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Why critics are wrong about a financial-transaction tax

By Stephany Griffith-Jones and Avinash Persaud - 12.03.2012 / 11:46 CET

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"All truth passes through three stages. First, it is ridiculed. Second, it is violently opposed. Third, it is accepted as being self-evident." Arthur Schopenhauer could have been describing the journey of financial-transaction taxes (FTTs), which are somewhere between stages two and three. Exactly where will be revealed at the meeting of EU finance ministers on Tuesday (13 March), where the European Commission's proposal for a 0.1% tax on bond and equity transactions and 0.01% on derivatives will be up for discussion.

Before the Great Contraction began in 2007, bankers had succeeded in painting FTTs as the concept of naïve idealists who knew little about the real workings of finance. This was quite a feat given that the idea had towering intellectual credentials. John Maynard Keynes had recommended it in his "General theory of employment, interest and money", and a Nobel prize-winner, James Tobin, later developed it.

Before the financial crisis, rather than looking to "throw sand in the wheels of finance" (to use Tobin's colourful phrase), the story propagated by the industry was that those wheels should spin ever more quickly. We were told that the faster money moved, the more efficiently it would be allocated. Bankers and hedge-fund managers would grow super-rich, but that was a minor distraction because the economy would be stronger and jobs more plentiful.

That story has been rumbled by the financial crisis.

Dynamic economies

Today, FTTs are no longer ridiculed. How could they be? The world's most dynamic economies, including Brazil, South Korea and India, use them, Europe's most successful large economy, along with eight other EU states, wants to adopt one, and last year approximately $38 billion (€29bn) was raised by FTTs in the 40 countries that have them. Since 1986 (and before in other forms), the UK government has unilaterally, without waiting for others to follow suit, levied a stamp duty reserve tax of 0.50% on transactions in UK equities. Despite not updating this tax to take into account derivatives and other innovations, it still raises around €3.8bn per year.

The reason why these FTTs work is that they are stamp duties on the transfer of ownership and not based on tax residence. If the transfer has not been 'stamped' and taxes paid, the transfer is not legally enforceable. Institutional investors who hold most assets around the world do not take risks with legal enforceability. Of the UK's receipts from its stamp duty reserve tax, 40% are paid by foreign residents. Far from sending taxpayers rushing for the exit, this tax gets more foreigners to pay it than any other.

A negative impact?

Having lost the argument on feasibility, the financial sector and their political friends are now vigorously opposing FTTs with ever more outlandish claims about their negative impact on the wider economy. They have latched on to very preliminary estimates by the European Commission that a 0.1% FTT on equities and bonds could reduce gross domestic product by 1.7%, without waiting for the final analysis.

In its latest iteration, the Commission's model takes into account that the overwhelming majority (85%) of investment comes from retained earnings or bank loans not subject to FTTs. Furthermore, as the Commission's analysis said from the start, the proposed FTTs would only apply to transactions between financial institutions and would not cover companies issuing new shares. Once these factors are taken into account, the Commission's model indicates that the estimated negative effect of FTT on GDP would fall to just 0.1%.

But this is not the complete story. It is necessary to add that the tax would fall most heavily on short-term holders of securities, such as high-frequency traders, hedge funds and bank proprietary trading desks. It would fall least on long-term holders such as pension funds, life-insurance companies and private equity firms. This would likely trigger a shift away from short-term trading in favour of long-term holding that will reduce misalignments in markets and their subsequent abrupt adjustments or crashes.

Crash course

FTTs would therefore somewhat decrease the likelihood of future crises. Indeed, among those countries that were least affected by the crash, countries with FTTs were disproportionately represented. If we conservatively estimate that the probability of crisis would decrease by only 5% as a result of the FTT, which is very low, and we take into account that on average financial crises decrease gross domestic product (GDP) by around 7%, we would have a positive impact of +0.35% of GDP due to smaller likelihood of future crisis. The total net effect of an FTT would be an estimated boost of Europe's GDP by +0.25%, not a reduction. A more detailed version of this analysis can be found in our recent report presented to the European Parliament.

At a time when many European governments face large deficits, in large part as a result of bailing out the financial sector, it seems reasonable to expect the financial sector to adopt measures to help reduce the likelihood of future crises. To us and hundreds of other economists, the evidence is clear that an FTT adopted by all 27 EU states or by the 17 members of the eurozone would help strengthen Europe's finances and reduce the likelihood of crises.

As the FTT is one of the first international taxes, a proportion of its revenues should be earmarked to finance the solutions to some of the world's most difficult international problems, such as poverty and climate change. Therefore, an FTT could help foster somewhat fairer and more sustainable growth in Europe and globally.

Professor Stephany Griffith-Jones *is the financial-markets programme director at the Initiative for Policy Dialogue at Columbia University in the US.* ***Professor Avinash Persaud*** *is chairman of Intelligence Capital Limited and a senior fellow at the London Business School.*