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FESE Input to the IMF Consultation Note on Financial Sector Taxation

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The Federation of European Securities Exchanges (FESE) represents the Market Operators of 42 securities exchanges active in equities, bonds, and derivatives in the European Union (EU) and Iceland, Norway and Switzerland.

With the present letter, we would like to share our Member Exchanges' views concerning the IMF preparatory work on a possible new financial sector taxation for the April meeting of the G-20. In principle, we are supportive of the principle of the financial sector industry shouldering the burden of the financial crisis. However, this should be based on two principles:

- The chosen method should be fair in design and application, with no significant risk of unintended consequences and economic distortions.
- The activities and actors targeted should be those that have the closest link to the origins of the crisis so as to focus the financial burden on those activities that, from a public interest perspective, should be restrained.

In light of these principles, we are convinced that the idea of a financial transaction tax is not the appropriate method for this purpose, given the difficulties of applying such a tax without competitive distortions and somewhat targeted to those at the origins of the crisis.

Specifically:

a) Empirical evidence shows that transaction taxes have negative effects on the economy:

Empirical evidence shows that transaction taxes have detrimental effects on liquidity, they increase volatility, volume fragmentation and market segmentation and lead to flawed price discovery. As argued in an IMF Staff Paper[1], transaction taxes can have negative effects on price discovery, volatility, and market liquidity in securities markets. These effects can lead to a reduction in market efficiency and may contribute to increased asset price volatility. The same paper studies the Swedish introduction of a transaction tax in 1984 and explains the negative effects this had on Swedish economy.

b) Transaction taxes are difficult to levy outside organised multilateral market but inherently unfair und counter-productive to financial market transparency and stability if they fail to cover all actors and all instruments:

[1] K Habermeier and A. Kirilenko, Securities transaction taxes and financial markets , IMF staff papers, 2003: http://www.imf.org/external/pubs/ft/staffp/2002/00-00/pdf/haberm.pdf

In order to be fair, the fiscal intervention should be aimed at the originators and dealers of the complex financial products at the origins of the crisis. The crisis originated from the US and specifically from the unregulated part of the market, i.e. structured products and over-the-counter (OTC) derivatives. It is therefore necessary to avoid any attempt to tax financial transactions that would fail to cover OTC transactions and unfairly shift the burden on the public markets. According to our estimations, 38% of European equity trading is OTC. As of December 2008, the breakdown of the global derivatives market was of 90% OTC[2]. Fixed income global markets, finally, are predominantly OTC[3]. The predominant shares of the capital markets in all asset classes would therefore remain outside the scope of the proposed taxation.

Moreover, there is a risk of unintended damage to retail investors. Generally, OTC is used by institutional investors who want to execute large orders to prevent adverse price movements; smaller and retail investors instead use public and transparent markets. Therefore, taxation on on-exchange transactions only would end up hitting small investors and small companies. In other words, the burden would once again be on the victims of the crisis. Finally, another important aspect to consider is that of providing an incentive to execute trades OTC - in order to escape the taxation, volumes would migrate to the assets that are not subject to the tax.

c) **If not consistently implemented in <u>all</u> countries, it can have very serious effects on the competitiveness of those countries where the tax is applied.**

The last problem is geographical. In order to be effective, taxation should be implemented globally not to favour an economy over another. To do so, a strong political agreement would be necessary; the G-20 did not include a recommendation for an international transaction tax in the September 2009 Statement after the meeting in Pittsburgh, exposing the heterogeneity of the leaders' views on this proposal. In the months following the meeting, this divergence has not been addressed; the lack of political agreement is still a relevant element to consider.

It is worth highlighting that several EU countries already have in place a securities transaction tax already. This tax has different labels and characteristics in different countries. In the context of the efforts to harmonise the taxation practices of EU Member States, an additional tax would create confusion and be duplicative.

In conclusion, we recommend against using the financial transaction tax as a policy for the IMF's stated objectives.

We hope that these views will prove to be helpful when presenting the IMF initial analysis to the G-20 finance ministers in April 2010.

Sincerely yours,

J. Hardt

Judith Hardt – Secretary General

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2 http://www.eurexchange.com/download/documents/publications/WPDerivativesMarketBlueprint.pdf

3 IFSL Bond market Report: http://www.ifsl.org.uk/upload/Bond%20Markets%202009.pdf
and SIFMA 2009 Jan-Nov Average Daily Trading Volume:
http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USBondMarketTradingVolume.pdf