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Financial Transaction Tax

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Summary

The European Commission has proposed to unilaterally introduce a financial transaction tax. Its aim is to collect a “fair contribution from the financial sector." I believe a transaction tax is a poor instrument to achieve such goal as (1) transactions will move offshore, (2) artificial derivatives will be created to circumvent the higher tax on an underlying security, (3) risk-sharing and economic growth are hampered, and (4) classic derivatives will become substantially more expensive. Market-based economies such as the UK and the Netherlands will be hardest hit by the proposed measure.

1 An assessment of the financial transaction tax

On September 28, the European Commission has adopted a proposal to set up a financial transaction tax in the EU-27. In a press release that day, Algirdas Semeta, Commissioner for Taxation, Customs, Anti-fraud, and Audit said:

> With this proposal the European Union becomes a forerunner in the global implementation of a financial transaction tax. Our project is sound and workable. I have no doubt this tax can deliver what EU citizens expect; a fair contribution from the financial sector. I am confident that our partners in the G20 will see their interest in following this path.

To achieve such aim through a distortionary transaction tax strikes me as a poor idea for the following main reasons:

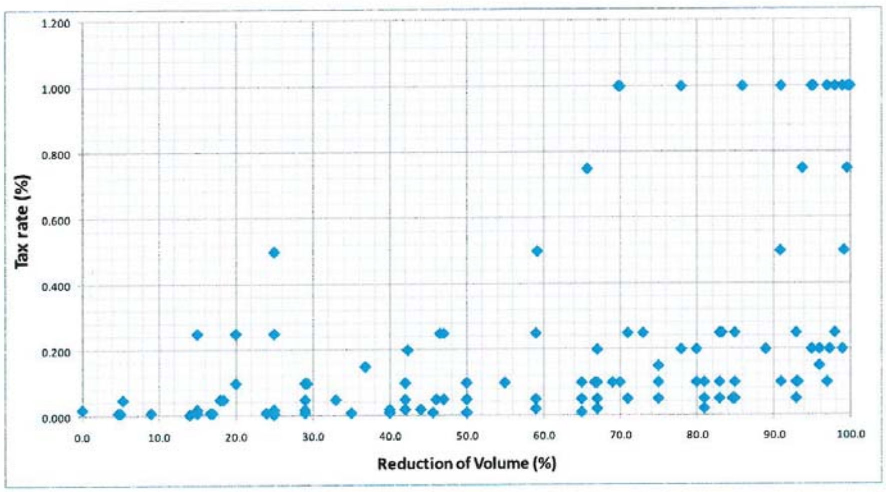
1. The EU brokerage industry will move transactions offshore.

2. The industry will create ‘artificial' financial derivatives on underlying securities to have clients pay the derivative transaction tax (0.01%) as opposed to the transaction tax on the underlying security (0.10%). A simple example is that equity futures will be traded instead of equities themselves. As activity shifts to such derivatives, trading in the underlying securities might become so thin that it harms price discovery and causes excess (transitory) volatility.

   Furthermore, such migration to new derivatives increases the risk that end-users (e.g., retail investors) do not fully understand what they buy into when transacting in these products. This is reminiscent of one of the contributing factors to the 2007-08 financial crisis where, by some accounts, some risks attached to mortgage-related derivative products were not fully understood by ultimate buyers.

3. In addition to migration, financial market activity simply shrinks as transacting becomes more expensive which, in turn, hampers risk-sharing and economic growth. The main role of financial markets is to (1) allow investors to share risk and to (2) allocate capital to (risky) projects that enable economic growth. Markets need to be active/liquid in order to fulfill these roles and such liquidity is harmed by taxing transactions.

A collateral effect of diminishing activity is that the tax base itself shrinks. McCulloch and Pacillo (2011) review the assumptions in all models that specify how the tax base responds to tax rate increases. They plot their findings in the following graph (p.46):



Event studies on the U.K. and Sweden have shown that a transaction tax decrease of one percentage point leads to a volume increase of 50-70%.[1] The 1975 abolition of U.S. mandated minimal commission rates decreased transaction costs by 31-44%, which prompted volume increase of 30-100% (Jarrell (1984)).

4. Classic derivatives (e.g., put and call options) become substantially more expensive. These derivaties are essentially a dynamic trading strategy in the underlying security and therefore pay the transaction tax in the underlying multiple times (cf. Black-Scholes).

2 Who will be hardest hit?

In decentralized, market-based economies investors use financial markets to save, insure, and invest. For example, citizens contribute to pension funds that invest on their behalf in order to finance their retirement plan. Ultimately, they will pay the transaction tax as such cost will be passed onto them by financial intermediaries.

In centralized, government-financed economies on the other hand, there is less need for markets. Pensions, for example, are financed by taxing the young generation to pay the retirement of the old generation|no market required. It is for this reason that the U.K. and the Netherlands will be hardest hit by the proposed transaction tax.

[1] See Jackson and O'Donnell (1985), Lindgren and Westlund (1990), and Ericsson and Lindgren (1992).

3 Will a transaction tax reduce short-term speculation?

In 1972 James Tobin proposed a currency transaction tax to discourage short-term speculators. Whether or not such goal will be achieved remains a controversial topic among academics. Friedman (1953), for example, challenged this notion (shortened quote):

> “Speculation is destabilizing" is equivalent to saying that speculators lose money, since speculation can be destabilizing only if speculators sell when the currency is low in price and buy when it is high.

Speculators, often referred to as arbitrageurs, buy low and sell high; they create buying pressure when prices are below fundamental value and selling pressure when they exceed fundamental value. Their trades therefore push prices back to fundamental value.

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