The European Commission's Proposal for a Financial Transactions Tax: A Critical Assessment

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Abstract

A financial activities tax (FAT) and a financial transactions tax (FTT) are the main alternative ways of recouping some of the public money used to bail out the financial sector after the great crisis of 2007-8. In preparing a common proposal for the European Union, the European Commission initially appeared to favour the FAT but then swung its weight behind the FTT in late 2011. Its rationale was that in addition to generating revenue this tax could also help to stabilize the financial markets by curbing excessive speculative trading. This paper takes a different position. Its central argument is that the FTT would amplify rather than dampen market instability by interfering with the functions of important financial institutions. Its chief conclusion is that the FAT is superior to the FTT.

Key words: European Commission; financial transactions tax; financial activities tax

1.Introduction

In late September, 2011, the European Commission proposed that a Financial Transactions Tax (FTT) be the preferred method by which European governments should tax their financial systems to recoup some of the losses incurred in the financial crisis of 2007-8[1]. Although the Commission's staff also studied the merits of a Financial Activities Tax (FAT), which is a tax on the profits and wages of financial institutions rather than a tax on transactions in the financial markets, it had finally decided in favour of the FTT on the grounds that it would both generate revenue for governments and also help to stabilize the financial markets by curbing trading volumes. In arguing that a transactions tax would have a stabilizing effect on the financial markets, the Commission in effect made clear its acceptance of a key premise underpinning that position, namely, that as all short term trading is purely speculative it can only be central to the functions of institutions that are peripheral to the financial system and only peripheral to the functions of those institutions that are central to the system.

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[1] Council directive on a common system of financial transaction tax and amending Directive 2008/7/EC; Commission Staff Working Paper (28.9.2011);, Executive Summary of the Impact Assessment (accompanying Directive on a common system of financial transaction tax (28.9.2011)

The present paper challenges this premise. While it accepts that a significant amount of short term trading in the money and capital markets is speculative and thus potentially destabilizing, it also argues that an equally significant amount constitutes an integral part of the day to day activities of commercial banks and asset management firms. Short term trading may have been exogenous to the financial intermediation functions of these institutions in previous historical periods, but following recent structural changes to capitalist economies it has now become an integral part of those functions. In view of the importance of the commercial banks and institutional asset managers to the European financial system, it follows that the introduction of a European FTT that indiscriminately restrains all short term trading would bring about a result that is the very opposite of that intended by the Commission. Rather than enhance the ability of the European financial system to service the real economy in a stable and cost efficient manner, the proposed tax would on the contrary severely undermine that ability. Our central conclusion is that it would be far better to allow important financial institutions to perform their functions unhindered and then tax any excessive profits made out of the performance of those functions.

The structure of this paper is as follows. Section two reviews the reasons behind the Commission's choice of a transactions tax. Section three looks at some accounts of security trading. Section four focuses on the effects of a capital market FTT on European asset managers. Section five focuses on the effects of a money market FTT on European banks. Section six looks at some strategic and policy implications. Section seven concludes.

2. The Rationale for a European FTT

As a result of the extensive damage to domestic economies and public finances wrought by the financial crisis, a number of European governments, in common with those in many other parts of the world, introduced special tax measures aimed at making the financial sector bear some of the costs of the crisis. Fearing that the lack of coordination of these national measures could fragment the European internal market for financial services, the European Council and the European Parliament called upon the European Commission to prepare a proposal for a common approach to taxing the financial sector[2]. In response to these calls the Commission authorised several studies that compared the relative advantages of two major types of tax instrument, the Financial Activities Tax that would be levied on the value added by financial institutions and the Financial Transactions Tax that would target trading activity in the financial

[2] Council of the European Union, 17 June, 2010; Resolution of the European Parliament, March 10, 2010.

markets[3]. Although at one point it looked as though the FAT would be favoured[4], the Commission finally decided in favour of the FTT on the grounds that not only would this tax be marginally more effective in achieving the revenue raising objective but also that it alone would be able to achieve the second major objective of "*limiting undesirable behaviour and thus stabilizing markets*" (2011b,p.3). Central to this conclusion is the identification of 'undesirable behaviour' with 'trading behaviour': while the FTT would have a directly negative impact on trading volumes by raising the cost of financial transactions, the FAT would have no equivalent impact. As the Commission's Impact Assessment states: "*The FAT does not have a direct impact on the trading behaviour in financial markets*" (ibid., p.6)

It has been said that the Commission's directive on the FTT makes no distinction between 'good' and 'bad' financial trades[5]. This is not quite correct. The Commission does appear to differentiate 'good' from 'bad' trades according to whether or not they have some link to underlying economic fundamentals. Thus the Commission does not intend to apply the tax on primary market transactions "*so as not to undermine the raising of capital by governments and companies*." (ibid.,p.4). Similarly, the Commission's logic in advising that the FTT should be set at relatively low rates is that it would have no significant impact on low-speed transactions connected to real sector activities but a negative impact on high-speed transactions that have no such connection. Where there is validity to the criticism that no distinction is made between 'good' and 'bad' trades is in relation to short term trades in the secondary markets. The Commission appears to consider all such trades as 'bad' with any differences between them merely being differences in the degree to which they are bad. High frequency trading is singled out for special attention but the fact that the Commission considers all types of automated trading to be speculative is made clear by its intention to apply the FTT to a very wide range of financial instruments and institutions (see figure 1).

[3] EU Commission staff working document, Innovative Financing at a Global Level, (1 April, 2010a); EU Commission staff working document, Taxation of the Financial Sector, (7 October, 2010b)

[4] See in particular the EU Commission staff working document, Innovative Financing at a Global Level.

[5] Vella et.al (2011, p.)

Figure 1

The Commission's Proposed FTT in Outline

Rate of FTT	0.1% for securities 0.01% for derivatives
Range of Financial Instruments Subject To FTT	Range covers all instruments which are negotiable on the capital market, money market instruments including repurchase agreements (repos),units or shares in collective investment undertakings (including undertakings for collective investment in transferable securities (UCITS) and alternative investment funds) and derivatives contracts.
Range of Financial Institutions Subject to FTT	Range includes investment firms, organised markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, holding companies, financial leasing companies and special purposed entities.
Residence Principle	The FTT applies if one of the parties to a transaction is a financial institution that is established in a Member State, where 'established' means that the financial institution has its registered seat, its permanent address, its usual residence or a branch in that Member State.

The controversy that has followed the proposal for a European financial transactions tax has centred on two broad issues, feasibility and desirability. As regards feasibility, the strong objections to the FTT voiced by the British government have served to highlight the risk that if Europe proceeds with the FTT without any global agreement to implement the tax a substantial proportion of financial trades currently conducted in Europe will be redirected to untaxed jurisdictions and markets. Unfortunately for the Commission these same concerns were shared by so many other EU member governments that in the end only a minority ~~number~~, 11 out of the total of 27, are prepared to proceed with the implementation of an FTT in 2014. In light of this development, the Commission decided in February, 2013, to withdraw its original proposal for an EU wide FTT and replace it with a proposal for "enhanced cooperation in the area of financial transaction tax amongst the EU members who support this tax" (2013). It is made clear that the new "proposal is based on the Commission's original proposal of 2011 in that it respects all the essential principles thereof" (2013, p.5). However, some adaptations had to be made. Thus to take account of the "new context of enhanced cooperation", it is now proposed that the "FTT jurisdiction be limited to participating Member States" (ibid.). Furthermore, to help assuage fears that taxable transactions will be redirected to untaxed jurisdictions, it is proposed to complement the residence principle with an 'issuance principle", the principle that

even financial institutions based in non-FTT jurisdictions will be subject to the FTT when they trade in financial instruments that are issued in FTT jurisdictions.

In persisting with the FTT despite substantive opposition within the EU over feasibility, the Commission has shown the extent to which it considers this particular tax to be the most desirable method of taxing the financial sector. This is where we disagree with the Commission. Recall its claim that the FTT's decisive advantage over the FAT is that it can achieve two objectives simultaneously: market stabilisation in addition to revenue generation. The central idea behind this claim is that there is a positive correlation between trading volume and price volatility: by reducing the volume of short term trading the FTT can help to reduce price volatility, which must in turn help to promote the informational efficiency of the financial markets. As the Commission's Impact Assessment study asserts: "*The aspects of dealing with risk and behavioural aspects of the FTT relate to the possibility of the FTT to curb speculation, noise trading and technical trade, and to decrease market volatility"* (2011b,p10). The problem with this assertion is that it does not receive unambiguous support either from the empirical evidence or from economic theory. While some studies show a positive correlation between trading volume and price volatility, others show no correlation while yet others show a negative correlation (low trading volume leads to higher price volatility due to 'market thinning')[6]. Similarly, while some academic economists favour the imposition of financial transaction taxes to curb price volatility, others oppose such taxes on the grounds that high trading volume can aid the price discovery process and the efficient allocation of risk.[7]

In sum, the Commission's economic case for the FTT is not a powerful one. However, if the Commission persists with this tax policy this is in part because the standard economic arguments against the FTT also lack sufficient power[8]. The reason for this is that most of the current assessments of the costs and benefits of the FTT only focus on the impact on financial market stability that is transmitted via the impact on *financial prices* while largely ignoring the impact on stability that is transmitted via the impact on *financial institutions*. We take a different position. While we accept that a significant amount of short term trading is speculative, we also believe that an equally significant amount has nothing to do with speculation and forms, instead, an indispensable part of the daily operations of major institutions such as pension and

6 See IMF, 2010, for a survey of studies on the impact of an FTT on price volatility.

7 European Parliament, *Crisis Management, Burden-sharing and Solidarity Mechanisms in the EU*, 2010

8 See IMF, 2010, pp.17-20, for a list of objections to the FTT. For a critique of each of these objections to the FTT see Schulmeister, 2011.

mutual funds on the one hand and the commercial banks on the other. It thus follows that any complete assessment of the costs and benefits of the FTT must also focus on its impact on these institutions. Before elaborating on this point it first helps to briefly survey theoretical accounts of security market turnover.

3. Explanations of Security Trading Volume

It is widely acknowledged that secondary security markets support and even make possible primary markets by giving the first investors in a security a way to exit from the investment. In this sense the ability to trade on secondary markets is functional regardless of the motive for such trading, although of course the importance of this exit possibility might be different for different investors. However, while the indirect functionality of secondary markets is generally accepted, there is also a general view that much of the observed large volumes of secondary market trading is superfluous to this functionality. Part of the explanation for the popularity of this view is that it is only recently that financial theorists have begun to pay attention to trading volumes, as opposed to their central focus on prices and valuations. Several have commented on the puzzle that huge financial market turnovers represent for the general equilibrium theories, such as the capital asset pricing model (CAPM), which have provided the paradigmatic account of financial markets. Indeed, that equilibrium approach has generated several versions of a "no trading theorem," which shows that the very strong full-information conditions used to characterize asset-market equilibrium are incompatible with active trading[9]. These theorems can be seen as counterparts to the Grossman-Stiglitz critique of the efficient market hypothesis: the former indicate that on a fully efficient financial market there would be no trading; the latter turns the same logic around to show that such a market is itself an impossibility[10]. If we move away from equilibrium accounts of financial trading there are a range of explanations, each with a somewhat different status.

(i) We can begin with *"noise" or "liquidity"* trading, often hypothesized precisely to provide a rationale for the existence of some trading within models that are otherwise of the general equilibrium type. An analogy, within a completely bank-based financial system, would be withdrawals or deposits driven by unforeseen changes in the circumstances of the account-holders. This type of transaction is clearly functional but of limited explanatory significance. It

[9] For example, Milgrom, P. and Stokey, N, (1982)

[10] S.J. Grossman and J.E. Stiglitz, On the Impossibility of Informationally Efficient Markets, *American Economic Review*, June 1980, Vol. 70 Issue 3, p393,

would be relevant to trades by institutional investors that are driven by sales or purchases by retail customers.

(ii) *Price discovery* is an essential function of financial markets and typically agents who have collected costly information would seek a reward through trading at prices that they now judge to be obsolete. As such trades take place the prices of the relevant assets are corrected. Although this is clearly absolutely necessary for financial markets to work at all, it can have dysfunctional aspects. The key incentives may not be simply to discover relevant information but to do so a few minutes earlier than other market participants. The market in fact is working well when very small amounts of trading suffice to update valuations and when disclosure rules and rules against insider-trading support a flow of publicly available information.

(iii) The term *churning* can be used to denote the most clearly dysfunctional class of security trades – trades undertaken because of, rather than in spite of, the transactions costs involved. It may be the case that political pressure on the fund management sector has greatly reduced this kind of abuse but the conflicts of interest which gave rise to it persist. One conclusion that might be drawn is that reform proposals have focused too much on wholesale markets and institutional structures. One key to a leaner, more effective, financial system is to assert the interests of retail customers in the most unambiguous way.

(iv) Although much trading on many financial markets is purely speculative, one cannot immediately dismiss all *speculative trades* as dysfunctional. One key point is that speculation by one agent may permit hedging by another. More importantly, the recent investigation of trading volumes has had to introduce the problem of *differences of opinion*.[11] Such differences can explain trading, particularly after events which are interpreted in different ways by different market participants. Here is a good example of the tension between Walrasian and Austrian views of market processes. The Walrasian conception, accepting that market efficiency has logically to refer to market outcomes, postulates an idealized unanimity: rational agents with the same information must reach the same conclusions~~ – even if they began with different priors~~. The Austrian conception on the other hand, which works with the possibly incoherent notion of markets as an efficient process, would take a diametrically opposite position: one key strength of markets is that they provide an arena in which different points of view can confront each other and a laboratory in which conflicting theories can be put to the test.

[11] Varian (2000), Difference of Opinion and the Volume of Trade

(v) The explanation that will be stressed in this paper is *portfolio balancing*, which is probably the main driver of trading by the institutional investors. It might be thought that a passive investment portfolio is self-balancing, but such a view itself derives from inappropriate equilibrium assumptions. O'Hara has pointed out that an enormous volume of trading would be needed even to replicate one of the well-known stock market indices.[12] In practice, institutional investors will hold only a sample of the stocks constituting a specific market but this means that they have to trade continuously to maintain the representative nature of their portfolios. This observation implies that the conventional distinction between 'passive' and 'active' portfolio management as one that is synonymous with the distinction between no trading ('buy and hold' investors) and intensive trading ('buy and sell' investors) is no longer valid. Rather, both forms of portfolio management involve intensive trading with the difference now merely being in the scale of intensity. What this means is that only by reversing the ongoing trend towards index benchmarking can there be a significant reduction in the volume of portfolio rebalancing transactions. However, this is unlikely to happen for reasons to be discussed in the next section.

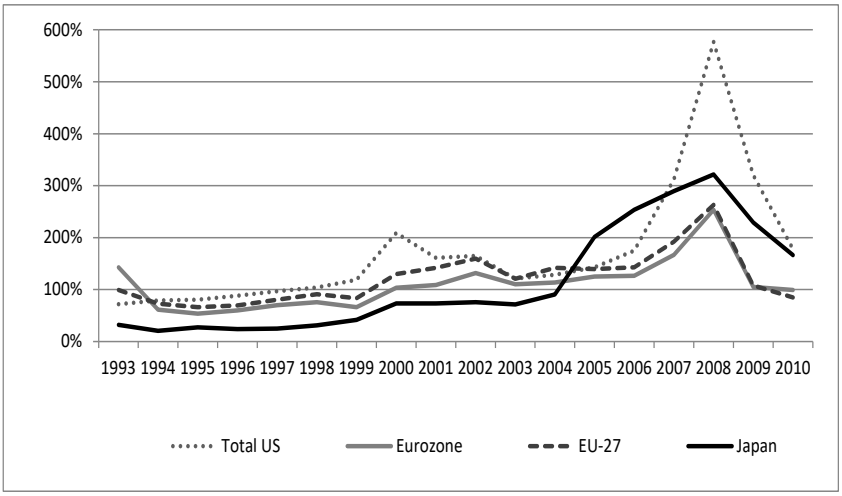
4. Capital market taxes and the asset management function.

When one looks at recent trends in equity market trading one can understand why the Commission has singled out high frequency trading (HFT) for special attention when making its case for the FTT. As can be seen in figure 2, while trading volumes in the world's largest equity markets grew steadily between the early 1990s and the mid-2000s, there was a sharp upward spike in volumes after this point before they again fell after the financial crisis. There is no doubt that this upward spike was in large part caused by the advent of high frequency trading. Although the electronification of securities trading dates from the early 1970s with the formation of NASDAQ in the US, it was not until the 1990s that securities trading in the EU area began to grow in fully automated exchanges and it is not until the mid-2000s that HFT became established as a significant proportion of automated trading (Gomber et.al.2011)

[12] Maureen O'Hara, "Presidential Address: Liquidity and Price Discovery," *Journal of Finance*, Vol LVIII, No 4, August 2003.

Figure 2

Share Trading % of Domestic Market Capitalisation

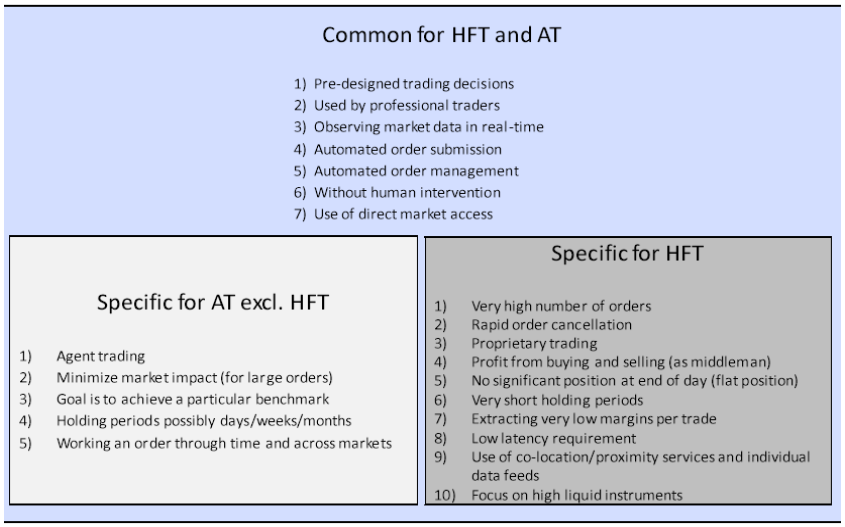


Source: ECMI (2011)

We make two concessions here. First, that HFT is purely speculative in nature as can be seen from the list of its defining characteristics presented in the bottom right box in figure 3, and, second, that the imposition of the FTT will certainly help to curb HFT. However, we also ask two questions that are never raised by the Commission. The first is what is the percentage share of high frequency trading out of all automated trading? The commission's proposal for the FTT gives the impression that HFT is the dominant form of automated trading, but while this may be true in the US where current estimates are that HFT account for 50 to 55% of all automated trading, the remainder comprising of algorithmic trading, the estimates for the EU are that algorithmic trading continues to account for the majority share of automated trading, 70 to 75% (Valiante and Lanoo, 2011, p.36)

Figure 3

Algorithmic versus High Frequency Trading



Source: Gomber et.al. (2011)

The second question is who are the agents engaging in algorithmic and high frequency trading respectively? The fact that the Commission singles out HFT for special mention when discussing automated trading may give the impression that its other important subset, algorithmic trading, is not all that different from HFT either in terms of the trading players involved or in terms of the central trading purpose. This impression is wrong. While algorithmic trading and HFT have several common characteristics by virtue of being subsets of automated trading (as shown in the top half of figure 3) the differences between these two subsets are more important because they relate to two contrasting types of financial function performed by two contrasting types of financial institution. Where HFT is speculative trading conducted primarily by hedge funds and other proprietary trading vehicles, algorithmic trading is portfolio trading conducted by institutional asset managers and in particular by the mutual funds. As the latter have a fairly long history one may well wonder why it is relatively recently that they have begun to use algorithmic forms of trading on so comprehensive a scale. The answer lies in the new pressures on fund managers as much as in technological advances. Algorithmic trading, like HFT, is a recent phenomenon but while new computerised techniques have enabled its development it is the structural changes in the fund management industry that have been its chief motivation.

It is a general rule that whenever an industry grows in scale there is a corresponding shift towards more standardized forms of provision in order to accommodate increased demands while containing costs. The fund management industry is no exception. In place of the broad based and discretionally managed portfolio that was previously the norm, what is now more typical is the narrow portfolio managed to a particular investment target. Indexation strategies are at the heart of the new approach to fund management, for it is by taking a market or sub-market index as a benchmark, while varying tracking error limits, that a portfolio can assume the form of a standardized product carrying a specified set of risk-return characteristics. The advantages arising out of the separation and narrowing of portfolios are two-fold: on the one hand there is better 'risk-conservation' as each additional unit of risk is matched more closely to a corresponding unit addition of return; on the other hand there is a more accurate measure of managerial performance because it may be easier to assess this performance and avoid confusing high returns based on risk from those which reflect superior knowledge and judgement. These advantages apply to all large institutional investors but they are especially significant for mutual funds that have to cater for both institutional and retail clients.

The rise in algorithmic trading closely ties in with the increasing standardization of fund management because it helps managers to resolve a trading dilemma that has become particularly acute with this development. On the one hand trading for portfolio balancing purposes has greatly intensified: where trading was previously an exogenous activity in that while required to set up a portfolio it was not subsequently necessary to the latter's maintenance, trading has now become an endogenous activity, necessary for keeping a portfolio to a specified investment target. Algorithmic trading facilitates this need for constant portfolio rebalancing by helping to speed up the execution of institutional orders. On the other hand, trading can be very costly even while it is unavoidable: the trading of large institutional orders can cause price disturbances that then create opportunities for poachers to front-run the orders and thereby raise trading costs. Institutional investors have traditionally sought to minimize the price impact of their trades by slicing large 'parent' orders into many smaller 'child' orders that are then fed through the exchanges. Algorithmic trading facilitates this price impact minimization by helping managers to determine how best to slice large orders into smaller orders and where best to execute these orders. In sum, algorithmic trading is 'portfolio-serving', trading to keep a portfolio to its benchmark, in contrast to high frequency trading that is 'self-serving', trading purely aimed at making a profit. However, a further important point to note here is that HFT is not only fundamentally antithetical to algorithmic trading but is also

parasitic on the latter. Where institutional asset managers typically engage in algorithmic trading to avoid price volatility and thus avoid giving profitable opportunities to poachers, the hedge funds and other speculative vehicles on the contrary are the poachers and engage in HFT precisely in order to feed off any price volatility caused by institutional trading. This is why HFT concentrates on large cap liquid securities, those that dominate the indexes used by the mutual and pension funds as their benchmarks, and this is why hedge funds place their computers in close proximity to those used by the mutual funds in the major trading venues.

The conclusion from the above discussion is that the imposition of the FTT in the secondary equity markets would be self defeating. The tax would certainly succeed in curbing HFT but in doing so it will also harm algorithmic trading on which HFT is parasitic. To use an analogy, it is like giving a pet dog that has fleas so strong a medicine that it also kills the dog: effective but pointless. It could of course be argued that this negative side effect may be a price worth paying if HFT volumes can be significantly reduced. However, this argument would only hold if the current trends in portfolio management that give rise to algorithmic trading as an indispensable activity were themselves not an irreversible aspect of the contemporary European financial landscape. The reality is that they are. The greater the pressures on government finances, which have been further severely stretched by the financial crisis, the greater are the government incentives to force increasing numbers of middle and higher income households to make their own arrangements for supplementary pension and other welfare provision. The greater the drive towards welfare arrangements focussed on protecting lower-income groups and moving them towards median positions, the greater will be the corresponding demands made upon the asset management industry and the greater therefore is this industry's drive towards standardization as a means of coping with these demands. The upshot is that algorithmic trading is set to continue to expand in importance given the ongoing shift towards standardization and the benchmarking of portfolios and given the necessity of trading to index benchmarking. If it is still the intention to constrain HFT, a far better approach for doing so without hindering algorithmic trading is to directly subject this form of trading and the principal institutions engaging in it to stricter regulatory controls.

In pointing to the irreversibility of algorithmic trading and of the structural changes in the fund management sector with which it is associated our aim is not to idealize this sector or to suggest that the interests of the institutional investors always coincide with those of the retail customers. We recognize that pressure from both legislators and the public alike have recently compelled

them to lower their costs and adopt more efficient procedures. We recognize also the importance of the Commission's own contribution to this development as attested by its undertakings in collective investment in transferable securities (UCITS) directives that stretch back to 1986 and by its two directives on markets in financial instruments (MiFIDs 1 and 2). Our argument rather, is that the move towards leaner financial intermediation, more closely aligned with customer interests, is one that will inevitably increase rather than reduce security trading because intensive trading is a key component of this more efficient model. This is why we believe that the Commission's decision to push ahead with FTT as its preferred method for taxing the financial sector is in the end profoundly contradictory, for having done everything to promote financial market reform it then proposes to introduce precisely the one type of tax that would be an obstacle to that reform.

5. Money market taxes and the banking function.

Trading volumes in the money markets, like those in the capital markets, have in recent decades grown at rates far in excess of what can be meaningfully explained in terms of real sector activities for which reason the Commission has proposed to bring all money market instruments under the scope of the FTT. In our view, this proposal is wrong because the growth of money market trading, while having relatively little to do with the pressures on the banking function emanating from the product markets, has on the contrary everything to do with the pressures on that function emanating from the securities markets. The rapid development and international integration of the money markets is a direct consequence of the increased role of institutional investors and the accompanying shift away from classical bank intermediation towards greater use of the security markets. It is important to recognise that this shift is not going to be reversed by current regulatory reforms; we are not about to move to small-scale financial systems of Arcadian simplicity. On the one hand such a move would fragment financial systems at a time when economic systems are increasingly integrated. On the other hand, tighter regulatory constraints on banks will require them to reduce their use of leverage and this in turn will mean that they hold fewer long-term assets and make more use of securitisation. The higher capital ratios to which the banking system is moving are already making it more advantageous to distribute loans via the security markets and disadvantageous to hold them to maturity. Thus large banks and security markets will continue to function in symbiosis, with the banks performing many functions tied to the security markets and especially supplying the transactions balances needed by the agents trading securities. The money market is a key point of tension in

this function because of what has been called "the paradox of disintermediation" [13]: money is less and less held as an asset but is increasingly needed as a means of exchange to support the growing volume of security trading. The money market resolves the paradox by accelerating monetary circulation to an astonishing degree: huge sums are transferred from bank to bank at enormous speed and at very low cost.

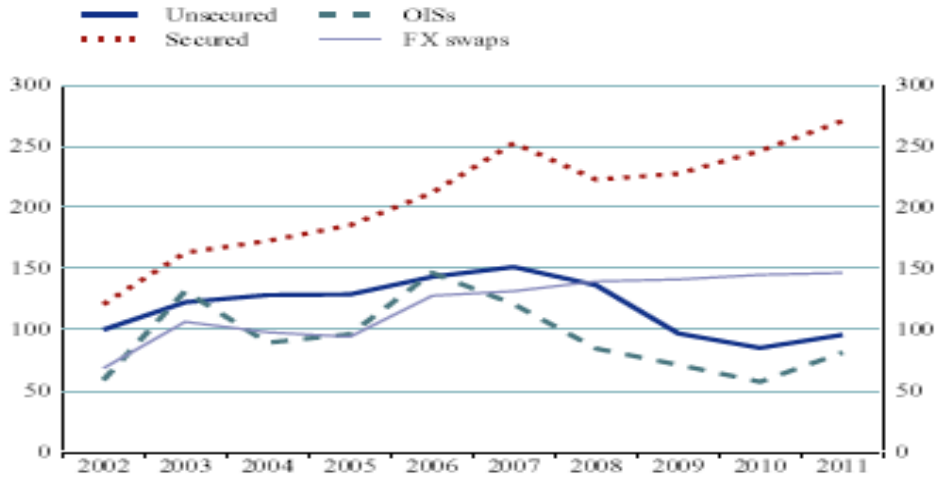
Inter-bank transactions essentially take two forms: unsecured (i.e no use of backing collateral) and secured (i.e use of backing collateral). As unsecured borrowing involves more risk to lenders, this is typically confined to the very shortest of time spans. This said, it should be noted that after the recent financial crisis where the trust between banks has become more fragile, the proportion of unsecured borrowing and lending activity has fallen in favour of securitised forms of activity(see figure 4). The principal form of securitised borrowing is the repo: the sale of collateral such as government bonds for cash, and the repurchase of these same bonds with cash. Now it is proposed to apply the FTT to repos on the grounds that a) they are 'transactions' inasmuch as they involve the sale and purchase of securities and b) these transactions are typically short term and hence presumably speculative in nature. This is illogical. Not only did the inter-bank money market break down during the crisis but there also subsequently occurred an even deeper and more comprehensive breakdown in Europe as a consequence of the sovereign debt crisis. This impairment of the money market can only be aggravated by the proposed tax on repo transactions. The suggested rate of 10 basis points is much greater than the interest charged on most repos because they are short-run credits meant only to finance rapidly executed portfolio changes. Indeed, it has been recently estimated by the European Repo Council of the International Capital Markets Association (ICMA) that the imposition of the FTT on repos would cause this market to contract by as much as 66%, a contraction that would make it more difficult for financial institutions and companies to raise capital from banks[14]. Since, as was argued in section 3, much of the trading in securities markets is economically functional and since increased constraints on the banks will make economies more dependent on these markets, the application of the FTT to secured inter-bank loans is likely to be economically damaging.

[13] See Grahl and Lysandrou, 2003.

[14] See Stevenson, 2013

Figure 4

Average daily turnover in various money market segments (index: unsecured transaction volume in 2002 = 100)



Source: ECB (2011)

The illogicality in the Commission's position is further compounded by the fact that it does not intend to extend the FTT to cover foreign exchange swaps. These FX instruments, which combine spot FX transactions with outright forward transactions, account for over 50% of all daily FX trading that is now in the region of $ 4 trillion. The major users of FX swaps are the dealing banks, and one motivation is that these instruments represent a cheap, because collateralised, form of borrowing a foreign currency; thus when a eurozone bank wants to borrow dollars short term, it is cheaper to do so through an FX swap, selling euros for dollars in a spot transaction and repurchasing the euros with dollars in the reverse forward transaction. However, a more important reason why banks use FX swaps is that these serve as an alternative type of repo: a eurozone bank wanting to borrow euros can either engage in a straightforward repo transaction – using government bonds as collateral – or in an FX swap – selling dollars for euros and then repurchasing the dollars with euros, the point here being that dollars not government securities act as the collateral. Now there is already a perceived tendency to supplement ordinary repo transactions with FX swaps on the part of eurozone banks because of the increasing shortage of good quality government bonds to serve as collateral. Following the introduction of euro, the world's investors for a time treated all eurozone government bonds as a more or less homogenous class because of the elimination of currency risk, a development that became manifest in the narrowing of government yield spreads. With the advent of the sovereign debt crisis and the consequent rise in credit risk considerations in the minds of bond

investors these yield spreads have again widened as the eurozone government bond market again fragmented into heterogeneous groups. Among the best quality government bonds are those of the German government but these are in short supply due to the heavy pressure of demand from investors seeking a safe haven (according to a recent survey on the European repo market (ICMA, 2012), the share of German government bonds as collateral in repo transactions fell from 22.4% in June 2011 to 20.7% in June 2012). As a result, the eurozone banks have had to find alternative assets to use as collateral, including the US dollar. A measure of the extent to which these banks rely on FX swaps less for currency related than for repo type borrowings is indicated by the unusually high ratio of inter-dealer FX transactions in the euro area: 64% (67% for FX swaps) as compared with a rest of the world average of 39% (ECB, 2010).

Given that the Commission proposes to tax repos but not FX swaps, the use of these instruments as alternative credit transactions to the repo will increase further, thus boosting the already large FX swap daily volume. This is ironic because the original Tobin tax that gave inspiration to all subsequent financial transaction tax proposals was specifically directed at FX transactions but here we have a situation where the Commission's imposition of the FTT on ordinary repos will help to swell FX transactions by conferring a tax advantage on them. It was because they recognised this anomaly that members of the European Parliament recommended in May 2012 currency spot transactions be brought under the scope of the FTT[15]. However, the fact that the European Parliament did not vote to also bring FX swaps (or outright forward currency transactions) under the scope of the FTT only served to further highlight the inconsistency in the Commission's proposal to tax one form of collateral (repos) but not another (US dollars). This inconsistency is the most worrying feature of the FTT and likely to make it unworkable as an EU strategy ~~not only~~ because it would not only further undermine the liquidity of euro-denominated bond markets but also make the liquidity of the European banking system completely dependent on credit conditions in the US. Here is another example of a profound contradiction in the Commission's position, for if one of the major aims of European financial integration is to give the European financial sector some degree of independence from credit conditions in other regions of the global economy, the proposed FTT would on the contrary close down that independence.

[15] European Parliament, legislative resolution of May 23, 2012, and report on the proposal for a Council directive of 28 September 2011 on a common system of financial transaction tax.

A final important observation to make here is that the weakening of the inter-bank money market also has serious implications for the implementation of monetary policy. Monetary policy today relies on the existence of an integrated money market which gives the central bank's actions in that market macroeconomic significance. This is one reason the ECB is trying to end the exclusion of banking systems in the periphery from the money market – until it does so the transmission of monetary policy decisions will be partial and uneven. Indeed, if integral money markets cannot be restored then monetary policy will be ineffective. In the first instance the central bank will have to engage in separate negotiations with each fraction of the divided market and have to judge what the effect of this multiplicity of individual interventions will be. But further, as Hicks pointed out[16], the efficacy of monetary policy depends on the existence of an elastic supply of credit; monetary policy affects the terms on which that credit is issued. If banks and other financial corporations find that credit is not available, then they will accumulate big money balances to reduce the risk of not being able to carry out their desired transactions. Once financial agents have insulated themselves from the credit system in this way they have also insulated themselves against central bank actions – since they are not making substantial use of the money market, changes in money market conditions have no certain~~clear~~ impact on their own strategies.

To summarise, the proposed application of the FTT to repo transactions has three very undesirable effects. Firstly, it will intensify the contractionary effects of the FTT on security market trading by impeding inter-bank transactions. Secondly, it will promote the use of dollars rather than euro-denominated securities in the functioning of EU money markets, thereby undermining EU autonomy. Thirdly, by fragmenting short-run credit markets it will obstruct~~prevent~~ the effective implementation of monetary policy that requires all financial agents to be integrated into a unified system. Any one of these effects is damaging, but to introduce a measure that impairs the EU money markets in all three ways comes close to vandalism.

6. Strategic and Policy Implications

As previously noted, most of the economists who have addressed the subject of the FTT have directed attention to its impact on financial prices rather than ~~to~~ its impact on financial institutions. Had they done the latter, it is doubtful whether any of them could have given

[16] *The Crisis in Keynesian Economics*
See e.g. Lysandrou, 2012

serious support to this form of taxing the financial sector. However, the fact that they continue to be preoccupied with the impact on financial prices helps to explain why they are deeply divided over the implementation of the FTT. Although there are many economists of high standing who are strongly opposed to this tax, there are also many economists of equally high standing who strongly support it as can be seen by scrolling down the names of the 1,000 economists from 53 countries who petitioned the G20 meeting of finance ministers in April 2011 to implement the FTT[17]. Given that the economics profession remains divided over the FTT, it follows that political considerations must figure as heavily as economic ones behind the Commission's determination to press ahead with a European FTT.

The key political problem is the conflict between strong popular demands for a tax on banks and the equally strong opposition to any form of bank taxation mounted by the banks themselves. The Commission appears to have decided that the FTT represents the most judicious way of resolving this conflict. On the one side, the FTT has received backing not only from major EU member governments such as those of France and Germany but also from a wide array of non-governmental organisations and interest groups for whom the FTT has become identified as a 'Robin Hood tax', that is, as a tax that has a redistributive and hence moral appeal in addition to any technical advantages. On the other side, the FTT represents less of a threat to banks' interests as compared with a FAT. This is not only because the FAT is a direct tax on bank profits unlike the FTT that taxes trading activities that only form part of the source of profits. It is also because the FAT can be focussed on specific institutions unlike the FTT that indiscriminately affects all types of institution engaging in the transactions that are subject to this tax. The banks, as explained, may be the institutions most affected by a FTT in the money markets, but in the capital markets where it is the large fund managers who do most of the trading it is these non-bank institutions that will be most affected. In the end, the banks prefer the FTT as the least threatening form of taxation because they know that that it will not work and that it will be eventually repealed not only because of the refusal of the UK and other EU national authorities to implement the tax but also because of the very strong objections to it that are raised by the European fund management industry on account of its negative impact on portfolio rebalancing transactions. An early measure of the strength of these objections was the European Pparliaments' recommendation in May 2012 to exempt pension funds from the FTT in direct opposition to the Commission's view that such a move would violate the principle of a level playing field for all fund managers. Aside from the complaints of being unfairly treated,

[17] See Stewart, 2011

however, there are two further reasons why the mutual fund and insurance company sectors will raise strong objections to the FTT.

The first is that the fund management sector neither caused the financial crisis nor benefitted from any of the government financial assistance that was given in the aftermath of the crisis. While certain non-bank financial institutions, notably the hedge funds, may have been to some extent complicit in precipitating the subprime crisis that subsequently mutated into a full blown financial crisis[18], the pension and mutual fund sector could reasonably argue that their role in that initial crisis was more that of the victim than that of the perpetrator. The second reason for this sector's opposition to the FTT is that short term trading was not a root cause of the last financial crisis and thus its curtailment will not necessarily help to prevent a future financial crisis. The Commission has argued that the FTT would " *complement regulatory measures aimed at avoiding future crises*" *(*2011a, p.2) but the fact is that trading played no major role in the last financial crisis. The products at the epicentre of the initial subprime phase of the crisis were CDOs, credit instruments that were so complex and opaque in structure that they could not be easily traded and priced according to any market standard. Indeed, it was precisely because they were difficult to price and consequently difficult to trade that these products helped to precipitate the breakdown in trust between banks that in turn caused the money and interbank markets to freeze up completely in August, 2007. In this second phase of the financial crisis, trading was again to play no major role. Rather, that role belonged to the huge asset-liability mismatches of the bank owned conduits and structured investment vehicles (SIVs). Thus while it was indeed the case that the 'particularly risky behaviour' on the part of the banks and other segments of the financial markets was a root cause of the financial crisis, that risky behaviour had less to do with financial trading than with excessive leverage and capital inadequacy.

The above observations mean that the ~~Commission's~~ logic behind the Commission's~~its~~ choice of the FTT as the preferred means of taxing the European financial sector can be stood on its head. If the intention behind a European financial tax is not only to force financial institutions to bear some of the costs of the last financial crisis but also to force changes in their behaviour so as to prevent a future financial crisis then it is not the FTT but the FAT that is superior. The explanation is clear. If it is the prospect of distributing huge financial profits in the form of generous salaries and bonuses that is the chief motivation for excessive leverage and other types

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of excessive risk taking in the financial sector, then it must follow that the most effective way of dealing with this problem is to tax financial profits before they can be privately distributed.

7.Conclusion

There is a widely held view that as long as the banks are taxed to help repay some of the vast sums of taxpayers' money they have absorbed since the crisis, it does not really matter what type of tax policy is applied. This paper has argued that it does matter enormously. Apply the wrong tax and the objective of getting the banking sector to shoulder its part of the post-crisis financial burden will ultimately fail. The better tax is the financial activities tax because the better strategy for raising public revenues is to tax the immense private fortunes that have been accumulated by the very same abuse of financial and corporate power that has rendered democratic governments insolvent. It is hard to deny that a FAT would perform this necessary redistributive function far more effectively than a FTT or that, together with a reassertion of consumer and broader social priorities, a FAT would represent a far more effective contribution to the reconstruction of the financial system.

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