Europe's financial-transactions tax

Bin it

Plans for a transactions tax ought to be dropped

ANY idea that has bankers up in arms and America, of all places, whingeing about intrusive lawmaking must have something going for it, right? Wrong. The European Commission's proposals for a financial-transactions tax (FTT), published on February 14th, are a masterpiece of bad design.

A group of 11 European Union member states, among them France, Germany and Italy, wants to impose a 0.1% tax on equity and debt transactions, and a 0.01% charge on derivatives transactions. These countries are pressing ahead on their own because other EU members, including financial hubs like Britain and Luxembourg, are opposed.

The notion of a tax on financial transactions is not new. Britain has been charging stamp duty on equity purchases since 1694. James Tobin, a Nobel prizewinning economist, proposed a global tax on foreign-exchange transactions in 1972. The idea of skimming a tiny bit of revenue off the top of financial trades, and retrieving money for taxpayers from an industry that has benefited greatly from their largesse, has the ring of natural justice.

The rates proposed sound negligible, but the tax would be imposed at each point in the transaction chain. A 0.1% rate therefore translates into something much bigger as securities move from seller to buyer via financial intermediaries. Even the headline rates are less innocuous than they look. A 0.1% charge on repo transactions, a way for banks to finance themselves overnight, turns into a 25% charge over the course of a working year. A 0.01% tax on a derivative trade sounds small, but is a hefty increase in costs given the large notional amounts involved-up to 18 times more than current costs in the most liquid markets, according to one calculation.

A Bank of Canada analysis of the effect of previous ftts found that they tend to harm market quality, by increasing volatility, reducing volumes and raising the cost of capital. The early effect of a French equity ftt that was introduced last summer was to hit trading in the shares of smaller firms. Without a co-ordinated global approach, the taxes are also likely to be circumvented by savvier investors, leaving retail investors to pick up the bill. After Sweden levied an ftt in the 1980s, 60% of trading volume in the most actively traded share classes moved to London; the tax was repealed in 1991.

Even the commission says that the tax will have a small negative effect on long-run growth. And its impact could spread far beyond the 11 consenting countries. To prevent activity fleeing the ftt zone, the commission proposes to tax trans

actions on the basis of issuance as well as residency. So buying a share in Siemens, say, would incur the tax even if the counterparties were two American firms in Chicago. The proposal is not the only attempt to extend the laws of one state into the jurisdiction of another. The Dodd-Frank act does so with derivatives that involve an American counterparty; and foreign financial institutions are being forced to help Uncle Sam tax American citizens' offshore assets.

Taxation without borders

In a world of mobile capital, it is tempting to legislate beyond borders. That might just work for America—having the world's largest capital markets and its reserve currency gives you a bit of leverage-but is unlikely to for Europe. These plans threaten to give investors an extra reason not to buy Europe's securities or transact with its institutions at a time when it can ill afford to drive away economic activity.

If the ftt-11 want to extract more money from finance, they should drop this idea and instead impose a levy on their own banks' balance-sheets. That would be more precisely targeted, easier to collect and more respectful of legal jurisdictions. Unfortunately, the ftt has powerful political appeal, not least in Germany, where elections loom. Demands by the European Parliament to impose a cap on bankers' bonuses are hard to oppose for the same reason (see page 69), even though they would encourage firms to raise fixed pay and increase their cost base.

Finance needed reform, which is why new rules on capital, liquidity and derivatives are coming in. They should make the financial system work better. This proposal will not.

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