



## Why an EU financial transactions tax is a red herring

Written by Philip Whyte, 26 January 2012

Ever since it was first mooted in the 1970s, a financial transactions tax (FTT) has often been thought of as an interesting idea that cannot work in practice (because it needs to be adopted universally if it is not to be undermined by tax arbitrage). In other words, the difficulty of implementing the FTT has often been an excuse for not taking a view on its underlying substance. However, the terms of the debate have now shifted. Many EU countries want to adopt an FTT, whether others do or not. All of which raises two questions: what explains the political momentum behind an FTT; and is it a good rather than just interesting idea?

The politics of the FTT are not hard to understand. Public finances across the EU are weak, and governments are looking for new sources of tax receipts. The financial sector is deeply unpopular and is an obvious target to tax. Opinion polls consistently show that there is a strong democratic demand for an FTT: around two-thirds of voters across the EU (including in the UK) would support one. Against this backdrop, pressure to introduce an FTT has grown. So the European Commission, strongly encouraged by the European Parliament and individual countries such as France, submitted a proposal for an EU FTT in September 2011.

On the face of it, the tax treatment of the financial sector looks ripe for change. The financial sector is under-taxed (because it is exempt from value added tax). Parts of it enjoy an implicit but egregious state subsidy (because of the 'too-systemic-to-fail' problem). Some of the income of the financial sector is generated by rent extraction, rather than wealth creation. And while it performs a key function in a market economy, it is also a pollutant – as the vast costs of the financial crisis (in terms of output and jobs lost, as well as taxpayer support) testify. In principle, it is no less legitimate to tax financial than environmental pollution.

For many of its proponents, the case for an FTT rests on a vague sense that it would strike a blow against bad things like 'bankers and speculators', while

contributing to good things like financial stability and greater social justice. The European Commission makes similarly ambitious claims. It argues that an EU FTT would, among other things, discourage risky trading activities, increase financial stability, raise extra tax revenue (partly to fund the EU budget), and ensure that the financial sector pays "its fair share" of the costs of the financial crisis. But would an FTT help to meet the objectives that its proponents invoke to justify it?

The most plausible claim is that an FTT would curb the volume of financial transactions in the EU, and activities that Lord Turner, the chairman of the UK's Financial Services Authority, has called "socially useless". Some 'high frequency trading' (the computer-aided exploitation of tiny, fleeting information advantages in financial markets) would become uneconomic, and wasteful investment 'arms races' in the computer infrastructure that supports such trading would be checked. But an FTT that was adopted by a sub-group of EU countries might simply encourage trades to be conducted by firms incorporated elsewhere.

Even if an FTT caused a reduction in trading volumes, moreover, it cannot be casually assumed that asset prices would become less volatile as a result. Since markets would be less liquid, asset prices might become marginally more, not less, volatile. At best, evidence for the impact of lower transaction volumes on price volatility is mixed. Besides, it is misguided to suppose (as some politicians appear to) that by curbing 'speculative activity', an FTT could be a weapon in the fight to save the eurozone: a modest transaction tax will not stop investors from reducing their exposures to banks and governments that they believe to be at risk of insolvency.

An FTT, moreover, would not necessarily fall on 'economic polluters' in the financial sector. Not only is an FTT a blunt instrument that would hit all sorts of financial institution – from highly leveraged banks that pose a major threat to systemic stability, to unleveraged money market and mutual funds that pose none. But much of the bill for the tax would simply be passed on to consumers – that is, businesses and companies. An FTT, in other words, might do as much to punish virtuous behaviour among non-financial agents (individuals saving for their retirement) as to discourage economically polluting behaviour by financial intermediaries.

Nor, finally, is it clear that an FTT would actually raise much revenue. The European Commission argues that it would, and that the receipts could become a new 'own resource' for the EU budget. Projections for the tax receipts generated by an FTT are fraught with uncertainty. However, there is one reason to think that the Commission's forecasts of around €50bn may be too

optimistic: it estimates that an FTT would lower GDP (because of higher financing costs), but it does not factor in the revenue lost from other taxes as a result of lower GDP. A study by Ernst & Young estimates that this effect could more than offset the revenue raised by the FTT.

Popular as it is with many across Europe, an FTT is a bit of a red herring. The real scandal of the financial crisis is that many institutions became too highly leveraged, were bailed out when they ran into trouble, and imposed intolerable costs on society at large. A good way to tackle these problems was outlined by the Commission in a Communication in 2010. It is to make sure that countries implement special 'resolution regimes' to make it possible for banks to fail; and to discourage excess leverage by introducing a 'pollution tax' (or bank levy) on short-term debt.

So far, just over a third of EU countries have implemented resolution regimes and bank levies. Political energies would be better devoted to making sure that other member-states follow suit than to pushing for divisive distractions such as an EU FTT.