

Regulating the Financial Industry through Taxation: Intended and Unintended Consequences of the Financial Transaction Tax

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Abstract

This paper examines regulatory taxes as an alternative to regulating the financial industry to address negative externalities in financial markets. We review the theory on financial transaction taxes and provide an analysis on the economic consequences of such taxes. We argue that the implementation of the FTT could trigger significant increases in the cost of capital for firms as well as relocation and substitution risks, with detrimental effects on investment and economic growth. We furthermore analyze the challenges for the regulator to design and implement financial transaction taxes, while paying attention the current state of the art within the EU and in Spain. In this respect, we put forward that care should be taken when enacting financial regulatory taxes, especially when EU member countries implement such taxes unilaterally without a coordinated agreement.

Keywords: banks, regulatory taxes, financial transaction tax, regulation

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1. Introduction

Since the aftermath of the Financial Crisis of 2008, policy makers, academics, and regulators have been discussing policy tools to improve financial stability and prevent other financial turmoil. Proposals have spanned from regulating the financial industry through traditional “command&control” regulations to imposing regulatory taxes to address the “negative externalities” often associated with financial crises (i.e., excess risk-taking).

Negative externalities occur when economic agents do not fully bear the costs of their actions. Hence, the cost borne by the society as a whole is greater than that borne by the economic agent who has engaged in the activity producing the externality. In practice, negative externalities result in market failures (e.g., moral hazard) since economic agents do not fully internalize the costs created by the negative externalities.

Theory shows that, when trade is possible over externalities and transaction costs are sufficiently low, a Pareto efficient outcome is available through bargaining, regardless of the initial allocation of property among the agents.² However, these assumptions are oftentimes not satisfied (e.g., transaction costs are rarely sufficiently low to allow for efficient bargaining). Hence, under certain circumstances, it could be desirable for the regulator to intervene and regulate. One way to do so is by taxing the economic agent that creates the negative externality. This way, its marginal cost of production will increase and, correspondingly, its output – which embeds the externality – will decrease. Furthermore, by relying on regulatory taxes to curb negative externalities in financial markets, the regulator could also achieve the objective of raising tax revenue to fund potential future bank bailouts.

In this paper, we focus on regulatory taxes, and particularly on the financial transaction tax (herein, “FTT”), as a tool to cope with negative externalities in financial markets. Although it might sound appealing for the regulator to use the taxing power to both raise revenue and regulate financial institutions, we will argue that care should be taken when enacting financial transaction taxes. Indeed, after providing the reader with a theoretical analysis on the effects of the FTT, we will point to several economic consequences that could arise from implementing such a tax. Subsequently, we will elaborate on the challenges that a regulator would face when designing FTTs. We will focus on the EU Commission’s Proposal on an EU-wide FTT, which, to date, has yet to reach a wide consensus among member countries. In this regard, some countries have been vigorously opposing an EU-wide FTT (e.g., the United Kingdom) and some others have favored it such that France in 2012, Italy in 2013 have already enacted FTTs unilaterally. Finally, we will conclude with the current Spanish Proposal of implementing its own FTT.

2. Theoretical Background on the FTT

The Financial Transaction Tax is a tax targeting transactions that involve the trading of several types of securities. Specifically, the FTT should apply to every transaction involving “the purchases and sales of financial instruments as well as other types of financial transactions that may not technically constitute a purchase or sale (e.g., derivatives) but have a similar scope and effect. As such, FTTs can be levied on one, a

² Coase, R. H. (1960): The Problem of Social Cost. *Journal of Law and Economics*, 3, pp. 1-44.

few, or a broad range of instruments, including stocks, fixed income securities, derivatives, and foreign exchange.”³

The regulatory goal of the FTT is to reduce short-term speculative trading and the consequent market volatility. Hence, the fundamental assumption of the FTT is that financial markets are characterized by excessive short-term trading, which gives rise to “long swings in asset prices and persistent deviation from their fundamental equilibria”.⁴

The twofold aim of reducing short-term trading and market volatility should be achieved through imposing an additional transaction cost – the amount of the FTT – on targeted transactions. The underlying idea is that the higher the number of transactions taking place, the higher the amount of taxes because of the “cascading effect” of the FTT. Ultimately, such a cascading effect should discourage short-termism, favor long-term investment and align asset prices to their intrinsic values.

The idea of taxing financial transactions for the above regulatory purposes dates back to the Great Depression of August 1929. The first to theorize the FTT was John Maynard Keynes in 1936. While observing the short-term speculation occurring in Wall Street during the 1930s, Keynes was worried that the speculative trading of noise traders (i.e., traders who do not make trades based on fundamental values) could cause security prices to move away from their fundamental equilibrium values, with negative effects on the real economy. This noise trading would in turn reduce the information content of market prices and generate excess volatility in the market. To overcome such issue, Keynes proposed “[t]he introduction of a substantial Government transfer tax on all transactions [which] might prove [to be] the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise.”⁵

Several years later, in 1978, the Nobel Prize James Tobin proposed a foreign exchange tax (i.e., the so-called “Tobin Tax”) similar to Keynes’ FTT. The Tobin Tax should have uniformly applied to all spot currency conversions with the aim of stabilizing currencies after the breakdown of the Bretton Woods system.⁶ Tobin’s proposal further gained momentum in the 1980s, when the liberalization of financial markets boosted the trading activity, leading to short-termism and excess volatility. In 1984, Tobin suggested to broaden the scope of the Tobin’s tax to the trading of all financial instruments, not only currencies, to mitigate excess volatility and better align prices to their intrinsic values.

In the aftermath of Financial Crisis of 2007-9, regulators as well as academics have revived the idea of taxing financial institutions and their transactions on the grounds that such a tax would improve financial stability and discourage market participants from excess risk-taking (i.e., the Pigovian motive for correcting externalities) and would raise tax revenues (i.e., the fiscal motive). In 2011, the European Commission promoted the adoption of a tax on all financial transactions involving a European-based institution. Although the EU Commission proposal for a common FTT has not found yet the necessary consensus to be adopted, some countries (e.g., France in 2012 and Italy in 2013) have followed that suggestion and have unilaterally introduced FTTs into their tax systems.

³ Brondolo, J. D. (2011): Taxing Financial Transactions: An Assessment of Administrative Feasibility. IMF working paper No. WP/11/185.

⁴ Schulmeister, S. (2009): A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal. Wifo working papers 344/2009, at 3.

⁵ Keynes, J. M. (1936): The General Theory of Employment, Interest and Money, 160 (1st ed.).

⁶ Tobin, J. (1918): Proposal for International Monetary Reform. *Easter Economic Journal*, (3-4), pp. 153-159.

Other countries, such as Spain, have announced the initiation of the passage through parliament of the adoption of an FTT in 2020.

3. The EU Commission's Proposal for an FTT

On September 28, 2011, the European Commission enacted an FTT proposal, which follows the regional multilateralism model (hereinafter, the "EU Proposal" or "EU FTT").⁷ The original intention of the European Commission was for the proposal to be unanimously approved by all Member States of the European Union. However, several Member States have so far opposed to the unanimous consensus. Therefore, the EU Proposal has been the subject of an "enhanced cooperation" procedure, promoted by ten Member States.⁸

The aim of the EU Proposal for an EU FTT was to "address particularly risky behavior". In particular, such tax rests on the assumption that, over the last two decades, the steadily increase in trading activity in the EU financial markets has led to excessive liquidity.⁹ Hence, the EU FTT would be an EU-wide tax on securities aiming at both correcting negative externalities in financial markets and raising revenue from the financial sector to fund public goods and services.

In the aftermath of the proposal, several criticisms have arisen, particularly from the financial industry. The most relevant argument against the tax has maintained that the increase in trading activity experienced over the last decades in Europe, and particularly the trading on derivatives, has represented normal hedging that allows genuine price discovery, rather than trading activity for speculative purposes. To the extent that such trading allows agents to hedge risky positions, it should not be subject to neither regulation nor taxation, as it would be detrimental to the financial sector.

Other concerns have also been raised that such financial transactions tax would give rise to unintended consequences on volume and market liquidity. Several observers claim that reducing short-term trading volumes and market liquidity is not a goal to pursue. Such opponents highlight that, based on the efficient capital market hypothesis¹⁰, high trading volumes play a fundamental role in the process of price discovery and in driving asset prices toward their price equilibrium. Indeed, given that the FTT affects the *whole* trading activity and not just the speculative one, some authors have suggested that the FTT could have a negative effect on liquidity providers and informed traders who usually act as price stabilizers in the market. Specifically, by reducing the amount of informed trading, the

⁷ Commission Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC, COM (2011) 594 final (Sept. 28, 2011).

⁸ The Council authorized the requesting Member States to engage in the enhanced cooperation procedure on January 22, 2013. Initially, eleven Member States requested to engage in the enhanced cooperation procedure: Austria, Belgium, France, Estonia, Germany, Greece, Italy, Ireland, Portugal, Slovenia, and Spain. On May 6, 2014, Slovenia expressed reluctance on signing a declaration through which the requesting Member States committed themselves to finalize the procedure. Therefore, there are currently only ten Member States proactively engaged in the enhanced cooperation procedure.

⁹ Schulmeister, *supra* note 4, at 5, 7.

¹⁰ Fama, E.F. (1970): Efficient Capital Markets: A Review of Theory and Empirical Work. *Journal of Finance*, 25 (383).

FTT would move away asset prices from their fundamental values,¹¹ which in turn would increase “noise trading”¹² and volatility.¹³

Furthermore, some scholars have also warned about a potential impact of the FTT on the cost of capital.¹⁴ The underlying assumption is that higher transaction costs increase the required rates of return that investors demand.¹⁵ The increase in the cost of capital could in turn have adverse effects on investment and employment and, more generally, on the economy.¹⁶

3.1 Design of the FTT and Related Issues

The EU FTT should apply to a broad range of securities and financial transactions that are negotiable on the capital markets. To name the most important categories, transferable securities and money market instruments –with the exception of the instruments of payment– shares in collective investment undertakings, and derivative agreements, as well as transactions outside the organized markets (including over-the-counter (OTC) transactions) all would be subject to the EU FTT.

Some transactions would be exempt from the tax, and particularly those transactions involving the European Central Bank or national central banks of EU Member States. Despite the wide reach of the proposed tax, the transactions connected with business activities or carried out by retail investors in their capacity as citizens would also be excluded (e.g., insurance contracts, mortgage lending and consumer credit, etc.). In addition, the EU Proposal sets forth an exception for primary market transactions –such as initial public offerings on regulated stock exchanges– and for transactions arising from restructuring operations.

The FTT would be levied on the price of the security or, as is the case of derivatives, on the notional amount. Whenever the transaction is carried out between related parties and the negotiated price is well below the market price, the tax would be computed using the relevant market price at the time the parties entered into agreement. The tax rate would be about 0.1% for transactions involving stocks and bonds, and 0.01% for derivatives transactions.

Regarding the apportionment of the tax revenue to member countries, the criterion would be the place of establishment of the financial institutions involved in financial transactions and not the place of trade. This criterion likely satisfies the demands of Member States like France or Germany, which host large financial institutions, but it could create discontent among other countries, which headquarter smaller institutions with lower transactions volume and value. It is also worth pointing out that, some of the revenues

¹¹ Schulmeister, Schratzenstaller and Picek, *supra* note 7, at 7.

¹² Stiglitz, J. E. (1989): Using tax policy to curb speculative short-term trading. *Journal of Financial Services Research*, 3, pp. 101-115.

¹³ Amihud, Y., Mendelson, H. (2003): Effects of a New York State Stock Transaction Tax. *NYU Working paper*. Furthermore, short-term trading often entails hedging activity, not only short-term speculation. See Habermeier, K., Kirilenko, A. A.: (2003): Securities Transaction Taxes and Financial Markets. IMF Staff Papers, 165(178).

¹⁴ Garbarino & Allevato, *supra* note 17. See also Cortez, B., Vogel, T. (2011): A Financial Transaction Tax for Europe, 20 *EC Tax Rev.* 16, at 21. See also Amihud, Y., and Mendelson, H. (1992): Transaction Taxes and Stock Values. In *Modernizing U.S. Securities Regulation: Economic and Legal Perspectives*, pp. 477-500. Edited by Lehn, K. and Kamphuis, R. W. New York: Irwin Professional Publishing.

¹⁵ Amihud, Y., and Mendelson, H. (1986): Liquidity and Stock Returns. *Financial Analysts Journal*, 42(3), pp. 43-48.

¹⁶ Cortez, B. and Vogel, T (2011): A Financial Transaction Tax for Europe, *EC Tax Review*, 20(16).

raised with the FTT are supposed to fund the EU budget, thereby reducing the share of transfers assigned to each Member State.

However, the relocation and substitution risks could make the tax revenue unpredictable.¹⁷ The risk of relocation is due to the existence of competing jurisdictions that do not impose an FTT, which ultimately aim to attract trading from tax jurisdictions that enforce an FTT. In this regard, the globalization of financial markets as well as the digitalization of the economy make it easier to relocate low-tax jurisdictions, as most of the trading activity nowadays take place electronically. Hence, the usage of online platforms, which formally are resident in tax jurisdictions that do not impose FTTs, is a low cost option that allows saving on taxes.

Moreover, the FTT is exposed to the substitution risk. In particular, investors could replace taxable transactions with non-taxable transactions. This strategic behavior arises when the tax does not apply to transactions of all kinds but only to certain specific transactions (e.g., transactions involving shares, corporate bonds, derivatives, or currencies). In such a case, it is reasonable to expect a shift of investments from one type of instruments to another solely for tax reasons, thus producing economically inefficient outcomes. The shift from one type of investment to another that is not subject to tax would be even more pronounced if the marginal costs of switching were lower than the tax imposed on a particular type of investment, all else being equal.¹⁸

Finally, the EU Proposal would follow the territorial approach, which states that a transaction falls under the scope of the tax as long as at least one of the parties is a financial institution established in a Member State participating in the enhanced cooperation procedure. This approach, however, still bears the risk relocation to other jurisdictions that do not participate in the enhanced cooperation procedure. Further, whenever both transacting parties are established within jurisdictions that do not adopt the FTT, the transaction is not subject to the FTT. Such avoidance behavior might not be pursued by small institutions, as their group structure usually lack establishments in no-tax jurisdictions. On the contrary, larger institutions could take advantage of such an opportunity. Hence, the tax could make smaller financial institutions worse off because they would bear most of the tax burden.¹⁹

4. The Spanish Proposal for an FTT

On February 18, 2020, the Spanish government initiated the passage of an FTT that would only apply to the acquisition of stocks in listed Spanish companies that have a market capitalization above Euro 1,000 million. The tax rate is set at a 0.2% on the aforementioned transactions and the taxpayer liable for this new tax will be the financial institution in charge of executing the acquisition, regardless of tax residence. Hence, as opposed to the EU FTT, Spain will impose an FTT that follows the worldwide approach as it applies to all transactions on Spanish stocks, regardless of the location of the transaction or place of establishment of the parties and the intermediaries.

¹⁷ Vella, J., Fuest, C., and Schmidt-Eisenlohr, T. (2011): The EU Commission's Proposal for a Financial Transaction Tax, *British Tax Review*, 6(607), at 612-13, 616.

¹⁸ *Supra* note 4, at 20.

¹⁹ See Carlo Garbarino & Giulio Allevato (2012), Financial Transaction Tax europea: obiettivi dichiarati e potenziali effetti distorsivi, 12 *Fiscalità e Commercio Internazionale* 14, 17-19.

However, a unilaterally-implemented worldwide FTT implies significant enforcement and collection complications in case of transactions carried out abroad which involve foreign parties: indeed, in such a case, Spain would need to rely on voluntary compliance by the parties of the transactions or on cooperation by other countries.

Given the threshold triggering the tax, as of now, about 60 companies would actually be tax liable. These companies are also the largest listed in the Ibex, whose value added amounts to about 8% of the national GDP and whose workforce exceeds 1 million employees. This, in turn, raises concerns on the selectivity of the tax, which would only applies to a handful of corporate taxpayers.²⁰

Finally, it is worth pointing out that, Spanish financial institutions are already subject to a statutory corporate income tax rate that is higher than that paid by the corporate sector (i.e., the tax rate levied on banks is 30%, while that on the corporate sector is 25%). An additional levy on these economic agents may actually exacerbate the tax burden and may incentivize negative behavioral responses, such as passing on the economic burden on the FTT on clients and investing in securities that do not fall under the scope of the tax. The latter response could become very problematic as it contradicts the principle of diversification, which mandates that capital should be allocated in a way that reduces the exposure to any one particular asset or risk. Indeed, by investing in a variety of assets, financial institutions reduce concentration risk and volatility.

5. Final Remarks

This paper examined regulatory taxes as a tool to make the financial industry internalize negative externalities in financial markets, with a specific focus on the FTT. In particular, the paper has illustrated the theory on the FTT and its intended and unintended consequences. It has been highlighted how the regulatory goals of the FTT – namely the reduction of excessive market liquidity and short-term market volatility – are not unanimously accepted as entirely desirable goals. In addition, the analysis conducted in this paper has illustrated how the implementation of the FTT may trigger significant capital cost increases, relocation and substitution risks, with detrimental effects on investment and economic growth.

Finally, we argued that adopting the FTT unilaterally increases its unintended consequences and further impairs the effectiveness of such regulatory tax. Therefore, we believe that governments should aim at a multilateral implementation of the FTT. Specifically, the design and the adoption of such tax should be the result of multilateral cooperation between all the countries belonging to a given market region. For all these reasons, we believe that any EU Member State should refrain from developing its own FTT, which may prove ineffective at achieving its regulatory objective or even counterproductive - and insist on the achievement of multilateral coordination at the European level. The expectations on the feasibility of such an agreement, however, are very low, as the failure of the EU Commission's proposal demonstrates, and the Brexit scenario frustrates the ambitions of advocates of a common EU FTT even further.

²⁰ Izquierdo Llanes, G. (2020): El error del nuevo impuesto sobre las transacciones financieras. *Cinco Días, El País Economía*.