Non-technical summary

The banking and financial crisis of recent years has spurred a new look at financial sector regulation in order to prevent a repetition of events and improve the resilience of the financial sector. Given the costs that bank rescue has inflicted on taxpayers, the demand to make the financial sector contribute to the financing of crisis-intervention costs has also gained political voice and support.

Against this background, the paper studies the impact of a securities transaction tax (STT) on financial trading, stock prices and real economic variables in a dynamic stochastic general-equilibrium (DSGE) model with financial frictions. The paper addresses two main questions in the controversy about the merits of the STT, namely: (1) What is the long-term impact of an STT on firms' financing costs, investment and economic activity? (2) Does introducing an STT reduce (non-fundamental) volatility of asset prices and real economic variables? While the adverse impact on financing costs generally considered the major drawback, the reduction of non-fundamental volatility is regarded as primary regulatory merit of the STT.

The contribution and novelty of discussing the impact of securities taxation in a DSGE framework is the emphasis on macroeconomic effects and the exposition of transmission channels from financial to real economy variables and from noisy expectations to real effects. The approach contrasts with existing partial equilibrium models of the financial sector that exclude interactions between financial and real sectors and conjecture the impact of an STT on the real economy off-model.

The paper includes two types of financial frictions into an otherwise standard Real Business Cycle (RBC) model. First, it incorporates short-term financial trade with not fully rational ("noise") traders. Noise traders act on non-fundamental information. Their trading behaviour is a source of economic fluctuations. Second, we introduce a financing constraint which links firms' investment expenditure to the value of outstanding shares. The model is parametrised to match stylised facts about financial markets and firms' financing.

The simulations suggest that, through its impact on share prices and financing costs, the STT is similarly distortive as corporate income taxation. The STT reduces macroeconomic volatility, although the stabilisation gain from a small tax (to collect 0.1% of GDP tax revenue) appears modest.