The European Financial Transaction Tax: A Pragmatic Debate About the Merits of Using Taxation to Curtail Volatility in Financial Markets

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In September 2011, the European Commission proposed to impose a tax of 0.1 percent on financial transactions involving stocks and bonds, and a tax of 0.01 percent on transactions involving derivatives. The motivation was partly to increase tax revenue and partly to discourage financial market speculation. However, the effectiveness of the European Commission proposal for combating excess market volatility is uncertain because the tax fails to address other sources of volatility such as excessive leverage and misaligned invectives for executives. Moreover, the tax will increase transaction costs, which leads to lower trading volume. A reduction in trading will impede market liquidity and restrain price discovery mechanisms by making it more costly for market participants to restore prices to their fundamental values. As a result, the financial transaction tax may in fact exacerbate volatility stemming from errors in market pricing. The tax will also increase the cost of capital, and thereby make it more expensive for companies to finance real economic activity. Lastly, many European countries oppose the tax due to the lack of global implementation. In their opinion, the tax will encourage the movement of financial activity away from the European Union. Consequently, the proposal faces a wide array of challenges before a potential implementation, and will likely not achieve complete support until the Commission revises the proposed directive to adequately address these issues.

On September 28, 2011, José Barroso, the President of the European Commission launched a proposal to introduce a tax on financial transactions within the European Union. Although the debate concerning financial transactions has been raging for years, beginning with its first advocate, John Maynard Keynes, in 1936, the concept gained massive support following the recent financial crisis. Proponents view the notion of a financial transaction tax as a targeted means of making financial institutions pay for a crisis they largely created, and to limit future exposure to financial crises. However, several EU member states, including the United Kingdom and Sweden, have expressed their stark opposition to the proposal arguing that the tax will reduce the competitiveness of EU economies. In order for the proposal to pass, the proposal would need unanimous support among the member states. Therefore, in large part due to the opposition by some of the member states, eleven member states petitioned the European Commission in 2012 to proceed with the tax under the alternative enhanced cooperation framework, which would lead to limited implementation in those eleven countries alone.

The European Commission proposal would impose a tax of 0.1 percent on financial transactions involving stocks and bonds, and a tax of 0.01 percent on transactions involving derivatives. The tax would apply to any transaction that involves at least one financial institution located within the European Union. The motivation for introducing a financial transaction tax is essentially two-fold. First, authorities need to increase revenue to counteract the increasing national budget deficit and to avoid a debt crisis. And relatedly, the tax would penalize the financial sector and make the financial sector contribute a fair share to the economy. Second, the tax discourages financial market speculation by raising the costs of financial trading, and thereby reducing the probability of a new crisis of the same magnitude.

The financial transaction tax is commonly applauded for its ability to remedy many issues at once. First of all, like most taxes, the financial transaction tax will raise revenues for the European Union countries. Under the Commission's proposal, part of the revenues will go to the central EU budget, while the rest will be applied towards reducing the individual countries' national contributions to the European Union. As a result, the financial transaction tax could provide much-needed funds to struggling European economic with rising public debt. In the aftermath of the financial crisis, European Union member states contributed more than 4.6 trillion euros to the financial sector, equaling 39 percent of EU-wide Gross Domestic Product in 2009, and public debt rose from around 60 percent to 80 percent. Secondly, the tax would harmonize the internal market by creating a minimum standard across the European member states for taxing financial transactions. Lastly, and most importantly, the tax could contribute to curbing excessive volatility by making short-term trading more expensive and thereby discouraging speculative activities.

While the tax for the most part should satisfy the two first goals, it is questionable whether it will decrease excessive volatility. Although the tax seeks to minimize market volatility by making short term speculative trading more expensive, it is unlikely to truly remedy harmful volatility that exists in the market. Essentially, the tax is not a suitable solution because it only targets one possible source of volatility—speculative trading. Indeed, during the recent financial crisis it became clear that speculative trading was not the sole cause of the crises, but other issues also contributed to the crisis, such as excessive leverage and misaligned invectives for executives. The structure of the financial tax would not remedy these sources of volatility, and notably the European Commission proposal fail to adequately address these risks. Moreover, the tax will reduce trading, which in turn will impede market liquidity. This is problematic because market liquidity plays a critical role in price discovery. Consequently, the financial transaction tax may in fact exacerbate volatility stemming from errors in market pricing because the tax would make it more costly for market participants to restore prices to their fundamental values.

Furthermore, implementation of the tax can have additional negative consequences for financial institutions, yet the Commission's proposal does not adequately address these potential issues. First, the tax will increase the cost of capital, which will make it more expensive for companies to finance real economic activity. The financial transaction tax will increase the cost of capital because the tax imposes additional transaction costs on the investors. For investors that hold shares or bonds through a European financial institution, they will incur an additional cost when they purchase and sell securities. The size of the increase in cost of capital will depend on several factors such as holding period, the type of instrument, and the average bid-ask spread for that security. Moreover, the tax will likely reduce the capital base of financial institutions at a time where the economic crisis has led to increasingly stringent regulations on capital requirements. Although the proposal attempts to prevent disruptions to company financing through the exclusion of primary markets, the tax will still affect the company financing through its effect on the secondary markets. As mentioned previously, the tax will likely increase the cost of capital, and in turn, this can reduce investment in financial sector because the tax would reduce the attractiveness and profitability of this sector. Additionally, many European countries oppose the tax due to the lack of global implementation. In their opinion, the tax will encourage the movement of financial activity away from the European Union, which will lower EU-wide GDP. The Commission proposal analyzes the GDP effect of the tax, and concludes that the gains from the tax will likely exceed any reduction in GDP, but it should be noted that this calculation rests on several assumptions that may not hold in practice. Additionally, previous experiences with the financial transaction tax in Sweden in the 1980s demonstrate that revenue forecasts for a financial transaction tax may significantly differ from the actual results upon implementation. If the tax causes a shift in financial activity away from the European Union, there is also a risk that this shift will benefit tax havens that have less stringent regulations than most other jurisdictions. The lower level of supervision in these jurisdictions can lead to increased tax evasion or other legal violations that harm European Union economies.

Overall, the largest shortcoming of the Commission's proposal is the failure to ignore obvious risks stemming from implementation of the proposal. Furthermore, the financial transaction tax may be less suited to remedy the issues that the Commission seeks to resolve by implementing the tax, but instead the Commission chose this approach due to the wide public support the financial transaction tax has. While the public at large views the financial transaction tax as a modern day "Robin Hood," the reality is that the tax may instead affect “the poor” in the form of regular consumers and businesses. Additionally, the tax may significantly impede the financing of companies by increasing the cost of capital for investors, without yielding any corresponding decrease in volatility. Consequently, the European Commission should instead consider alternative, less invasive methods, such as other types of financial taxes as well as a higher focus on stricter regulatory measures, including capital requirements, and closer monitoring of the risks borne by financial institutions.