# Regulating the financial industry through taxation: Consequences of the financial transaction tax

Advocates of a financial transaction tax (FTT) believe it could help curtail excessive risk and market volatility, despite the potential adverse consequences for both investors and financial markets. Recently, some EU Member States introduced their own FTTs, which could imply certain risks and drawbacks compared to an EU-level initiative.

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Abstract: The notion of a financial transaction tax (FTT) gained popularity in the aftermath of the 2008 crisis as a way of curtailing excessive risk and financial market volatility. Such a tax targets transactions involved in the trading of several types of securities. Interestingly, the idea first appeared during the Great Depression in the work published by J. M. Keynes, and subsequently in the form of the so-called 'Tobin Tax', theorized by James Tobin in 1978. In 2011, the European Commission promoted the adoption of an EU-wide FTT. However, the proposal has attracted numerous criticisms relating to its unintended consequences on transaction volumes and market liquidity, the role of

normal hedging activities, and the potential impact on the cost of capital. In the absence of a unilateral agreement across Member States, Spain has sent a draft law for an FTT to Parliament in February. The Spanish FTT proposal would impose a 0.2% tax rate on transactions that covers securities issued by around 60 Spanish firms. However, to be successful, this initiative requires the voluntary cooperation of international parties and other countries. Moreover, as currently conceived, the Spanish FTT would impose a greater tax burden on the financial sector, which already pays a higher tax rate than the corporate sector. For all these reasons, if an FTT is to eventually be enacted, an EU-level FTT would be preferable to those enacted unilaterally by EU Members States.

## Introduction

Since the aftermath of the financial crisis in 2008, policy makers, academics, and regulators have been discussing policy tools to improve financial stability and prevent new episodes of financial turmoil. Proposals have spanned from regulating the financial industry through traditional "command and control" regulations to imposing regulatory taxes to address the "negative externalities" often associated with financial crises (*i.e.,* excess risk-taking).

Negative externalities occur when economic agents do not fully bear the costs of their actions. Instead, the cost borne by the society as a whole is greater than that borne by the economic agent who has engaged in the activity producing the externality. In practice, negative externalities result in market failures (*e.g.,* moral hazard) since economic agents do not fully internalize the costs created by the negative externalities.

Theory shows that when trade is possible and when externalities and transaction costs are sufficiently low, a Pareto efficient outcome is available through bargaining, regardless of the initial allocation of property among the agents (Coase, 1960). However, these assumptions are oftentimes not satisfied (*e.g.,* transaction costs are rarely sufficiently low to allow for efficient bargaining). Hence, under certain circumstances, it could be desirable for the regulator to intervene and regulate. One way to do so is by taxing the economic agent that creates the negative externality. This way, its marginal cost of production will increase and, correspondingly, its output –which embeds the externality– will decrease. Furthermore, by relying on regulatory taxes to curb negative externalities in financial markets, the regulator could also achieve the objective of raising tax revenue to fund potential future bank bailouts.

In this paper, we focus on regulatory taxes, and particularly on the financial transaction tax (herein, "FTT"), as a tool to mitigate negative externalities in financial markets. Although it might sound appealing for the regulator to use its taxing power to both raise revenue and regulate financial institutions, we will argue that care should be taken when enacting financial transaction taxes. Indeed, after providing the reader with a theoretical analysis on the effects of the FTT, we will point to several economic consequences that could arise from implementing such a tax. Subsequently, we will elaborate on the challenges that a regulator would face when designing FTTs. We will also focus on the EU Commission's Proposal for an EU-wide FTT, which, to date, has yet to achieve a broad consensus among Member States. In this regard, some countries have been vigorously opposing an EU-wide FTT (*e.g.,* the United Kingdom) and some others have favored it, such that France in 2012 and Italy in 2013 have already enacted FTTs unilaterally. Finally, we will conclude with the current Spanish proposal for implementing its own FTT.

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## Theoretical background on the FTT

The financial transaction tax is a tax targeting transactions that involve the trading of several types of securities. Specifically, the FTT should apply to every transaction involving "the purchases and sales of financial instruments as well as other types of financial transactions that may not technically constitute a purchase or sale (*e.g.*, derivatives) but have a similar scope and effect. As such, FTTs can be levied on one, a few, or a broad range of instruments, including stocks, fixed income securities, derivatives, and foreign exchange" (Brondolo, 2011).

The regulatory goal of the FTT is to reduce short-term speculative trading and by extension its impact on market volatility. Hence, the fundamental assumption of the FTT is that financial markets are characterized by excessive short-term trading, which gives rise to "long swings in asset prices and persistent deviation from their fundamental equilibria" (Schulmeister, 2009, p. 3).

The twofold aim of reducing short-term trading and market volatility should be achieved through imposing an additional transaction cost –the amount of the FTT– on targeted transactions. The underlying idea is that the higher the number of transactions taking place, the higher the amount of taxes because of the "cascading effect" of the FTT. Ultimately, such a cascading effect should discourage short-termism, favor long-term investment and align asset prices to their intrinsic values.

The idea of taxing financial transactions for these regulatory purposes dates to the Great Depression of August 1929. The first to theorize the FTT was John Maynard Keynes in 1936. While observing the short-term speculation occurring on Wall Street during the 1930s, Keynes was worried that the speculative trading of "noise traders"

(*i.e.*, traders who do not make trades based on fundamental values) could cause security prices to move away from their fundamental equilibrium values, with negative effects on the real economy. This noise trading would in turn reduce the information content of market prices and generate excess volatility in the market. To overcome this issue, Keynes proposed "the introduction of a substantial Government transfer tax on all transactions [which] might prove [to be] the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise" (Keynes, 1936, p. 160).

Several years later, in 1978, Nobel Prize winner James Tobin proposed a foreign exchange tax (the so-called "Tobin Tax") similar to Keynes' FTT. The Tobin Tax would have uniformly applied to all spot currency conversions with the aim of stabilizing currencies after the breakdown of the Bretton Woods system (Tobin, 1918). Tobin's proposal gained further momentum in the 1980s, when the liberalization of financial markets boosted trading activity, leading to short-termism and excess volatility. In 1984, Tobin suggested broadening the scope of the Tobin Tax to capture the trading of all financial instruments, not only currencies, to mitigate excess volatility and better align prices to their intrinsic values.

In the aftermath of the financial crisis of 2007-2009, regulators as well as academics have revived the idea of taxing financial institutions and their transactions on the grounds that such a tax would improve financial stability and discourage market participants from excess risk-taking (*i.e.*, the Pigovian motive for correcting externalities) and would raise tax revenues (*i.e.,* the fiscal motive). In 2011, the European Commission promoted the adoption of a tax on all financial transactions involving a European-based institution. Although the EU Commission

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proposal for a common FTT has not yet found the necessary consensus for its adoption, some countries (*e.g.*, France in 2012 and Italy in 2013) have unilaterally introduced FTTs into their tax systems. Other countries, such as Spain in 2020, have initiated the parliamentary procedure for of an FTT.

## The EU Commission's proposal for an FTT

On September 28th, 2011, the European Commission enacted an FTT proposal, which follows the regional multilateralism model (hereinafter, the "EU Proposal" or "EU FTT"). [1] The original intention of the European Commission was for unanimous approval of the proposal by all EU Member States. However, several Member States have so far opposed to the need for unanimous consensus. Therefore, the EU Proposal has been the subject of an "enhanced cooperation" procedure, promoted by ten Member States. [2]

The aim of the EU Proposal for an EU FTT was to "address particularly risky behavior". Specifically, the tax rests on the assumption that, over the last two decades, the steady increase in trading activity in EU financial markets has led to excessive liquidity (Schulmeister, 2009, note 4, p. 3). Hence, the EU FTT would be an EU-wide tax on securities aimed at both correcting negative externalities in financial markets and raising revenue from the financial sector to fund public goods and services.

In the aftermath of the proposal, several criticisms have arisen, particularly from the financial industry. The strongest argument against the tax has maintained that the increase in trading activity experienced over the last decades in Europe, and in particular the trading of derivatives, represents normal hedging that allows genuine price discovery, rather than trading activity for speculative purposes. To the extent that such trading allows agents to hedge risky positions, it should not be subject to either regulation or taxation, as it would be detrimental to the financial sector.

Other concerns have also been raised that a financial transactions tax would give rise to unintended consequences for volume and market liquidity. Several observers claim that reducing short-term trading volumes and market liquidity is not an appropriate goal to pursue. They highlight that, based on the efficient capital market hypothesis (Fama, 1970), high trading volumes play a fundamental role in the process of price discovery and in driving asset prices toward their price equilibrium. Indeed, given that the FTT affects all trading activity and not just speculative trades, some authors have suggested that the FTT could have a negative effect on liquidity providers and informed traders who usually act as price stabilizers in the market. Specifically, by reducing the amount of informed trading, the FTT would cause asset prices to diverge from their fundamental values, (Schulmeister, 2009, note 4, p. 3) which in turn would increase "noise trading" (Stiglitz, 1989) and volatility (Amihud and Mendelson, 2003). [3]

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Furthermore, some scholars have also warned about a potential impact of the FTT on the cost of capital. [4] The underlying assumption is that higher transaction costs increase the required rates of return that investors demand (Amihud and Mendelson, 1986). The increase in the cost of capital could in turn have adverse effects on investment and employment and, more generally, on the economy (Cortez and Vogel, 2011).

## Design of the FTT and related issues

The EU FTT should apply to a broad range of securities and financial transactions that are negotiable on the capital markets. The most important categories include transferable securities and money market instruments –with the exception of the instruments of payment– shares in collective investment undertakings, and derivative agreements, as well as transactions outside the organized markets (including over-the-counter (OTC) transactions).

Some transactions would be exempt from the tax, such as those transactions involving the European Central Bank or national central banks of EU Member States. Despite the wide reach of the proposed tax, the transactions connected with business activities or carried out by retail investors would also be excluded (*e.g.*, insurance contracts, mortgage lending and consumer credit). In addition, the EU Proposal sets forth an exception for primary market transactions –such as initial public offerings on regulated stock exchanges– and for transactions arising from restructuring operations.

The FTT would be levied on the price of the security or, as is the case of derivatives, on the notional amount. Whenever the transaction occurs between involved parties and the negotiated price is well below the market price, the tax would be computed using the relevant market price at the time the parties entered into agreement. The tax rate would be about 0.1% for transactions involving stocks and bonds, and 0.01% for derivatives transactions.

Regarding the distribution of the tax revenue to member countries, the criterion would be the country in which the financial institutions involved in a financial transaction are established and not the place of trade. This criterion likely satisfies the demands of Member States like France or Germany, which host large financial institutions, but it could create discontent among other countries, which headquarter smaller institutions with lower transactions volumes and values. It is also worth pointing out that some of the revenues raised with the FTT are supposed to fund the EU budget, thereby reducing the share of transfers assigned to each Member State.

However, the relocation and substitution risks could make the tax revenue unpredictable (Vella, Fuet and Schmidt-Eisenlohr, 2011). The risk of relocation is due to the existence of competing jurisdictions that do not impose an FTT, which ultimately aim to attract trading from tax jurisdictions that enforce an FTT. In this regard, the globalization of financial markets as well as the digitalization of the economy make it easier for traders to relocate their activity to low-tax jurisdictions, as most trading activity takes place electronically. Hence, the usage of online platforms, which are formally registered in tax jurisdictions that do not impose FTTs, are a low-cost option that allows saving on taxes.

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Moreover, the FTT is exposed to substitution risk. In particular, investors could replace taxable transactions with non-taxable transactions. This strategic behavior arises when the tax does not apply to transactions of all kinds but only to certain specific transactions (*e.g.,* transactions involving shares, corporate bonds, derivatives, or currencies). It is therefore reasonable to expect a shift of investments from one type of instruments to another solely for tax reasons, thus producing economically inefficient outcomes. The shift from one type of investment to another that is not subject to tax would be even more pronounced if the marginal costs of switching were lower than the tax imposed on a particular type of investment, all else being equal.

Finally, the EU Proposal would follow the territorial approach, which states that a transaction falls under the scope of the tax as long as at least one of the parties is a financial institution established in a Member State participating in the enhanced cooperation procedure. This approach, however, still bears the risk of relocation to other jurisdictions that do not participate in the enhanced cooperation procedure. Furthermore, whenever both transacting parties are established within jurisdictions that do not adopt the FTT, the transaction is not subject to the FTT. Such avoidance behavior might not be pursued by small institutions, as their group structure usually lacks establishments in no-tax jurisdictions. However, larger institutions could take advantage of such an opportunity. Hence, the tax could make smaller financial institutions worse off because they would bear most of the tax burden (Garbarino and Allevato, 2012).

### The Spanish proposal for an FTT

On February 18th, 2020, the Spanish government approved a draft law for a proposed FTT that would only apply to the acquisition of stocks in listed Spanish companies that have a market capitalization above 1 billion euros. Contrary to the EU Proposal, the tax rate is set at 0.2% on these transactions and the taxpayer liable for this new tax would be the financial institution in charge of executing the acquisition, regardless of tax residence. Hence, as opposed to the EU's FTT, Spain aim's to impose an FTT that follows the worldwide approach as it applies to all transactions on Spanish stocks, regardless of the location of the transaction or place of establishment of either parties or intermediaries.

However, a unilaterally-implemented worldwide FTT implies significant enforcement and collection complications in cases where transactions occur abroad and involve foreign parties. Under such circumstances, Spain would need to rely on voluntary compliance by the parties of the transactions or on cooperation by other countries.

Given the threshold triggering the tax, about 60 companies would be subject to the tax. These companies are the largest listed on the Ibex, with a value added that amounts to about 8% of Spain's GDP and whose workforce exceeds 1 million employees. Thus, there are concerns regarding the selectivity of the tax, which would only apply to a handful of corporate taxpayers (Izquierdo Llanes, 2020).

Finally, it is worth pointing out that Spanish financial institutions are already subject to a statutory corporate income tax rate that is higher than that paid by the corporate sector. Specifically, the tax rate levied on banks is 30%, while the corporate sector faces a tax rate of 25%. An additional levy on these economic agents may exacerbate the tax burden and could incentivize negative

behavioral responses, such as passing on the economic burden of the FTT's to clients and investing in securities that do not fall under the scope of the tax. The latter response could become very problematic as it contradicts the principle of diversification, which mandates that capital should be allocated in a way that reduces the exposure to any one particular asset or risk. Indeed, by investing in a variety of assets, financial institutions reduce the concentration of risk and volatility.

## Conclusion

This paper examines regulatory taxes as a tool to make the financial industry internalize negative externalities in financial markets, with a specific focus on the FTT. In particular, the paper illustrates the theory on the FTT and both its intended and unintended consequences. The regulatory goals of the FTT –namely the reduction of excessive market liquidity and short-term market volatility– are not unanimously accepted as entirely desirable goals. In addition, this paper illustrates how the implementation of the FTT may trigger significant capital cost increases, relocation and substitution risks, with detrimental effects on investment and economic growth.

Finally, we argue that a unilateral adoption of the FTT increases its unintended consequences and further impairs the effectiveness of such a regulatory tax. Therefore, we believe that governments should aim at a multilateral implementation of the FTT. Specifically, the design and adoption of such a tax should result from multilateral cooperation between all the countries belonging to a given market region. For all these reasons, a unilaterally adopted FTT may prove ineffective at achieving its regulatory objective – or even counterproductive. Rather, achievement of multilateral coordination at the European level would be the preferred outcome. The probability of reaching such an agreement, however, is very low, as the failure of the EU Commission's proposal demonstrates, and because Brexit has frustrated the ambitions of advocates of a common EU FTT even further.

## Notes

[1] Commission Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC, COM (2011) 594 final (September 28th, 2011).

[2] The Council authorized the requesting Member States to engage in the enhanced cooperation procedure on January 22nd, 2013. Initially, eleven Member States requested to engage in the enhanced cooperation procedure: Austria, Belgium, France, Estonia, Germany, Greece, Italy, Ireland, Portugal, Slovenia, and Spain. On May 6th, 2014, Slovenia expressed reluctance on signing a declaration through which the requesting Member States committed themselves to finalize the procedure. Therefore, there are currently only ten Member States proactively engaged in the enhanced cooperation procedure.

[3] Furthermore, short-term trading often entails hedging activity, not only short-term speculation. See Habermeier and Kirilenko (2003).

[4] Garbarino and Allevato, note 17. See also Cortez and Vogel (2011) and Amihud and Mendelson (1992).

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