Europeans for Financial Reform

"Fighting for a Financial Transaction Tax - how and why?"

15th March 2010

Bibliothèque Solvay, Rue Belliard 137, 1000 Brussels

Background paper

Any further information can be obtained through
Ernst STETTER, FEPS Secretary General (ernst.stetter@feps-europe.eu)

GLOBAL
PROGRESSIVE
FORUM

FOUNDATION FOR EUROPEAN
PROGRESSIVE STUDIES
FONDATION EUROPÉENNE
D'ÉTUDES PROGRESSISTES

Under the auspices of the Global Progressive Forum (GPF) and the Foundation for European Progressive Studies (FEPS), the present paper intends to go from theory to practice, and promote the implementation of a universal Financial Transaction Tax. The GPF is a common initiative of the PES, the S&D group in the European Parliament and the FEPS. It brings together progressive politicians, leaders of international organisations, Trade Unions, NGOs and civil society representatives from all over the world to promote the Progressive agenda on the global stage.

After presenting the progressive position and our statement of intent, this background paper introduces the two main political arguments for such a tax. The final part is dedicated to a thorough theoretical analysis of the concept of a financial transaction tax, traces its origins and develops economic arguments to support it.

The progressive position

The Europeans for Financial Reform campaign (EFFR) presented a contribution to the IMF consultation, prepared by FEPS, arguing the case for a universal FTT.

The EFFR is a campaign initiated by the GPF which advocates for a global financial reform, in close cooperation with the Americans for Financial Reform Campaign, and hundreds of other stakeholders, including the Party of European Socialists.

The PES, the S&D group, FEPS and the GPF call both G20 leaders and European law-makers to act swiftly in implementing a global tax of 0.05% on all financial products. Such a tax is both desirable and required. It is one policy instrument out of many, which serves both financial reform and fiscal stabilisation purposes.

The Financial Transaction Tax is an old idea, but it has never been as relevant as it is today. We must seize the momentum that the financial and economic crisis has created for changing our economy for the better.

We as a society must learn from our past mistakes. We as Progressive forces must demonstrate that we were and we are right in calling for a strong control of society over the financial sector, and make our voice heard in the current favourable political context.

The criminal financial deregulation of the last three decades – and its devastating economic and social consequences – must become a thing of the past. Now is the time for society and the real economy to regain power over the financial sector, to get financial institutions to pay for their crisis and to ensure that the crisis will not occur again.

Statement of intent: towards a universal financial transaction tax

We have reached a momentum for a Financial Transaction Tax in Europe and on the global stage.

The case for either a global or a European Financial Transaction Tax is growing stronger. The growing support which the idea attracts reflects it well. Over the last months, many prominent politicians and other public figures voiced their support for a tax on financial transaction:

> *"There is a clear-cut case for a global FTT: it would be just, would do no harm, and would do a lot of good. If there is a better idea for fair burden-sharing between the world's Main Streets and its Wall Streets, let's hear it. If there isn't, let's have an FTT now."*
> Peer Steinbrück, Former German Finance Minister
>
> *"If you want to stop excessive pay in a swollen financial sector you have to reduce the size of that sector or apply special taxes to its pre-remuneration profit."*
> Adair Turner, Chairman of Britain's financial Services Authority
>
> *"I believe the transaction tax still has a great deal of merit."*
> Nancy Pelosi, Speaker of the U.S. House of Representatives

At the last G20 summit in September 2009, global leaders mandated the International Monetary Fund (IMF) with preparing a report to consider "how the financial sector could make a fair and substantial contribution towards paying for any burdens associated with government intervention to repair the banking system".

In January 2010, the Obama administration announced plans for a "Financial Crisis Responsibility Fee" in order to recoup taxpayer funds used to bailout financial institutions in trouble. This bank levy would raise $90 billion over the next 10 years.

Conservatives are trying to frame the debate in such a way that the IMF's choice becomes a either/or dilemma between the introduction of a tax on financial transactions – as supported by most European law-makers – and a bank levy targeted at financial institutions balance sheet – similar to the US proposal. But there are no fundamental contradictions between the two instruments. In fact, they complement each other in their purpose as well as functioning. Both instruments would aim at downsizing the financial sector, mitigating its procyclicality and tackling speculation, as well as raising revenue under the principle of "fair burden sharing". Furthermore, in targeting more specifically speculators such as hedge funds, the Financial Transaction Tax would leave investment banks and other financial institutions relatively untouched. To this respect the "bank levy" would act as a useful complement to the Financial Transaction Tax.

Even if the Managing Director of the IMF, Dominique Strauss-Kahn promised that civil society and various types of specialists would be consulted, there remains strong resistance against the implementation of a universal Financial Transaction Tax in the financial services industry, governments and international organizations.

Progressive parties, trade unions and civil society organisations will play a major role in the coming weeks in order to put the Financial Transaction Tax on the political agenda of the next G20 Summit in June 2010.

Specifically in the EU, pressure has to be put on the European Commission to effectively explore ways of introducing and implementing a Financial Transaction Tax at the European level. The recent resolution passed by the European Parliament calling the European Commission to do an impact assessment on the introduction of a Financial Transaction Tax is the right first step. But it will only pay off if it is followed by a constant involvement of all stakeholders in the debate, from grassroots campaigns and NGOs to political forces and Trade Unions.

A desirable and necessary tax

The implementation of a universal Financial Transaction Tax (FTT) is not only desirable from a progressive perspective; it is also required in the current policy context, with respect to both the necessity to change the financial sector and to consolidate public finances.

Progressive forces in Europe have been calling for appropriate policy instruments to be used in order to restore sustainable private and public finances. In particular, the PES, FEPS and the GPF have been very active, even prior to the financial crisis, in proposing new regulatory tools aimed at shutting down the shadow banking system, downsizing the financial sector, mitigating its procyclicality and restoring a strong, two-sided link between the financial sector on the one hand and the real economy on the other.

In this respect, promoting active and contracyclical fiscal policies to tackle the recession could generate long-term growth and create jobs. Now that conservative governments in Europe intend to withdraw the fiscal stimuli – a policy shift coined as the "exit strategy" – it is argued that such a move would be detrimental to economic growth and thus public finances in the long run. The PES has been calling for an "entry strategy" into the labour market, which is the continuation of discretionary expansionary fiscal policies, re-oriented towards public investment and structural reforms.

Indeed, when some economists assess that the roots of the crisis lie as much in structural causes as in the loose regulatory framework of the financial sector, characterised by global imbalances and deregulated markets, one must have in mind that one of the most important imbalances in global economic activity is a hyper-inflated financial sector. Financial transactions volumes have increased drastically to reach 70 times world GDP in 2007, when this ratio was only 15:3 in 1990. In this respect, the implementation of a Financial Transaction Tax must aim at shrinking the financial system.

A Financial Transaction Tax is a policy instrument which matches both policy objectives of regulating the financial sector and consolidating public finances while paving the way for long-term growth and a transition towards smart, green jobs. It is a tool which can restore both sustainable public and private finances.

In addition, another structural imbalance fed the over-development of financial markets, namely a decrease in the share of wages in GDP and an increase in profits. These profits were invested in financial activities, resulting in low growth and unemployment. In this respect, a Financial Transaction Tax would not only allow to share the burden of the crisis for political reasons, but would also curb speculative behaviour and therefore help in reaching a stable and sustainable accumulation path, by both balancing the size of the financial system compared to activities in the real economy and raising aggregate demand.

A Financial Transaction Tax is not a golden bullet; it is only one instrument out of a wide array which must be used if we are to leave the crisis stronger than we entered it.

A Financial Transaction Tax is technically and politically feasible, and could be implemented as early as 2011. As a first best, progressive forces advocating for a universal Financial Transaction Tax both in terms of tax base and geographical scope. However, a Financial Transaction Tax limited to the European Union would constitute a good first step towards the establishment of a global one.

The Financial Transaction Tax: a single instrument for two objectives

A tool to change the financial system

A Financial Transaction Tax is a tax on all financial transactions, the bulk of which today are derivatives. The role played by derivative products in the financial and economic crisis, being both opaque and disconnected from their underlying assets, is instrumental. From the use of derivatives on mortgage-backed securities in the so-called "subprime" crisis, to the sovereign Credit Default Swaps used to speculate against Greece's debt, there are many example of how these largely unregulated and uncontrolled sophisticated financial products have became, as experienced speculator George Soros puts it, "*financial weapons of mass destruction*".

Derivative products are not new, but their exponential growth is; in particular in the "over-the-counter'" market. Derivatives now represent nearly 90% of all financial transactions, a proportion which has been growing constantly for the past 20 years. Over the same period of time, "real money" or spot transactions have remained more or less constant. The total value of all financial transaction represents around 70 times the world GPD, 450% more than twenty years ago. And all of the increase accounts for derivative transactions.

The simple fact that the financial economy outweighs so largely the real economy indicates that the vast majority of financial transactions are about one thing only: speculation. The world economy can do without most of this trade

A Financial Transaction Tax acts as a deterrent to socially useless, short-term oriented speculative transactions. **The shorter the time horizon of a transaction is, the bigger the impact of a Financial Transaction Tax on the cost of this transaction.** To put it simply, adding 0.05% transaction cost to a trade which is only worth making on the basis of a miniscule price variation lowers greatly the profitability of this transactions, and thus the incentive to carry it through. Comparatively, in raising the cost of speculation, a Financial Transaction Tax makes productive investment more appealing to financial actors.

The FTT is a transformational tool: if implemented, **it would reorient the financial sector away from speculation and towards real, growth enhancing and job creating investments**.

In tackling speculation, a Financial Transaction Tax would also bring greater financial stability. It would reduce market volatility and velocity, limit the natural tendency of financial markets to "overshoot" and prevent the formation of speculative bubble. Ultimately, this means that a global FTT would significantly reduce the incidence of crisis episodes in the financial sector, and bring prices closer to their real equilibrium

The Financial Transaction Tax serves both of the policy objectives of bringing the financial sector closer to the needs of the real economy and providing greater financial stability. It fits in the global financial reform agenda, in particular with respect to the regulation of hedge funds and private equity, derivatives and banks' operations.

A tool to raise revenue

The overall value of all financial transactions globally is of the scale of €3,000,000 billion a year. This illustrates the simple fact that **even a diminutive tax rate of 0.05% could generate huge revenue, considering the size of the tax base**.

Figure 1 presents the revenue potential of a 0.05% Financial Transaction Tax in selected countries. In Europe alone, a Financial Transaction Tax could bring in nearly €200bn a year, which is more than the current budget of the European Union. Globally, the Financial Transaction Tax could generate more than €500bn annually, over 5 times more than what is required to attain the UN Millennium Development Goals.

Figure 1: Revenue potential of a 0.05% Financial Transaction Tax in selected countries

Selected Country	GDP forecats 2011 (billion)	Tax receipts Coefficient, in % of GDP	Potential Tax revenue for 2011	Public deficit 2011 (billion)	Current Commitment to development Goals (billion)	Additional fund needed to reach the Millennium Goals' target (0.7% GNI)
Austria	€290.052	0.460%	**€1.334bn**	€15.373	€ 0.873	**€1.051bn**
Belgium	€356.413	0.769%	**€2.741bn**	€20.672	€ 1.941	**€0bn**
Italy	€1,623.511	0.240%	**€3.896bn**	€82.799	€ 2.538	**€8.565bn**
Netherlands	€599.201	0.672%	**€4.027bn**	€33.555	€ 3.943	**€0bn**
France	€2,056.803	0.612%	**€12.588bn**	€158.374	€ 7.374	**€5.194bn**
Germany	€2,503.007	1.070%	**€26.782bn**	€115.138	€ 8.370	**€8.475bn**
United Kingdom	€1,686.942	6.352%	**€107.155bn**	€187.251	€ 9.611	**€3.244bn**
Total Europe	€12,811.079	1.528%	**€195.753bn**	€883.964	€ 45.932	**€34.449bn**
USA and Canada	€11,430.258	1.557%	**€177.969bn**	€1,497.364	€ 20.923	**€48.692bn**
Total World	€46,984.587	1.097%	**€515.421bn**	na	€ 79.556	**€ 89.199bn**

GDP is expressed at current prices.
GDP data sources: Eurostat, Departement of finance Canada, IMF
The development aid data is based on OECD Official Development Aid (ODA) data and constitutes the most recent projections for 2010.
The Tax receipts coefficients are taken from: S. Schulmeister; M. Schratzenstaller & O. Picek "A General Financial Transaction Tax. Motives, Revenues, Feasibility and Effects", Austrian Institute of Economic, march 2008. We usd in this table the medium reduction in transaction volume scenario, for a FTT on all products, including OTC derivatives, set at 0.05%

The revenue potential of a Financial Transaction Tax is large when compared to concrete policy objectives. However, it appears fairly small when compared to the current debt-burden policy environment. **The financial crisis will have resulted by the end of 2011 in an extra €3,000 billion in public debt in the EU – which will require decades to be absorbed.** A 0.05% Financial Transaction Tax would only cover about 5% of the overall European public deficit forecasted for 2011.

The scale of public deficits reached after the crisis calls for a new tax stream, and not for spending cuts. The Financial Transaction Tax as a revenue-generating instrument must be part of the solution.

The Financial Transaction Tax is particularly appropriate as a new fiscal instrument. It constitutes progress towards a fair burden sharing of the cost of the crisis between the financial sector and the real economy. Furthermore, after decades of gradual increase in the taxation of labour relative to the taxation of capital, it represents a fair first step towards rebalanced taxation systems.

The theory behind the Financial Transaction Tax

The political economy behind the Financial Transaction Tax

In a cumulative effect, short term speculation, which is at the least "*socially useless*", can in fact produce persistent destabilising and unsustainable long term deviations, identified as financial bubbles. In addition, empirical evidence suggests that the economic crisis was deepened by the instability of stock prices, exchange rates and commodity prices.

This is in fact hardly surprising given that it has never been demonstrated that the economic system, independently of any external intervention, could produce an acceptable social order. Nobody has been able to show that the economy, through the intermediation of the markets alone, could reach a state of rest satisfying individual desires. The rhetoric on the necessity to liberalise markets has therefore to be interpreted as ideology. As rightly emphasised by Soros: "*Instead of a tendency towards equilibrium, financial markets have a tendency to develop bubbles. Bubbles are not irrational: it pays to join the crowd, at least for a while. So regulators cannot count on the market to correct its excesses*"[1]. In this respect, Soros does not depart from the pure Keynesian statement on the functioning of financial markets: "*professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees*"[2].

From this analysis, it should be **clear that the aim of a Financial Transaction Tax is not to avoid bubbles** as such, which could be considered to be the normal functioning of a market economy **but mainly to avoid the increasing discrepancy between investment in the financial markets and in the real economy** allowed by technical trading, for a more stable accumulation path. As will be seen later on, such a tax would not only curb speculative behaviours but would also aid the prevention of long-term boom and bust cycles. As rightly emphasised by Keynes: "*It is rare, one is told, for an American to invest, as many Englishmen still do, "for income"; and he will not readily purchase an investment except in the hope of capital appreciation. This is only another way of saying that, when he purchases an investment, the American is attaching his hopes, not so much to its prospective yield, as to a favourable change in the conventional basis of valuation, (...). Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future*

[1] G. Soros, "Do not ignore the need for financial reform", Financial Times, 25th October 2009, available at http://www.georgesoros.com/articles-essays/entry/do_not_ignore_the_need_for_financial_reform/

[2] Keynes (1936), *The General Theory of Employment, Interest and Money*, Chapter 12, available at http://www.marxists.org/reference/subject/economics/keynes/general-theory/ch12.htm

yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism (...).The introduction of a substantial Government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise"[3].

However, one should also be clear in stating that the implementation of Financial Transaction Tax stems from a more global vision of capital market interconnections than one aimed at legitimising a Currency Transaction Tax after the collapse of the Bretton Wood system. As stated earlier, **it is on the basis of the intrinsic instability of financial markets that a Financial Transaction Tax is needed**. It is the very same reason which implies that it must be levied on all types of financial transactions. Such a tax could be part of a more global taxation of the financial system, with stamp duties and bank debit taxes. In this respect, one must be intellectually careful in stressing the need for a Financial Transaction Tax. The tax should not be designed in order only to grasp temporary negative externalities in some markets[4]. Indeed, the problem at stake is to limit financial transactions globally, by limiting their relative profitability compared with productive activities in real sectors and consequently, to curb their destabilising effects.

From a perspective of a history of economic thought Keynes did not recommend a Financial Transaction Tax for reasons of market failure. Following the same line of reasoning, Minsky (1986)[5] argued that fiscal and monetary policy tools cannot bring the economy to a full employment equilibrium when financial markets are highly speculative. In fact for Minsky: "*stability – or tranquillity is destabilising*" and the fundamental instability is upward. A period of tranquillity (in which the financial system is robust and there are no relevant shocks, so that profits are systematically greater than debt commitments) increases the confidence of firms and financial intermediaries, thus reducing both the value placed upon liquidity and the borrowers' and lenders' risks. This means that the price of capital asset increases and that the desired safety margins decreases. According to Minsky, the result is an increase in investment financed by indebtedness. In this way the expansion turns into a boom financed by indebtedness. The risk of default increasing, this could lead to a crisis of the financial sector, and consequently of the whole economy. Only such measures could be able to lead to more stable, and therefore sustainable, growth path. In this respect, **the implementation of a Financial Transaction Tax could represent a tool for a "*comprehensive socialisation*" of investment which is considered to be*"the only means of securing an approximation to full employment."***[6]

Such a tax would ultimately be borne by hedge funds and investment banks. As stated by Kapoor (2010)[7], high frequency trade now accounts for a significant and increasing share of market volume. Hedge funds represent more than 30% of the volume in high yield debt, 90% in convertible bonds, almost 90% of distressed debt and emerging market debt. Hedge funds are the dominant players in the credit default swap market accounting for more than 60% of market volume. Hedge funds are responsible for between 55% and 60% in leveraged loans. Moreover, the proposed increase of bank capital requirement will make it less profitable for banks to engage in heavy financial market trading. Since this constraint will apply

[3] *Ibid*.
[4] Darvas & Weizsäcker (2010), "Financial transaction tax: small is beautiful", European parliament, DG for internal policies, Policy department A: Economic and scientific policies.
[5] *Stabilizing an Unstable Economy*, McGraw-Hill (2008).
[6] Keynes (1936), Chapter 24, available at http://www.marxists.org/reference/subject/economics/keynes/general-theory/ch24.htm
[7] "Financial Transaction Taxes – Who will really pay?", Re-Define policy Brief.

only to banks and not for example hedge funds, this will accelerate the trend towards financial market volume shifting away from banks.

Under the recently announced Volker rule in the United States[8], banks will no longer be allowed to engage in proprietary trading or own hedge funds. It is in fact the proprietary trading desks of banks and in house hedge funds which account for a very large share of banks' total trading volume so that when banks are forced to separate these functions the total share of banks in trading volume is likely to fall significantly. Finally, new regulatory guidelines which include a strong emphasis on standardising derivatives, clearing them through a central counterparty and trading them on exchange will also push trading volumes away from banks and towards actors such as hedge funds. This means that the initial implementation of the financial transaction tax will vary across financial markets but for a number of major markets such as equity, derivatives, commodities, high yield debt and foreign exchange will be borne increasingly by hedge funds including high frequency trading shops. Investment banks are still likely to be liable for a significant but declining share of the tax. Commercial banks are more active in certain market segments such as government debt so will pay part of the tax revenue in those segments.

The economics of the Financial Transaction Tax

As Blanchard – & al. (2010)[9] rightly emphasised: "*Financial regulation targeted the soundness of individual institutions and aimed at correcting market failures stemming from asymmetric information, limited liability, and other imperfections such as implicit or explicit government guaranties. In advanced economies, its systemic and macroeconomic implications were largely ignored*". In this respect, one should refrain for calling for a Pigouvian Transaction Tax[10]. **What must be tackled through the implementation of a Financial Transaction Tax is the speculative behaviour of financial actors.** This technical trading is destabilising in the short-term while it creates wrong information regarding economic fundamentals in the medium or long-term.

Nonetheless, one must recognise the social benefits of being able to easily trade in markets for existing assets. At the same time, enhancing the liquidity of assets also creates problems for the functioning of the economy. Fundamentally, these problems flow from the fact that highly liquid financial markets promote speculative trading practices that distort pricing, resource allocation and investment, creating imbalances between financial and real activity, and thereby contributing to macroeconomic instability. As such, **excessive speculative financial trading is a form of unproductive activity** in precisely the sense of Bhagwati's (1982)[11] notion of "*directly unproductive profit seeking*", by which he means activities that may be privately profitable but do not directly increase the flow of goods and services.

Indeed, the increase in financial transactions, and especially in derivatives trading, has been, to be fair, too high to be accounted for by hedging activities. The overall transaction volumes stems from technical trading since this practice uses data of ever higher frequencies. At the same time, technical trading seems unrelated to fundamentals. Moreover, since a general financial transaction tax makes transaction

---

[8] See also Pagliari (2010), "The Second Life of Mr. Volcker: The shifting ground in banking regulation within the United States", available at http://www.feps-europe.eu/fileadmin/downloads/political_economy/1002_FEPS_Pagliari_Volcker.pdf

[9] "Rethinking Macroeconomic Policy", IMF Staff Position Note, available at http://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf

[10] Darvas & Weizsäcker (2010), "Financial transaction tax: small is beautiful", European parliament, DG for internal policies, Policy department A: Economic and scientific policies.

[11] "Directly Unproductive Profit-Seeking Activity", *Journal of Political Economy.*

costs higher the shorter the time horizon is, it will specifically dampen technical trading. In this respect, the counter-argument stating that a financial transaction tax would limit market efficiency is just wrong. Indeed, technical trading i.e. speculation, does not play the role liberal economists expect it to play. Instead of being a tool for price discovery and risk diversification, it culminated in producing long-swings in asset prices, unrelated to their fundamentals. In this respect, it is hardly conceivable to consider that prices reflect all the information. **The global deregulation of financial markets did not allow a better and more sustainable allocation of resources, on the contrary, it lead to the regular formation of financial bubbles.** In this respect a Financial Transaction Tax represents the opportunity to curb socially useless speculative behaviours and stabilise our economic growth path.

Efficient market proponents have looked for evidence showing that increasing stock market liquidity enhances long-run economic growth (Levine & Zervos (1998))[12]. Zhu & al. (2004)[13], however, showed that no empirical evidence existed concerning the relationship between stock market liquidity and growth[14].

Moreover, if markets are persistently and unpredictably moved away from fundamentals by noise traders, it no longer becomes logical for even well-informed traders and professionals to try to trade on the basis of fundamental information. As Evans (2003)[15] showed, the 1990s U.S. stock market bubble was significantly influenced by the large growth in mutual fund trading activity. Evans' econometric findings show that the impact of these professional traders influenced equity prices to a statistically significant extent, independently of the behaviour of firms' revenue and profitability: "*As such, one might even argue that while "fundamentals" such as revenue, sales, and profitability certainly exist as valid performance standards for firms, they do not exist as the "fundamental" bases on which firms are valued—or even could be valued—in markets driven by what average opinion thinks average opinion will be. Overall then, according to these critical perspectives, thick but unregulated financial markets operate inefficiently and irrationally*"[16]. This then means that some other investments could have been carried out in a more efficient way. **Indeed, one broader effect of excessively speculative financial markets is that they tend to encourage short-term thinking among both investors and managers.** The highly liquid financial markets enable investors to sell assets at low transaction costs whenever they are dissatisfied with a firm's performance, in response, for example, to a firm's unsatisfactory quarterly return. **This creates persistent pressure for short-term success**, to which managers in turn respond by gearing their investment projects and ongoing operations to satisfying the short-term horizons of financial market investors. As a result, highly speculative financial markets tend to discount projects which require long-term nurturing before generating profitable returns.

---

[12] "Stock Markets, Banks, and Growth", *American Economic Review.*

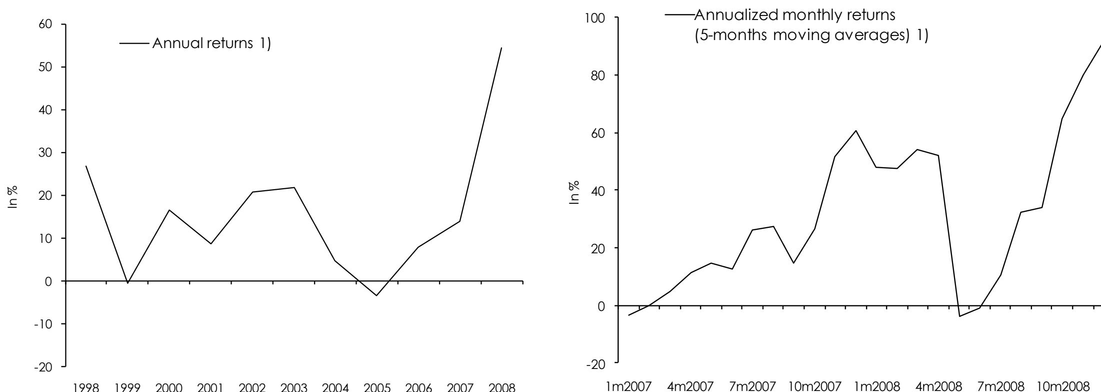
[13] "Stock Market Liquidity and Economic Growth: A Critical Appraisal of the Levine/Zervos Model", *International Review of Applied Economics.*

[14] See also Arestis & al. (2001), "Financial Development and Economics Growth: The Role of Stock Markets", *Journal of Money, Credit, and Banking.*

[15] *Why the Bubble Burst: Explaining the U.S. Stock Market, 1982-2000*, Northampton, Edward Elgar.

[16] In Pollin & al. (2003), "Securities transaction taxes for U.S. financial markets", *Eastern Economic Journal*, vol. 20, n°4. Available at http://college.holycross.edu/eej/Volume29/V29N4P527_558.pdf

In fact, as illustrated by Schulmeister & al. (2008)[17] and Schulmeister (2009)[18], traders form their price expectations according to the most recent movements, i.e., when prices move persistently up (down) they expect the respective trend to continue. Hence, they buy (sell) when prices are rising (falling), which in turn strengthens the trend. As a consequence of the "trending" of asset prices, rational investors (in the sense of profit seeking) will try to systematically exploit this non-randomness in price dynamics. **All models of "technical analysis" have in common that they attempt to exploit price trends and by doing so they reinforce the pattern of asset price dynamics as a sequence of upward and downward trends.** In the process of moving towards a new moving equilibrium[19] (Hicks (1939, 1965, 1973) the use of trend-following trading strategies will in turn increase the momentum of price movements which will then overshoot the new equilibrium values: "*The pattern of asset price dynamics as a sequence of very short-term runs which accumulate to "bull markets" or "bear markets" and, hence, to long swings around the fundamental equilibrium suggests that the cumulative effects of increasingly short-term transactions are rather destabilizing than stabilizing. The growing importance of technical trading systems in financial markets might contribute significantly to this pattern of price dynamics. This seems plausible for at least two reasons. First, technical trading strengthens and lengthens persistent price runs. Second, technical trading is increasingly based on high frequency (intraday) data*"[20]. The fall of stock prices and commodity prices has been strengthened by trend-following technical trading via taking huge short positions in the respective derivatives markets. Due to the extraordinary strength of these "bear markets", hedge funds using these models reported higher returns than ever before.



Source: www.turtletrader.com 1) Unweighted average of the returns net of fees and transaction costs of 17 hedge funds using trend-following technical trading systems.

Since a Financial Transaction Tax increases transaction costs to a greater extent the lower they are (before tax), it will generally hamper derivatives trading to a greater extent than spot trading. Since spot transactions are more long-term oriented and, hence, based to a larger extent on fundamentals than (speculative) derivatives transactions one can presume that a Financial Transaction Tax will hamper

[17] Schulmeister & al. (2008), "A General Financial Transaction Tax: Motives, Revenues, Feasibility and Effects", Österreichisches Institut für Wirtschaftsforschung, available at http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/S_2008_FINANCIAL_TRANSACTION_TAX_31819$.PDF

[18] Schulmeister (2009), "A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal", Österreichisches Institut für Wirtschaftsforschung, available at http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/WP_2009_344$.PDF

[19] The concept of "Traverse" is an Hicksian concept (*Value and Capital* (1939); *Capital and Growth* (1065); *Capital and Time* (1973)) stating that the economy is always in disequilibrium tending towards a moving equilibrium.

[20] Schulmeister (2009).

specifically short-term, non-fundamental transactions. At the same time, derivatives transactions for hedging purposes would not be affected by a low Financial Transaction Tax (between 0.1% and 0.01%) since one usually needs just one transaction for hedging an open position stemming from "real-world-transactions" (e. g., future export earnings in foreign currency). In this respect, one could clearly consider that criticisms of the implementation of a Financial Transaction Tax based on the fact that it would create distortion become null and void. As such, it is hardly conceivable to consider that prices reflect information. The global deregulation of financial markets did not allow a better and more sustainable allocation of resources.

In addition, **one should not consider that the implementation of a Financial Transaction Tax is dependent upon a general agreement at a global level**. Indeed, many countries have applied financial transaction taxes in the past and a limited number of countries continue to apply financial transaction taxes today[21]. These taxes are primarily levied on spot share trading, but in a few countries, other types of transactions, including derivatives, are taxed as well. The best-known example is the UK's stamp duty: it is a 0.5 %tax on the value of spot transactions in shares of UK companies. The tax rate on share trading is one percent in Ireland, 0.5 percent in Korea, while tax rates between 0.15% and 0.3% are applied in Australia, Switzerland, Greece, Hong Kong, India and Taiwan. The Taiwanese transaction tax is rather broad and covers various kinds of securities, including bonds and futures contracts: a 0,3% tax is applied for shares or share certificate embodying the right to shares issued by companies; 0,1% tax for corporate bonds or other securities approved by the government; a tax rate between 0,0000125% and 0,06% would apply on future contracts. However, the Taiwanese Ministry of Finance indicated that, from January 1, 2010, corporate and financial bond transactions would be exempt from the securities transaction tax for seven years. France also, had a tax rate between 0,15% and 0,30% for each transaction, with a maximum fiscal amount, but it was abandoned in January 2008. In the UK it is still possible to sell a share to a counterparty abroad so that it leaves the UK system and can thereafter change hands without being subject to UK stamp duty. However, a transaction that exits the system in that way is in effect charged at a rate of three times the normal stamp duty, thereby inoculating the system to some extent against geographic relocation of transactions.

Finally, technically, a Financial Transaction Tax can be levied easily and at very low costs. All transactions at the stock exchanges are captured by electronic platforms. A simple electronic tag would automatically transfer the tax to the relevant tax office: "*it is increasingly easy to implement. The greater centralisation and automisation of the exchanges' and banks' clearing and settlements systems – as well as the greater standardisation that will imply far more derivatives transactions settled on exchanges after the financial crisis – make the collection of such a tax much easier. It also makes avoidance of payment more difficult and less desirable, as the established settlements system would offer safety for such transactions*".

[21] See Schulmeister & al. (2008) and Darvas & Weizsäcker (2010), "Financial-transaction tax: Small is beautiful", Bruegel policy contributions, available at http://www.bruegel.org/uploads/tx_btbbreugel/pc_tobintax_080210.pdf

GLOBAL
PROGRESSIVE
FORUM

FOUNDATION FOR EUROPEAN
PROGRESSIVE STUDIES
FONDATION EUROPÉENNE
D'ÉTUDES PROGRESSISTES

Europeans for Financial Reform

Europeans for Financial Reform is a coalition of progressive forces, ranging from NGOs to trade unions, citizens, academics and progressive politicians that have come together to spearhead a campaign for real reform in our banking and financial system.

FOUNDATION FOR EUROPEAN
PROGRESSIVE STUDIES
FONDATION EUROPÉENNE
D'ÉTUDES PROGRESSISTES

GLOBAL
PROGRESSIVE
FORUM

GLOBAL
PROGRESSIVE
YOUTH
FORUM

EUROPEANGREENS.EU

REGULATE
GLOBAL FINANCE
NOW!