Extraordinary Delusions and the Madness of Crowds – The European Financial Transaction Tax

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1. Tulip Mania

Do you know the connection between Tulips and the Euro Crisis?

I remember reading, a few years ago, the "Extraordinary Popular Delusions and the Madness of Crowds" by Charles Mackay, a book that offered, among many other things, an overview of historical economic bubbles and their effects.

After reading this book, one word marked me forever: Speculation...

Which kind of thing has the power to drive men into a state of near-insanity? Having some doubts... I'll work it out for you: Money!

And how do men obtain large amounts of money in such a broken financial world? The answer is simple: same way we have been doing that for ages: speculating, buying and selling on the markets, but not just that, avoiding regulation, evading the tax system, whar is also important for traders looking to make some serious money!

But now people appear to be acting even more insane than before, the ones who began all this... because now we have Structured Financial products (or toxic, if you know what I mean), with names that would be better applied into some fictional character in a cartoon, and with mechanisms of application that almost everybody fails to understand. Such financial products also have an enormous power...

But let's not get ahead of ourselves:

Have you heard about the Dutch Tulip Mania?

Indubitably, as we were beginning to clarify, men like to speculate. Better yet, man loves, longs, cannot live without, and so on, just to be able to speculate, sell, buy, make some money on the side, buy sugar and magically sell it as if it were gold... that's who we are now!

And it all began with the Tulip Mania, the first financial bubble of all times!

Can you imagine living in a time where simple tulip bulbs would be traded or sold for more than 10 times the annual income of a skilled craftsman? That time, a Tulip was worth the same as a house.

That happened... came like the wind, and went by like the wind: it was in February 1637! When that bubble collapsed, it left financial holocaust all over Europe. All because of speculation! And people are still doing it, but now it is even worse. They do it not caring about anything, much less about moral hazard, taxes or justice. And that has to stop!

Here we stand in 2012 and we are doing it all over again! We are turning the markets into a giant bubble that will (no doubt about it) collapse!

Speculation does not walk alone: tax evasion, double taxation and distortions of competition within the Market's are problems without an apparent solution. No returning point! That's where we are. Or so it seemed...

The main reason behind my words is the speculation around the European Country's debts. I believe financial speculation nowadays to be what the Tulip Mania was back then.

The world is holding breath, and everybody is thinking: can Greece hold on? Can Ireland? Spain? Portugal? And people are betting on it. Make no mistake: huge financial transactions are being held on European soil, without a solid tax regulation to prevent evasion.

That's why a tighter regulation is needed. And for a while, the European Union appeared not willing to intervene!

Or so it seemed to us before a proposal for the introduction of a Financial Transaction Tax (the "FTT") in the 27 Member States of the EU was made. An historical day: 28 September 2011!

Alongside with the emission of Eurobonds that we defended in our latest article, we believe this to be a huge step towards a stronger Euro-zone economy, and the end of the crisis.

Shall we have a look at the FTT?

2. FTT

Notwithstanding the difficulties that the European Commission (the "Commission") has encountered, and struggled with, to obtain the approval for the FTT from all the 27 Member States of the European Union (the "EU"), this FTT is really to be applied.

So it is important to analyse such proposal, granting an overview of its bases, it's possibilities of application, even if through a mechanism of enhanced cooperation, such as its effects and next steps until it's conclusion and entering into force.

3. The Proposal

The proposal seeks to set up a harmonised tax at EU level to create a solid internal market for financial services. This tax would prevent tax evasion, avoid double taxation and minimise distortions of competition within the EU's Single Market.

The Commission has decided to propose this new FTT to (i) ensure that the financial sector makes a fair contribution at a time of fiscal consolidation in the Member States and (ii) to strengthen the EU Single Market.

Nowadays 10 Member States already possess a FTT similar to the one the Commission has proposed. However, this proposal seeks to impose minimum tax rates and to harmonize the different taxes over financial transactions that already exist in the Member States.

4. Definition of FTT

A FTT is a tax applied to financial transactions, usually at a very low rate. A financial transaction applies for the exchange of financial instruments ((securities, bonds, shares and derivatives) between banks or other financial institutions.

The European Parliament (the "EP") voted in favour of the Commission proposal on 23 May 2012, and issued an opinion defending the need to better design the FTT in order to capture more traders and make evasion unprofitable. The EP, although presenting a series of amendments to the proposal, considers that such proposal should be adopted, even if it fails to be adopted by all Member States.

The Commission proposed minimum tax rates for the trading of the bonds and shares of 0.1% and 0.01% for derivative products. The EP considered such tax rates to be sufficient.

Based on the original proposal, the FTT was only based on a "residence principle". The transactions will be subjected to the FTT if at least one party to the transaction is established in a Member State.

The EP imposed an "issuance principle" whereby financial institutions located outside the EU would also be obliged to pay the FTT if they traded securities originally issued within the EU.

5. Tax base

One of the major goals of the Commission and of EP is to prevent the evasion to FTT, turning such an evasion more unprofitable than to pay it, trough minimum tax rates. As such, the tax base proposed by the Commission is very broad, aiming to reduce the risks of tax evasion and dislocation of the markets. The tax rate above mentioned is the minimum rate, although, all Member States will be free to apply higher tax rates.

6. Benefits of the FTT

The Commission aims for the FTT to be applied in all 27 Member States, with the purpose to contribute, like any other tax does, to the public finances. As for the FTT, part of the revenue will go to the EU budget and another part will help finance the budgets of Member States. The Commission estimates that, at a rate of 0.1% to bonds and shares and 0.01% for derivatives, the tax could raise € 57 Billion per year.

It is intended to benefit the companies and the citizens with the FTT, through the increase in the public accounts, that can be utilised to create economic growth and bring prosperity to the EU.

7. How will the FTT be charged?

The tax burden will fall on the financial institutions (banks, investment companies, insurance companies, collective investments undertakings and their managers, alternative investment funds such as hedge funds and others). The FTT will be applied to all transactions if at least one party to the transaction is established in a Member State and to all financial institutions that trade securities originally based within the EU.

The FTT will be paid immediately by financial institutions to Member States on the basis of the transactions undertaken, before netting and settlement.

8. Mitigation of the risk of the tax being passed on to consumers

To prevent such an indirect risk, the Commission has proposed that the FTT should cover only transactions where financial institutions are involved, taxing only the financial sector, not their clients. However, in case private households and enterprises were to purchase or sell financial products, financial institutions could pass on the tax, charging an amount for each transaction.

The Commission will be looking for excessive amounts charged by financial institutions and will intervene if it happens.
Of an extreme importance is the fact that the transactions made on the primary market are exempt from the FTT. This will prevent investments that contribute to the real economy from being subject to the tax.

9. Next steps

The EP has issued an opinion on the proposal and such amended proposal was discussed by all Member States in the EU's Council of Ministers on 22 June 2012. The Commission will present it to the G20 Summit in November 2012.

Even though some of the Member States are against the application of a FTT, the Commission and the EU intend it to enter into force, even if failing to do so in all Member States, envisaging an enhanced cooperation.

It was proposed by the Commission and adopted by the EP that the FTT will be adopted until 31 December 2013, entering in force on 1 January 2014.

10. Conclusion

Will the FTT solve speculation problems? Probably not, but it will help and show to the meanest traders out there that regulation is really possible, even to financial transactions.

Like the stories reported by Charles Mackay at the "Extraordinary Popular Delusions and the Madness of Crowds" have shown us, men's social psychology and psychopathology is even more toxic than economics and financial markets!

You have read it here: go on, run and tell the world!

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