Europe's Bad Tax Brainstorm

The EU is considering not one but two proposals for a financial-transaction tax. From the perspective of the long-term investor, the first is terrible and the second is worse.

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(As published in the Wall Street Journal on January 29, 2012.)

Financial transactions taxes (FTT) are a bad idea that just won't die. These schemes purport to punish financial institutions for bad behavior in the financial crisis, or to tax these institutions, for the sake of "fairness," for the costs of government bailouts. But in fact, these taxes punish savers, pensioners and long-term investors—none of whom directly contributed to the banking crisis. At the same time, FTTs slow economic growth, drive away financial activity and make markets less efficient.

Europe is now in the curious position of considering not one but two FTT proposals. From the perspective of the long-term investor, the first is terrible and the second is worse.

The original notion was a tax on every trade that involves a financial institution in a European Union member state. In its impact assessment on the proposal, the European Commission states that the foremost reason for the FTT is "raising revenue from the financial sector"—a point echoed last week by Michel Barnier, the commissioner for internal market and services. But this tax won't just fall on banks and financial institutions. A substantial portion of any revenues collected will come from individuals saving through mutual funds and other collective investment vehicles.

Why? As envisaged, the tax would be levied both on investors as they purchase or sell mutual fund shares and on the fund each time it purchases or sells stocks, bonds or other portfolio securities. Thus, if an investor purchases mutual fund shares for €1,000 and the fund then purchases securities, then that €1,000 is taxed twice. It's taxed two more times when the investor later redeems the units and the fund sells securities to pay the investor. If the fund does any trading to manage its portfolio in the meantime, those trades will also be taxed.

Each of these tax payments will come directly from the fund's owners—the investors holding its shares. In short, the mere act of putting aside €1,000 for an individual's retirement will cost that investor at least four FTT payments.

These multiple tax payments will devastate money-market funds, wreaking havoc on their shareholders. Individuals and businesses use these collective investment vehicles to manage their cash, buying and redeeming shares frequently. These routine transactions, combined with the short maturities of money-market fund portfolios, mean that these funds buy and sell securities in volume—and each of these trades would be subject to FTT. The tax burden on money-market funds would likely drive away investors, depriving individuals of a convenient saving tool and denying businesses and governments a reliable source of short-term funding.

The United Kingdom and other prominent market centers announced that they would not support or enact the EU's FTT, so the levy in that form would do little more than cause trading to flee Europe for untaxed markets. But in a bid to bring the British on board, a recent proposal has emerged to have the U.K.'s stamp duty reserve tax apply to equity trading on the Continent.

The stamp-tax proposal would shift even more of the burden of the tax onto ordinary investors. The stamp duty also taxes fund investors twice, on their fund shares transactions and on the fund's portfolio trades. And rather than hitting its claimed target—financial engineers and active traders—in practice the stamp tax comes down squarely on pensions, savings and the economy.

The U.K.'s stamp tax is levied only on trades in equities, contracts to deliver equities (for example, equity options), and certain bonds. As such, it exempts the routine trading tools of hedge funds and financial engineers—futures, swaps and other derivatives. The tax also misses most of the activity of high-frequency traders, the vast majority of whose trades are eventually canceled and thus never taxed.

The stamp tax's record in London is clear. A 2007 study sponsored by the Investment Management Association and others found that three-quarters of stamp duty revenue was collected from pension funds, insurers, investment trusts and individual shareholders. Rather than curbing financial engineering, the study found, the stamp tax has driven down stockholding and increased trading in derivatives.

In either version—the terrible or the worse—an FTT would make markets less efficient by reducing liquidity, increasing bid-ask spreads and transaction costs, and impairing price discovery. It will slow growth in an already anaemic economy, as the European Commission's own staff shows in its impact assessment of the original FTT proposal. The EU should lay this idea to rest once and for all.

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