The case against a financial transactions tax

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by

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About the author

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Introduction

This paper is a short introduction to the ever-burgeoning literature on the proposed financial transactions tax (FTT). It does not attempt to be either all-inclusive or definitive. Rather, the aim is to provide answers to the common questions asked about the FTT.

A financial transactions tax is, as the name suggests, a tax on each and every financial transaction. Such taxes have been proposed by economists of the stature of J. M. Keynes and James Tobin in past decades and interest has been revived recently by the Robin Hood Tax campaign and a variety of official bodies such as the European Commission.

Keynes thought that excessive speculation could be damaging, although that did not stop him being one of the most aggressive commodities speculators of his day. Tobin was worried about exchange rates in the context the tail end of the Bretton Woods system in the late 1960s and early 1970s. Fixed exchange rates (which could only be changed by agreement and *in extremis*) were giving way first to various 'dirty' floats and then to the more free market approaches of recent decades. Specifically he proposed his Tobin Tax on currency transactions in order to reduce the liquidity of currency markets. His point was that governments ought to be able to determine the exchange rates and speculation made this more difficult so speculation should be discouraged through taxation.

This particular reason for an FTT rather goes away if it has already been decided to have freely floating exchange rates. Once this has been done there is no reason to limit speculation, a policy which would result in movements coming in discrete and large steps. It is preferable to have deep and liquid markets so that changes are incremental and smooth.

The Robin Hood Tax campaign seems to think that hundreds of billions of dollars can be extracted from the financial markets without anyone really noticing very much: a rather naïve if cute idea. The European Commission is continuing its decades-long campaign to have its 'own resources'. Under its proposal, FTT revenue would be sent to the Commission, which would thus become less dependent on national governments for its budget. This is neither unusual nor reprehensible in a bureaucracy. It is the nature of the beast that it would like to have its own money to spend without being beholden. We should be aware of this background though when evaluating justifications for an EU FTT.

Despite these motivations it is still possible that an FTT is desirable and that the incidence will fall on the desired targets; even that it might reform the financial markets so that current economic woes will be less likely to occur in the future.

The rest of this paper asks and then, as far as the literature already does so, answers the following questions about an FTT.

- Is it feasible?
- How much revenue will be raised?
- What will be the incidence?
- How will it change financial markets?
- Will it make another financial crash less likely?
- Could it be extended to currencies?

Is a financial transactions tax feasible?

A financial transactions tax is certainly feasible. It is possible to tax just about anything from head of population through transactions to windows. That the last UK attempt to have a poll tax led to riots and the results of the taxation of windows can be seen in the blanks on nearly every Georgian house in the country does not mean that feasible is to be equated with desirable and so it is with an FTT.

An FTT can be imposed with varying effects depending upon how many other governments do so at the same time. A purely EU FTT would see much trading leaving the EU, as happened to Sweden when it unilaterally imposed such a tax in the 1980s and 90s. A global tax would not have the problem of trading moving but would still have all of the other associated problems.

The feasibility or not of the FTT is something of a red herring: the UK government does say that it would only consider one if it were universal but this is much less important than the longer list of things which are wrong with an FTT in principle, however widely it may be levied.

How much revenue will be raised by an FTT?

No net revenue will be raised by the specific proposals that have been put forward. This will sound strange to those who can see that there will indeed be revenue coming from the tax, but that is because while there will indeed be revenue from the tax itself there will also be falls in revenue from other taxes. The net effect of this is that there will be less revenue in total as a result of an FTT.

But of course, do not just take our word for it. That of the European Commission should be sufficient[1]:

> 'With a tax rate of 0.1% the model shows drops in GDP (-1.76%) in the long-run. It should be noted that these strong results are related to the fact that the tax is cumulative and cascading which leads to rather strong economic reactions in the model.' (Vol. 1 (*Summary*), p. 50)

Revenue estimates are as follows:

> '[A] stylised transaction tax on securities (STT), where it is assumed that all investment in the economy are financed with the help of securities (shares and bonds) at 0.1% is simulated to cause output losses (i.e. deviation of GDP from its long-run baseline level) of up to 1.76% in the long run, while yielding annual revenues of less than 0.1% of GDP.' (Vol. 1 (*Summary*), p. 33)

A reasonable estimate of the marginal rate of taxation for EU countries is 40-50% of any increase in GDP. That is, that from all of the various taxes levied, 40-50% of any increase in GDP ends up as tax revenues to the respective governments. Thus if we have a fall of 1.76% in GDP we have a fall in tax revenues of 0.7-0.9% of GDP. The proposed FTT is a tax which collects 0.1% of GDP while other tax collections fall by 0.7-0.9% of GDP. It is very difficult indeed to describe this as an increase in tax revenue.

There are, however, bureaucratic reasons why the European Commission might still suggest such a tax move. The revenues from the FTT would be designated as the EU's 'own resources', that is, money which comes to the centre to be spent as of right; not, as with the current system, money begrudgingly handed over by national governments. The EU bureaucracy therefore has a strong interest in promoting such a change. What's in it for the rest of society is harder to spot.

This result is not unexpected. When the Institute for Fiscal Studies looked at the impacts of the UK's own FTT, Stamp Duty upon shares[2], they found much the same result – from the same cause too. Such a transactions tax upon securities lowers securities prices. This then makes the issuance of new securities more expensive for those wishing to raise capital. More expensive capital leads, inexorably, to less of it being used and thus less growth in the economy.

Please note that this is not some strange application of the Laffer Curve argument. It is not to say that lowering all taxes, or any tax, leads to such extra growth that revenues increase. Rather, it is derived from Diamond and Mirrlees (1971)[3] that transactions taxes multiply then cascade through the economy. They are therefore best avoided if another method of achieving the same end is available. Indeed, they point out that taxation of intermediate inputs is to be avoided if possible – better by far to tax final consumption or some other final result of the economy. This very point is acknowledged in the way VAT is structured. Rather than a series of sales taxes which accumulate as one company sells to another along the production chain, there is a value added tax which amounts to one single rate at the point of final consumption.

That this point is recognised in a major part of our taxation system suggests that it might be wise to recognise it with regard to the FTT.

1 http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/impact_assessment.zip
2 http://www.ifs.org.uk/wps/wp0411.pdf
3 Diamond, P. A. and J. A. Mirrlees (1971) 'Optimal Taxation and Public Production II: Tax Rules', *American Economic Review*, 61, 3, 261-78.

What will be the incidence of an FTT?

Incidence refers to who really bears the economic burden of a tax, not who hands over the cheque for that tax. More formally, the legal incidence is not always the same as the economic incidence. The most obvious example of this is with employers' national insurance contributions. It is the company which hands over the cheque but almost all economists are united in saying that much (and possibly all) of the economic burden is carried by the worker in the form of lower wages. Quite how much depends upon the elasticity of the supply and demand of labour and quite how much is still an area where economists argue – but some to all being 'really' paid by the worker is the general conclusion. The worker might believe, however, it is really the company paying, which is arguably what makes such payroll taxes so appealing to unscrupulous politicians.

Another way of putting the same point is that a tax, all taxes and any tax, means less money in the wallet of some live human being. The study of incidence is the study of whose wallet gets picked.

The first and great lesson of tax incidence is that taxes on companies are not paid by companies. They are not, despite legal personality, live human beings and therefore cannot carry the ultimate burden of any tax. We see this when we discuss the incidence of corporation tax. Companies do not pay this, cannot. It is some combination of shareholders in lower returns, workers in lower wages and/or customers in higher prices who do. The general result in an open economy like the UK's is that workers carry the majority of the UK's Corporation Tax in the form of lower wages. Similar results are found for other countries, shareholders bearing more where the economy is either larger or more closed, workers more where the economy is smaller and/or more open.

The statement is not that companies and or shareholders conspire to make the workers pay what government has righteously decided should be paid by companies. There is no attempt to 'pass on' the tax. Rather, there is a world return to capital and a corporation tax reduces, in that taxing jurisdiction, the rate to below that. Capital will therefore flow out (or fail to flow in) until the scarcity of capital pulls the after tax return up to the world return. This clearly means less capital being applied to the labour available in that jurisdiction which imposes the corporation tax. Less capital being applied to labour is, other things being equal, going to lead to less productive labour for it is capital added to labour which increases productivity. As average wages in a country are determined by average productivity in that country that lesser amount of capital is going to lead to lower average wages.

It is not that the employees of the company being taxed get paid less: it is that less capital being employed *in toto* leads to lower wages for all in the country.

The importance of this effect is still argued over. Various reports from various people with different assumptions about capital openness and so on lead to estimates of 30-70% of corporation tax really being paid by the workers, the rest by the shareholders. One study, Atkinson and Stiglitz (1980)[4], points to the at least theoretical possibility that the incidence on the workers' wages can be over 100%. That is, that the employees lose in wages more than the revenue raised by the tax.

So what will be the incidence of an FTT? The one place we know the tax cannot fall is on the banks. For the banks are corporations and corporations cannot bear the burden of a tax; it has to be some human being. We have some combination of the workers, the shareholders and the customers to consider.

The simplest method of tracking this incidence is to look at, as in the IFS report, the incidence of Stamp Duty and then to add what we have been told by the European Commission.

From the IFS report we see that the incidence of stamp duty is dual: some part of it falls upon capital, making raising capital more expensive. This, in turn, just as with the corporation tax, will affect the workers' wages: more expensive capital leads to less of it being employed and thus lower average wages. Note that this does not mean that it is bank-

4 Atkinson, A. B. and J. E. Stiglitz (1980) *Lectures on Public Economics*, New York: McGraw-Hill.

ers earning less: it is the workers who earn less as a result of less capital being employed. The second part is the incidence upon the users of the financial markets: a fairly obvious result of a transactions tax. The IFS found that pensions achieved lower returns, partly as a result of lower share values as a result of the tax and partly as a result of paying the tax itself when changing which shares were owned in the pension fund. So part of the incidence of the FTT will be upon all users of any financial instrument, for all financial instruments are to be taxed.

Finally, from the European Commission numbers, we can see that the Atkinson and Stiglitz result is likely to be true. The loss in GDP as a result of the tax is larger than the revenues raised from the tax. Thus, quite clearly and obviously, the total incidence, the total lost from all pockets, is higher than revenues and thus the incidence of the tax is over 100%.

So we can say that the incidence of the FTT will be upon workers in the form of lower wages, upon consumers of financial products in higher prices and that the incidence, the loss of income resulting from the tax, will be over 100%. The loss will be greater than the revenues raised.

There really are good reasons why Diamond and Mirrlees say that we should not tax intermediate inputs if we can achieve the same aim in some other manner.

How will an FTT change financial markets?

An FTT would certainly make financial markets smaller. To many proponents of the tax this is a good enough reason to desire it. However, smaller financial markets seem an odd thing to desire. It is necessary to have a better argument than a distaste for Mammon before changing the world so much. The argument usually given in a lot of the pro-FTT literature is that speculation increases volatility. This is nonsense as is well known, so among the more intelligent proponents there is the argument that 'excessive' speculation increases volatility, while 'not-excessive' speculation reduces it. This is indeed possible and a number of theories have been put forward as to how 'noise traders' and the like increase rather than reduce volatility.

Of the various papers that have been written the one with the best overview of this part of the argument is the one from the Institute of Development Studies[5]. It looks at the various theoretical papers which have outlined how this might be true. The second section, which examines empirical studies, is of particular interest to us. It is concluded that:

> 'The balance of evidence would seem to suggest that there is a positive relationship between transaction costs and volatility, although the size of this effect varies across different studies. Whether a Tobin Tax would affect volatility in the same way as underlying market transaction costs is not clear.'

This suggests that a transaction tax would *increase*, not decrease volatility.

Since an FTT would decrease the size of the financial markets, prices would jump around rather more than they do at present - completely the opposite of what certain supporters of the FTT conclude in their theoretical musings. It is a reasonable intellectual exercise to theorise but it is necessary at times to calibrate such theories to the real world. The FTT would increase volatility.

5 'Tobin Tax: A review of the evidence', Economics Department Working Paper Series, Institute of Development Studies.

Will an FTT make another financial crash less likely?

A smaller financial market might reduce the probability of there being a repeat of the events of 2007/8. However, it is worth noting that an FTT would have had no effect whatsoever on the financial crash that actually happened in 2007/8, nor on the current problems of the eurozone.

The markets that do the sort of high volume, low margin trades that would be affected by an FTT are the foreign exchange (FX), futures, options and stock markets (with special reference to high frequency trading of the often demonised computer algorithm type). None of these markets failed in any manner in the recent or current troubles. Indeed, it is possible to find entirely respectable economists (Robert Shiller for example) arguing that it was the lack of options and futures markets in housing that failed to prick the US housing bubble before it blew.

What we did have was a housing bubble and collapse with the consequent falling over of large parts of the banking system. But none of that has anything to do with high volume or low margin trading activities. Mortgage Backed Securities (MBS), Collaterialised Debt Obligations (CDO), Credit Default Swaps (CDS) and the leverage of the banks themselves were what did cause the problems in 2007/8 and none of them would have been affected in the slightest by the imposition of an FTT. They just weren't traded all that often. MBS and CDO securities, like most bonds, were traded once, at date of issue and parked in an investment account. However much they may have been misvalued, having them being traded less as a result of a tax on them wasn't really possible, let alone helpful. The current woes are about sovereign debt which does, at least normally, have a liquid market. But even then the addition of a tax is not going to change the frequency of trading all that much as bonds just aren't traded all that much - nowhere near as much as FX, stocks, options and futures are.

So the FTT doesn't even work as a way of avoiding the recent financial crash: for it taxes the things that did not cause problems and would not make much difference to those things which did.

Could the FTT be extended to currencies?

The FTT could not be extended to currencies in the European Union. The EU's preliminary report[6] stated:

> 'At least for a levy on currency transactions some legal aspects have to be considered. In relation to the original proposal by Tobin for a currency transactions tax legal obstacles were put forward by the ECB on its compatibility with the **free movement of capital and payments between Member States and between Member States and third countries** [emphasis in original] under Article 63 of the Treaty on the Functioning of the European Union (TFEU) (ex Article 56 of the Treaty Establishing the European Community (TEC)). Since the mechanism of a currency transactions levy is supposed to be based on taxing the net position of foreign exchange transactions, it could represent a restriction of the free movement of capital and payments (Article 63 TFEU). Besides the effect on the netting operation itself, it indirectly restricts underlying transactions, including those between Member States and with third countries, by rendering them more costly. It is unlikely that, for this restriction, a justification sufficient for the purposes of the Treaty could be found. Even if e.g. raising funds to benefit stability funding were to be considered as an overriding requirement of general interest, that requirement could not explain why transactions involving countries with different currencies would be treated less favourably than those involving only one currency. Furthermore, the tax is considered to be disproportionate as funds could alternatively be raised by other means of budget attribution without affecting a basic freedom of the Treaty and, in any event, because the scope of the tax would be unrelated to the risks to be covered by the tax revenue raised. Even a very low tax rate would constitute an infringement, and it would not be possible to establish a threshold of insignificance.'

An FTT on FX in the EU would be illegal and it is doubtful that anyone wants to go through the process of revising the basic treaty to change this. It is worth noting that the EU's later and most recent proposal for an FTT specifically excludes the possibility of an FTT on spot FX trades. However, in the details of the longer version[7] at various points the revenue from such an FX tax does appear. It appears that it was only late in the analysis that the illegality was remembered and thus not all of the supporting work has been changed to agree with the top of the report.

6 http://ec.europa.eu/economy_finance/articles/international/documents/innovative_financing_global_level_sec2010_409en.pdf
7 http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/impact_assessment.zip

Conclusion

As well as the EU, several papers on FTTs have been written by other more or less reputable organisations including the IMF[8]. There have also been studies from organisations such as the TUC and the Robin Hood Campaign, but we have restricted ourselves to details from those bodies with at least a working knowledge of economics and financial markets.

The end result of this survey of papers about the proposed financial transactions tax is clear. It is not possible to impose an FTT on foreign exchange transactions in the EU. An FTT will not reduce volatility, it will increase it. An FTT would not have prevented either the Great Financial Crash or current sovereign debt problems. It would shrink those parts of the financial markets which did not in any manner contribute to these problems.

An FTT is feasible but then so are many things that are not desirable. The FTT would not increase revenue collected. Indeed it would reduce total revenue by shrinking the overall economy. Finally, those who would carry the economic burden of the FTT would not be the banks but workers and consumers in general, and their burden would be more than 100% of the revenue raised by the FTT.

8 For example: http://www.imf.org/external/pubs/ft/wp/2011/wp1154.pdf; http://www.imf.org/external/np/g20/pdf/062710b.pdf

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