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THE GREAT REBALANCING

How to fix the broken economy

EDITED BY
Andrew Harrop

FABIAN SOCIETY

3 | A FINANCIAL TRANSACTION TAX

Stephany Griffith-Jones

At a time when many European governments face large deficits, partly as a result of bailing out the financial sector, it seems reasonable to expect the financial sector to support the balancing of the books. To hundreds of economists, the evidence is clear: a financial transactions tax would help strengthen the public finances across European nations including the UK, reduce the likelihood of future financial crises, and provide a new source of finance for European and UK growth.

There is growing support in continental Europe for the approval of a financial transaction tax (FTT). This support has moved from just civil society and progressive political parties, as had been widespread in the past, to concrete support by the governments of 12 countries, including most of the major European economies (such as Germany, France and Italy) as well as Austria, Belgium, Greece, Holland, Portugal, Slovenia, Slovakia and Estonia. These twelve governments are close to agreeing a formula for the FTT similar to that proposed by the European Commission, of a 0.1 per cent tax on bond and equity transactions, and 0.01 per cent on derivatives. This would be achieved under a mechanism called the 'enhanced co-operation procedure', which allows some member states to move ahead when not all EU member states agree a

measure. It will require the European parliament to give its consent, which it is likely to do by December 2012, and the European Council would then hopefully adopt the authorisation decision under qualified majority voting of all 27 member states in early 2013.

The German government is already assuming this will happen and has budgeted small resources for FTT implementation for 2013, and income from its revenue starting in its 2014 budget. Though the main push has come from social democratic parties, it is interesting that several conservative governments, like the German and Spanish ones, have committed to approve and implement the FTT. A clear exception is the UK Conservative-led government, which has opposed this tax, even though the UK is one of many countries implementing a very successful stamp duty on sales of stocks and shares. It is widely seen that the position of the UK government is based on a narrow defence of the short-term interests of the City, and of high income individuals in the financial sector, rather than of the interests of the broader UK economy as well as people more generally. Even the financial sector itself would benefit in the long-term from the additional stability and growth that an FTT would bring.

It is important for the UK Labour party to join other progressive European parties in supporting an FTT. At this stage, it could put pressure on the coalition to at least support the enhanced co-operation of other EU countries to implement the FTT, to ensure that this is approved by the European Council early in 2013.

In the future, a Labour government should itself use the enhanced co-operation procedure to join other European governments in implementing the FTT along the lines the European Commission is suggesting, and the European parliament is backing. There is very strong support amongst British people (at over 70 per cent in recent polls[1]) for a financial transaction tax. The revenues of FTT could

be for example partly used to capitalise a British investment bank (BIB), which is one of the visionary proposals of the Labour party to help restore growth to the British economy. According to an IPPR report on the British investment bank, a £40 billion capitalisation over four years would allow the institution to immediately raise funds on capital markets by issuing bonds up to a leverage ratio of 2.5:1, which would mean the BIB could have a balance sheet of £140 billion within four years. In fact, this is a conservative estimate as the European Investment Bank (owned by all European Union governments), which is increasing its capital by around 10 billion euros, is estimating a much higher leverage ratio of 8:1.[2]

BIB funds could be used to increase lending for commercially viable infrastructure investment and for lending to SMEs. These are very much needed, especially at a time, when private lending is still falling, due to the deleveraging linked to the financial crisis. This lending would not just help boost growth and employment in the short term, but – as or more important – also increase supply in the UK economy in the medium and long term, and facilitate the necessary restructuring of the British economy towards internationally competitive and more dynamic sectors.

Preliminary estimates for the annual income of an FTT in the UK vary in the range of £9 billion[3] to much higher amounts.[4] If the latter estimates were more correct, in the first few years of the tax part of the funds could go to capitalising the British investment bank, and the rest could go to budget consolidation. When these urgent needs are met, then in later years, some of the resources could be channelled to financing climate change prevention, especially in the developing world, that would both help the world's poorest people and help protect the planet.

In the first phase, financing the BIB capital and budget consolidation would have clear positive macroeconomic impacts. Taxing mainly the most speculative frequent

financial transactions, (such as 'high frequency trading', which has no socially useful effect on the economy, but with potential serious negative effects on financial stability) could actually boost future levels of UK GDP, mainly by reducing somewhat the likelihood of future financial crises. Raising this tax, which would be paid mainly by very high income people with high propensity to save, would in the short-term not reduce aggregate demand too much. If the additional tax income went to financing the capital of the BIB, its lending would clearly boost investment, growth and employment. Even if part of the revenue went for budget consolidation, this would lower borrowing costs for the government, as well as increase future debt sustainability of the UK government.

Before the great contraction began in 2007, bankers had succeeded in painting financial transaction taxes as the idea of naïve idealists who knew little about the real workings of finance. This was absurd given that the idea had towering intellectual credentials. Keynes had recommended it in *The General Theory* and Nobel prize winner James Tobin later developed it. Many leading economists, like Joseph Stiglitz, now support the idea.

Before the financial crisis, rather than looking to "throw sand in the wheels of finance", in James Tobin's colourful phrase, the story propagated by the industry was that those wheels should spin ever more quickly. The faster money moved, and the larger the financial sector, the more efficiently savings would be allocated, we were told. 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 knocked down by the financial crisis. Recent empirical studies by the IMF, including in its 2012 Financial Stability Report, and by the Bank for International Settlements, conclude that increasing the size, and pace of growth, of the financial sector is good for economic growth – up to a

point. Beyond this point, a larger financial sector seems to reduce growth, as well as increase its volatility.

In this context, FTTs are no longer ridiculed; how could they be when the world's most dynamic economies – like Brazil, South Korea and India – use them? When in 2011 approximately $38bn was raised by FTTs in the 40 countries that have them? When Europe's most successful large economy, Germany, wants to adopt one, along with eleven other EU states? 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 per cent on transactions in UK equities. Despite not updating this tax to take into account derivatives and other innovations, nor taxing other instruments like bonds, it still raises $5bn per year.

One of the key reasons why these FTTs work is that they are stamp duties, on the transfer of ownership, and are 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. 40 per cent of the UK stamp duty reserve tax receipts are paid by foreign residents. Far from sending tax-payers rushing for the exit, this tax gets more foreigners to pay it than any other. It is very encouraging that the latest version of the FTT, being discussed in the European parliament, incorporates positive lessons from the UK stamp duty on stocks and shares and proposes that both residence and place of issue should be taken into account. This combination will make it far harder for evasion of this tax to occur by trading in other centres, such as the US or Asian ones.

An incorrect argument, promoted by the City of London, is that it is necessary for all major financial centres to impose an FTT, to avoid the risk of relocation; this is used as a deterrent for governments not to join the FTT. However, FTTs have always been levied unilaterally to

date. The argument that the UK would have to wait on the US or any other financial centre to introduce a broad based FTT flies in the face of the global experience. As pointed out, over 40 unilateral FTTs have been levied – either temporarily or permanently – to date, including leading nations such as South Africa, India, and Brazil, not to mention UK stamp duty and the small levy that funds the Securities and Exchange Commission in the United States. An FTT can also be designed – as with the European legislation – to tax transactions wherever in the world they take place (residence principle) as well as to tax transactions issued in a particular country (issuance principle). The relocation argument is therefore a mirage, one which does not stand up to the close scrutiny of FTTs in either theory or practice.

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. In fact, the European Commission model estimates in its latest iteration that a 0.1 per cent FTT on equities and bonds could reduce GDP by just 0.1 per cent. This takes into account that the overwhelming majority (85 per cent) of investment is financed from retained earnings or bank loans not subject to FTTs. Furthermore the proposed FTTs would apply only to transactions between financial institutions and would not cover companies issuing new shares.

But this is not the complete story. It is necessary to add that the tax would fall heaviest on short-term holders of securities like high-frequency traders, hedge funds and the banks' proprietary trading desks and fall least on long-term holders like 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. FTTs

would therefore somewhat decrease the likelihood of future crises and indeed those countries that have FTTs were disproportionately amongst those least affected by the crash that started in 2007. If we conservatively estimate that the probability of crisis would decrease by only 5 per cent as a result of the FTT, which is very low, and we take into account that on average financial crises lower GDP by around 7 per cent, we would have a positive impact of 0.35 per cent of GDP due to smaller likelihood of future crisis. The total net effect of an FTT would be an estimated boost of European GDP by 0.25 per cent, not a reduction.[5]

At a time when many European governments face large deficits, partly as a result of bailing out the financial sector, it seems reasonable to expect the financial sector to support the balancing of the books as well as adopting measures to help reduce the likelihood of future crises, and, perhaps most urgently, helping finance measures that lead to the promotion of European growth. To hundreds of economists, the evidence is clear that an FTT would help to strengthen the public finances across European nations including the UK, reduce the likelihood of crises, and provide a new source of finance for European and UK growth. Then as the crisis recedes a proportion of FTT revenues can in the future be ear-marked for helping to finance solutions to some of the world's most difficult international problems like poverty and climate change.

Endnotes

1 www.ituc-csi.org/g20-told-voters-want-banks-to-put.html

2 Griffith-Jones, S., Kollatz-Ahnen, M., Andersen, L., Hansen, S. (2012) "Shifting Europe from Austerity to Growth: A Proposed Investment Programme for 2012–2015" FEPS – IPD – ECLM Policy Brief www.feps-europe.eu/uploads/documents/shifting-europe-from-austerity-to-growth-FEPS-IPD-ECLM-3.pdf

3 Persaud, A. (2012) The Economic Consequences of the EU

Proposal for a Financial Transaction Tax, Intelligence Capital www.stampoutpoverty.org/download.php?id=444

4 Ernst and Young (2011) Outlook for Financial Services, Issue number 3, Winter 2011/12 Forecast www.ey.com/Publication/vwLUAssets/ITEM_Club_Financial_Services_Winter_2011-12/$FILE/EY_ITEM_Financial_Services_Winter_2011-12.pdf

5 A more detailed version of this analysis can be found in Griffith-Jones, S. and Persaud A. (2012) Financial Transaction Taxes, Report presented to the European Parliament. http://policydialogue.org/publications/network_papers/financial_transaction_taxes