financial institutions had a one-third share in that year. Non-financial customers participated with 14 percent (BIS 2005: 6). Roughly one third of the trade was local, among traders located in the same country, and two thirds of the turnover fell on cross-border deals with traders located in two different countries. Trade in foreign exchange is highly concentrated. 75 percent of the total turnover in the US was conducted by 16 banks; in the UK, Japan, Singapore and Hong Kong by eleven banks each. Among the EU member states, two thirds of the total turnover was settled by six banks in France and by four banks in Germany. Switzerland, an important non-EU European player, had five banks settling the bulk of the turnover (BIS 2005: 11).

Revenues from the Tax

In order to arrive at an estimate of the revenues from a foreign exchange tax, assumptions must be made about a few key parameters. The decisive question arising here is what reduction in trading volume would have to be expected due to the tax. The answer requires an assumption about the likely extent of fiscal evasion, the share of trade possibly exempted from taxation (*«official» trading*), and the pre-tax transactions costs for dealer banks, other financial institutions and non-financial customers. Further, volume elasticity must be estimated for each of the three groups of potential taxpayers in the case of various tax rates.

Depending on the above assumptions, the estimates for global revenues from a foreign exchange tax differ widely. The lowest revenue was estimated by Kapoor.⁶ Calculating with the 2004 daily turnover, with no fiscal evasion, pre-transactions costs between 0.01 percent and 0.03 percent and a very low 0.005 tax rate, he arrived at an annual tax revenue of USD 10 to 15 billion. The high end of the altogether 13 independent estimates shows annual revenue of USD 176 billion, USD 177 billion and USD 180 billion.⁷

6 Calculations by Kapoor, published in 2004 as cited in Jetin/Denys (2005: 131).

7 Calculations by the Ministry of Finance, Finland in 2001; Frankel (1996), and Felix/Sau (1996) as cited in Jetin/Denys (2005: 131).

There are four estimations for the tax revenues in the European Union. The French Ministry of Finance, working with 1998 turnover data, arrived at USD 22 billion revenues from the tax with differentiated tax rates (0.01 percent for dealer banks, 0.2 percent for others).⁸ Spahn (2002: 57), working with 2001 turnover data and differentiated tax rates (0.01 percent for dealer banks, 0.02 percent for others), arrived at a range of USD 16.6 to 20.8 billion annual revenues at EU-15 level. The Belgian Ministry of Finance, based on 1998 turnover data, estimated USD 9 to 39 billion, depending on the tax rate (0.01 percent and 1 percent, respectively).⁹

The most recent and detailed estimation has been made by Jetin/Denys (2005: 131) for the Eurozone, the EU-15 and the EU-15 plus Norway and Switzerland. The authors calculated with differentiated pre-transactions costs (0.02 percent for the dealer banks, 0.05 percent for other financial institutions and 0.1 percent for non-financial institutions) and volume elasticity (-1.75 for the dealer banks, -1.1 for other financial institutions and -0.55 for non-financial institutions) (see table 2).¹⁰

Jetin/Denys reckon with fiscal evasion ranging from 25.2 percent in the case of the lowest and 40 percent in the case of the highest tax rate. A wide range of tax rates are tested, the lowest being 0.01 percent and the highest 1 percent. The authors' central estimation is based on a 0.02 percent tax rate for dealer banks and a 0.1 percent tax rate for other financial institutions and non-financial customers. At these tax rates the fiscal evasion is assumed to reach 25 percent to 26.5 percent in the Eurozone, 20 percent to 21.5 percent in the EU-15 and 18 percent to 19 percent in the EU-15 plus Norway and Switzerland. The endogenous reduction of the volume of transactions would amount to about 70 percent in the dealer banks' group and in the circle of other financial institutions, and somewhat above 30 percent in the non-financial sector.

Table 2: Main Assumptions in Jetin/Denys's Central Estimation for the EU-15

	Reported dealers	Other financial institutions	Non financial institutions
Fiscal evasion (in %)	20.3	21.5	21.5
Pre-tax transaction costs (in %)	0.02	0.05	0.1
Tax rate (in %)	0.02	0.1	0.1
Elasticity (in %)	-1.75	-1.1	-0.55
Endogeneous reduction of volume (in %)	70.3	70.1	31.7

Source: Jetin/Denys 2005: 131 ff.

8 Calculations by the Ministry of Finance, France in 2000 for the EU-15, as cited in Jetin/Denys (2005: 131).

9 Ministry of Finance, Belgium (2001) as cited in Jetin/Denys (2005: 146 ff.).

10 Transactions costs may actually vary in a very wide band. Concerning volume elasticities, Frankel (1996: 61 ff.) warns that any hypothesis concerning the volume elasticity is arbitrary.

Based on 2004 global trade volume data, the estimated tax revenue for the Eurozone amounts to USD 29.3 billion a year. (See figure 1) In the EU-15 the revenues would be USD 47.5 billion, the upward jump is explained by the extraordinary importance of the market place London. Finally, in the EU-15 plus Norway and Switzerland tax revenues would amount to USD 55.3 billion.

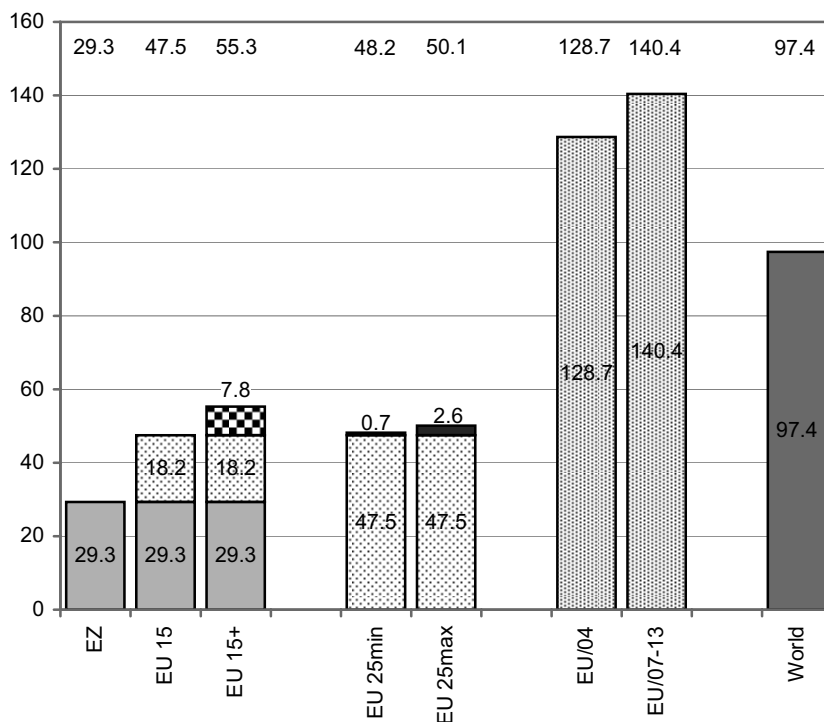
A back-on-the-envelope estimate for the EU-25 can be made by taking the share of the new members in the global foreign exchange turnover.¹¹ In 2004 the EU-15 had a share of 47.9 percent in the global foreign exchange turnover, the ten new members of 0.7 percent (BIS 2005: 12). That means that, if the tax revenues from the EU-25 were proportional to the old and new members' share in global foreign exchange turnover, the EU-25 tax revenue would amount to USD 48.2 billion, that is USD 0.7 billion more than for the EU-15. In another approach we may apply a GDP-proportional estimation. The GDP of the EU-25 is 5.4 percent higher at current exchange rates than that of the EU-15 (Podkaminer et al. 2006: vi). With regard to the lower level of development of the new member states, we may take this as the upper limit of a potential NMS contribution to the revenues from an EU-wide foreign exchange transactions tax. This sum is USD 2.6 billion. Supplementing the estimation by Jetin/Denys for the EU-15 by the GDP-proportional new member states' contribution, we arrive at USD 50.1 billion tax revenues for the EU-25.

It turns out from all these estimations that independently of the methodology selected and the range of the tax rates and other important parameters, the estimated revenues from a foreign exchange transactions tax are far from the needed resources for the EU budget. The EU's own resources in 2004 amounted to EUR 103.5 billion (European Commission 2005: 112), or USD 128.7 billion.¹² In 2007 to 2013 the annual average own resources will amount to about EUR 117 billion. Reckoning with a USD/EUR exchange rate of 1.2 the above sum will amount to USD 140 billion a year in the period concerned.

A common feature of all estimations that they reckon with a substantial decrease in the volume of transactions. Unless the foreign exchange transactions tax is introduced globally, the reduction registered is the outcome of two processes: on the one hand, transactions will not be realized under the changed conditions (absolute decline), on the other hand they will be realized but outside the jurisdiction of the involved region (relative decline due to relocation). This latter is the more inconvenient for the financial market places benefiting from their outstanding role in foreign exchange transactions. Even if there are no estimates about the possible extent of relocations after the introduction of the tax, the prospect of London's downgrading as a financial market place will make the government of the United Kingdom, beyond any doubt, a fervent opponent to the foreign exchange tax.

11 Bulgaria and Romania joined the EU in January 2007. The BIS data used here refer to 2004, a year when these two countries were not in the EU yet, further in that year they had no respective registered foreign exchange turnover.

12 At an exchange rate of 1.2439 USD/EUR.

Figure 1: Foreign Exchange Transactions Tax Revenue, Estimates for 2004 (USD billion)

EZ: Eurozone, EU 15: Eurozone plus United Kingdom (UK), Sweden (SE) and Denmark (DK), EU 15+: EU 15 plus Switzerland (CH) and Norway (NO), EU 25min: EU 15 plus new member states (NMS) min., EU 25max: EU 15 NMS max., EU/04: EU own resources 2004, EU/07-13: EU own resources annual average 2007-2013

Source: Jetin/Denys 2005, for EU-25 min. and EU-25 max., own calculations

Assessing the Foreign Exchange Tax as an EU Tax

In the more than a decade long discussion on possible new own resources for the EU a couple of criteria have been used for the assessment of individual proposals. These can be allocated in three groups. First, criteria addressing the need to turn the EU the Union of its citizens, in this respect via the taxation; second, criteria related to the practical budgetary aspects and finally the criteria dealing with equity of taxpayers. Next follows a short assessment of the foreign exchange transaction tax according to these criteria.

Creating a union of the citizens The foreign exchange tax, as a newly introduced tax, could be easily made fully independent of the national budgets. As concerns visibility, the foreign exchange tax would perform poorly. Citizens resident in the Eurozone and traveling rarely outside it would practically never come across the tax. Citizens in the currently

14 non-Eurozone member states would have more chance to experience the tax, but only as tourists travelling abroad and changing money in their home country or in another EU member state.¹³ Direct »visibility« would be confined to the level of firms (and those employees whose daily work involves currency exchanges).

With regard to the widespread sentiments in the population of the EU member states against speculation in general, the idea of the tax may become popular or can be made popular with public relations campaigns. For the non-professional audience it may seem that the tax is paid predominantly by the dealer banks and other financial institutions. The secondary redistribution of the tax burdens and the fact that eventually all economic agents and finally the citizens themselves would participate in financing the EU budget will remain disguised. If the main target consists in citizens getting closer to their Union in the sense that they sacrifice a small fraction of their incomes for supporting the provision of EU-wide public goods from a community budget, then the above-mentioned effect is negative. If the main target is to introduce a European tax which is easily acceptable for the citizens, then the hidden secondary redistribution is an important advantage.

With regard to foreign exchange transactions, we cannot speak about externalities in the traditional sense (protection of the environment, less consumption of alcohol and tobacco).

Nevertheless, the likely sharp decline in the foreign exchange turnover is an externality to be reckoned with. But the classification of this externality as desirable or undesirable depends on the observer's judgement of the role of speculation in the economy as well as on the extent to which other than speculative transactions would be affected. Practical experience with the primary and secondary impacts of the tax would verify or reject the predictions in this field.

Budgetary aspects The revenues generated by a foreign exchange tax would not be sufficient to deliver the resources required to finance the EU budget completely. Even according to the most optimistic estimate the potential revenues would cover only about 39 per cent of the EU's current expenditures. The collected tax, however, would be sufficient to replace the notional VAT component of the current system. It is highly questionable though, whether it is worth taking the related political and economic risks for the sake of a partial solution to the original problem. In terms of stability, the foreign exchange tax is not among the best candidates for an EU tax with regard to the uncertain degree of turnover reduction triggered by the tax. Collection costs may be kept relatively low with regard to the high degree of computerization in this segment. Nevertheless, as a new tax, the instalment of the collecting bodies and the organization of management and control may induce high initial costs.

13 If foreign exchange transactions in the range of average tourists' needs were exempted from the tax, as it would be expedient due to the high costs of collection relative to the revenues, the citizens would practically never come across the tax.

Equity With equal tax rate(s) across the three main groups of participants in the foreign exchange market in each member state, the conditions for equal treatment at the level of enterprises is secured. An important advantage is that, being a new tax, no harmonization across member states would be necessary. In the case of this tax vertical equity (high-income tax payers should contribute more to the EU budget than low-income ones) can hardly be interpreted. A likely differentiation in the tax rate applied (lower for the reporting dealers, higher for the other financial and non-financial institutions) would reflect the different pre-tax transactions costs for participants in the groups concerned and by no means a differentiation between wealthy and less wealthy taxpayers. About the vertical equity emerging in the course of the secondary redistribution of the tax burdens we do not know anything.

By far the most important issue for »equity« will be the fair contribution across member states. The participation of the individual EU member states in global foreign exchange trade may be the starting point for an assessment. Under the assumption that the proportions of the global market shares reflect the proportions of the foreign exchange tax revenues that may be collected in member states, it turns out that the United Kingdom would deliver about two thirds of the revenues from an EU-wide foreign exchange tax. Other big member states such as Germany, France and Italy would contribute to the common budget with ten percent, five percent and less than two percent of the total, respectively. The new member states together (without Malta and Cyprus) would contribute about 1.4 per-cent to the collected revenues. It is obvious that this allocation across member states is far from being fair as it does not reflect the proportions of the EU member states' actual economic performance. Further, the proportions in the global foreign exchange turnover before the introduction of the tax are not necessarily identical or similar to those emerging after the introduction of the tax. The reduction in trading volumes may be different across member states, thus it is impossible to predict the proportions of member state contributions to the EU budget after the introduction of the tax.

If we drop the requirement for a fair sharing of burdens across member states and opt for regional arbitrariness, the performance of the tax on foreign exchange transactions is better. In the EU-15 about 13 percent of the revenues would come from reporting dealer banks, 43 percent from other financial institutions.¹⁴ Both groups consist of typically multinational firms. In the group of the ten biggest reporting dealer banks, US institutions are playing a dominant role.

As mentioned above, we do not know anything about the emerging proportions of market shares in the global foreign exchange turnover after the introduction of the tax. Due to likely relocations of related activities to non-taxed jurisdictions, the European market place for foreign exchange transactions would lose its current significance, but we do not know either how much or in what cross member state proportions.

The special position of the United Kingdom has to be carefully analysed. Should its outstanding position in the global foreign exchange market be maintained in the future,

14 Calculation based on Jetin and Denys (2005: 149).

the »nominal« UK contribution to the EU budget would be extremely high relative to the country's economic performance. But, in the opposite case, if the relevance of the London market declined to a level where the UK contribution would be consistent with the country's relative economic strength in the EU, the loss of secondary benefits derived from London being one of the most eminent market places in the world would make any British government an implacable opponent to an EU-wide foreign exchange tax.

When assessing the political reception of a foreign exchange transactions tax it must be recalled that the intention to utilize the potential revenues for financing the EU budget may meet strong opposition by anti-globalization movements, as this would diminish the chances that global development targets will be financed with the help of exactly these revenues.

Concluding, in my opinion based on the above considerations, the foreign exchange tax is not among the most promising candidates for a European tax. The search for new ways of financing the EU must carry on, even if it will practically be impossible to find a solution which fulfils all criteria. It is still a long way to go until a compromise based on clever balancing of advantages and disadvantages for individual member states can be achieved.

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Shift of the Use of Bilateral Investment Treaties as a Shield to Using Them as a Sword Against Government Activity?

*Christian Bellak**

According to many observers, one of the reasons why the Multilateral Agreement (MAI) failed was that it departed from conventional regulation, where the state sets the framework of rules and defines the obligations of companies. The MAI instead tried to define the rights of investors and the obligations of the state – and this fact applies largely to Bilateral Investment Treaties (BITs) as well.

In a nutshell, according to the United Nations Conference on Trade and Development (UNCTAD), BITs

»are agreements between two countries for the reciprocal encouragement, promotion and protection of investments in each other's territories by companies based in either country. Treaties typically cover the following areas: scope and definition of investment, admission and establishment, national treatment, most-favoured-nation treatment, fair and equitable treatment, compensation in the event of expropriation or damage to the investment, guarantees of free transfers of funds, and dispute settlement mechanisms, both state-state and investor-state.« (UNCTAD 2006a)

Current State of BITs

At present, the situation with respect to BITs is characterised by three main features.

First, a strong increase in the *number of BITs* occurred recently.

* Vienna University of Economics and Business Administration. This contribution builds on an earlier contribution to a panel discussion on »Towards a More Coherent International Policy Framework for MNEs«, chaired by Professor Rajneesh Narula, at the 30th European International Business Academy meeting in Fribourg, Switzerland.