Varazdin Development and Entrepreneurship Agency
in cooperation with
University North, Croatia
Faculty of Management University of Warsaw, Poland

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23rd International Scientific Conference on Economic and Social Development

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ENTERPRISE IN TURBULENT ENVIRONMENT

ENTREPRENEURSHIP CAUGHT BETWEEN CREATIVITY AND BUREAUCRACY

FINANCIAL TRANSACTION TAX IN EU: ESTIMATION OF ECONOMIC IMPLICATIONS

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ABSTRACT
The need to reexamine the European tax system in relation to undertaxed and privileged financial system has been rising along with the development of financial crises and the rise of public financing of financial instituions in the EU. Since 2011, there are ongoing negotiations on the proposal for a Directive on the unified European financial transaction tax (FTT). The initial EU–wide proposal came into question, mostly because of the Member's disagreement about the issues of how the tax will apply to derivative trades, and to transactions executed by pension funds. It is intended that FTT will be applied in just ten member states under the enhanced cooperation legislative mechanism. Altough the scope and objectives of the original FTT proposal have been limited in the latest modified proposal, it is expected that general impacts on EU financial system and economy are still significant. The aim of this paper is to present all the potential effects, implications and restrictions of the FTT introduction. These effects concern trading volume and speculation, liquidity, asset price volatiliy, asset prices and the cost of capital, cascading and intersectoral distortions, financial stability and budget revenues. One of the most pronounces economy impact is probably increasing the transaction costs and decreasing the profits of financial institutions. This study summarizes recent literature on the possible positive and negative effects of European financial transaction tax.
Keywords: *financial institutions, financial transaction tax, government revenues, Europan union*

1. INTRODUCTION

Despite the remarkable interest of scientific and professional public for taxing of financial sector in the wake of the financial crises, the idea of taxing financial transactions has a long history. It was introduced almost before a century by economist John Maynard Keynes (1936). In the 1970's James Tobin proposed specific currency transaction tax, in order to stabilize excessive exchange rate fluctuations. The primary purpose of applying the FTT in national financial system is to ensure stability and to prevent or at least reduce the negative consenquences of the future crises. But in the recent years and in the case of EU proposal, there is evident a significant influence of political and social circumstances, because of the widley accepted opinion that financial sector have to take part in achieving greater stability and economic justice. The European Commission has launched the idea of a EU-wide levy in a form of harmonised financial transaction tax (FTT) in September 2011. According to the proposal of European Commission (2011) the objectives are 'to assure that the financial sector makes a fair and substantial contribution to public finances to recoup the costs of the crisis, to alleviate Member States' contributions to the EU budget and to discourage to a certain extent risky market behaviours.' During the crisis, EU member states supported the financial sector with EUR 4.6 trillion (i.e., 39% of EU27 GDP in 2009), which of course had significant budgetary consequences (Solilová, Nerudová, Dobranschi, 2016). Budgetary consequences were not the only drivers of the discussions for introduction of FTT; the argument for taxes in the financial sector as a regulatory tool also played a very important role. However, after disagreement of involved countries, a group of eleven[1] EU countries started to negotiate a common FTT through the mechanism of enhanced cooperation[2]. After the FTT introduction date has been repeatedly postponed, even its actual implementation is still not clear. The aim of this paper is to determine the financial, economic and wider, social effects of the introduction of a FTT tax on countries involved. Even the prediction of budget benefits differs among literature, it is undeniable that increase in tax revenues will have immediate positive impact. FTT impacts on financial institutions will be particularly unfavorable because of the low-yield environment and tighter and more strict supervision and regulation. The paper is divided into five parts. The introductory remarks provide insight into the subject and the research problem.The first part briefly reviews the design of FTT proposal given by the Europen Commission. The third part offers literature review on estimated economic FTTs impact, while the forth section of the paper is focused on wider social and other non-economic aspects of FTT introduction. Finally, the last section offers conclusion.

2. THE EUROPEAN COMMISSION'S PROPOSAL OF HARMONISED FINANCIAL TRANSACTION TAX

According to European Council Directive, FTT is a tax with a very low rate to be collected from the total value of all financial transactions, conducted between financial institutions of which at least one party is located in a country participating in the initiative. Financial transactions that are taken in account are those made by financial institutions and carried out on organized/regulated markets as well as on over-the-counter markets. Financial transactions include sale/purchase, lending/borrowing, transfer of ownership, conclusion or modification of derivative contracts and financial instruments such as stocks, bonds, currency transactions[3], derivatives agreements and structured products. The definition of financial institutions is wide and includes investment companies, regulated markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, financial leasing companies and other persons carrying out certain financial activities with more than 50% financial transactions in their annual turnover. Financial institutions from the EU that are party to the FTT transaction acting on either on their own behalf or on behalf of their clients, or in the name of a party in a transaction. The Directive aimed the harmonization of the regulation on taxation of financial transactions in order for financial instrument transactions to operate properly in the domestic market (European Commission, 2013). Original proposal for FTT took a “triple A” approach, i.e., the tax should apply to all markets (such as regulated markets or over-thecounter transactions), all instruments (shares, bonds, derivatives, etc.), and all financial sector actors (banks, shadow banks, asset managers, etc.). The base of the tax is very wide, covering transactions carried out by financial institutions on all financial instruments and markets when at least one party to the transaction is located in the EU. Nevertheless, according to the last proposal from February 2013 (EC, 2013), FTT base is narrower and would apply to the purchase of a equity or derivatives for a exchange-based transactions but also to over-the-counter transactions. Tax rates are set very low, for basic financial instruments at 0.1% of the value of buying and selling transaction (except the primary market for shares and bonds), whereas the tax rates of 0.01% of nominal contract value are defined for derivative products (Olgić Draženović et. al. 2016: 1067).

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[1] Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain. Estonia, withdrew its participation in March 2016, leaving the total participating countries to ten.

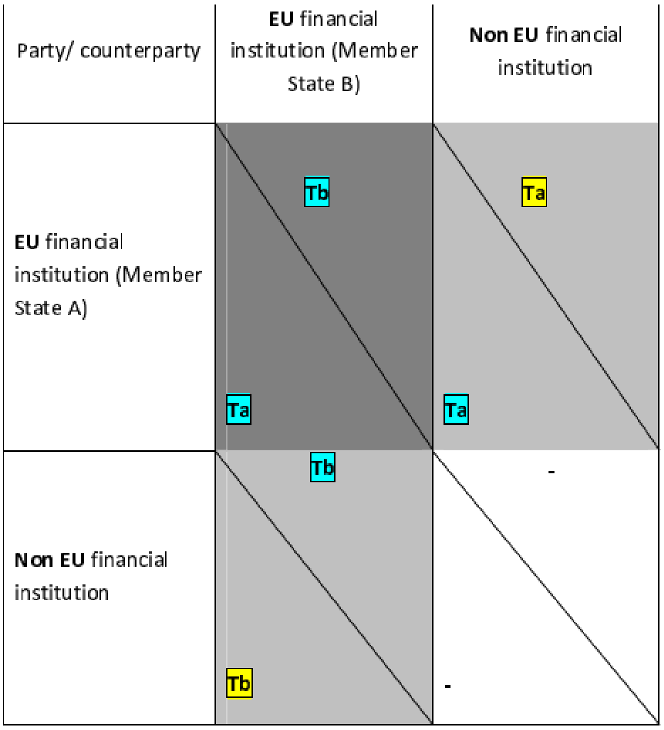
[2] The mechanism of enhanced cooperation is a procedure where at least 9 member states are allowed to establish advanced integration or cooperation, without involving other member states. This possibility is based on the Article 20 of the Treaty on the EU and Articles 326 and 334 of the Treaty on the Functioning of the EU.

[3] Currency derivative agreements are defined as taxable financial transactions, while spot currency transactions do not constitute taxable base.

Also, the EC proposal foresees a list of exemptions. Therefore, the scope of FTT is primarily limited to financial industry and it would not apply to:

- day-to-day transactions of households and businesses,
- enterprise borrowing/lending, mortgage loans and consumer credits,
- spot currency transactions,
- transactions on primary capital market (including underwriting),
- investment banking activities,
- transactions in and with foreign currencies,
- transactions carried out as a part of restructuring operations,
- the transactions carried out by the central banks of participating nations,
- the transactions carried out by central securities depositories,
- refinancing operations with the ECB, the European Financial Stability Facility, the European Stability Mechanism and with the EU institutions.

Under current proposal, there will be no exemptions for pension funds, market makers and risk management transactions. FTT atracted special public attention due to its possible impact on outside its boundaries. It is proposed that the tax function on the residence principle but also have some elements of the issuance principle. The general rule is that the tax would be levied by the residence principle i.e. on all financial transactions between financial institutions, if at least one of the party is established in the territory of the FTT-jurisdiction and at least one financial institution there established is involved. The issuance principle implies that worldwide transactions of instruments issued in EU-11 could be liable to pay the tax regardless the geographic residence of the entities party to the transaction. The primary motive for implementing this approach is to reduce level of risk of tax avoidance through geographical realocation of transaction outside the FTT zone. This implies its possible positive impact on fighting tax avoidance because it does not matter where a transaction is carried out but who the transaction partners are.



Legend:

Ta: tax of country A; Tb: tax of country B; Tax paid by EU Party; Tax paid by Non EU party

Figure 1: Residence principle in EU FTT (EC 2011)

3. ECONOMIC IMPACTS OF THE FTT INTRODUCTION IN EUROPEAN FINANCIAL MARKETS

Introduction of FTT is proposed following two main motivation. First, it is a form of a Pigouvian tax due to its aim of correcting the market failures. Second, it is very efficiant model for raising government revenues. The possible effects of the introduction of a FTT are strongly disputed between supporters and opponents of the proposal. This debate is based on numerous literature that has evaluated proposition of J.M.Keynes (1936) for a transaction tax on equity trades to discourage speculation and the proposition of Tobin (1972) to introduce a tax on currency transactions to reduce volatility. Both argued that short-term trades were more likely to destabilize financial markets than long-term trades. Later arguments in favour of FTT were presented by the work of Stiglitz (1989), Summers and Summers (1989), Spahn (2002) and Schulmeister (2010). They stated that financial transaction levy reduce curtail shortterm speculation, thereby reducing market volatility and achieve better asset determining. Opponents (e.g. Oxera 2011) arrgue that introduction of FTT would result in lower asset prices, increased cost of capital for businesses, reducing liquidity and increasing volatility and lower returns to savings. An important argument of proponents of an FTT is that it will reduce systemic risk by reducing volatility or the incidence of asset price bubbles. The effect on volatility has been extensively studied, both empirically and experimentally. The majority of studies conclude that transaction taxes either increase volatility or have no effect. Bubbles are therefore potentially the most important aspect of systemic risk an FTT may have impact on. Also, FTT will significantly reduce activities of High-Frequency Traders - at least those residing within the geographical scope of the proposed tax. An additional point is that the financial sector is under-taxed and that a financial transaction tax is simply an efficient way to raise taxes (Anthony, Bijlsma, Elbourne, Lever, Zwart 2012, p. 7).The opposite view is given by Matheson (2014). Study found that increases in FTT-like fees were associated with a reduction in volatility, while Xin and Wei (2014) study shows that the effect on volatility may depend on how well-developed is the market for a particular asset. One of the main motivations brought forward by proponents of a FTT is the revenue raising. The European Commission original proposal (2011) expects the EU-wide tax revenue potential of roughly €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 under enhanced cooperation (EC 2013), estimated revenues are €35 bn, or 0.4% of euro area GDP. Last EC projections revised downward total revenues, suggesting that the levy would rise around €22 bn per year (Colussa, Hempell, Späte 2016). Also, there are some factors that could significantly alter the estimated revenue base, and, as a consequence, the actual revenue collected from the tax. One of them is a possible change in behaviour of both providers and users of financial services and producing some financial innovation to avoid the tax.

/*Chart following on the next page*

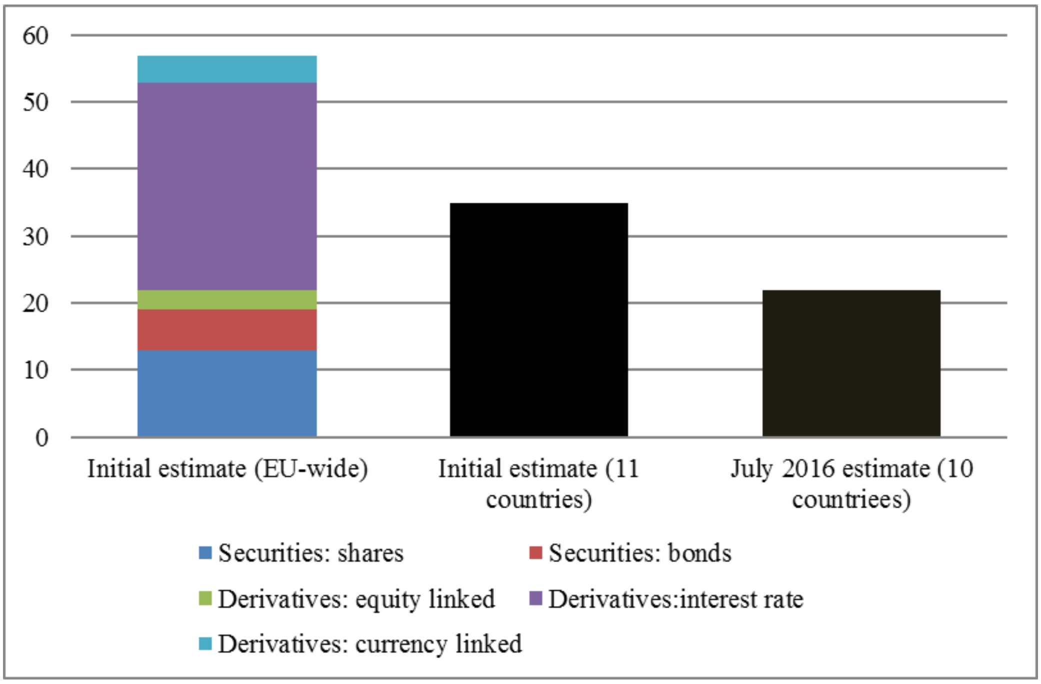


Chart 1: Projected revenue from EU FTT, in EUR bn/year (Colussa, Hempell, Späte, 2016, p. 2)

Furthermore, FTT in general is in general easy and inexpensive to administer, as most transactions are carried out electronically and the tax can be collected electronically and at the source. FTT can be collected at very low cost of less than 1% of revenue raised, especially when there is existing market infrastructures, e.g. trading platforms, trade repositories or clearing houses (Matheson, 2011).

Projections of EC (2011) assumed that the turnover on securities markets will decline by up to 20%, namely with respect to the segment of high frequency trading. The turnover on derivatives markets is expected to decline by up to 90% in some market segments, especially in the market segment of high frequency trading and highly-leveraged products.

Opponents are worried that financial institutions will pass on the FTT related costs to the to private households and businesses, thus resulting in a considerable burden on private pension systems, corporate finance and taxpayers due to increasing costs to finance the government. Also, effective tax burden can be significantly higher than the headline tax rate of 0.1% and 0.01%, due to the cascade effect. The cascade effect indicate that the tax will require multiple payments i.e. FTT will be payable at each level of intermediation in a transaction chain.

4. WIDER MACRO-ECONOMIC IMPACTS OF THE FTT INTRODUCTION IN EU

Special aspects of FTT introduction are possible macro-economic impacts and the real social costs. Imposing the FTT will couse higher capital costs and consequently in reducing willingness to invest, which leads to declining growth rates. Thus, negative influnce on employment can also be expected. According to the EC (2011) scenario, FTT of 0.1% and 0.01% would have limited negative impacts on employment of respectively -0.03% and -0.20%. Impact on GDP has been topic of many empirical an theoretical studies. According to Griffth-Jones and Persaud (2012) the introduction of FTT could generate a positive effect on growth of 0.25% GDP. Other authors aggree that influence of FTT on GDP will be negative, but there are some significant differences over the scale of the impact. Current ECs (2013) study estimates that GDP will be reduced by 0.28%, while other authors predict a larger negative impact.

Namely, Anthony et. al. (2012) estimate a reduction in GDP between 0.4% and 1.2%; London Economics (2013) predicts a reduction of 1% of GDP; and the most severe reduction of 2.42% GDP was estimate by Oxera (2011) for the first EC proposal. FTT's proposal states that private households and SMSs not actively investing in financial markets will not bear the economic incidence of the tax. However, there are many opposite opinions. For example, EFAMA (2013) argue that ordinary citizens investing in UCITS would experienced reduced value of their savings by 15% of their total contribution as a result of the FTT.

Some authors point out the potential for pension funds to be affeced with a fall in equity prices due to the FTT introduction and higher transaction costs when buying or selling. Still, it is worth point out that historically pension funds favoured a valuation based low turnover approach to investing so a low-rate FTT levied at points of entry and exit from the market would have minimal impact on returns. While a significant proportion still adopt such strategies, in recent years a variety of forces (low interest rates) have encouraged increased turnover of assets which is contributing to a significant percentage of pension funds' high costs (estimates vary from 2% to as high as 20%). Therefore, for pension funds with a long term investment approach the FTT will add a negligible cost (a small fraction of transaction costs) and the extent to which an FTT moves funds toward lower turnover in the markets should benefit pensioners (Gray, Griffith-Jones, Sandberg 2012).

Anthony et. al. (2012) claim that in the longer term, prices and wages will adjust to the new tax. As a result, costs will be borne by the financial sector itself (in the form of lower rents), the consumer (in the form of higher prices for financial services), or firms (in the form of higher costs of capital) and governments (higher interest rate on government bonds). For example, companies may pass on transaction taxes (partially) into higher output prices or lower wages and pension funds into lower pensions.

5. CONCLUSION

Global financial crises seriously affected EU economies and their public finances and the finance sector has played an important role in the finanacial crises. There has been a strong consensus that finance sector must be taxed to make greater contribution to the crises related costs. Therefore, European Commission proposed introduction of harmonised EU financial transaction tax as a common levy for financial institutions in a EU-11 under the EU's enhanced cooperation procedure. The introduction of FTT creates significant implications for the economy of involved EU countries. Among wide range of economic and wider effects these are the most important: it will raise up budget revenues, stabilise financial markets by reducing short-term transactions and involve the financial sector in the costs of the financial market crisis. In the longer run, it is possible to have some negative macroeconomic effects because it is likely that ultimately it will be paid by customers' of the financial sector. FTT also have some broader benefits for clients of the pension and investment funds due to moving them in direction of responsible investments and longer-term strategies and which reduces de-stabilising elements such as high frequency traders while not significantly harming liquidity. Considering the idea of imposing a tax on financial transactions in EU is still facing large political and economic discussions, it is clear that FTT introduction is uncertain. Certainly, since it is not the only mechanism against future financial crises, improving financial market operations should be set as far more consensus among EU member countries.

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