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European Commission proposal for a directive on a common system of taxation on financial transactions

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The Swedish National Debt Office firmly rejects the EU Commission's proposal for a tax on financial transactions. The proposal is particularly poorly analysed and motivated. A tax of this nature would have serious effects on the functioning of the Swedish financial market. This applies particularly to the government securities markets, where the basic conditions for secondary trading would more or less disappear. This would diminish the possibilities of financing the central government debt at a reasonable cost. Similar effects would occur in the market for mortgage bonds, leading to an increase in bank borrowing costs and thus the cost of mortgages.

General points

A common objection to transaction taxes is that they are easy to circumvent by shifting financial transactions to other countries. The solution should therefore be a global agreement on taxing financial transactions in a uniform manner. This suggests that the major problem is that any tax without global reach will generate little revenue. This is certainly true, as confirmed by what was experienced in Sweden in the 1980s. But this view ignores the fact that for transactions where the transfer is complex – which in principle would apply to all transactions with a global application – the result is a deterioration of the conditions for providing any financial services which involve transactions. Transactions – in the broadest sense – are often a precondition or at least a catalyst for the ability of the financial markets to perform their basic functions. Many financial services would become more expensive if trading in key markets became difficult or dried up completely. Those who would ultimately be affected by this would be those who use these services, i.e. savers, investors, policyholders, borrowers etc.

There are obviously some forms of behaviour and phenomena in financial markets that need to be regulated and monitored. That is why these markets are subject to special attention from the state. Similarly, it is possible that some markets are characterised by higher turnover than is appropriate in some broad economic sense. But there is no basis for the argument that transactions of any type whatsoever are *in themselves* a major factor behind financial imbalances or crises. This applies particularly to the recent crisis which in the first place was – and is – the result of reckless lending by lenders; a development that presupposed an equally reckless build-up of debt by borrowers.

There are also many examples of transactions that contribute to stabilising markets. One benefit is that unwarranted price movements are more rapidly countered in a market where it is easy and cheap for investors to trade. A tax that indiscriminately applies to all types of transactions is therefore a most inappropriate way to overcome the overwhelming majority of the problems that can be found in the financial markets.

Viewed in this perspective, the possibility that the tax could lead to relocation is actually an advantage from an economic point of view. It would in that case contribute to the financial markets as such being able to continue to function reasonably well, despite the fact that a transaction tax has been introduced. But it is obviously absurd to even consider introducing a tax with such serious distorting effects that the best thing that could happen would be the tax payers managing (at low cost) to avoid paying the tax.

The proposal is shaped by the fact that the EU Commission has decided *a priori* that a transaction tax must be introduced and then formulated the reasons for it accordingly in the memorandum. Thus, it is the *means* that matter, not the objective (or objectives) to be achieved. There is no evidence that any attempt has been made to present a real analysis proving that a transaction tax is the best conceivable measure.[1]

There has also been no real discussion of alternative ways of taxing the financial sector, if it were deemed desirable. In its background materials, however, the Commission does consider a special tax on profits or remuneration in the financial sector, known as the financial activity tax. The prospects of introducing a tax with properties similar to the Swedish stability fee approach, on the other hand, is not discussed, although such an approach may have great potential to achieve better the objectives of the Commission, in particular because it might be possible to design it in such a way that it reduces incentives for risk-taking.

Given the poor quality of the document, the Debt Office considers that it is futile to look in detail at the Commission's proposal. We will confine ourselves therefore to a number of comments about some of the arguments offered by the Commission. In addition, we highlight the consequences which a transaction tax of 0.1 per cent would have on the Swedish government securities market.

[1] The Commission has presented some background material, including what is called an impact study. The Debt Office has not analysed all the material, but after a cursory review has found that although there is a more discursive tone than in the proposal it cannot be regarded as an unbiased analysis of whether the transaction tax is a reasonable means to achieve the objectives set. Not least, there is no analysis of the significance of transactions as a catalyst in the financial markets.

The underpinning of the proposal – some quotations with comments

In order to justify a financial transaction tax the Commission is forced to use a simplified and misleading picture of the operation of the financial markets and their role in the economy. We will confine ourselves to a few references.

> Transactions on the primary markets for both securities (stocks and bonds) – in order not to undermine the ability of the state and the corporate sector to obtain capital – and currencies are not included in the scope of the tax. (p. 5)

The basic assumption here is thus that the financing costs for states (and other issuers of securities) are not affected by transactions in the secondary markets. Experience shows, however, that a properly functioning secondary trading is a crucial factor when an investor decides to buy securities in the primary market. This is also shown by the fact that issuers are willing to incur costs to ensure that their securities can be traded in well-functioning secondary markets. If secondary market trading was not of value, it is difficult to explain, for example, why companies pay to list their shares on stock exchanges, or why issuers of fixed-income securities commission primary dealers with the task of quoting prices in the secondary market.

The rule is simple: The more dysfunctional the secondary market, the higher the required rate of return. Poorly functioning trading also means that short-term price movements are magnified, which will also increase investors' risk level. A tax that hits the secondary market – which a transaction tax does; see below – will thus raise costs for issuers.[2]

This applies in particular to central governments, which in many countries, including Sweden, are the issuers of the most actively traded securities. We see here the peculiar effect that trading in government securities will be affected far more than trading in, for example, corporate bonds, because the turnover of the latter from the outset is low or even non-existent. These additional costs will – directly through the costs for the payments that are passed on to the government as the issuer, or indirectly through turnover dropping dramatically – influence the government's borrowing costs. The state is thus hit particularly hard by a transaction tax. And as shown below, the quantitative effects can be significant.

Transactions that disappear provide no revenue but still cost the government extra money in the form of higher interest rates in the primary market. It is not at all unlikely that the rise in the Member States' borrowing costs would in many cases be several times

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[2] On a more technical level, it may be noted that it is unclear how the tax would affect a primary market in which only the primary dealers have the right to bid, as in the Swedish government securities market. In such a market the dealer typically makes a bid on behalf of an end-investor. If resale by the primary dealer to the end-investor is not excluded, a tax of 0.1 per cent will also be levied on primary market transactions. This would directly increase government borrowing costs, particularly at shorter maturities; see below. Even if the intention is to exempt such resale, it is not obviously easy in the calculation of how much tax an institution shall pay to separate out the transactions that are linked to the primary market.

greater than the revenue that a transaction tax of this kind would generate.[3] The fact that the EU Commission (supported by some Member States) is even considering such a tax does not make sense, especially in the current fiscal situation in which a number of Member States are more dependent than ever on keeping down their borrowing costs and on well-functioning government securities markets.

Although the Commission cites, among other things, concern for financial stability, the effects of a transaction tax are substantially at odds with the on-going regulatory work in this area. There emphasis is put in particular on the importance of banks having liquidity buffers in the form of assets which can be rapidly and securely sold if the bank is facing a liquidity strain, including government securities. This assumes that there are deep and liquid markets where these assets can be sold when needed. By impairing the liquidity in the fixed-income markets, a transaction tax undermines the on-going work on strengthening financial stability through better designed liquidity rules for banks.

The Commission is supposedly intending to "discourage transactions that do not improve the efficiency of financial markets" (p. 2), but by proposing a tax that will strike as broadly as possible, the tax will discourage all types of transactions, whether they might contribute to inefficiency and instability or not. Well-functioning fixed-income trading as a source of funding for states and a source of liquidity for squeezed banks, as mentioned above, provide examples of transactions that contribute to stability.

> Transactions with the European Central Bank and the national central banks are not included in the scope of application in order to avoid adverse effects on financial institutions' refinancing opportunities, or on monetary policy in general. (p. 7)

Since financial institutions are major issuers of securities, they will also be affected by a tax that hits secondary trading. This applies not least in Sweden, where secured bonds are an important source of financing for institutions and a market that typically enjoys good liquidity.

To achieve the effect claimed in the above reference, it is almost necessary to imagine that all securities borrowing is replaced by loans from the Central Bank. Given the recent developments in the euro area, where banks have become more and more dependent on the ECB for their funding, such an outcome cannot be ruled out, but it hardly seems to be a normal or desirable arrangement.

> Private households and small and medium sized businesses that do not actively invest in the financial markets are unlikely to be affected by this proposal, thanks to the limited format of the tax. (p. 5)

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[3] The asymmetry of this becomes particularly noticeable if the proceeds from the transaction tax, in accordance with another proposal from the Commission, are partly used to finance the EU budget and thus do not revert to the Member States.

This gives a picture of financial institutions devoted exclusively to placing their own money and lending to each other. But the reality is that financial institutions – particularly funds and insurance companies – manage funds of private individuals, in many cases even in mutual forms. Small and medium sized companies will be similarly affected by the terms under which the banks can fund themselves, as they typically depend on bank loans.

The idea that a tax on transactions concluded by these institutions will not affect their customers is absurd. It is also questionable how the above reference is supposed to be compatible with the ambitions expressed in the Commission's work on the regulation of securities markets, such as MiFID. There, the idea is that small investors should be given opportunities to become more active in the securities markets.

The examples of unreasonable and inconsistent reasoning could be multiplied. The Debt Office can only conclude that the proposal is based on absurd premises.

One might also imagine that a key issue in designing a tax like this would be the choice of the tax rate. However, this is not discussed at all in the reasoning, and the minimum rates are in fact only reported in the text of the Directive. Not even in the underlying impact assessment is the choice of tax rate given much further justification. This is true despite the fact that a supposedly uniform tax could have dramatically different effects on similar transactions; see below.

The Debt Office can only conclude that the Commission's proposal is not seriously substantiated. That it is nevertheless being submitted for serious discussion is, in our opinion, difficult to describe with any word other than appalling.

The proposal's impact on the Swedish fixed-income market

The tax rate for transactions other than derivative contracts is set in the proposal at 0.1 per cent. This means that in a sale of securities of, for example, SEK 100 million, tax of SEK 100,000 will be paid. The Debt Office, as just mentioned, has not found any analysis of the choice of tax rate. Had this been done, it would quickly have become clear that the tax would have absurd effects, not least on the Swedish government securities market.

Swedish government securities are traded primarily through primary dealers. The primary dealers are banks that have agreed to be prepared on a continuous basis to buy and sell government bonds and treasury bills. Specifically, this means that on trading screens they display the bid and offer rates that set out the conditions under which they are prepared to trade. The difference between bid and offer rates – known as the spread – varies slightly, but is usually in the range of 1–2 basis points (0.01 to 0.02 percentage points). The spread reflects the margin the primary dealers require to cover their costs, and to protect themselves against unfavourable price movements during the period of time before a government security is re-sold (or bought).

Now assume that the primary dealer must pay a tax of 0.1 per cent on the amount of the purchase and sale transaction. This represents 0.2 per cent of a transaction in which the primary dealer acts as an intermediary between two end-investors. The tax must be borne by the spread like the other costs.

It is worth noting that in Swedish fixed-income trading the closing is in terms of interest, rather than price. The proposed tax, on the other hand, is to be levied on the amount paid in the transaction. This means that the tax may have different effects on spreads depending on the maturity. The relationship is illustrated in the table below. (The other side of this is that the tax eats up different shares of the return calculated in SEK depending on the maturity.)

Cost of a transaction tax of 0.1 per cent in terms of interest rate (basis points).

Maturity	Cost
1 month	115
3 months	40
1 year	10
2 years	5
10 years	1
30 years	0.5

Thus, the transaction tax corresponds to approximately 115 basis points for a treasury bill with one month maturity. Therefore, with current interest rates, a single transaction in the secondary market will eat up much of the return on a security with a short maturity. It should be obvious that such a tax undermines the conditions for secondary trading.[4] For longer maturities, the effect is smaller, but even for one and two-year bonds the tax means that spreads have to be multiplied five or tenfold, which significantly raises the cost of buying government securities.

It would be difficult to find any reasons related to the purpose of the tax that justify such large differences in the proportion of returns that are eaten up by taxes depending on the security's maturity. Selling or buying one-year securities is hardly ten times more harmful to society than transactions in a ten-year security. This illustrates the fact that the tax strikes at random.

In the above table, we show the effect on standardised maturities which the Debt Office normally uses for the issue of government securities. Much of the turnover in the Swedish fixed-income market takes place in even shorter maturities, primarily through

[4] If it turns out that the transfer from the primary dealer to the end-investor is taxable as discussed in footnote 2 above, then, for example, at the auction of a three-month bill tax corresponding to about 40 basis points will be paid. The market rate on three-month bills is currently about 1.25 per cent. It is inconceivable that the primary dealers will pay the tax with their own funds, or that investors will suddenly be content with an after tax return of 0.85 per cent. Everything suggests, to the contrary, that the interest rate would fall close to 1.65 per cent, i.e. through demands for higher interest rates in the auctions, the government would have to pay most of the tax.

so-called repo transactions. A repo is the sale of a security with an agreement to repurchase it at a specified future date. A repo acts as a short-term cash loan in which government securities are used as collateral. The transaction can be initiated by the purchasing party's need to gain access to a particular asset, for example to complete a delivery commitment. In such transactions, the maturity is often a week or even shorter.

It appears from the proposal (Article 2.1.1 a) that repos will be subject to the transaction tax in the same manner as other securities. If, using the same method as in the above table, we calculate a tax of 0.1 per cent on a repo with a one-week maturity on interest terms, we end up with 500 basis points, i.e. 5 percentage points.

Let us illustrate the impact of this with a specific example. Suppose an investor repos out government bonds with a value of SEK 1 billion. The reason could, for example, be that this specific paper is particularly in demand in the secondary market. This means that the investor sells government bonds and simultaneously agrees to buy them back a week later at a predetermined price. The price is determined in terms of an agreed repo interest rate. Let us assume that the normal rate in the repo is slightly below the Riksbank's key policy interest rate, say 1.50 per cent when the key policy interest rate is 1.75 per cent.[5] In practice, this means that the investor borrows SEK 1 billion during seven days at the agreed repo rate. The interest cost on the loan is therefore equal to 7/360 x 1.5 per cent, or about SEK 300,000. Suppose that the investor invests the borrowed billion so that the return is equal to the key policy interest rate, 1.75 per cent. The margin is thus 0.25 per cent on an investment of seven days, equivalent to about SEK 50,000. This is therefore the return that investors receive for lending securities worth SEK 1 billion for a week.

With a tax of 0.1 per cent on both the sale and repurchase transaction, on the other hand, the cost would amount to SEK 2.3 million, representing an annual interest rate of nearly 12 per cent. Obviously, no trader would be willing to pay 12 per cent for a seven-day loan (with government securities as collateral) when the regular short-term rate is 1.75 per cent. Such a tax therefore makes repo transactions impossible.

The inevitable result of such a tax is that the repo market will disappear. The next question is whether this makes any difference. What would happen if it was no longer possible to repo Swedish government and mortgage securities?

The Debt Office believes that the consequences would be extremely serious, both for the functioning of the fixed-income markets and, by extension, for the ability of banks and other players to manage liquidity risk in SEK.

A well-functioning repo market is crucial to the liquidity of the Swedish government securities market. This is particularly true in the present situation, when the supply of government securities is falling as a result of surpluses in the state budget. In order to be

[5] In practice, the difference between the policy rate and interest rate in a repo transaction will in many cases be much less. This reinforces, in that case, the effects described below.

prepared to commit to buying and selling government securities, primary dealers are dependent on the possibility of locating and obtaining government securities through repo agreements. Precisely for this reason, the Debt Office offers primary dealers a repo facility in government bonds in order to reduce uncertainty in situations where there is a temporary shortage of certain securities. This also ensures that there are no delivery failures. There are also a number of private investors with large government bond holdings that offer them in the repo market. Without repos, primary dealers cannot fulfil their role of ensuring liquidity in the secondary market. The terms of trade would change fundamentally, with significant consequences for the government as a borrower. The same effects would occur in the mortgage bond market, with a corresponding decline in access to finance for mortgage institutions as a result.

The impact on liquidity risk management would be as serious. Banks are expected to have stock of liquid assets available in case they suffer a cash outflow. Typically, a simple measure in such a situation is to use a repo to borrow money with for example government securities as collateral. As the example above shows, this route will be closed by a transaction tax. It is only through repos with the central bank that the banks can obtain liquidity, as these, under the proposal, will be exempt.

A transaction tax also means that the Debt Office's decision in September 2008 to issue additional T-bills to support the government securities markets and financial stability would not work. The measure meant that banks had access to bills that they via repos could use as collateral for loans. The measure was also based on the Debt Office returning the borrowed funds to the banks by concluding repos in mortgage securities. Both of these transactions would have been prevented by the proposed transaction tax.

Concluding remarks

One possible response to the above description of the tax effects could be that the rate should be adjusted so that repos and other transactions in securities with short maturities are still feasible. However, we believe that the problem with a financial transaction tax is deeper than that. The proposal is fundamentally misguided in that it identifies *transactions as such* as a source of financial instability. This attitude is unjustified. As shown, certain transactions can be critical to maintaining financial stability. But an attempt, within a regulatory framework built on a broadly based- tax, to find the “right” rate for each transaction type is doomed to fail.

This does not preclude an approach based on using taxes to discourage transactions which on the basis of a thorough analysis are deemed to be harmful. This would amount to a kind of environmental tax in the financial field. However, such an approach requires that one first identifies the harmful transactions and then focuses the tax on them. And it cannot be a simple matter to combine this approach with the ambition of finding new lucrative tax bases, since a consequence may be that the harmful activity greatly reduces or ceases, and the tax revenue therefore dwindles into insignificance. In principle, with such an approach it should also be possible to conclude that certain types of transactions are so socially beneficial that they should be subsidised, i.e. subject to a reverse transaction tax.

If the aim is to counter the more general risks in the financial system, an approach based on taxes (or fees) that are directly related to the risks of an institution would be more efficient. Such a system of stability taxes would also – in contrast to a transaction tax – be able to capture credit risk, which, from experience, has shown to be the main cause of financial instability and costs that may be passed on to taxpayers. How such a tax should be designed is an open question. It depends, for example, partly on the structure of the other banking regulations. But there is nothing to suggest that the analysis will lead to the conclusion that a transaction tax is effective for this purpose.

Nor is a transaction tax a reasonable measure with regard to the objective of generating greater tax revenue and for distributive or other political reasons obtaining such revenues from the financial sector. Since transactions (as shown above) are in many cases extremely sensitive to even low tax rates, it is difficult to imagine a tax with more severe distortion effects. This implies that tax revenue is expected to be small, particularly in relation to the distortion effects that arise, but in absolute terms as well. Other tax bases than transactions would therefore have the potential to provide more revenue, and this revenue could be generated without harming the central parts of the securities markets.

In this matter, the Director General of the Swedish National Debt Office, Bo Lundgren, has taken a decision after a submission by Chief Economist Lars Hörngren. The final consultation was also attended by Magdalena Belin, Head of Analysis.

Bo Lundgren

Lars Hörngren