TOWARDS A EUROPEAN FINANCIAL TRANSACTIONS TAX

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In this essay, Patrick Lavelle thoroughly explores the much-disputed European Financial Transactions Tax. He examines the rationale behind the tax and addresses the concerns critics have voiced in terms of its practicality. He pays particular attention to the potential such a tax bears for the migration of market activity, drawing on evidence from the Swedish case to support his argument.

Introduction

In the aftermath of the financial crisis, financial markets came under great scrutiny. Many felt that greater financial regulation was required. In September 2011, the European Commission released a proposal for the introduction of a financial transactions tax (FTT) in the European Union (EU), perhaps as a response to these growing concerns. The proposed FTT would be levied on all transactions between financial institutions, in which at least one part of the transaction is located in the EU (European Commission, 2011). While several member states were opposed to the idea, in early 2013, the Council of the European Union allowed eleven Member States to proceed with the introduction of a common FTT, using the enhanced cooperation process. Negotiations are ongoing between these Member States. This paper will discuss the proposed FTT. The rationale behind the introduction of an FTT will then be examined, followed by a critical analysis of the practicality of the tax.

Proposal

The European Commission's tabled proposal advocates a taxation of securities at 0.01% of the market price, to be paid by both the purchasing and selling financial institutions, as well as a taxation of derivatives at 0.01% of the notional amount underlying the product, to be paid by all financial institutions involved (European Commission, 2014). The issuance of shares, enterprise bonds, public bonds, other public debt instruments, shares in UCITS and alternative investment funds are to be ring-fenced from the tax, as well as transactions in and with foreign currencies and 'traditional' investment banking (European Commission, 2014). Similarly, recent reports have suggested that a wide

range of derivatives will be included. However, there are likely to be exemptions granted for derivatives linked to sovereign bonds, as well as an exemption for sovereign bonds more generally (Reuters, 2015).

Objectives

It is perhaps pertinent to first discuss the rationale behind the introduction of a European Financial Transactions Tax. The European Commission has stated two primary objectives of the proposed FTT. An FTT will ensure that the financial sector makes a fair contribution to cover the costs of the financial crisis. (European Commission, 2014). The FTT is viewed as a revenue source, as a means of compensating the public sector for the bailout of the financial sector and as an insurance premium to be used to deal with systemic risk problems in the banking sector (Kitromilides & González, 2012). This might be branded as politically motivated rather than economically sound. Equally, it might be viewed as a justifiable response to the costs borne by society from dangerous forms of speculative trading.

The FTT's second objective is to harmonise national legislation of the taxation of financial transactions (European Commission, 2014). The proposal responds to a proliferation of different kinds of FTTs in recent decades in different countries, with Kitromilides and González (2014) estimating that there are 40 'unilateral' FTTs in existence today. In addition, the EU's FTT aims to act as a step in the direction of a global FTT. The Commission believes that a unilateral European tax can ''pave the way towards a co-ordinated approach with the most relevant international partners" (Kitromilides & González, 2012:312).

A secondary objective of the introduction of an FTT is the creation of "appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures to avoid future crises" (European Commission, 2013:2). This aim is, perhaps, a response to the excessive speculation that has since been deemed a cause of the Great Recession. Economists have suggested various FTTs in the past, many of which were proposed in response to economic crises involving market failure. Among the earliest versions of an FTT was Keynes' securities transaction tax (STT) on stocks, aimed at discouraging the kind of speculation that fuelled the stock market bubble that led to the Great Depression (Burman et al., 2015). Keynes believed a substantial government transfer tax by the US government might prove the most serviceable reform in aiming to mitigate the dominance of speculation over enterprise in the USA (Davidson, 1998). In the 1970s, Tobin proposed a new kind of transactions tax, to be levied on all foreign exchange transactions (CTT), in order to limit currency fluctuations that impair a country's efforts to regulate aggregate demand (Matheson, 2011). Proposed in the context of the Bretton Woods system (Kitromilides & González, 2012), the Tobin tax as it is now known, was to be levied multilaterally by

world governments to tackle efficacy problems of unilateral national implementation (Eichengreen, 1996).

The Commission's FTT proposal, too, is driven by similar experiences. Advances in technology and product innovation, as well as deregulation, have seen a dramatic fall in transaction costs in the financial sector in the last 35 years (Matheson, 2011). According to European Parliament sources, the value of world financial transactions, which was 25 times world GDP in 1995, rose to 70 times that value by 2007 (Matheson, 2011). The chart below (Schulmeister et al., 2008) compares the dynamics of global transactions in foreign exchange markets to the development of overall world trade in goods and services, demonstrating the growth of financial transactions at a rate several times faster than the markets for goods and services. It is primarily the derivatives market that has driven this growth. Schulmeister et al. (2008) describe the cumulative effects of increasingly short-term transactions that have become common in recent decades as having a destabilizing effect. The result is asset markets characterized by excessive liquidity and excessive price volatility, which in turn leads to large and persistent deviations from their fundamental equilibria. The implementation of an FTT, however, will see those transactions with a shorter time horizon become more costly. In this way, an FTT will reduce excessive liquidity arising from financial transactions that are short-term oriented (Schulmeister et al., 2008).

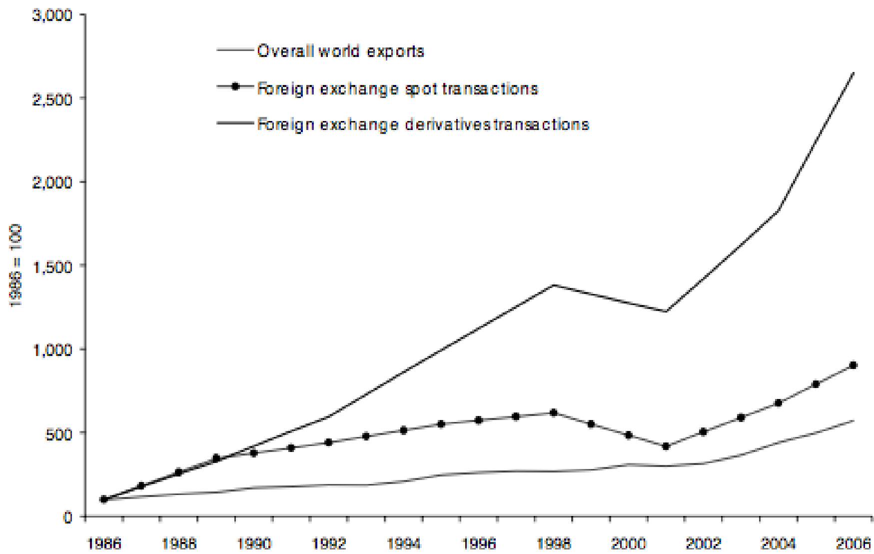

Table 1: World Trade and Foreign Exchange Transactions (Schulmeister et al., 2008)

Feasibility

It must be noted, however, that there are a number of potential issues that have seen critics question the feasibility of the proposed FTT. The most hotly debated issue in assessing the feasibility of the proposed FTT is the extent to which it can be avoided. Schulmeister et al. (2008) identify that investors, faced with the increased cost of financial transactions, may adapt their behaviour by: continuing to trade as normal and simply paying the tax (Option 1), changing the location of the trade (Option 2), trading substitute securities (Option 3) or choosing not to trade (Option 4). They argue that, "In general, an investor will pick the option that is least harmful to his profits" (Schulmeister et al., 2008:23). If substitutes are not widely available (Options 2 and 3), an investor will choose Option 1 as long as he/she continues to make profits from trading. Otherwise, he/she will select Option 4, choosing instead not to trade at all (Schulmeister et al2008). Thus, the likelihood of Option 2 and Option 3 being chosen must be discussed in order to assess efficacy of the proposed FTT.

The Commission's proposal seeks to cover all financial product markets in order to prevent the possibility of trading substitute products (Option 3). This, however, has proven a difficult balancing act in negotiations among Member States. The Commission proposed a 'triple A' approach. The tax would apply "to all markets (such as regulated markets or over-the-counter transactions), all instruments (shares, bonds, derivatives etc.) and all actors (banks, shadow banks, asset managers, etc.)", in order to "minimize potential distortions across different market segments and reduce the risk of tax-planning, [and] substitution" (Directorate-General for Taxation and Customs Union, 2014). However, many of the eleven participating member states have sought exemptions for sovereign bonds, some forms of derivatives and certain pension fund types from the FTT.

The capacity for the relocation of trade to other markets in response to the tax (Option 2) appears to be the crux upon which the success of an FTT will depend. Tobin argued that a financial transactions tax needs to be introduced multilaterally, as the world's financial transaction business will simply migrate to a location where such a tax is not imposed if one country imposes it. It has been suggested that it might suffice to secure agreement on an FTT among the states in which the world's largest financial transactions markets are located (Eichengreen, 1996). Eight such states have specifically been named, and include the UK and USA (Eichengreen, 1996). Indeed, in line with such rationale, the idea of an FTT was discussed at a G20 meeting in 2011. However, it failed to win support (Reuters, 2011). Similarly, the Commission's 2011 proposal for an EU-wide FTT posited that market access to the world's largest market dis-incentivised migration. This proposal, however, failed to gain EU-wide support, with 17 states opposing the plan, including states with large financial sectors such as the UK, Luxembourg, and the Netherlands. Thus, given that eleven Member States have chosen to implement an FTT independently,

we must appraise its feasibility with regards to the extent of the opportunities for tax avoidance through mass migration of trade to other financial centres outside of the tax jurisdiction.

The UK's pending exit from the EU further complicates this issue. It has been claimed that the absence of Europe's largest financial centre, the city of London, from the FTT would make the tax redundant. Activity would simply migrate from Member States to London. However, the uncertainty surrounding the UK's future relationship with the EU makes it difficult to ascertain the potential for activity to migrate to London, in the event that an FTT is implemented. On the one hand, a so-called "Hard Brexit" could reduce the capacity for the migration of financial activity, in which case the main opponent of the FTT would be removed from the negotiation table, thus increasing the pressure on smaller Member States opposing the FTT to join. On the other hand, the assumption that the migration of activity will not take place due to the sheer size of the EU is undermined by the fact that Europe's largest financial centre will no longer be located in the EU.

A Financial Transactions Tax in Practice

The Swedish experience of unilaterally introducing a securities transaction tax provides a relevant case study in this regard. In January 1984, Sweden levied a tax of 0.50% on the purchase and sale of equities (Burman et al., 2015). While the tax rate and other details changed over time the basic structure remained the same, namely that the tax was imposed on registered Swedish brokerage services (Burman et al., 2015). In the face of substantially declining trade levels and revenue figures that were far below projected levels, Swedish authorities repealed the tax in 1991, but it left lasting effects on the Swedish stock market. Activity had not yet fully recovered to pre-tax levels (Burman et al., 2015). The table from Schulmeister et al. (2008) below shows the transactions tax revenues. In the case of Sweden, mass migration of trading activity proved its downfall. The London Stock Exchange acted as an appropriate substitute market (Schulmeister et al., 2008). For example, in 1998 27% of Ericsson's shares, Sweden's most actively traded company, were conducted in Stockholm, falling further to 23% in 1989, and recovering to 41% in 1992 following the tax's abolition (Eichengreen, 1996).

Thus, a lesson can be learned from the Swedish experience - the tax liability for nationally based companies should be worldwide (Schulmeister et al., 2008). Opportunities for the migration of financial activity must be minimised. This very concept, referred to as the issuance principle, lies at the core of the current proposal for a European FTT. However the efficacy of enforcing this is unclear, with some non-participating member states expressing concern that that they will be required to collect taxes on transactions on behalf of a participating Member State (Crisp, 2014). Indeed, the UK has threatened to launch another court appeal against it, with its previous appeal

rejected by the European Court of Justice as premature. The UK, the Netherlands, Luxembourg, Ireland and the Nordic Member States have chosen not to partake. Consequently, many important financial centres in the Union will lie outside the tax jurisdiction, thus increasing the potential for the migration of market activity.

	Revenuues of Turnover Tax on Securities	Revenues of Turnover Tax on Securities	Transaction tax rate	Annual Swedish Trading volume	Trading of Swedish stocks inside Sweden	Trading of Swedish unrestricted shares inside Sweden
	In % of GDP	In % of total tax revenues	On equity traded, per round-trip	Executed in London	Average of 19 large Swedish companies	
1984	0.10	0.21	1%	NA	NA	NA
1985	0.13	0.27	1%	NA	NA	NA
1986	0.26	0.53	1%, 2%	NA	NA	NA
1987	0.35	0.66	2%	30%[1]	NA	NA
1988	0.34	0.66	2%	48%	61%	47%
1989	0.45	0.85	2%	51%	57%	42%
1990	0.43	0.81	2%	52%	56%	42%
1991	0.25	0.50	1%	NA[2]	52%	40%
1992	0.02	0.04	0%	NA	56%	50%

The revenue data are for the total of all turnover taxes on securities, while the transaction tax rate represented in column three only applies to the major tax on equity (there were different tax rates for other instruments. 1- For 1987, there is an estimate only by the Stockholm Stock Exchange. 2-In December 1991, all taxes were abolished.

Table 2: Swedish transaction tax revenues and trading migration (Schulmeister et al., 2008)

Conclusion

The practicality of a Financial Transactions Tax is much disputed. The EU's sui generis nature provides little precedent against which implementation of such a tax can be assessed in a supranational setting. However, it is a question that can only be answered when the tax is implemented and its effects observed. The issuance principle seeks to limit the risk of market migration. However, the Swedish case highlights the opportunities that the 17 non-participating Member States provide for its facilitation. Should the current proposal for an FTT prove successful in practice, it might well win favour among non-participating Member States. However, the decision to implement a European Financial Transactions Tax will ultimately come down to whether Member States agree with the rationale behind it, a source of debate that is unlikely to abate in the future.

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