
Financial Transaction Tax (FTT): Why the EU needs the FTT but the FTT does not need the EU

Jan David Schneider

BACKGROUND

The nature of the continuing crisis in the euro area has changed several times. With the collapse of Lehman Brothers in September 2008 and the subsequent outbreak of the global financial crisis, Europe's banking sector was on the verge of collapse. With already excessively high public debt levels accumulated in some parts of the European periphery, the required public support for the struggling financial sector overstrained the public financial capacities in these countries. Consequently, the banking crisis evolved into a sovereign debt crisis which pushed Europe into the worst recession since World War II.

The sluggish economic recovery and the unbalanced austerity policy as a response to the crisis have exacerbated the negative social repercussions for some parts of the eurozone's population, especially among the young. As a consequence, the crisis has developed into a social crisis that is likely to have a long-lasting effect on the well-being of European citizens and on the general state of the EU and its political stability. With potential long-term effects on Europe's future human capital, record high youth unemployment rates in the periphery and some core countries are challenging our understanding of generational equity.

Nevertheless, the economic fragmentation and divergence among euro area countries makes structural reform at the Member State level as necessary as ever. The countries most affected by the crisis have started their painful reform process which has already – although with mixed results – born some fruit.

At euro area level, important reform proposals to correct for the eurozone's missing fiscal union have been proposed and implementation is moving forward in many areas. The introduction of the 'Fiscal Compact', the 'Six-pack' and 'Two-pack' have enhanced debt monitoring and prevention while keeping debt mutualisation to a minimum. Furthermore, these actions are also important steps towards improving the much needed fiscal policy coordination between EU countries and, in an even more stringent way, for the eurozone.

In response to the negative feedback loop between sovereigns and banks, the effort to establish a Banking Union is a historical step forward to prevent the nationalisation of banks' debts in future crises. Founded on a Single Rulebook, major elements of the final proposal are the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). Whereas the SSM covers approximately 6000 banks, only the 128 largest banks will be directly supervised by the ECB. The SRM consists of a Single Resolution Board and a Single Resolution Fund (SRF) that is financed by the banking sector. Although the final shape of the Banking Union constitutes a great effort towards stabilising the financial sector, the feedback loop between sovereigns and banks could not entirely be broken. As the SRF will only be backed by 55 billion Euros, it remains questionable whether the SRM could handle large banks in distress. The SRF needs more funding in order to efficiently eradicate the possibility of further 'too-big-to-fail' situations.

At this point in time, finding the right balance between austerity and counter-cyclical fiscal policies is the key challenge policy-makers are facing. Legitimate calls for more fiscal stimulus and immediate support for growth inducing measures have been expressed by many. However, room for fiscal expansion within national budgets will be narrow in the next few years if not decades. As further debt financing is neither viable nor just towards

future generations, it would therefore be very useful to tap new sources of revenue – something that the introduction of an EU-wide Financial Transaction Tax (EU-FTT) could contribute to.

STATE OF PLAY

The Banking Union proposal is more of a long-term project to future-proof the eurozone for crises to come, but in addition, a timely introduction of the FTT could also benefit the participating countries in the short or medium term by providing them with more space for fiscal manoeuvre. Through an Enhanced Cooperation Procedure (ECP) eleven eurozone countries (ECP-11) – among them the four biggest, Germany, France, Italy and Spain – have aspired to go ahead with the introduction of a harmonisation and extension of their partly already existing but scattered FTT-regimes.

With respect to this, the European Commission had in February 2013 presented an ambitious proposal¹ outlining three main objectives: (i) preventing Single Market fragmentation by harmonising existing legislation; (ii) discouraging financial transactions which are harmful for the efficient functioning of financial markets and the real economy, and (iii) participation of the financial sector in sharing the burden of the crisis by making a contribution to public finances. Apart from the harmonisation aspect, the innovative part of the EU-FTT proposal would be that **all** transactions of financial instruments made by financial institutions such as banks, insurance companies, funds and asset managers, will be subject to the tax. This will include transactions of securities such as stocks, company bonds, government bonds, most money-market instruments and most importantly all derivatives, both for organised exchanges as well as over the counter. The original proposal was coined to include 'all instruments, all markets, all actors'.² It is also noteworthy that shadow banking activities such as securitisation and repurchase agreements (repos) are covered as well. The inclusion of the latter has however, caused some intense discussions and is unlikely to make it into the final directive. In terms of technical practicality, tax collection could be easily achieved through the involvement of existing clearing houses and trading platforms.

Regarding the revenue potential, the EU Commission calculated the estimated tax receipts from applying the original model to be 30 to 35 billion Euros – an excellent opportunity to create substantial revenues from a sector that, in comparison to others, has been widely undertaxed.³ These funds would be ideal to, for instance, intensify the fight against high youth unemployment levels. The EU Youth Guarantee scheme introduced in April 2013 will be backed by six billion Euros of EU money for distribution in the next few years. In 2012 the International Labour Organization has estimated the necessary funding to be in the area of around 21 billion Euros. Would it not make sense to use the FTT as a contribution from those actors that stood at the beginning of the crisis to those bearing the brunt today?

Although retail investors, SMEs and pensioners are explicitly excluded from the transaction tax, the tax will almost certainly be passed on to them, should their transactions involve any financial institutions. Some determined opponents against an FTT have used this fact for horror scenarios on sharp losses of pensioners' savings and so forth. However, as longer-term oriented buy-hold strategies will naturally require fewer transactions, the tax will be almost unnoticeable for the aforementioned groups since the rates will be set at fairly low levels – 0.1% against the exchanges of shares and bonds and 0.01% for derivative exchanges applied on the notional value of the underlying transaction. Such rates will nevertheless be high enough to create substantial revenues from those engaged in high-frequency trading due to the sheer amount of transactions that are necessary to sustain these types of business models.⁴

Other concerns brought forward against the original EU-FTT proposal can broadly be assigned to three different areas, all of them involving a reduction of financial liquidity: (i) the dichotomy between hedging and speculation, (ii) relocation and tax arbitrage, and (iii) the inclusion of repurchase agreements (repos).

Dichotomy between hedging and speculation

The discussions around the EU-FTT are inevitably linked to an evaluation of the prevailing theories on financial markets. According to the predominant Anglo-Saxon view on financial markets, trading activity, i.e. liquidity, exactly reflects the necessary amount for smoothing asset prices. An FTT would therefore significantly curb short-term transactions and thus reduce financial liquidity leading to higher asset price volatility, which would have direct repercussions on economic growth and competitiveness for the European economy.⁵ On the contrary, the Commission's proposal is expressing a fundamentally different evaluation of financial markets and criticises the perception of 'the more liquidity the better'.⁴ Due to a preponderance of short-term speculation, there is excess (or virtual) liquidity that is not necessary for the provision of financial services to the real economy. The reduction

of short-term speculation would even have positive effects on asset prices and thus the functioning of financial markets despite the existence of lower overall liquidity.

A rationale behind the harmful impact of short-term speculation and positive effects of an FTT on asset prices is exemplified in Schulmeister (2009):⁵ asset prices are constantly over- and undershooting their equilibrium prices in cyclical swings. Empirical findings suggest that short-term speculation prolongs these swings even further, a contradiction to the Anglo-Saxon view. In turn, this increased volatility for instance, adds to the creation of 'bubbles' and causes higher uncertainty, which entails costs to the economy. An FTT could smooth these swings through its dampening effect on short-term trading, in particular on derivatives transactions. Similar to an argument made above, risk hedging related to economic fundamentals requires fewer transactions than speculation and makes it consequently less affected by a low-rate FTT. In fact, the scholar argues that only a small fraction of derivatives trading is part of such hedging activities, the majority can be assigned to short-term speculation. These results are questioned by speculators that need to protect their business models. From a welfare perspective however, these practices are not in the interest of society and are therefore necessary to be corrected for. Financing, insurance and risk transformation, essential to the functioning of the real economy, are much less affected, if at all.

Relocation and tax arbitrage

Regarding the potential relocation of financial liquidity, a poorly designed FTT could cause an outflow of financial liquidity from the ECP-11 area to other financial centres such as London or New York. Due to this liquidity loss, price volatility would rise which would, contrary to the intended stabilising effect, negatively impact asset price stability.

The Commission's design of the EU-FTT can however prevent such major outflows, as the tax will not be determined by the location of the financial transaction but by the origin of the involved actors as well as the underlying asset ('residence plus issuance'). For example, a German bank that would want to avoid the payment of the tax would need to ignore its entire market operations in the ECP-11 as well as move its headquarters and cease trading all financial products from this area. The likelihood of this happening shows that a critical mass of participation could be established if the proposal was thoroughly implemented in all participating countries. Naturally, not all tax arbitrage possibilities and relocation effects can be prevented, so wider participation would provide even greater benefits to all participating countries.

Inclusion of repurchase agreements (repos)

A large part of the discussion on the loss of liquidity is connected to the debate around the inclusion of repos into the tax base. Although the inclusion was part of the original proposal from February 2013, in mid-2013 the French government, the ECB and representatives of the finance industry expressed their deep concerns over the taxation of repo transactions. Repos are liquidity-enhancing financial instruments with an advantageous risk management framework. The ECB considers repos as an essential part of its strategy to move away from being the largest intermediary of liquidity, a role it took over due to the collapse of inter-bank lending during the crisis.⁴

However, repos also provide an easy and cheap way to create leverage and hence risk, as basically any asset can be used as collateral and transformed into cash through repos. New repos are repeatedly used with the same collateral to create more and more leverage, a practice that could be reduced through a transaction tax. In times of crisis, when collateral depreciates due to plunging asset prices and increasing 'haircuts',⁶ the repeated use of the same collateral can take its toll, which may lead to massive defaults of financial institutions. The Lehman Brothers collapse can in essence be explained by what Gorton & Metrick (2012) called a 'run on repo'.⁷ A final decision on the inclusion of repos into the tax base has to eventually face the trade-off between long-term financial stability and the loss in liquidity. Whether such a liquidity loss is acceptable or not is directly linked to the position on the excess (virtual) liquidity issue.⁴

PROSPECTS

Some non-participating EU countries have expressed their concerns that the proposal would have implications for their domestic financial sector. In April 2013 the United Kingdom legally challenged the EU-FTT plans, criticising its potential impact on Britain's financial sector. The Commission responded that only transactions with a connection to the ECP-11 area would be affected, which would be fully in line with international law regarding cross-border taxation. The challenge was eventually dismissed by the European Court of Justice on 30 April 2014.

In addition to the discussions around repos, the willingness to go forward with the finalisation of an ambitious proposal has lost some momentum recently; some of the envisaged compromises may even threaten the viability of the whole project. On 5-6 May 2014, in the last Eurogroup and ECOFIN meetings before the European elections, the ECP-11 block, apart from Slovenia due to its government crisis, expressed to aim for a gradual introduction, i.e. the initial exclusion of certain derivatives.⁸ With the prospect of a full coverage only in the distant future, this may defeat the whole rationale of the tax. Including a wide tax base, thereby closing loopholes for speculation, was at the core of the initial proposal and remains crucial to ensure the collection of substantial revenues as well as for stabilising asset prices. It remains unclear when, and whether at all, a full coverage of all derivatives can be achieved in future. Furthermore the ECP-11 now seeks implementation of the directive only by 1 January 2016. Bearing in mind the initial plans for an introduction in 2014, this prevents the tax from being a short-term support to overcome the social impacts of the crisis. In addition, a strong commitment regarding the sensible usage of the tax revenues has yet to be made.

In the next few months it therefore becomes of vital importance to protect the February 2013 proposal from further far-reaching and counterproductive exemptions while negotiating towards a comprehensive inclusion of all derivatives as early as possible, in the way it was intended in the first place. Bearing in mind that several EU countries already have FTTs in place, a harmonising EU-FTT would also be a step forward for strengthening the Single Market.

Clearly, the EU-FTT is more than just a tax. It is a contribution to the much needed modification of the prevailing global Anglo-Saxon financial system, through making careful judgements on social and unsocial trading practices and by correcting for the latter.

Jan David Schneider is Economic Research Assistant at the European Policy Centre (EPC).

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- 1 European Commission 2013, 'Proposal for a Council Directive implementing enhanced cooperation in the area of the financial transaction tax', COM(2013) 71 final, 14 February, viewed on 6 June 2014, http://ec.europa.eu/taxation_customs/resources/documents/taxation/com_2013_71_en.pdf
 - 2 Apart from all primary market transactions and restructuring operations, most day-to-day financial activities relevant for citizens and businesses such as payment services, mortgage lending, conclusion of insurance contracts or bank loans are excluded from the tax. Whereas spot currency transactions do not fall under the tax, currency derivative contracts do. Refinancing transactions with central banks, ECB, EFSF, ESM and the EU are also exempted from taxation. For a detailed overview of the proposed scope of the tax see the proposal from 14 February 2013.
 - 3 Financial services are, for instance, excluded from value-added-tax.
 - 4 See Gabor, D 2013, 'A step too far? The European financial transactions tax and shadow banking', UWE Bristol, Working Paper.
 - 5 See Schulmeister, S 2009, 'A general financial transaction tax: a short cut of the pros, the cons and a proposal', *Austrian Institute of Economic Research (WIFO)*, Working Paper, No. 344.
 - 6 A repo 'haircut' is the deduction from the market value of an asset that is being used as collateral and reflects the risk of holding that very asset.
 - 7 Gorton, G & Metrick, A 2012, 'Securitized banking and the run on repo', *Journal of Financial Economics*, 104(3), 425-451.
 - 8 See Council of the European Union 2014, Press Release, 3310th Council meeting, Economic and Financial Affairs, 6 May, viewed on 6 June 2014, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/142513.pdf
 - 9 Schneider, JD & Zuleeg, F 2014, 'The future of the eurozone', trans. into Polish by Gmurczyk, J, *Instytut Idei*, No. 6, April, 76-79, The Civic Institute (Instytut Obywatelski), Warsaw, viewed on 6 June 2014, http://www.instytutobywatelski.pl/wp-content/uploads/2014/04/instytut-idei-6_WEB.pdf

European Policy Centre ■ Résidence Palace, 155 rue de la Loi, 1040 Brussels, Belgium
Tel: +32 (0)2 231 03 40 ■ Fax: +32 (0)2 231 07 04 ■ Email: info@epc.eu ■ Twitter: [@epc_eu](https://twitter.com/epc_eu) ■ Website: www.epc.eu



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