# The impact of Financial Transaction Tax on financial stability

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Emrah Arbak argues that the FTT fails to address the key factors that contributed to the global financial crisis

The European Commission has revealed its preferred method for taxing the financial services industry in October 2011. To the surprise of many, the measure came in the form of a financial transaction tax (FTT) despite concerns that the proposal will lead to a massive relocation of activities and increase the cost of capital. Although the FTT may raise sizeable tax revenues, which is a key concern in the on-going sovereign debt crisis, it fails to address (and may even worsen) the key factors that contributed to the global financial crisis of 2007/9.

Traditionally, the key aim of a financial transaction tax has been to discourage speculative trading. In the words of James Tobin, the measure's godfather, the taxes are to *"throw sand in the wheels of international finance"*, aiming to impose transaction costs for short-term trading, prevent excessive volatility and thereby mitigate the incidences of bubbles. But the current focus appears to be elsewhere. In the present context of a sovereign debt tragedy, the transaction tax has also been highly popular due to its revenue potential. According to the Commission's own arithmetic, the proposed tax can raise anywhere between €25 billion to €45 billion per year.

The FTT did not appear to be the top choice among the list of tax policy alternatives. In its earlier communications, the Commission appeared to prefer focus appeared to be more on the Financial Activity Tax (FAT), which would tax 'supra-normal' profits and remuneration. The application of a third alternative, the Financial Stability Contribution (FSC) and its variants, which would tax uninsured liabilities (excluding equity), has been left for the member states.

The Commission's initial preference of FAT was mostly in line with the guidance provided by the IMF's reports on taxing financial services published in 2010. Having considered the three tax alternatives, the reports argued that the FTT would fail to address the 'core sources of financial instability', avoidable, and can be easily passed-on to consumers[1]. The documents provided ample evidence, highlighting the Swedish and UK experience from the 1990s that suggested that transaction taxes tend to lower market liquidity - and not always the bad kind - increasing short-term volatility.

So, why did the Commission shift its focus? 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. The concept of a transaction tax is simple and strikes a sense of equity, given that most of the household transactions are subject to a tax while financial transactions tend to be untaxed. To top it off, 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 taxation from the industry, the Commission appears to have gone for the alternative with the most immediate political support.



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Instead of relying solely on political or revenue-raising rationalizations, the discussion should also consider the impact of taxes on financial stability. 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[2]. For those matters, three lessons learnt from the financial crisis of 2007/9 appear applicable.

First, the crisis highlighted the risks from '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 the managers to take on more risks. To a large extent, this particular form of moral hazard emanates from the facts that (i) the public authorities have the ability (ie. fiscal space) and the motive (ie. domestic interest) to engage in a bail out; and (ii) no credible resolution mechanism exists to prevent messy bankruptcy procedures. To the extent possible, the proposed policy should contribute to a solution and not aggravate the existing conditions.

Second, and in a related sense, there are incentives for financial institutions — especially for 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 counter-party and propagation risks[3]. Indeed, as the history of financial crises have amply demonstrated, speculation only becomes a problem when it is done with borrowed money, resulting in layers of promises that eventually become untenable as a whole.

Many reasons are put forward to explain the increased use of debt by financial institutions in recent years, including lax monetary policies, tax preference for debt financing, limited growth potential of traditional forms of funding, and incentives to match the volatility in asset valuations using short-term debt. To the extent possible, taxes should correct - and certainly not worsen - the incentives to take on more leverage.

Third, the crisis has confirmed the belief that tougher regulations do not automatically enhance stability when regulatory arbitrage is a viable option. Relocation to less regulated jurisdictions or the 'disappearance' of certain transactions through repackaging may simply hide problems beneath 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 home-state regulators' reach - did not stop the financial crisis to propagate globally. In short, whatever form of tax instrument is introduced, it must be relatively hard to avoid.

How does the FTT fare on these three fronts? Not so well. To the extent that 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, in all likelihood, the FTT will only be used as a revenue-raising tool for individual member states, which is partly behind its political acceptance[4]. The FTT could ideally play some role in mitigating systemic risks by targeting derivatives transactions, which give rise to such interdependencies. Despite this indirect impact, however, the FTT misses out completely on addressing the growth of leverage.

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 supervisors.

In contrast, the other alternatives originally on the table appear more appropriate in responding 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. FAT could correct the incentives for increased risk-taking by limiting excessive earnings. In this manner, the tax could 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.

In many respects, an FSC 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[5]. Taxes on (uninsured) liabilities are much harder to avoid provided that the tax basis is sufficiently broad, covering any activity that will arise from the use of offshore entities to offload taxable debt. The tax could also go a long way to address 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, addressing one of the key sources of moral hazard risks.

To sum up, although the FTT has received political support in some member states, it is unlikely to materialize as an EU-wide measure. The proposal will be at best 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 ultimate aim in taxing financial services should not be to implement what is politically feasible now but to use the instruments to address (and certainly not aggravate) some of the inherent weaknesses in the global financial system. In any case, the FTT should not undermine the chances of more meaningful tax options in the future. ■

**Emrah Arbak is a Researcher at the Centre for European Policy Studies (CEPS)**

*Endnotes*

*1. For more details on IMF's work on  nancial sector taxation, see Claessens, S, M Keen and C Pazarbasioglu (2010), "Financial Sector Taxation", IMF's Report to the G-20 and Background Material, International Monetary Fund (IMF), Washington DC*

*2. The quote comes from the US President Barack Obama, in signing the Dodd-Frank Wall Street Reform and Consumer Protection Act, in July 2010.*

*3. For evidence on over-leveraging in European and US investment banking, see Ayadi, R, E Arbak and WP de Groen (2011), Business Models in European Banking: A pre- and post-crisis screening, Centre for European Policy Studies (CEPS), Brussels.*

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

*5. Many variants of the FSC exist. Among these, see Perotti, E and J Suarez (2009), "Liquidity Risk Charges as a Macroprudential Tool", CEPR Policy Insight, No. 40, Centre for Economic Policy Research (CEPR), November; Bianchi, J and EG Mendoza (2010), "Overborrowing, Financial Crises and 'Macro-prudential' Taxes", NBER Working Paper, No. 16091, National Bureau of Economic Research (NBER), Cambridge, MA; Acharya, VV, LH Pedersen, T Philippon and M Richardson (2010), "A Tax on Systemic Risk", Working Paper, NYU Stern School of Business, New York, NY.*