Weltwirtschaft, Ökologie & Entwicklung
World Economy, Ecology & Development

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Factsheet

European Commission against Financial Transaction Tax

In an internal paper[1], the European Commission (EC) has made its point clear that they are rejecting a financial transaction tax (FTT), which countries like France, Germany, Belgium, Austria, and Germany are supporting. The explanation is that the FTT would:

- increase the cost of capital for the economy as well as for the states (government bonds)
- negatively affect the price discovery mechanism in markets
- increase volatility
- create less revenues than is claimed by its supporters, and
- distribute these revenues unequally.

The EC however, is not really dealing with the arguments brought forward by the FTT supporters and is not drawing a lesson from the financial crisis. Therefore, the proponents of the tax should keep their course and consequently engage for the implementation of an FTT.

1. An increase in capital costs?

The EC is suggesting that the FTT would lead to an increase of interest rates for private or public bonds because investors would compensate the tax in return with an increase in interest rates.

Thereby the FTT is misunderstood as a type of tax, which reduces the value of an asset. This misjudges the basic character of the FTT, which does not tax the value as such of an asset, and therefore does not raise its price, but which instead taxes the trade with an asset.

The actual effect of the FTT is the following: Two different effects arise for two different types of investors. On the one hand the investors that want to acquire an asset for a relatively long period of time, based on their expectations regarding future price developments, and on the other side investors that want to profit from short-term price fluctuations on the other hand. The long-term investors buy and sell less frequently and therefore are almost not affected by an FTT, but would benfit from the increasing stability and security on financial markets through the FTT for their long-term investments.

2. Distortion of the price discovery process

The EC assumes that the lower the transactions costs and the higher the level of transactions (liquidity), the better the price discovery process functions. Even though they recognize that there are damaging transactions, they believe that these can be neglected. The reality of present trade and the experience of the last decades, however, are not taken into consideration. Trade is accelerating and more and more and transactions are being made with the help of electronic systems, which analyse and evaluate historic data in order to determine price trends to then take advantage of this knowledge. 60% of all the transactions at the New York stock exchange

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[1] EU Commission. Issues Note. Financial Sector Taxation. August 2010. Not published

are high-frequency electronic trades made in seconds and microseconds. Looking at the international average, over 80% of trading are short-term trades with duration of up to 7 days.

Because high-frequency trading is not based on real economic information, it does not encourage rational price discovery, but rather complicates it. This acceleration does not permit rational choice. Instead a competition for faster and faster computers and for the best algorithms is evolving. The professional traders of the major banks and funds are the big winners at the expense of the other investors. High-frequency trading and the explosion of trading volume have increased instability of the markets. Volatility has dramatically increased. And also empirical evidence indicates that high-frequency trading has destabilized the markets. In this respect it is wrong, if the EC claims, that the FTT would not specifically affect destabilizing transactions, because it is exactly these types of trades that are affected by the FTT and thereby the FTT would drive back the excessive trade volume.

3. Increase in volatility

Financial crises have increased severely in the past decades. The EC suggest that the crises are not veritably due to the volume of trade, and can not be prevented by an FTT. The proponents of the FTT don't assume that the tax could prevent crises by itself, but only that financial markets with high-frequency trading are directed more strongly towards trends than towards fundamental economic data. Thus the tendency for bubbles rises. Short-term trends add up to long-term trends, which then lead to shifts between bull markets and bear markets, i.e. volatility is increased. Even if there has always been herding, the herd becomes an automatism due to computerized trading. The FTT would not be able to prevent herding, but it would weaken trends and dynamics that are not justifiable through fundamentals. If the EC denies this, they must answer the question why the financial markets could not reduce or mitigate crises. Many financial innovations are praised with the argument that they could prevent irrational price developments and handle risks better. During the latest financial crisis they have failed, and in fact they were even at the centre of the crisis.

4. Less revenue through the FTT?

The EC asserts that only derivatives traded on stock-exchanges could be taxed, although the FTT is actually also supposed to tax off-market trading (Over the counter – OTC), which makes out about 90% of all transactions. The idea that it is not possible to tax these trades, is simply erroneous, because the settlements of the OTC-trading are carried out over the central settlement systems CLS bank, Fedwire, TARGET, CHIPS, and furthermore pass the information system SWIFT. It is therefore very easy to levy the FTT with an electronic tag at the settlements systems.

5. Unequal distribution of revenues

The EC criticises that the revenues from an FTT would be distributed very unevenly as the distribution would match with the turn-over at different trading venues. Thus London would yield 70% of all FTT revenues. But also this problem can be solved during the tax collection at the settlement of the payments. Because the origin, as well as the destination of every transaction is now already electronically registered, the buyer and the seller (who both pay the FTT), as well as their national assignment can be identified, and the tax can be transferred to the particular central bank. Every country therefore obtains the tax component corresponding to the trade activities of its citizens and companies.

Berlin, 02.09.2010

Contact: Peter Wahl peter.wahl@weed-online.org Tel.: +49-(0)30-7582616 www.weed-online.org