

Will the financial transaction tax (FTT) enhance stability?

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In all likelihood, the European Commission's proposed tax on financial services, the financial transaction tax (FTT), will raise sizeable tax revenues, which explains its political appeal in the current context. However, the tax fails to address the key factors that contributed to the global financial crisis. Short of global or even EU-wide cooperation, many of the transactions subject to a tax will relocate to non-cooperating countries, thereby reducing revenue prospects and the effectiveness of supervision. Moreover, the proposal fails to address the growth of leverage, systemic risks, or the moral hazard risks arising from 'too-big-to-fail' or 'too-systemic-to-fail' institutions. Even if it becomes a reality, the proposal should not undermine the chances of more meaningful tax policy alternatives being implemented in the future.

After many months of waiting, the European Commission has finally revealed its preferred method for taxing the financial services industry. To the surprise of many, the measure comes in the form of a financial transaction tax (FTT). The published text proposes a tax of 0.1% on security trades and a 0.01% tax on all derivatives transactions, potentially bringing in substantial revenues.¹ The impact assessment accompanying the proposal suggests that it will lead to a massive relocation and 'disappearance' of activities and substantial hikes in the cost of capital, resulting in a reduction of long-run economic growth in the EU by an estimated 1.8%.

Traditionally, the key aim of a financial transaction tax is to discourage speculative trading. James Tobin, the godfather of the measure, promoted the tax as a way to "throw sand in the wheels of international finance", aiming to impose transaction costs for short-term currency trading to prevent excessive volatility and speculative attacks on currency (Eichengreen et al., 1995). In the present context of a looming sovereign debt tragedy, the tax has also become popular due to its revenue potential. According to the Commission's own arithmetic, the proposed FTT can raise anything between €25 billion to €45 billion per year. Whether it will achieve these aims is highly dependent on the plausibility of the Commission's underlying assumptions on avoidance and relocations. The probability of it being the best fiscal response among the existing potential policy options is even more questionable.

¹ For more details, see the European Commission's website on the financial transaction tax (http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm).

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As recently as this spring, the FTT did not appear to be the number one choice among the list of tax policy alternatives at hand. Instead, the focus appeared to be more on the financial activity tax (FAT), which would tax ‘supra-normal’ profits and remuneration. The application of the third alternative, the financial stability contribution (FSC) and its variants, which would tax un-insured liabilities (excluding equity), has been left to the member states.

The Commission’s initial preference for the FAT over the FTT was mostly in line with the guidance provided by the IMF’s reports on taxing financial services, published in 2010.² Having considered the three tax alternatives, the reports argued that the FTT would fail to address the “core sources of financial instability”, would be easily avoidable, and passed on to final consumers. The reports also provided evidence from Swedish and UK experience that suggests that transaction taxes tend to lower market liquidity – and not always the bad kind – and increase short-term volatility.

So, why did the Commission shift its focus suddenly? The reason appears to be political. Over the past few years, the measure has gained support in some member states, such as France and Germany, while being vehemently opposed by others, such as the UK. The Commission was given a green light to prepare an assessment by the European Parliament this March. Moreover, the concept of a transaction tax is simple and reflects a sense of equity, given that most household transactions are subject to a tax while financial transactions tend to be untaxed.³ To cap it all, as highlighted by Mr. Barroso, there is a sense that the moment is ripe for the “financial sector to make a contribution back to society”. In short, given the resistance to any form of taxation from the industry, the Commission appears to have opted for instant political support.

Instead of relying solely on political or revenue-raising reasoning, the discussion should focus on the impact of taxes on financial stability – some of which are already highlighted in the Commission’s impact assessment. Whichever alternative is chosen, it should not weaken financial stability and ensure that taxpayers would “never again be asked to foot the bill” for the banks’ mistakes.⁴ In this regard, three lessons learnt from the crisis appear to be applicable.

First, the crisis highlighted the risks of ‘too-big-to-fail’ or ‘too-systemic-to-fail’ institutions. Such institutions benefit from an indirect guarantee of a bail-out, which gives their shareholders an incentive to direct managers to take on more risk. To a large extent, this particular form of moral hazard emanates from the facts that i) the public authorities have the ability (i.e. fiscal space) and the motive (i.e. domestic interest) to engage in a bail-out; and ii) there is no credible resolution mechanism to prevent messy bankruptcy procedures. As far as possible, the proposed policy should contribute to a solution and not aggravate systemic risks.

Second, the crisis has confirmed the belief that tougher regulations do not automatically enhance stability when regulatory arbitrage is an option. Relocation to less regulated jurisdictions or the ‘disappearance’ of certain transactions through repackaging may simply

² See Claessens et al. (2010) and IMF (2010).

³ These concerns are not entirely unfounded. In the EU, as in many other advanced nations, financial institutions are exempted from value-added taxation (VAT), mainly due to the difficulties involved in associating a price to the intermediation services they provide. The European Commission’s own estimates, along with other estimates in the literature (Huizinga, 2002), suggest that the exemption translates into an advantage of 0.15% of GDP.

⁴ The words of US President Barack Obama, in signing the Dodd-Frank Wall Street Reform and Consumer Protection Act, in July 2010.

sweep problems under the carpet. It should not be forgotten that having the risks of global banks stored in off-balance sheet vehicles in offshore jurisdictions – tidily tucked away from the home state regulators’ reach – did not prevent the financial crisis from propagating globally. In short, whatever form of tax instrument is introduced, it should be relatively hard to avoid.

Third, there are incentives for financial institutions – especially investment banks – to become over-leveraged, especially through the use of debt with short maturities. These activities introduce systemic externalities through increased inter-connectivity, as well as counterparty and propagation risks.⁵ Indeed, as the history of financial crises has amply demonstrated, speculation only becomes a problem when it is carried out with borrowed money, resulting in layers of promises that eventually become untenable. Many reasons have been put forward to explain the increased use of debt by financial institutions in recent years, including lax monetary policies, limited growth potential of traditional forms of funding, and incentives to match the volatility in asset valuations using short-term debt.⁶ Wherever possible, financial services taxes should correct – and certainly not worsen – the incentives to take on more leverage.

How does the FTT fare on these three fronts? Not so well. Insofar as it can be used to contribute to a credible resolution mechanism, any tax can be used to tackle the moral hazard risks from big and systemic banks. However, the FTT will probably only be used as a revenue-raising tool, with no specific aims to strengthen financial stability or secure credible resolution mechanisms.⁷ The tax could also play some role in mitigating systemic risks by targeting derivatives transactions, which give rise to such interdependencies. Despite this indirect impact, the FTT misses out completely on addressing the growth of leverage or amending the tax preferences for debt, which are embedded in most tax systems across the EU.

A globally uncoordinated FTT is also likely to aggravate tax avoidance and relocations. As many observers have noted, trading operations are highly mobile, especially for the larger institutions. For those institutions, the list of ‘safe harbours’ will be long, given the fact that many G-20 countries, including the US and Canada – not to mention some EU member states, such as the UK – reject the idea of adopting an FTT. In driving a substantial proportion of the transactions away, the tax is also likely to hamper the monitoring and enforcement capacities of the home state supervisors.

In contrast, the other options originally on the table appear to be more appropriate responses to these challenges. On avoidance grounds, although the FAT liabilities can be mitigated by the existing profit-shifting arrangements, anti-transfer-pricing rules that are in place in many OECD members reduce the prevalence of such artificial transfers. The FAT could correct the incentives for increased risk-taking by limiting excessive earnings. In this way, the tax could

⁵ For evidence on over-leveraging in European and US investment banking, see Ayadi et al. (2011) and Adrian & Shin (2010), among others.

⁶ For a more ample discussion of the reasons behind excessive leverage and short-term build-up in the financial sector, see Brunnermeier (2009), Adrian & Shin (2010), and Acharya & Viswanathan (2011), among others.

⁷ The political support for the FTT mostly rests on its revenue-raising potential, implying that the receipts will most likely be diverted to a general budget or to the EU’s own sources (see the European Commission’s proposal for the Multiannual Financial Framework for 2014-2020, SEC(2011) 876 final, pp. 29-30). Therefore, unless the bank resolutions are properly addressed, the tax measures can actually contribute to increased fiscal space (either at the member state level or at the Community level) and increase the likelihood of future bail-outs, thus aggravating the moral hazard risks.

serve as a substitute for the value-added tax (VAT), which is not applicable to financial services due to inherent difficulties in charging taxes to margin-based intermediation services.⁸

In many respects, a Financial Stability Contribution would make a more fundamental contribution, effectively putting a price on systemic externalities arising from reliance on short-term funding, which constitutes the most volatile portion of banks' balance sheets.⁹ Taxes on uninsured liabilities are much harder to avoid provided that the tax basis is sufficiently broad, i.e. covering any activity that will arise from the use of offshore entities to offload taxable debt. The tax could also go a long way towards addressing one of the age-old problems in finance; namely the tax disincentive for raising capital since interest payments are tax-deductible while dividend payments are subject to taxation. Lastly, the FSC systems that are in place (or being considered) in many countries are often designed to contribute to the maintenance of credible resolution schemes, thereby addressing one of the key sources of moral hazard risk.¹⁰

To sum up, although the FTT may have received political support, it is unlikely to materialise as an EU-wide measure. The proposal will at best be implemented in a subset of member states (under the so-called 'enhanced cooperation' rules). This will throw the proposal's ultimate impact further into question, ensuring more flexibility in relocating and avoidance and diminishing the revenue expectations. The Commission's aim may be to implement what is politically feasible now; however, the FTT fails to address the inherent weaknesses in the global financial system and should not undermine the chances of other tax options in the future.

⁸ Financial institutions provide a number of intermediation services to their clients, which make it hard to determine the value-added for a specific service. For example, what is the cost of extending loans to a client? Would the deposit rate reflect the true cost of funds, given the fact that banks typically charge a variety of additional fees to depositors? Even if it did, what proportion of the interest margin – the difference between the interest rates for loans and deposits – would be due to the risk premium, and not subject to taxation? These complicating issues are particularly crucial when the client is a business, looking to obtain a credit for VAT paid on these services. For more on the difficulties of and arguments for the application of VAT to the financial institutions, see Huizinga (2002).

⁹ Many variants of the FSC exist. Among these, see Perotti & Suarez (2009) for liquidity risk charges, which apply taxes on short-term liabilities. According to Perotti & Suarez (2011), other forms of regulatory tools, such as the net stable funding, liquidity coverage or leverage requirements (as proposed by the Basel Committee on Banking Supervision), need to be considered alongside such levies to fend off systemic externalities and the moral hazard risks arising from deposit insurance coverage.

¹⁰ The European Commission has shown its preference for the construction of a resolution fund, without clearly defining a funding method. Imposing a levy on uninsured liabilities, effectively acting as a simple FSC, is identified as one of the many possible ways to build an *ex-ante* resolution fund, but this has been met with criticism, especially from the banking industry. For details, see the European Commission's Communication on bank resolution funds (COM(2010) 254 final) of October 2010 and the Commission's consultation on crisis management (http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_overview_en.pdf).

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