

Chapter 6

Finance Capitalism and Democracy: The Case of the Financial Transactions Tax



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Abstract This chapter analyses the pros and cons of financial transaction taxes (FTT) as mechanisms to mitigate financial instability and the proposal of the European Commission to implement an FTT in the EU in September 2011 until its suspension, as well as the prospects for it to be adopted in the future.

Introduction

The proposal of the European Commission to implement a financial transaction tax (FTT) in the EU (September 2011) can be considered an attempt to mitigate the contradiction between rising financial instability in the “real world” and mainstream economists’ unbroken belief in financial market efficiency. Such a tax would dampen asset price volatility, in particular caused by (ultra)fast trading techniques, yet it would represent a “softer” means of interference in market processes as compared to direct regulations. Based on empirical research on asset price dynamics, the Austrian Institute of Economic Research (WIFO) had presented already in February 2008 a comprehensive concept of a general FTT (Schulmeister et al. 2008). In contrast to a Tobin tax, the FTT should be levied on all transactions with any type of financial asset. The essential features of the WIFO proposal were as follows¹:

- The FTT is levied on all transactions involving buying/selling of spot and derivative assets, traded either on organized exchanges or over the counter.
- The tax base is the value of the underlying asset, in the case of derivatives their notional/contract value.

¹ The WIFO concept was not the first one, which would propose a *general FTT*. Pollin et al. (2003) proposed a “securities transaction tax” for the US markets, Summers and Summers (1989) had made “a cautious case” for such taxes. However, the WIFO concept was the most detailed and most comprehensive concept.

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- The tax rate should be low (between 0.01% and 0.05%).

This concept ensures the following: The “faster” an asset is traded and the higher is the leverage ratio, the more will the FTT increase transaction costs. Hence, an FTT with a low and uniform rate specifically dampens very short-term speculation in derivatives. High-frequency trading would become unprofitable even at a tax rate of 0.01% (or less). All other forms of short-term speculation would at least be dampened. As a consequence, asset price runs would occur less frequently and would become less persistent. Since long-term trends (“bulls” and “bears”) are the result of the accumulation of short-term runs, an FTT would also dampen the long swings of exchange rates, commodity prices and stock prices. As the financial crisis 2008 was directly related to the “tilting” of the bull markets of stock prices, commodity prices and house prices into three bear markets, the concept of a general FTT got more attention than ever before in the subsequent years.

The struggle over the FTT developed in three phases. In the first phase (2009 to 2011), the supporters of the tax went on the offensive. This phase ended with their (preliminary) “victory” in the form of the FTT proposal of the European Commission (EC) in September 2011. The second phase was shaped by the search for ways how to implement the FTT within the EU. It ended with the publication of a modified FTT proposal by the EC in February 2013 as basis for the implementation in 11 Member States (EU11). In the last phase, a strong counter-offensive of big “financial players” like Goldman Sachs deepened the conflicts among the EU11 group. As a consequence, several member states called for more modifications of the FTT concept of the EC and finally gave it up.

After the Financial Crisis: Pros and Cons of an FTT and the Fight for Public Opinion

Almost all NGOs active in the field of development aid and fighting poverty had for many years called for the Tobin tax. In the aftermath of the financial crisis, these groups switched to demanding a general FTT. Their campaigning was so successful that already in November 2010 61% of the respondents of a “Eurobarometer” poll supported the introduction of an FTT (EC 2011a). At the same time, the leaders of the two most important EU Member States, Chancellor Merkel and President Sarkozy, began to endorse such a tax. The “counter-attacks” against the FTT were put forward by economists of the IMF and – at first – also of the EC (IMF 2010; EC 2010a, b). Their objections were derived from equilibrium theory in general and financial market efficiency in particular.

- Objection 1: An FTT reduces liquidity and therefore hampers the price discovery process. It is assumed that rational traders drive the asset price to its fundamental equilibrium known to everybody. In reality, however, information is (very) imperfect, uncertainty is particularly pronounced in financial markets, and trad-

ing is not only based on rational calculations but also on emotions and social interaction (contagion, herding, market sentiments).

- Objection 2: The FTT does not specifically increase the costs of destabilizing trading. In fact, an FTT with the notional value as tax base increases the tax burden the more the faster transactions are carried out and the higher their leverage is.
- Objection 3: The distortive effects of an FTT will be higher than those of other kinds of taxes, in particular of a VAT, because the FTT is a turnover tax. This analogy is misleading. Buying an asset does not represent an (intermediate) input, and selling an asset does not represent an (intermediate) output. A more precise analogy to an FTT would be taxes on gambling where usually any bet/transaction is taxed.
- Objection 4: An FTT would raise the cost of capital because it has the same effect as taxes on future dividends. The assertion is wrong since a tax on dividends would affect any stock, whereas the FTT would affect only those stocks which are (frequently) traded. Compared to the trading volume of stock (index) derivatives, the volume of stock spot transactions is low.
- Objection 5: Most financial transactions are not driven by (destabilizing) speculation but stem from distributing risk. Before something can be distributed, it has to be produced. The production of risk and uncertainty in financial markets has risen due to the dominance of (automated) trading systems which disregard market fundamentals and are therefore destabilizing.
- Objection 6: Derivatives should not be taxed because this would increase hedging costs. Hedging involves only two transactions, opening and closing a derivative (counter-)position. At an FTT rate of 0.01%, the hedging costs would be only 0.02% of the insured value.

The Proposal of the European Commission and the Attempts to Implement the Tax

The European Commission changed its position towards the tax fundamentally between August 2010 (when it still rejected such a tax – see EC 2010b) and September 2011 (when it proposed a common system of financial transaction tax – see EC 2011b, c). The reasons for this turn were predominantly political: NGOs continued to campaign intensively for the FTT, most people in the EU supported it (EP 2011), and the European Parliament as well as the German and French government called for the introduction of this tax. The main features of the FTT proposal of the EC (ECP) are as follows (EC 2013).²

The tax base is defined comprehensively. Almost all transactions in financial instruments carried out by financial institutions (FIs) are subject to the tax. Tax

²For a more detailed summary of the EU proposal as well as a theoretical discussion of financial transaction taxes in general, see Griffith-Jones and Persaud (2012).

revenues accrue to the FTT countries (FTTCs) according to the “residence principle” and the “issuance principle”. The residence principle means that all transactions of FIs established in one of the 11 FTTCs are subject to the tax wherever the latter are carried out. The issuance principle means that also transactions in financial instruments, which are issued in an FTTC, are subject to the FTT even if none of the parties is established in an FTTC. For the minimum tax rates, the ECP proposes 0.1% as regards financial instruments other than derivatives (i.e. spot transactions) and 0.01% as regards derivative transactions. Each party has to pay the tax at the respective rates, i.e. 0.1% or 0.01%, respectively.

In February 2013, the EC published its modified proposal for an FTT implementation in the 11 EU Member States joining the ECP, among them all big euro countries. Finally, it seemed as if the FTT would soon be implemented in 11 countries. But it should come quite differently.

The Successful Counter-attack of the Financial Lobby Since 2013

Even though the modified proposal of the EC did not differ essentially from the original, the reaction of the financial lobby to its publication was completely different from the situation in fall 2011. This time, the respective institutions had enough time to prepare a most powerful campaign. Its targets were as follows:

- Bomb the public and politicians with as many assertions about the disastrous effects of an FTT as possible within a short period of time. What counts is quantity, not quality.
- Pretend that the interests of the national finance industry are national interests.
- Pretend that the interests of governments to finance their debts stay in conflict with the FTT proposal of the EC.
- Pretend that an FTT harms the interest of the (little) private investor in having his/her money “work”, in particular for his/her retirement.
- Ignore all arguments of FTT proponents concerning trading practices, “manic-depressive” asset price fluctuations and their impact on the real economy.

The most important intermediate target of the campaign against the FTT was to play off groups of actors and their interests against each other: national interests against the interests of “Brussels bureaucrats”, interests of EU Member States against each other, government’s interest in easy debt financing against the interests of the civil society, the interests of the latter against the interests of the (little) private investor, etc. The campaign of the financial institutions materialized primarily in pamphlets and press conferences of practically all big banks (Goldman Sachs, Morgan Stanley, Deutsche Bank, JP Morgan, Citigroup, etc.) and lobby organizations (International Banking Federation, International Capital Market Association, European Repo Council, European Fund and Asset Management Association, etc.).

In all their messages, the financial lobby repeated over and over again: The tax would hamper liquidity, increase the cost of capital and of financing the government debt; the tax would reduce profits of banks and, hence, their tax payments; hedging costs would rise; and, as a consequence, overall financial stability would be reduced. These assertions were then used to drive a wedge between the 11 FTT countries, in particular between France and Germany: “Indeed, we think the FTT would de facto be a transfer of French taxes (on, e.g., derivative transactions of the French banks, which are the market leaders in Equity Derivatives) to other jurisdictions” (Morgan 2013, p. 2).

The intention to play off governments against each other was facilitated by the fact that France and Italy introduced their own FTT in 2012 and 2013, respectively. The French tax is essentially a “stamp duty” on the change of ownership of French stocks, the scope of the Italian tax is wider as it also covers some derivatives. Once there were national FTTs introduced, the respective governments did no longer stick to the FTT proposal of the EC but wanted the latter to be changed according to their national FTT concepts. For example, the French government wanted the residence principle to be removed and derivatives to be excluded from the tax as both measures would hurt their national banks (in France, all big banks have specialized in “finance alchemy”, only Deutsche Bank). The financial lobby also mobilized the central banks. In May 2013, the then Governor of the Bank of England stated bluntly about the FTT: “Within Europe, I can’t find anyone in the central banking community who thinks it’s a good idea”. At the same time, the Governor of the Banque de France and the President of the German Bundesbank criticized the FTT explicitly in the public (see Corporate Europe Observatory 2013).

In addition, the financial lobby opened a new “front”: An FTT would almost destroy the repo market (with a repurchasing agreement, a bank raises cash by selling a security – usually a government bond – to the lender and commits itself to repurchase the security when the repo expires, in most cases just after 1 day). This assertion turned out to become the most effective weapon against the FTT proposal of the EC:

- As the EC had not dealt explicitly with the repo market, the lobby could pretend that the proposal had overlooked how this market would be affected.
- Politicians who had supported the FTT proposal became uncertain as they were in fact not familiar with repos.
- At first glance, it does indeed seem inconsistent that unsecured credits remain FTT-free whereas collateralized borrowing is taxed.
- The most important types of collateral in repos are government bonds. Hence, the financial lobby asserted that the FTT would raise the costs of financing the public debt.
- In a similar manner, it was argued that also pension funds would see lower returns as consequence of higher repo costs.

All this reasoning hides the core properties of repo transactions and of the repo market as the core component of the shadow banking system:

- Most repo transactions finance very short-term trading activities, in particular proprietary trading of banks.³ Intraday trading is financed by so-called tri-party repos where purchasing and repurchasing take place within hours.
- Repos facilitate leveraged trading to the extreme in the sense that one can purchase an asset (almost) without cash by borrowing money to buy the asset and simultaneously posting the asset as collateral.
- Short-selling is fostered by the repo market. One lends money in the repo market, takes the security one intends to short as collateral and then sells the security.
- The extremely high leverage of repo transactions strengthens boom-bust cycles and increases systemic risks: Rising asset prices stimulate repo financing which feeds back onto the bull market and conversely in the case of a bear market.
- The possibility to reuse the collateral produces “repo chains” (e.g. bank A sells a security to bank B in return for cash, bank B sells the security to bank C, etc.), feeding back on the strength of bull or bear markets.⁴

It is no surprise that the increasingly short-term repo transactions developed in tandem with the increasingly short-term proprietary trading of banks. This type of trading is predominantly unrelated to market fundamentals (it is to a large extent driven by trading systems). The financial lobby rightly expects repo financing to become unprofitable due to the implementation of an FTT. This, however, would be an advantage to the economy as a whole as these transactions finance predominantly short-term and destabilizing asset speculation. The “production” of systemic risks by short-term repos is confirmed by their role in the recent financial crisis (e.g. Hördahl and King 2008; Gorton and Metrick 2010; Tuckman 2010; for a summary, see Gabor 2016): Banks and their “special purpose vehicles” created securities from loans which often were backed by subprime mortgages. These securities were then used as collateral for repos. In this way, “securitized banking” created liquidity which further fuelled the booms of asset prices.

When the confidence in the real value of mortgage-backed securities became weaker, the confidence crisis spilled over to the repo market as a whole. The subsequent “run on repo” caused interbank interest rates to shoot up, and the bankruptcy of Lehman Brothers in September then accelerated the simultaneous fall of stock prices, house prices and commodity prices dramatically, turning the liquidity crisis of the banking system into a solvency crisis. All these aspects were neglected in the “scientific” documentation of the harmfulness of an FTT provided by the financial lobby. The most influential study became a research report of Goldman Sachs, in the following termed “GS study” (Goldman 2013).

This study is a perfect example how economists develop methods guided by the interest in reaching certain results, in this case “blowing up” the costs of the FTT to the maximum extent. The GS study summarizes the main results right at the

³According to survey studies of the Bank of England, two thirds of repo turnover concern overnight deals (Hördahl and King 2008).

⁴For the different channels through which the repo market produces (avoidable) systemic risk, see the excellent paper by Gabor (2016) and the literature quoted there.

beginning: “On a 2012 pro-forma basis, the FTT would amount to €170 bn...for the 42 European banks we have analysed.... By affected balance sheet category, the bulk of the impact stems from the European banks’ REPO books (€118 bn), followed by derivatives (€32 bn), equities (€11 bn) and government bond books (€4 bn). By bank, the impact extends across business models – investment, universal, global and domestic retail banks. Similarly, by geography, it has a reach well beyond the EU-11. Indeed, we show some of the most affected banks would be those in the UK and Switzerland. Individually, we show that the most affected banks are the French and German institutions. The six French and German banks show a 2012 pro-forma FTT as a percentage of 2015E PBT (i.e., profits before taxes) ranging from 168% (BNP), up to 362% (DBK) and finally 423% (Natixis). But even pure-play retail lenders – the Italian/Spanish domestic banks for example – stand to be significantly impacted (16–130% of 2015E PBT)” (Goldman 2013, p. 4).

In order to arrive at these “magic” figures, the GS researchers invented a new estimation procedure: “...we attempt to gauge what the 2012 FTT (theoretically) payable by individual banks would be, were they asked to apply FTT retroactively, to 2012 balances. This is a theoretical, ‘all else equal’, exercise...” (Goldman 2013, p. 16). In other words, when calculating the costs of the FTT, GS researchers assumed that transaction volumes remain unaffected by the tax – they call this the “pro-forma effect”. The seriousness of this procedure can be illustrated using the following example. Trading volume in UK financial markets amounted to 563 times the British GDP in 2010 (even without repo transactions which are not covered by the BIS data base).⁵ On a “pro-forma” base, an FTT rate of 0.1% would generate tax revenues of 56.3% of GDP; at a rate of 1%, the British government might even receive revenues amounting to 5.6 times the British GDP.

The GS researchers justify the “pro-forma” estimation arguing that “the results allow us to identify the business areas/product lines where the FTT impact would be most pronounced...”. This is simply wrong: The structure of activities differs between European banks. Banks which are specialized on short-term trading and repo financing (“finance alchemy banking”) will reduce these activities in reaction to the FTT implementation to a much greater extent than the more traditionally operating banks (“boring banking”). To serve its “research interest”, GS researchers introduced the concept of an “effective annual tax rate”. This means that the estimated *annual* FTT payments are related to the *average* repo value. In this way, one can document astronomically high “tax rates” as these rates become the higher the shorter the financing period of the REPO is. For tri-party REPOS which are turned over three to five times per day, GS Research arrives at an “effective annual tax rate” of the FTT of 360% (Goldman 2013, Exhibit 12 on p. 19). The absurdity of this procedure becomes evident if one considers the following example: A US household spends every day on average 100\$ on consumption for which it has to pay 5\$

⁵ Based on data from the World Federation of Exchanges (WFE) and the BIS, overall transaction volume in 2010 on UK markets is estimated at 1270,4 tn. \$.

in sales tax. What sense does it make to calculate an “annual effective sales tax” of 365 times 5% = 1825% instead of speaking of a general sales tax rate of 5%?

Another example for the predominance of the “research interest”: When discussing the FTT impact on the profits of European exchanges, the researchers did not stick to their “pro-forma” estimation but assumed an FTT-induced reduction of trading volumes. In this way, the GS reports arrive at the following conclusion: “...we estimate that the average European Exchange & IDB (i.e., interdealer brokers) under our coverage would see pre-tax profits decline by 22% as a result of the tax...” (Goldman 2013, p. 44). An exquisite example of manipulation concerns the impact of the FTT on retail investors: “Our analysis suggests that much of the burden of the FTT would fall on retail investors rather than institutional investors... we estimate that a typical retail investor from the Euro-11 area could expect to incur an annual FTT charge of 33 bp, while a similar institutional fund manager would incur 11 bp in tax. On this basis, a 30-year-old retail investor in the Euro-11 area who invested €1,000 a year until retirement at 65 could expect to see 14% of the principal investment consumed by the FTT” (*GS Report*, p. 54).

These calculations are biased in three respects. First, it is assumed that investors would not reduce the turnover of their portfolio due to the FTT. Second, it is – unrealistically – assumed that the retail portfolio returns over 35 years 6% p. a. on average. Both assumptions result in a high sum of cumulative tax payments (4875 €). Third, this sum is then related to the cumulative cash invested (35,000 €) leaving out the interest-compound effect. If one takes the latter – correctly – into account, the cumulative tax burdens amount to only 4.1% of the closing portfolio (this ratio is documented in Exhibit 34 but not mentioned in the main text).

The “dirty” campaign of the financial lobby was successful: The tensions between members of the “coalition of the willing” rose, in particular between Germany and France. On May 6, 2014, finance ministers of the EU11 declared: “...Our commitment to the introduction of a financial transaction tax remains strong... We agree on the following key elements... The progressive implementation will first focus on the taxation of shares and some derivatives”.

In plain language, this passage should read as follows: “The campaign of the financial lobby was too strong. This forced us to give up the ‘all institutions, all markets, all instruments’ approach proposed by the European Commission. Instead, as a first step we shall introduce a tax just on shares. We commit ourselves to call it ‘financial transaction tax’”.

It took the finance ministers of the ECP more than 4 years to finally arrive at this result. In December 2018, the German and French minister proposed the French model as the “new European Financial Transactions Tax”: Only spot transactions of stocks issued in an EU country should be taxed. One year later, the German Finance Minister Olaf Scholz trimmed the concept further: Only transactions with stocks of companies with a market value of more than 1 bn € should be comprised by the new “FTT”. This would mean that only less than 0.3% (!) of all financial transactions in

the EU would be taxed⁶ and it would also mean the “FTT” would tax exactly only those trades which are less used for short-term speculation and more for holding wealth (compared to derivatives). It won’t be too difficult for pension and investment funds to carry out a campaign against such a one-sided “FTT”. In addition, countries like Belgium and Austria which have been always supporting a comprehensive FTT (including derivatives) will leave the “coalition of the willing”. This means that Scholz’ “FTT” cannot not be implemented as the so-called enhanced cooperation needs the participation of at least nine member states (as yet, only ten have remained in the group). As a first indication of this development, the Austrian Ministry of Finance published a study immediately after the publication of the Scholz proposal which sharply criticized the “FTT” which would only tax stock transactions. However, in case of a new financial crisis, the idea of implementing a general FTT will pop up again.

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⁶Already in 2013, only 0.45% of all financial transactions in Europe concerned stock trading (spot). This share is nowadays most probably smaller as short-term speculation has increased above average and uses predominantly derivative instruments. In 2013, derivative trading in Europe comprised 83.5% of all transactions, foreign exchange spot trading accounted for 15.2%.

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