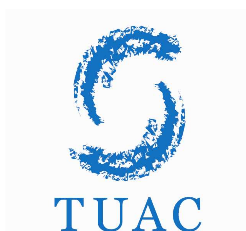

The Impact of a Financial Transaction Tax on Workers' Right to Retirement and their Pension Funds

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The European Commission proposal for a financial transaction tax (FTT) of September 2011[1] has been met with fierce resistance by the banking and asset management industry on the ground that it would increase transaction costs, and would in turn "*hit the real economy as these costs would largely be passed onto all end users [...] including pension funds*"[2]. Trade unions support the creation of an FTT. At the same time trade unions are attentive to the views of the pension fund industry and their asset managers. In what follows, we respond to the main criticisms and concerns about the impact of an FTT on workers' right to retirement and their pension funds.

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The macroeconomic impact on retirees and on workers' future retirement income

It has been claimed that the FTT "would unfairly hammer workers pensions" and the retirees. Broadly speaking, there are two distinct, but often complementary ways to finance pensions: through public transfers (pay-as-you-go, tax-financed) and through capital investments (pre-funded pension schemes). Across Europe, low- and middle-income worker pensions rely primarily on public transfers. These transfers will be unaffected by the FTT because they do not require transactions in the financial markets. The FTT will impact workers' pensions where these are financed by capital investments, or "pre-funded" systems.

According to the OECD[3] public transfers account for two thirds or more of retirees' income in across the EU with the exception of Ireland, Denmark, the Netherlands, the UK and Finland.

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[1] applying a rate of 0.1% on equities and bonds and 0.01% on derivatives http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/com(2011)594_en.pdf
[2] http://www.afme.eu/WorkArea//DownloadAsset.aspx?id=5755
[3] OECD Income-Distribution Database: http://dx.doi.org/10.1787/888932371025

By contrast, capital investments – including pre-funded pension schemes – account for less than 10% of retirees' income in all EU countries except Germany (15%) and are a substantial source of income (ie. above 20%) in 6 countries: Finland, Netherlands, UK, Denmark, Ireland, Sweden. Unsurprisingly it is in the latter list of countries that the debate on the impact of an FTT on pensions has been most visible.

Pension funds and the speculative investors

Critics of the FTT also argue that pension funds do not belong to the speculative investor category, which is aimed at by the FTT, that it is impossible to "distinguish speculators from long term investors", and accordingly pension funds will be innocent bystander victims of the new tax.

Pension funds have to deal with numerous transactions on a daily basis and accordingly they would be hit by an FTT no matter what. But pension funds are long term investors given their liability profile. Unlike banks they face very little short term liquidity pressures and are important owners of long term securities such as bonds. Compared to other investors, they have longer holding period policies and hence comparatively would be less exposed to the cost of an FTT. The cost of an FTT will be high for short term equity and bond trading – particularly hedge funds and high frequency trading. At the other end of the spectrum, the cost will be low for private equity funds (which invest in unlisted equity, each transactions spanning over three or more years)[4].

Transmission of the tax burden from asset managers to asset owners

It is also claimed that while theoretically pension funds themselves are expected to have longer holding periods than short term investors, in practice their portfolios is most often delegated to asset managers. Accordingly pension funds "will be hit twice" by the FTT: when the fund manager arranges a transaction on behalf of the fund and when the fund acquires or sells that asset".

There are two categories of financial investors: (i) asset owners – including pension funds, insurance companies and sovereign funds – and (ii) asset managers (or fund managers) – including banks' asset management branches, money market funds, hedge funds, private equity, etc. An asset manager trades on behalf of an asset owner. The asset owner (say a pension fund) makes a one-time transaction to the asset manager when the investment mandate is granted. Mandates span over a year, if not several years. As the holding period is long, the direct cost for the asset owner is therefore marginal.

Asset managers will take the bulk of the FTT. As noted above, the cost for the asset manager will depend on its investment strategy: high cost for short term holding period, low cost of long term period. Opponents to the FTT believe that 90-100% of the cost borne by asset managers will be transferred on pension funds. But there is no evidence that this will happen

[4] According to Stephany Griffith-Jones & Avinash Persaud "The average pension fund holds a stock on average for 2 years. If we assume then that there is a 0.1% transaction tax for buying and selling and every two years a pension fund has bought and sold 50% of its portfolio, it would pay transaction taxes equivalent to 0.05%. A High Frequency Trader will turn over its entire portfolio in a day, would pay transaction taxes of 50% per year, or 100 times more than an average pension fund. What is likely to happen therefore is that high-frequency trading falls off dramatically" (Griffith-Jones & Persaud 2012).

but rather be shared all along the investment chain. There is competition in the market place and asset managers will want to keep their clients.

It is undeniable that the FTT will impact the portfolio composition of pension funds and their risk management policy. But that in fact is the objective. There is a wide consensus that pension funds currently under-invest in "patient" and "productive" capital (infrastructure, green initiatives, SME finance) and are excessively reliant on external asset managers' short termism. The FTT will encourage pension funds to reduce exposure to short term trading and to increase pension money in long term investments.

A disproportionate impact via the OTC derivatives?

Because pension funds are heavy users of derivatives (to hedge pension liabilities), they may be impacted by the FTT disproportionably. And indeed the FTT on the model of the EC proposal will very likely wipe out a good part of the trading Europe of over-the-counter (OTC) derivatives. Pension funds are indeed key investors in the USD+450tr interest-related derivatives market. But here too what matters is the holding period. In essence OTC derivatives are insurance schemes. Pension funds buy them because they have a legitimate need for insurance, not for speculation. Accordingly they hold OTC derivatives until they reach maturity, which can span over several years. According to BIS statistics, of the USD394tr worth OTC single-currency interest rate derivatives held by investors other than large banks, 55% had a maturity above 1 year, and 24% had a maturity above 5 years (BIS 2011).

It is also worth mentioning the fact the OECD supports the creation of an FTT for OTC derivatives because it would *"help to reduce the trend towards less socially useful derivatives activity"*. The rationale for the OECD is as follows:

- The OTC market is already characterised by illiquidity, so the standard objection may not apply or matter.
- The FTT would help standardisation, clearing and trading on exchanges of derivatives and hence increase transparency and accountability.
- The incidence of the charge would fall more on "*short-term gambling/churning*" rather than on longer-term final user hedging (including pension funds) and it would lengthen the holding period of derivative products.

An FTT applied to OTC trading would contribute to greater standardisation and hence greater transparency and accountability and would lengthen the holding period of derivative products, which play in favour of pension funds.

Ex-ante exemption or ex-post compensation?

Based on a rough calculation, Dutch pension asset manager APG believes that an EC-Style FTT would have Dutch pension funds to "*pay 3 billion euro per year, which equals approximately 6% of the total taxes (57 billion euro) that the European Commission aims to collect*". Accordingly each Dutch pensioner would pay no less than €500 per year. Unfortunately that "rough calculation" is not detailed and cannot be verified. Financial advocacy networks have produced similar alarming figures. According to a report commissioned by the European bankers' lobby group AFME, and EC-style FTT would increase transaction costs "*by up to 18 times*" which "*would, in turn, hit the real economy as*

these costs would largely be passed onto all end users" including pension funds" (AFME 2012).

There are limits to what can be achieved with ex ante impact assessment and studies particularly on a topic such at the FTT. The Commission concedes that its own impact assessment "*should be interpreted with caution given certain limitations of the underlying models*", which "*could overestimate the negative GDP effects of the tax*" (EC 2011). The Dutch government think tank CPB agrees that "*To assess the macro-economic costs of a financial transaction tax, one would ideally draw on studies that estimate these effects directly. Such studies do not exist.*" (CPB 2012). The problem is even more acute for pension funds. Neither the European Commission, the IMF, the OECD, the ECB, the BIS nor Eurostat have sufficiently detailed data on pension funds' portfolio composition (beyond broad asset class division: bond, equity, mutual funds, cash, alternatives). By contrast *ex-post* periodic reviews in the implementation phase of the FTT would go a long way in mitigating any unintended negative impact of an FTT including on workers pensions. Many reforms are conducted that way.

About pension funds, taxation and government guarantees

Although not addressed by opponents to the FTT, it is worth recalling that pension funds already enjoy significant tax exemptions across Europe and beyond: tax exemptions on contributions by employers and employees, on capital gains by pension funds and/or on pension benefits by retirees. Several countries grant "government guarantees" to pension funds (Stewart 2007). These government guarantees do not come free. They are treated as contingent liabilities' on governments' balance sheet and are factored in their sovereign ratings.

The impact of an FTT on pension funds should be considered within the context of significant direct tax exemptions as well indirect exemptions (via VAT exemptions benefiting the asset management industry). If needed, these tax exemptions could be adjusted so as to protect pension plan members' retirement income and rights. Also, given that the revenue of the FTT would go the government budget, it would, indirectly, help strengthen pension-related government guarantees where they exist.

Source

Griffith-Jones & Avinash Persaud 2012 "Financial Transaction Taxes" Stephany Griffith-Jones and Avinash Persaud, February 2012 http://www.stephanygj.net/papers/FTT.pdf

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