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A financial transactions tax and its impact

Should financial transactions be taxed in future? This question is currently being discussed by political leaders not only in Germany. A financial transactions tax (FTT) can only work if it is imposed internationally and not solely in Germany – this is the best-known argument against such a tax, but not the only one. As so often happens, the devil is in the details.

What type of tax should an FTT be?

If there were actually to be agreement that a financial transactions tax should be introduced in, for example, the G20 countries, this raises the question of whether a uniform framework for national taxes or an international tax would be better. It is important to deal with this question because the resulting tax revenue would be spread extremely unevenly. Most financial transactions take place at the big global financial centres, which means that the bulk of the revenue would be raised there. This is illustrated particularly well by a look at the foreign exchange markets. According to the figures compiled by the Bank for International Settlements (BIS) most recently in 2007, transactions to the value of around \$ 800 trillion were handled by international foreign exchange markets worldwide. Just six financial centres – London, New York, Zurich, Tokyo, Singapore and Hong Kong – accounted for around three-quarters of this turnover.

If the financial transactions tax were to be a national tax, the UK for example could collect a considerable share of its national fiscal revenue from this source alone. German companies conducting financial dealings in London would also have to pay the FTT

A brief word



An old friend – The Tobin tax – has resurfaced in a new guise. Now called a “financial transactions tax (FTT)”, it would make the financial markets pay a share of the cost of current and future crises. Worldwide, it would raise several hundred billion

dollars worth of extra fiscal revenue. Politicians are already outlining their ideas on how the money should be spent.

Yet the fiscal riches that an FTT would purportedly generate are merely a pipedream. Such a tax cannot – and should not – be levied.

Financial transactions are not a stable tax base.

If they are taxed, ways to avoid the tax are quickly found. And even if not, who would ultimately pay the tax? Financial institutions would have to pass on at least part of the costs to issuers and investors. In the end, companies would co-finance this tax if they obtain their investment capital on the financial market. But citizens, too, would have to pay more when investing in provision for old age. This cannot be politically desirable.

Anyone who believes that a financial transactions tax would limit or even prevent crises in the future is mistaken. On the contrary, an FTT would distort market prices and, as a result, impair transparency, liquidity and thus financial market efficiency as a whole. The idea flies in the face of all efforts to make financial markets more stable.

A handwritten signature in black ink, appearing to read 'Manfred Weber', written in a cursive style.

Prof. Dr. Manfred Weber
Chief Executive

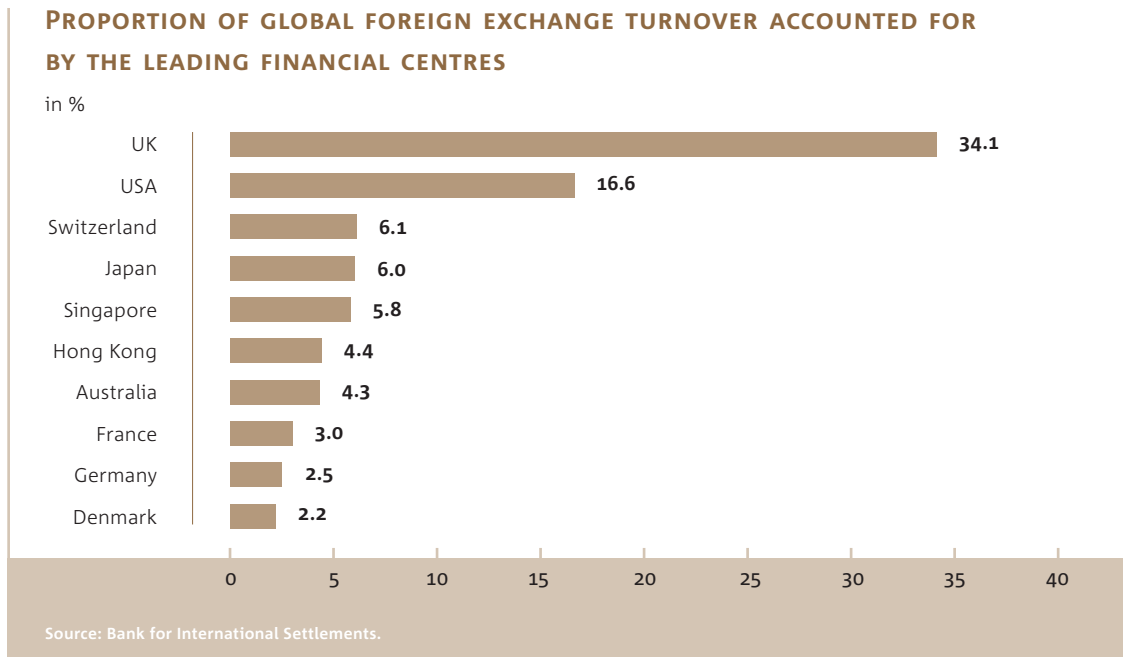
to the Treasury. The new tax boon would allow other taxes such as income tax to be lowered appreciably. So it is obvious that countries which are home to the six major financial centres would be put at a considerable advantage in the international competition between tax regimes and business locations. It is therefore highly unlikely that any other countries would go along with such an approach.

The alternative to a national tax would be introducing the FTT as an international tax to apply in all G20 countries and then distributing the revenue among all countries according to a previously agreed key. But so far not even the EU is entitled to levy taxes of its own. It would thus be a breach of the current political consensus if agreement were actually to be reached on encroachment upon national fiscal sovereignty at, for example, G20 level.

Dubious steering effects

Much more serious in economic terms than the question of how a financial transactions tax would be implemented legally are the adverse effects on government borrowing, the real economy and financial markets. The FTT is modelled on the so-called Tobin tax, which was designed somewhat differently as a means of curbing speculation specifically on the foreign exchange markets. The Tobin tax incidentally remained theory and never had to prove that it worked in practice.

An FTT would be levied on all transactions conducted on financial markets, i.e. on trades in foreign exchange, shares, fixed-interest securities, commodities and derivatives. The underlying assumption is, however, the same as that with the Tobin tax, namely that speculation causes instability and crises, so such transactions should be taxed. The more short-term the speculation, the more effective the tax – it throws a spanner in the works of the financial markets. In this way, it is



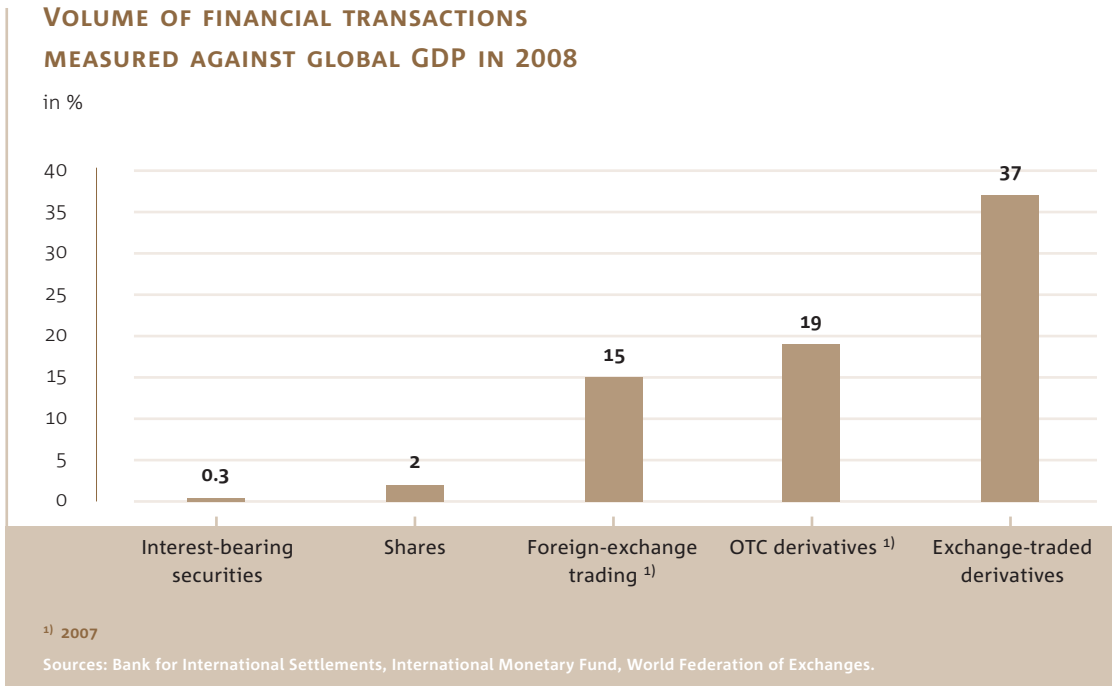
supposed to lessen the incentive to speculate and thus reduce the volume of trading – and, ultimately, the threat of crises as well.

But, for one thing, the over-speculation argument is simply not backed up by, for example, foreign exchange trading and, for another, there are a number of reasons for crises that would not be corrected in any way by an FTT:

- To many, the foreign exchange market is a prime example of rampant speculation, as transaction turnover there surpasses the volume of world trade many times over. Yet it is overlooked that foreign exchange transactions are usually the exact opposite of speculation. They are, above all, transactions to hedge risks arising from exchange rate fluctuations. When any foreign exchange position is offered, non-speculative market participants react by passing on the amount that exceeds their risk-bearing capacity. This results in a chain of transactions that essentially poses no threat to stability but in fact limits the risk exposure as a whole. An FTT changes – indeed distorts – prices. Assessing the market situation becomes more difficult, making risk management more uncertain.

- An FTT is being called for as a lesson learned from the on-going financial crisis so that future crises can be limited or prevented. Yet had it already been introduced, it would not have been able to prevent the crisis or positively affect its impact. Short-term speculators did not set off the earthquake on the markets. The causes lay elsewhere – for example, in the way structured financial products, particularly collateralised debt obligations (CDOs) backed by mortgage loans, were valued in balance sheets and rated, and in the fact that, contrary to expectations, risks posed by credit default swaps (CDSs) were not transferred to market participants who were better able to absorb these. The failure of individual securities and finally the collapse of the entire CDO market were not triggered by short-term trading activity and could not have been hindered by an FTT. The same goes for the CDS market.

An FTT would therefore not only be the wrong instrument for preventing crises but even carries the threat of harmful side-effects. After all, such a tax is more than just an additional cost factor for market participants, and it distorts prices. Securities quotes which come about in a system in which a tax is levied on short-term transactions



no longer reflect the actual value of securities. Capital would no longer be used optimally from a macroeconomic perspective and, at the end of the day, the economic investment process would also be disrupted. The longer-term consequence of an FTT would be less economic growth and lower real wages.

Companies which refinance themselves on the financial market would feel the consequences directly. To take one example: the wide-spread practice among German companies today of refinancing themselves by issuing short-term money market paper that would also be subject to the FTT would become more expensive than other forms of funding. Company profits would drop and thus ultimately also the revenue raised by taxing profits. So companies would have to change the way they refinance themselves. This would result in their switching to alternative tax-free means of funding, in which case the state would not collect any FTT revenue at all.

Conclusion

The introduction of any new tax must be considered very carefully, especially when it is likely to have effects as serious as those of a financial transactions tax. Because an FTT could be easily avoided, European political leaders must at any rate be warned against going it alone and introducing such a tax in the EU. And even if the scope for avoidance could be limited, the uncertain revenue would have to be set against definite drawbacks. An FTT would increase the cost of finance for companies and act as a drag on growth. Investors, too, would face higher costs. The tax would adversely affect financial market efficiency and thus weaken the competitiveness especially of economies which, like Germany's, rely heavily on capital due to high wage costs.

The Association of German Banks is convinced that an FTT would be harmful to both growth in Germany and the global economy and therefore strongly advises against introducing such a tax.