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Impacts of a European Financial Transaction Tax

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- Since mid-2010, EU member states have been discussing the introduction of a European financial transaction tax (FTT), a levy that may charge 0.1% on the exchange of shares and bonds and 0.01% on derivative transactions.
- Due to lack of broader support in the EU, a group of ten countries (including France, Germany, Italy and Spain) has pushed ahead with the idea, following the permission of the European Commission for enhanced cooperation.
- After the FTT introduction date has been repeatedly postponed, even its actual implementation is still not clear.
- If introduced, the tax would add to the burdens on European financial institutions from the ultra-low yield environment and tighter regulation.
- It would negatively impact on market liquidity and increase the costs of capital for corporations, while the fiscal benefits will be limited by the firms' option to relocate to EMU members not introducing the FTT.

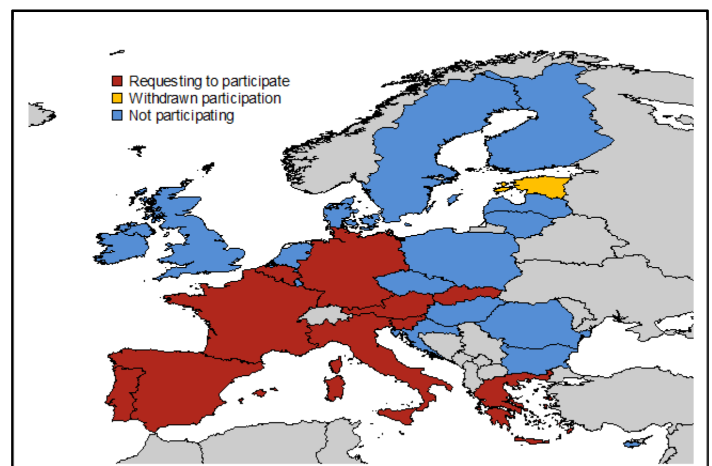
On Monday next week (Oct 10), the Eurogroup will convene to discuss a number of topics, including the disbursement of the €2.8 bn aid tranche to Greece and the draft budgetary plans that the member states must submit to the European Commission (EC) by October 15. While not formally on the agenda, another key issue will likely be discussed: the EU financial transaction tax (FTT). A few weeks ago, Bloomberg news reported that the October meeting would be the time for a make-or-break decision.

The EU Commissioner for Economic and Financial Affairs, Pierre Moscovici, recently affirmed he was confident about a positive conclusion of the negotiations and a rapid implementation of the levy (possibly by as soon as 2017). However, talks have repeatedly stalled in the past and a conclusive agreement is far from certain. In this note, we shed more light on the content of the proposal and its likely impacts should it become effective in the future.

Enhanced cooperation just above the quorum

The first discussion over the introduction of a EU-wide FTT goes back to mid-2010. In May 2010, the first aid package to Greece was approved. It was based on bilateral loans from EU member states, so with no money coming from the EU budget. However, a debate started on how to retrieve resources for future bailout programs in a more centralized way, but without subtracting resources from the common budget. With public money being injected more and more frequently into troubled banks (e.g. Ireland, Belgium, Spain etc.), EU politicians targeted financial transactions as a possible source of revenue. In order to maximize the latter and to limit tax avoidance, the FTT has to be applied uniformly across countries. Consequently, the preliminary discussions aimed to establish a EU-wide levy.

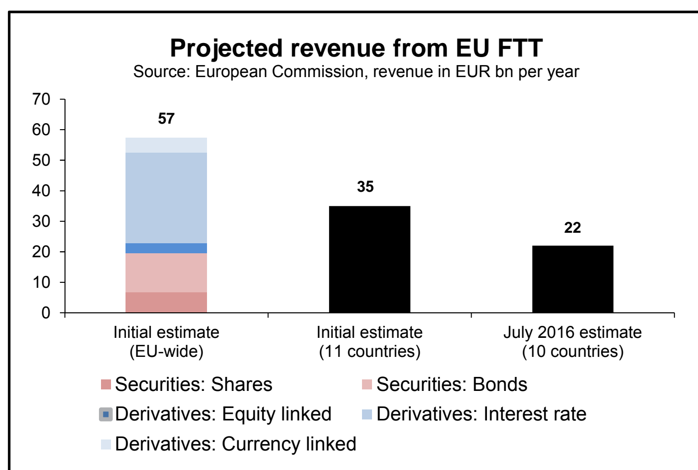
After 2-year long inconclusive talks within the 27 EU member states – Croatia only joined in July 2013 – the EC proposed to exploit the enhanced cooperation mechanism to push the project ahead. According to EU treaties, the enhanced cooperation is a procedure where a minimum of 9 member states are allowed to establish advanced integration or cooperation, without involving other member states. Eleven countries agreed to participate in the proposal of the EC: Austria, Belgium, France, Estonia, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain. Estonia, however, withdrew its participation in March 2016, leaving the total participating countries to ten.



According to the most recent press rumors, Belgium may decide to leave, with other smaller states (Slovenia, Slovakia) also at risk. As a result, the successful implementation of the FTT remains far from being a done deal. The focus is now on the Eurogroup meeting in Luxembourg next week.

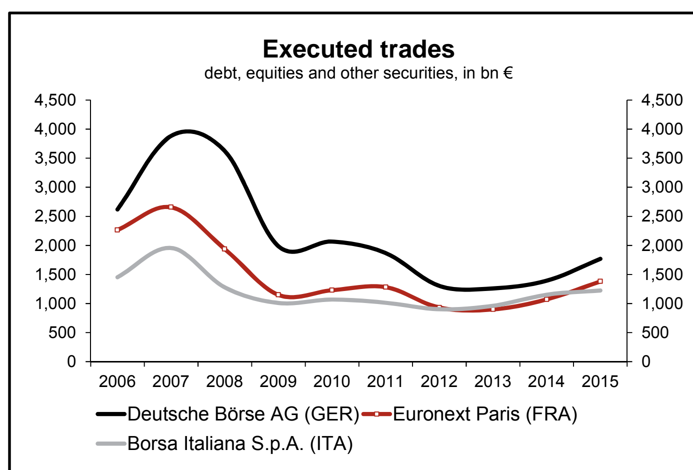
The European Commission's proposal

Looking into the details of the EC proposal, the FTT would apply to all transactions between financial institutions, of which at least one is based in a country participating in the initiative. The key cornerstones consist of a 0.1% levy on sales and purchases of bonds and shares and a 0.01% on the notional value of traded derivatives. In order to limit the negative impact on economic activity, the EC proposal foresees a list of exemptions. The FTT would not apply to: i) day-to-day transactions of households and businesses; ii) transactions for the purpose of raising banks' capital; iii) transactions carried out as a part of restructuring operations; iv) refinancing operations with the ECB, the EFSF, the ESM and the EU.



The EC provided its estimates on the revenue flow from the FTT. The original proposal (a EU-wide levy) would result in tax revenues of €57 bn per year, of which nearly two-thirds from derivatives and €19 bn from shares and bonds. Limiting the scope of the FTT to the 11 countries originally involved, the EC estimated a revenue flow of €35 bn, or 0.4% of euro area GDP. That said, the EC has recently revised downward its projections, suggesting that the levy would rise around €22 bn per year.

Italy and France have already introduced variants of an FTT. In the case of Italy, a security transaction tax (STT) introduced in March 2013 included a tax on all transactions of shares issued by Italian companies (0.12% on regulated markets, 0.22% for OTC transactions) as well as a tax on high-frequency trading involving Italian shares (0.02% if orders are modified/deleted within half a second and exceed a certain ceiling), even though with a longer list of exemptions. In France, the FTT introduced in March 2012 applies to the acquisition of equity securities, as well as high-frequency trading and naked sovereign CDS transactions. In contrast to these national schemes already in place, the tax envisaged by the ten European partners is targeting a much broader tax base, including bond and foreign exchange transactions.



Impact of an FTT

To start with, the possible effects of the introduction of a FTT are strongly disputed between supporters and opponents. Moreover, the impact of a FTT will depend very much on the concrete design of the tax and the group of participating countries. Nevertheless, in the following some general conclusions regarding the likely impact of a European FTT are derived.

One argument put forward is the expected decrease in price volatility on financial markets. The tax would curb speculative high-frequency trading and thereby contribute to the avoidance of price bubbles. However, such a conclusion appears at least questionable. The tax would not only hamper noise traders but would also influence trading based on fundamentals not least due to higher bid-ask spreads. This trading tends to stabilize markets and lower price volatility. Empirical findings about the effects on volatility are inconclusive but the majority of studies indicate higher volatility as a consequence of a FTT (e.g. an ECB study based on Italian experience).

Closely connected with this observation is the likely drop in market liquidity. The increased costs for trading will lead to lower trading volumes (which is partly intended by the implementation of the tax). This will slow the price discovery and it will take longer until financial markets have incorporated new information and will adjust to a new, fair value. Ultimately, it reduces the efficiency of financial markets and weakens the signaling function of market prices.

Generally, this results in higher cost of capital for companies. Both financial and non-financial corporates are likely to reduce their investment activity somewhat. This impedes the build-up of a capital stock and, in the end, it lowers long-term growth.

This is connected to an argument brought forward by proponents of a FTT – the increase in tax revenues. While the immediate positive impact is obvious, the negative repercussions on growth refute this thesis. What is more, the more the FTT succeeds and reduces socially undesirable transactions, the less revenue is raised. Moreover, as a FTT will not be implemented globally, market participants can try to avoid it by relocating to other, less regulated locations. This is particularly important for the EU as the current proposal is not supported by all EU countries and will not comprise all EU countries. Given the free factor movements within the EU, there are no major obstacles to a relocation to other EU countries not participating (e.g.

Luxembourg, Ireland, the Netherlands). Overall, the market intervention can induce an unwelcome change of economic agents' behavior with accompanying negative side effects. However, the experience of well-constructed FTTs in other countries (e.g. UK) suggests that it is still likely that a FTT will be able to raise revenues in the participating EU countries in the years to come. But resulting relocations and growth dampening negative effects suggest that the actual fiscal relief for participating countries can turn out to be lower than expected.

Finally, it should be noted that a FTT constitutes an additional burden for the European financial sector. The low yield environment and the tighter regulation have already been putting pressure on the sector over the last years, an additional tax could undermine confidence and profitability further and could trigger another round of concerns about the health of the banking system. The resulting damage is expected to outweigh other positive effects of a FTT.

Conclusion

The introduction of a European FTT is still facing large political and economic hurdles and its ultimate introduction is by far not a foregone conclusion. While the tax may be welcomed by governments as an additional source of revenue, the actual receipts may prove much smaller than projected and diminish over time with firms using the option to relocate to non-participating EU members. The financial and economic impact of the tax will be particularly unfavorable for European financial institutions, which are already burdened by the low-yield environment and tighter regulation. Moreover, the tax would likely not only reduce market liquidity, but also generate competition distortions between firms located in the ten participating countries and companies located elsewhere in the EU. Finally, to the extent that also the costs of capital for non-financial firms are affected, the tax would reduce rather than foster incentives for firms to promote European growth by engaging in new investments.

Imprint

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