# Special Report 2011/23

## Financial Transaction Tax: stabilising or disruptive?

*The financial crisis has led to increased interest in a financial transaction tax (FTT). However, such a tax has been the subject of controversy for decades. Proponents of the tax want the financial sector to make a bigger contribution to the costs of the crisis, and also believe it will lead to greater financial stability. Opponents on the other hand think that these aims will not be achieved, and that financial markets will become less efficient. Who is right?*
*This Special Report looks at the expected effects of a FTT.*

### Political debate

Since the onset of the financial crisis, a FTT has been considered at various policy levels. The tax is considered to be one of the possible measures to make the financial sector contribute to the costs incurred by governments to rescue banks. However, international agreement has not been reached so far, with opposition from the US, and most notably, the UK[1]. Since the crisis, the European Commission (EC) has endorsed a global FTT and presented its proposal for an EU-wide introduction last September (box 1) (EC 2011). However, opinions in the European Council are sharply divided. Whether the proposal will be adopted is thus highly questionable.

**Box 1. What is the EC proposal?**

***The rate:** 0.1% of the price established in financial transactions. The rate for derivatives transactions would be at least 0.01%. The tax will be levied on net transactions.

***Scope:** all financial transactions in which at least one party is located in the EU. There will be, among other things, an exemption for transactions in the primary market (issuance of shares and bonds) and for transactions with central banks.

***Objectives:**

1) A *fair contribution* by the financial sector to cover the costs of the recent crisis. (Expected annual revenues approximately €57 billion.)

2*) Financial stability*: the discouragement of undesirable market behaviour, i.e. transactions that do not contribute to the stability of the market.

3) Promotion of the *internal market* through harmonisation of national legislation and current initiatives in this respect.

### Historical background

*Securities transaction tax - Keynes*

Already in 1936, just after the Great Depression, John Maynard Keynes argued for the introduction of a small tax on securities transactions. He took the view that excessively speculative transactions had a destabilising effect, and increased volatility in the financial markets. This was cited as one of the causes of the Great Depression. A tax would discourage short-term transactions and thereby stabilise share prices in the long term (Keynes 1936). However, the proposal attracted little support in the subsequent decades (Schulmeister et al. 2008).

*Currency transaction tax*

A tax on financial transactions returned to the agenda after the collapse of the Bretton Woods system[2] in the early 1970s, as volatility in foreign exchange rates exploded. To combat this instability, James Tobin, influenced by the ideas of Keynes, came up with the idea ”to throw some sand in the wheels of our excessively efficient international money markets” by imposing an international uniform tax on all spot *currency* transactions, known as the ‘Tobin tax’. His idea was to discourage short-term

[1] The UK already has a kind of FTT at national level in the form of stamp duty tax (Bond 2004).

[2] The Bretton Woods system, which existed from 1945 to the end of 1973, had the objective of guaranteeing monetary stability. All the currencies of the participating countries were linked to the dollar, which in turn was linked to gold.

currency transactions and thereby increase international stability and strengthen the role of monetary policy. The generation of revenues, which is the aim of the EC proposal, was for Tobin not an objective in itself (Tobin 1978). A Tobin tax was never imposed on currency transactions, but there have been instances of a tax on other financial transactions, for example in Sweden (from 1984 to 1991) and China (since 1990) (Culp 2010). Both countries have had to revise the rate of their tax several times.

In 1995, Paul Bernd Spahn came up with a new version of the Tobin tax. According to Spahn the Tobin tax is unenforceable, because it is impossible in a free market to distinguish between normal liquidity trading and speculative transactions. If a high tax rate were to be imposed, this would have a negative effect on the operation of financial markets and lead to international liquidity problems. On the other hand, the lower the rate, the less effective it would be in discouraging speculative transactions. Spahn therefore proposed a two-tier system for the Tobin tax: a very low rate (even as low as 0%) on all currency transactions in times of monetary stability, and a much higher rate (up to 80%) when prices begin to fluctuate widely. The so-called Tobin-Spahn tax was introduced into law by the Belgian parliament in 2004.[3]

## Contradictory objectives

The two main objectives the EC wishes to achieve with its proposal, namely to raise revenue and to discourage speculation, are mutually contradictory. To reduce speculation, the number of short-term transactions has to be limited. To accomplish such a change in behaviour, a sufficiently high rate of tax is needed. The resulting decline in transaction volume will inevitably lead to a decline in the revenue that can be raised (Culp 2010). This was the case in Sweden, where a tax with a maximum rate of 0.15% was introduced for transactions in (fixed-income) bonds and their associated derivatives in 1989. In one week, trading volume in bonds fell by 86% and in futures by 98%. As a result, the tax raised only 3% of the income that had been expected. The rapid decline in bond trading volume was attributed to the ease with which a fixed-income bond could be converted into a forward contract or a preference bond, which were not taxed (Umlauf 1993).

## Impact of FTT

**Financial stability**

One of the reasons put forward for introducing a FTT is that it will contribute to financial stability. The idea behind this is that speculative transactions cause instability, and that the more short-term transactions are, the more effective the tax will be. However, there is no consensus regarding the question of whether speculators disrupt commodities and currency markets, or whether they are to a significant extent responsible for the high price volatility seen in recent years (Culp 2010). Short-term transactions are not by definition speculative, and they increase market liquidity. Sufficient liquidity in the market is of crucial importance for financial stability. A study by the Austrian research institute WIFO shows that a FTT of between 0.1% and 0.01% would mainly affect very short-term transactions (intraday) in derivative instruments.

On the other hand, the tax would have less effect on derivatives traded for the purpose of hedging open positions, or reducing risk. These transactions have a much longer time horizon than (intraday) speculation, such as high frequency trading. The study concludes that an international introduction of a FTT with a low rate would most probably reduce excessive liquidity and thus would reduce the instability of asset prices (Schulmeister et al. 2008).

However, other studies, most of them empirical in nature, show that even a low tax rate

[3] For the adopted bill, see: http://www.lachambre.be/FLWB/pdf/51/0088/51K0088001.pdf. The Act will however only take effect when similar legislation is introduced at European level. It concerns the taxation of euro transactions, which could affect the exchange rate of the euro.

would significantly increase the costs of all financial transactions and would present an obstacle to both desirable and undesirable transactions. The liquidity of the market would be significantly reduced, which would have a negative effect on financial stability. The evidence from financial transaction taxes that have previously been implemented in countries, including the UK, Japan, China and Sweden, indicates that higher transaction costs do not reduce price volatility, and that the volatility remains the same or even increases (Culp 2010, McCulloch et al. 2011).[4]

## Avoidance of the FTT

*Geographical relocation*

The EC has stated that a FTT would have to be implemented across the whole EU, since financial transactions are extremely mobile. The World Bank takes the view that a FTT at European level would, because of this high degree of mobility, result in a shift of a part of the transactions, either to large financial centres outside the EU or to smaller, less regulated financial centres (Honohan et al. 2009).

This study shows that even a very low tax rate could lead to a significant change in the behaviour of market participants. Some transactions, such as those in the leading European shares and their associated derivatives, would be less affected by geographical relocation (Schulmeister et al. 2008). Institutions that would have difficulty in relocating their operations, such as pension funds, would probably be relatively hard hit by EU-wide implementation. Geographical relocation will not only lead to lower tax revenue, it will distort a level global playing field in the financial sector. Relocation could be avoided by implementation of a uniform global tax, a point stressed by Tobin twenty years after his original proposal (Tobin 1996).

*Innovation*

The World Bank also concludes that a FTT could affect innovative behaviour by market participants. This particularly applies to financial operations whereby large numbers of transactions are executed on a continuous basis. The tax burden on for example high frequency traders, financial intermediaries and pension funds, can be relatively heavy as a result of so-called cascade effects.[5] In an attempt to avoid the tax, institutions will try to bundle transactions and only execute them periodically. The World Bank states that this will not necessarily involve a loss of wealth, but it does say that it will probably lead to lower tax revenues.

## Impact on the real economy

Various studies in the past have demonstrated how a tax on financial transactions can lead to higher funding costs for businesses (Bond 2004; Shome 2011). Higher funding costs are consequently an obstacle to investment growth. An impact analysis conducted by the EC shows that the introduction of a tax at a rate of 0.1% would result in a cumulative reduction of GDP by 1.76% over the long term. In an alternative EC scenario, in which they took account of various mitigating factors on implementation, including an exemption for transactions in the primary market, the long-term negative effect on GDP is 0.53%.[6] The effect on the EU's GDP thus varies from at least € 65 billion to a maximum of € 216 billion. The fall in employment estimated in various scenarios ranges from 0.03% to 0.20% in the long term. The effect on employment largely depends on the assumptions with respect to the geographical relocation of transactions to areas outside the EU. Lastly, it should be noted that the EC model does not take account of interaction between the FTT and the

[4] It should be noted here that the empirical studies are based on transaction taxes that relate only to one type of transaction and not to all transactions. In addition, the effects depend on the structure of the market, which varies depending on the segment and the country concerned.

[5] This refers to the 'chain' of transactions, mostly through brokers, which might be created by only one deal.

[6] For comparison: the benefits calculated of the internal market in 2005 amounted to at least 2% to 3% of GDP (per capita) for the EU as a whole (CPB 2008).

effects of parallel policy initiatives that will also affect funding costs and the provision of credit, such as Basel III at an international level, but also national legislation in the form of the bank tax and the Deposit Guarantee Scheme.

## Conclusion

*The debate regarding the introduction of a tax on financial transactions usually resurfaces in times of crisis. Whether the proponents of this policy are right or wrong is not immediately clear-cut. In our view, the negative consequences seem to outweigh the advantages. The theoretical assumption that a FTT would benefit financial stability cannot be clearly confirmed by empirical studies. The expected revenue will probably not be realised, due to avoidance and the decline in market liquidity. Furthermore, several studies underline the negative effects of a FTT on economic growth and employment. The negative effects could be mitigated by introduction at a global level, but given the limited support for the tax internationally this does not seem to be feasible.*

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