The relevance of the Swedish case in the current FTT debate

Introduction

As a result of the 2008 financial sector meltdown, the idea of introducing a financial transactions tax (FTT) has been intensely discussed. While the debate at the global level has been slow-moving and hesitant, the EU has now arrived at a point where concrete policy proposals are on the table.

The FTT idea as such is, however, very controversial also in Europe. The opponents often use the failure of the Swedish FTT in the 1980s as an argument against the present Commission proposal. This was, for example, frequently done during the high-level conference on the future Multi-annual Financial Framework in Brussels 20-21 October 2011.

During a meeting with the French Minister of European Affairs Mr Jean Leonetti he asked me if that comparison was relevant, and if I could produce an analysis of the Swedish õcaseö compared with the EU Commission´s more modern FTT proposal. I promised to deliver that, and here it is.

The aim of this short note is to evaluate the relevance of the Swedish case for the assessment of the Commissionøs FTT proposals. What can the Swedish FTT of the 1980s tell us about the potential effects of a similar type of EU level legislation being introduced today? Following a summary of the Swedish case, that particular experience is compared with the Commission proposal on three key points: size, scope and mechanism.

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Sharp proposals finally on the table

In September 2011, the European Commission presented the concept of a coordinated framework of nationally based transaction taxes that would in total raise around 57 billion euro a year. All Member States would have to respect a set of general guidelines and two minimum rates: 0,01% for derivatives and 0,1% for shares and bonds. Before taking this initiative, the Commission had in June argued in favour of using national FTT revenues as a way of financing part of the multiannual EU budget for 2014-2020. Since such revenues ó estimated at 37 billion euro per year ó would be fully offset by reduced national membership fees and would therefore not expand the EUøs financial muscles, the motive would be to create a more stable funding base for EU activities, and to ease the burden of the GNI based EU contribution on national budgets.[1]

The Commissionøs move on the FTT means that a discourse that has until now been largely theoretical must turn practical. The rather vague political argumentation that has so far been used by both proponents and opponents needs to be more firmly anchored in reality. One of the few empirical references that are actually being made is to the Swedish case, which in particular is brought forward by opponents seeking to discredit the Commissionøs proposals. Because a transaction tax ó the argument goes ó reduced market volumes and pushed trading away from Sweden in the 1980s, the concept could never work in the EU as a whole in the 2010s.

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[1] For the Commission proposal, see European Commission 2011-09-28a. All descriptions in this note of the Commission proposal are based on that document. The complete material produced by the Commission on the FTT can be found at: http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm.

The Swedish FTT in brief

The Swedish FTT was introduced in 1984 and abolished in 1991.[2] Its size and scope was changed on several occasions. From 1984 until 1989, it applied primarily to transactions in stocks and stock-based derivatives. From 1989, transactions in fixed-income securities ó primarily bonds and bills ó and derivatives based on those securities were included as well.

The driving force behind the tax was LO (the Swedish Trade Union Confederation). In spite of protests from the Finance Ministry and the opposition, LO managed to secure support for the tax from the ruling Social Democratic Party. The primary aim in the first phase was to dampen the rapid wage increases taking place in the financial sector. Adding fixed-income securities in the second phase was more about trying to curb speculation.

Partly because of the political focus on wages in the domestic financial sector, the tax was levied on Swedish brokerage services. Brokers generally made a lot of money at that time and all transactions of a substantial size carried out in Sweden depended on such services. This meant that the tax did not apply to small transactions where a broker was not involved. It also meant that transactions in Swedish securities via non-Swedish brokers outside of Sweden were not made subject to taxation.

In the first phase, stock transactions were from 1984 taxed at 0,5% on both purchase and sale (ie 1% per round-trip). Stock options were taxed at 1%. In the first two years of these rates being applied, the effects were limited. Revenues were a disappointment. Therefore, the rates were doubled in 1986, raising the tax on stock transactions to 1%. This increase quite drastically altered market behaviour. In order to avoid the tax, foreign actors shifted large parts of their transactions in Swedish stocks to non-Swedish brokers that were not based in Sweden. Around 60% of the trading volume in the most actively traded Swedish stock classes moved to London. Swedish investors, on the other hand, could not avoid the tax that easily. Some of them established offshore domiciles or companies to use non-Swedish brokers, but that was an expensive manoeuvre. The main reaction from Swedish actors was instead a dampening of transaction volumes. Overall, the 1986 rate increase did not reduce total trading volumes in Swedish stocks by much, but rather pushed trading from Stockholm to London ó meaning that tax revenues in Sweden remained very small.

In the second phase, taxes on some fixed-income securities and some associated derivatives were added. The key categories were government bonds and bills. The tax rates varied, but the maximum rate was no higher than 0,15% of the underlying notional or cash amount. For bills and bonds, longer maturities meant higher tax rates. While maturities of more than five years were taxed at 0,015%, maturities under 90 days were taxed at 0,001%. This fixed-income addition had a very drastic impact on market behaviour. In the first week, for example, trading in bonds fell by around 85% and trading in futures on bills and bonds by as much as about 98%. Consequently, revenues turned out to be scant. The reason for the market collapse was not emigration of the trading abroad, but instead the fact that there were excellent fixed-income substitutes in the Swedish market to the instruments that were made subject to taxation. In order to avoid the tax, investors very easily and inexpensively moved from bills and bonds into non-taxed instruments like debentures, variable-rate notes, forward-rate agreements and swaps.

Because of the bad performance of the Swedish FTT in most markets, it was phased-out and eliminated in 1990-1991. There is broad agreement in the financial literature that the tax was a failure. Schulmeister et al succinctly conclude that the tax õfailed due to a bad tax design and the resulting migration of trading volumeö.[3]

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[2] This brief summary of the Swedish case is based on the accounts in Campbell & Froot 1994 and Umlauf 1993.
[3] Schulmeister et al 2008, 24.

Size

Comparing the size of the Swedish FTT with the EU FTT proposed by the Commission is straight-forward when it comes to stocks. The Swedish tax on stock transactions was at 0,5% (1984-86) and 1% (1986-90) 5 to 10 times higher than the 0,1% minimum level put forward in the Commission proposal. This must be seen as a substantial difference.

On bonds, the relationship is the opposite. The Swedish rates (around 0,015-0,001%) were markedly lower than the Commission's 0,1% minimum level.

On derivatives, comparisons are a bit difficult. In general, however, Swedish rates were much higher than the 0,01% Commission minimum. In Sweden, derivatives were taxed at rates ranging from 1% (stock options from 1986) to levels at or below 0,15% (some derivatives from 1989).

What is most often being discussed when the Swedish case is brought up is the migration of trading in Swedish stocks to London and the collapse of parts of the domestic derivatives market. When making such references, it is thus important to bear in mind that the Swedish rates in these areas were much higher than in the current Commission proposal.

Scope

Although the Swedish FTT via the addition in 1989 grew into a rather broad taxation structure, it contained some important empty spaces. In the Commission outline, a very wide general scope is somewhat limited by a couple of key exemptions. These exemptions relate to transactions directly involving private households and SMEs, spot transactions in the currency exchange market as well as the raising of capital by companies and public bodies in primary market operations.

The empty spaces in the Swedish FTT scope turned out to be very troublesome from a taxation point of view. In particular, since there were excellent non-taxed substitutes for bonds and the other fixed-income instruments that were taxed from 1989, applying such a narrow scope in the fixed-income area was a mistake. Taxes were smoothly avoided by investors.

The Commission in its proposal seems determined not to repeat such a mistake. It explicitly points out that "[t]he scope of the tax is wide, because it aims at covering transactions relating to all types of financial instruments as they are often close substitutes for each other".[4] It seems unlikely that the few exemptions being proposed would open up any troublesome empty spaces.

Mechanism

A second drawback in the Swedish FTT design was that the tax was levied on Swedish brokerage services only, with the effect that foreign actors moved large parts of their trading in Swedish stocks to brokers established in London.

The Commission prefers to apply the FTT to all transactions between all financial institutions – with a broad definition of what should be seen as such an institution. It also introduces a residence rule, meaning that any transaction in the world where a European institution is involved should be subject to taxation in Europe. These two principles, if they work reasonably well when put into practice, should be able to function as relatively strong mechanisms against tax avoidance.

The Swedish-style migration problem, however, is not specifically taken care of in the Commission proposal. There still seems to be an opening for non-European institutions to at least partly avoid

[4] European Commission 2011-09-28a, 6.

the tax by carrying out more of their trading in European financial instruments outside of Europe with other non-European institutions.

One example of how this Swedish dilemma could be handled is the mechanism of the British stamp duties. These duties are levied on transactions in shares in UK companies no matter who is involved in the transaction or where it takes place in the world. There are some minor loopholes, but as a general rule, everyone trading in British stocks has to pay the tax.[5] With such a provision in the Swedish FTT design, the migration problem could have been dealt with. It is not perfectly clear if the British stamp duty mechanism would be allowed under a new EU FTT legislation or if other Member States would be allowed to copy it. It is quite clear, however, that this detail is important for how efficient a future EU FTT system would be.[6]

In sum, the Commission proposal makes it a bit harder for non-Europeans to take their EU-related business elsewhere than it was for non-Swedes to move their Sweden-related trading to London. At the same time, the unclear status of the possible use of the stamp duty mechanism makes the comparison difficult.

	Swedish FTT 1980s	**EU FTT**
Market	8 million	500 million
Size Stocks Bonds Derivatives	 0,5 ó 1,0% 0,001 ó 0,015%ª 0,15 ó 1,0% º	 0,1% 0,1% 0,01%
Scope	1984ó Stocks, stock-based derivatives. 1989ó Addition of some fixed-income securities (primarily bonds/bills) and associated derivatives. Substantial empty spaces ó good non-taxed substitutes.	Very wide general scope limited by a couple of key exemptions: households/SMEs, currency spot market, raising of capital in primary market operations.
Mechanism	Narrow. Tax levied on Swedish brokerage services only. Avoidance very easy for non-Swedish actors.	Inclusive. Tax levied on all transactions (minus exemptions) between all financial institutions.

n: Number of citizens.
a: The 0,001% rate was applied to bills.
o: Some derivatives rates were fixed below 0,15%.

Conclusion

The Swedish FTT should be seen as a first try in an area where well-functioning taxation is rather difficult to put into place. Sweden really went into uncharted territory when shaping the national FTT strategy in the early 1980s. It is not very surprising that mistakes were made.

In one way, the Swedish FTT case is highly relevant in the current FTT debate. It contains a couple of useful indications on what to avoid in a present-day FTT. The rates on stocks and some

[5] European Commission 2011-09-28b, 4ff.
[6] Darvas & von Weizsäcker (2010, 7) identify the mechanism chosen in this context as being a key factor that largely determines the revenues and impact of an FTT. With the Swedish FTT, avoidance was much easier than with the British stamp duties. Schulmeister et al (2008, 26) draw a similar conclusion, highlighting that õthe importance of the tax design cannot be overratedö.

derivatives were probably too high, the strategy of only taxing national brokerage services was too narrow and the idea of leaving some fixed-income securities untaxed was flawed. All this is valuable information.

Using the Swedish case as proof of what is to be expected if the new Commission proposal is implemented, however, is questionable. There are too many differences between that case and the present EU FTT concept. The Swedish FTT was much higher regarding stocks and derivatives. It had a major flaw in the area of fixed-income instruments that the Commission has avoided. Its mechanism, targeted at Swedish brokers, did not work. The Commission proposal is better in this regard and there is possibly an opening for individual Member States to apply more efficient taxation solutions based on the British stamp duty dynamics. And, of course, Sweden was a much smaller market with some 8 million inhabitants ó much easier to abandon ó compared with the 500 million EU consumers.

However ó some of the problematic consequences of the Swedish FTT may appear also for an EU FTT. Trading volumes in European markets might decrease and there could be a certain degree of evasion. At the same time, there is no reason to believe that the EU FTT would deliver the dramatic negative effects that the Swedish predecessor did. There are also strong arguments for assuming that the EU FTT would be more efficient on the revenue side than the Swedish FTT.

The Swedish FTT case is good for information, but a weak basis for claiming that the proposed EU FTT could never work.

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