

FINANCIAL TRANSACTIONS TAXES: INACCESSIBLE AND EXPENSIVE

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Financial transactions taxes (FTTs) have become increasingly popular since the 2008 financial crisis. During the 2020 Democratic presidential primary race, FTTs featured prominently on the platforms of both moderate Michael Bloomberg and socialist Bernie Sanders. The likely nominee, Joe Biden, has also expressed support for an FTT, albeit without offering any details in his election platform (CNBC 2019).

FTTs are taxes on the purchase or sale of financial instruments. Some countries, such as Britain and Hong Kong, have long had a form of FTT they call “stamp duty” on shares. Yet, while still by no means exceptional, FTTs had declined in popularity during the 1990s and 2000s, as countries abolished them in a bid to make their capital markets more competitive. But the 2008 crisis prompted a revival, as some regulators called for curbing “socially useless” financial market activity and politicians looked for retribution against the financial services industry. The need to balance government budgets after the Covid-19 pandemic may give these efforts new vigor in many countries.

Some politicians advocate FTTs as a progressive revenue-raising measure to help taxpayers “get even” with financial institutions that benefited from their support in the past. But although some economists argue that well-designed FTTs can serve to deter socially

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harmful financial activity, even they tend to regard FTTs as a relatively inefficient way to raise revenue because of the large behavioral changes they cause. And despite their theoretical usefulness as a behavioral tax, actual instances in which FTTs might be desirable have been fewer than proponents claimed.

Theoretical Case for FTTs

In his *General Theory of Employment, Interest, and Money*, John Maynard Keynes advocated for “a substantial Government transfer tax on all [investment market] transactions . . . , with a view to mitigating the predominance of speculation over enterprise in the United States” (Keynes [1936] 1965: 160). He worried that wider access to stock and bond markets thanks to innovation and affluence, and the growing liquidity of financial instruments, would make short-term speculation—“the activity of forecasting the psychology of the market”—predominant over long-term investment, or enterprise—“the activity of forecasting the prospective yield of assets over their whole life” (ibid.: 158). In proposing such a tax for the United States, Keynes had the British model in mind, noting approvingly that it made the London stock market “inaccessible and very expensive” to the ordinary investor (ibid.: 159).

Keynes’s proposal, on which he didn’t elaborate further, and the U.S. experience notwithstanding, the academic case for FTTs was first made in earnest by James Tobin in a 1972 lecture and a subsequent article, “A Proposal for International Monetary Reform” (Tobin 1978). What motivated Tobin was the breakdown of the Bretton Woods regime, with a consequent dramatic increase in cross-border capital movements as investors responded to (and helped amplify) fluctuations in exchange and interest rates. That breakdown “severely restrict[ed] the ability of central banks and governments to pursue monetary and fiscal policies appropriate to their internal economies” (ibid.: 154).

To preserve domestic policy autonomy, Tobin called for “an internationally uniform tax on all spot conversions of one currency into another,” the goal being to “particularly deter short-term financial round-trip excursions into another currency” (ibid.: 155). Because he was skeptical that such moves “by traders in the game of guessing what other traders are going to think” could guide economies toward efficiency, Tobin viewed short-term trading as harmful on the margin.

If that was true, a “Tobin tax,” as the proposal has come to be known, could restore trading to its socially beneficial level—at least in the friction-free setting of theoretical welfare economics.

As U.S. and international financial markets liberalized in the 1980s, other academic economists joined Tobin in his advocacy for an FTT. Harvard’s Lawrence Summers, who would become Secretary of the Treasury during the Clinton administration, coauthored a 1989 article making “a cautious case” for a tax on securities transactions (Summers and Summers 1989). His argument, similar to Tobin’s, was that short-term trading causes volatility without bringing stock prices closer to their fundamental (i.e., true) values (*ibid.*: 170–71). He saw further evidence of a “market failure” in the legions of talented graduates then flocking into the securities business, and the vast resources devoted to investment research relative to corporate profits (*ibid.*: 174). Summers also noted that many countries with developed financial markets, such as Britain, Japan, the Netherlands, and Switzerland, had an FTT (*ibid.*: 177).

Not all economists are enthusiastic about FTTs, though. In his review of the British tax system, James Mirrlees (2011) argued against transactions taxes, including FTTs. He contended that, while “their continued use reflects the ease with which such taxes can be levied, . . . they are unattractive from an economic point of view” (*ibid.*: 151). By discouraging mutually beneficial transactions, FTTs hinder the movement of assets into the hands of those who value them most, creating inefficiency. Nor are they obviously progressive, falling “arbitrarily heavily on those who, for whatever reason, engage in more transactions” (*ibid.*). Mirrlees also said those who believe FTTs punish financial intermediaries confuse legal with economic incidence. Much as proponents might hope otherwise, FTTs fall primarily on savers in the form of lower returns.

Decline and Rebirth of FTTs

At the time Keynes was writing, the United States already levied an excise tax on the issuance and subsequent transfer of stock (Keightley 2010: 21). This tax remained in place for more than 50 years before Congress repealed it in 1965. The state of New York, home to America’s largest capital market, has also taxed stock transfers since 1905, but taxpayers have been able to claim a refund since 1981 (Burman et al. 2015: 6). Besides these two taxes, the

Securities and Exchange Commission levies a small *ad valorem* fee on most securities transactions, revenues from which it uses to fund its operations. Currently, the rate is \$22.10 per million dollars, or 0.00221 percent (SEC 2020).

In the late 1980s, as countries throughout the world sought to make their capital markets internationally competitive, FTTs entered a period of decline (Matheson 2011: 4). Whereas Summers reported in 1989 that France, (West) Germany, Italy, and Japan imposed FTTs, by 2010 all of them had abolished or, in Italy's case, substantially reduced them (*ibid.*: 9). Sweden's experience with an FTT in the late 1980s offered an unusually stark illustration of its perils: In its seven-year existence, during which the range of securities to which the tax applied only expanded, the Swedish FTT caused share trading volume to decline by 30 percent, and bond trading volume by 85 percent (Wiberg 2013). Nor did Japan's FTT, which only expired in 1999, prevent a massive stock boom-and-bust between 1985 and 1990 (Stone and Ziemba 1993).

But FTTs' trend of decline reversed with the 2007–2009 financial crisis. To some regulators, the extreme volatility of financial markets during the crisis and the high cost of taxpayer-backed financial institution bailouts were evidence that the sector had grown too large. Adair Turner, then-chairman of UK regulator the Financial Services Authority, said in a September 2009 speech that “not all financial innovation, not all trading plays a useful role . . . more trading and more financial innovation can under some circumstances create harmful volatility” (Turner 2009). In a 2010 speech, Bank of England chief economist Andy Haldane implied that liquidity and information in financial markets might have become “too much of a good thing” (Haldane 2010: 7).

Although they echoed older arguments of excess volatility as a market failure, Turner's and Haldane's remarks did not persuade the British government to raise or expand the scope of stamp duty on shares. But other European countries did move to introduce or reinstate FTTs. Having abolished its earlier FTT in 2009, France imposed a new one, at a rate of 0.2 percent, which increased to 0.3 percent in 2017, on transactions in the stock of French-headquartered companies with a market value greater than €1 billion (BYN Mellon: 6). Italy raised its FTT, as did Finland and Belgium (*ibid.*: 5–8). Finally, earlier this year Spain passed a tax on stock transactions in Spanish-listed firms with a market cap above

€1 billion (Garcia and Blanco 2020). At the time, there were 64 companies whose stock would have been subject to this FTT, but the economic impact of Covid-19 has since caused a more than 25 percent drop in the value of Spanish equities and reduced the tax base to 57 firms.¹

The most ambitious, and perhaps for that reason still unadopted, proposal came from the European Commission in 2011 (see European Commission 2011a). It would have taxed stock and bond transactions between financial institutions in which at least one party was located in the EU at a rate of 0.1 percent, and derivatives contracts at a rate of 0.01 percent of notional value (European Commission 2011b). But financial centers such as the United Kingdom and Luxembourg, besides fearing for their competitive position, had no interest in sharing their tax base with other countries. Owing to their opposition, the EC plan became one for just eleven—later ten—EU members (European Commission 2013). But even that shrunken version failed to take off, leaving member countries to set up their own individual FTTs. Recently, France and Germany have attempted to revive the EC proposal, albeit with a much narrower base (Asen and Miller 2019).

Tax Revenue from FTTs

Experience from around the world presents two disappointing trends for FTT proponents as far as tax revenues are concerned. Not only do FTTs tend to raise very little revenue compared with other taxes, but they consistently raise less than forecast, mainly because trading activity inevitably moves to avoid the tax.

Matheson (2011: 10) reports that France, Germany, Japan, and Italy never managed to raise more than 0.2 percent of GDP with their FTTs in the period between 1990 and 2010—and they usually raised much less than that. With total tax revenue in these countries equivalent to between 25 and 45 percent of GDP during that period, FTTs amounted at most to 0.44 percent of the tax take. Postcrisis FTTs have not improved on this performance: France's post-2012 tax raises around 0.03 percent of GDP (European Commission n.d.), whereas the Spanish government expected its new FTT to bring in

¹Author's calculations using Spanish stock market data.

just under 0.07 percent of Spanish GDP—a figure others thought too high even before Covid-19 hit (Page and Monzón 2020).

Even in less tumultuous times, FTTs have dashed their proponents' revenue-raising hopes. The dramatically adverse impact of Sweden's FTT on stock and bond trading in that country has already been mentioned (see also Umlauf 1993). But recent French and Italian FTTs also undershot official revenue projections by 50 percent and 80 percent, respectively (Swanson 2020: 6–7). Like in Sweden, the main reason for the shortfall seems to have been a rapid shrinking of the tax base. In countries that are only small or midsize financial centers, neither listed companies nor traders have an overwhelming incentive to stay put after the introduction of an FTT. In a world of open capital markets, firms can easily list in foreign untaxed venues, and traders can shift activity into jurisdictions unencumbered by transactions taxes.

FTTs and the “Socially Optimal” Amount of Trading

Even if FTTs are not particularly useful for raising revenue, they may still be desirable in order to reduce harmful short-term trading. Just as Keynes worried in the 1930s that reductions in transactions costs had caused a predominance of speculation over enterprise, some present-day market observers are concerned that, by lowering the cost of trading, technology has drawn in new participants whose short-term orientation may have destabilizing consequences (Haldane 2010: 10–11). Often, they point the finger at high-frequency traders (HFTs), who use fast computer infrastructure and algorithmic trading to get ahead of other orders, profiting from the price difference (Bernstein 2015).

Reports that HFTs recently accounted for as much as 50 percent of equities trading volume, whereas long-term “fundamental” traders accounted for just 10 percent, might seem like evidence that we are past the point Keynes warned against, when speculation would overtake enterprise (CNBC 2017). But it is not obvious that even HFTs make financial markets less efficient. While some studies have found that they increase stock volatility and drive prices away from fundamentals (Zhang 2010), others have reached the opposite conclusion (Brogaard 2010). Still others argue the impact depends on the type of HFT, “passive” or “aggressive” (Burman et al. 2015: 22; see also Wang and Yau 2012: 4). Nor is it clear that FTTs serve to reduce any

adverse impact from trading. They do tend to decrease market liquidity and trading volume, as their proponents intend (Burman et al. 2015: 24). But their impact on volatility is ambiguous, with many studies finding no or even a positive relationship between FTTs and asset price volatility (Šramko 2015: 56; Keightley 2019: 3; Wang and Yau 2012: 6–7).

Even taxes on the most short-term-oriented of traders have ambiguous effects. For example, in addition to its main FTT, France introduced a 0.01 percent tax on cancelled or modified orders within a short time period—clearly aiming at high frequency trading.² But the tax appears to have raised no revenue and had no impact on volatility or bid-ask spreads. Yet it did reduce trading volumes and made markets less efficient by causing prices to deviate from fundamentals (Veryzhenko et al. 2017). Contrary to proponents’ assertions, it is not obvious that the market participants who first exit after an FTT’s introduction are those who foment volatility (Eichengreen 2012).

What about the “Success Stories”?

While the recent experience of FTTs has been decidedly mixed, it is worth asking whether some prominent financial centers, such as Britain and Hong Kong, might have managed to make a success of this type of tax. Britain has in fact levied its FTT (stamp duty on shares) since the late 17th century, with no obvious adverse impact on its status as a global trading hub (Burman et al. 2015: 8).

Still, stamp duty’s longevity on its own tells us nothing about whether a jurisdiction’s success occurred thanks to, regardless of, or in spite of it. As it happens, the British rate of stamp duty dropped from 2 percent to 0.5 percent in the 1980s, just before the City of London once again became a global financial center after a period of retrenchment (Bond, Hawkins, and Klemm 2004: 4). Furthermore, since 1997 financial intermediaries have been exempt, blunting stamp duty’s impact on London’s attractiveness to traders and market-makers, but also weakening any moderating effect on “excessive” trading (Oxera 2007: 3). There is also some evidence of stamp duty

²République Française, Code Général des Impôts, Section XX bis: Taxe sur les Opérations à Haute Fréquence.

avoidance through the use of derivatives, known in the UK as “contracts for difference” (*ibid.*: 23). Still, the tax is not without impact, with studies of rate-cut announcements finding that they increase the prices of frequently traded shares most (Bond, Hawkins, and Klemm 2004: 18).

For its part, Hong Kong imposes stamp duty on shares at a rate of 0.2 percent, but it has no capital gains or dividend taxation, making share ownership in the territory more attractive than elsewhere (KPMG 2018: 3, 6). In Hong Kong’s case as well as Britain’s, it seems other public policies—such as open capital markets, a stable and transparent legal system, and moderate taxation and regulation—work to compensate for the adverse impact of FTTs. At any rate, their example offers little hope that FTTs will not drive financial activity away from other jurisdictions, even if their impact on volatility and asset price behavior is unclear.

Implications for the United States

Because much of the evidence on FTTs concerns smaller financial centers, it might be thought less relevant for the United States, the world’s biggest capital market. Even with an FTT, U.S.-listed firms might find it unattractive to move if it meant losing access to this deep pool of capital. Traders could also have a difficult time avoiding the tax if it applied to a broad base, covering all transactions with at least one U.S.-based party (Miller and Tyger 2020: 3). This would imply a less elastic revenue, and potentially also a smaller decline in beneficial trading, than has been observed elsewhere.

Some expert estimates do suggest that an FTT would raise more revenue relative to GDP in the United States than in other countries. The Congressional Budget Office, for example, expects that a broad FTT at a rate of 0.1 percent on most stocks and bonds, and on payments actually made in derivatives contracts, would collect \$776.7 billion over ten years (CBO 2018). That would be equivalent to 0.35 percent of 2019 U.S. GDP, more than most other countries have managed to raise, although their FTTs typically apply to a narrower base than the proposal the CBO evaluated.

These revenue estimates are uncertain, hinging not just on the U.S. economy’s long-term performance, but also on the elasticity of trading volume with respect to the tax rate. Matheson (2011: 16–17) reports high elasticities for stock and futures markets from a range of

countries and assets, including S&P 500 futures contracts. They suggest activity would substantially decline after the introduction of an FTT. Nor is it obvious that such a tax would end up applying to as broad a base as the CBO anticipates. On the contrary, there would be pressure to exempt assets deemed low-risk, such as U.S. Treasury bonds, and to reimburse lower-income investors, as Senator Sanders' bill provides for (Miller and Tyger 2020: 5). Exemptions like these would not only narrow the tax base, but also increase opportunities for avoidance.

Still, even if its revenue-raising prospects were brighter than elsewhere, a U.S. FTT would suffer from similar problems with such taxes in other jurisdictions. By making short-term trading more expensive, it would probably reduce trading volume and liquidity. But whether this impact would be stabilizing is unclear, as the short-term traders the FTT would penalize could be informed arbitrageurs and market-makers, or momentum-driven speculators. The tax could also disproportionately raise the cost of capital for smaller listed firms, at a time when many of them may be looking to raise investor funds to weather the ongoing recession.

Conclusion

Despite their recent comeback, the case for FTTs is no stronger today than it was in the early 2000s, when they were in a slow but steady decline. FTTs raise little revenue, no matter the optimistic promises of the politicians who advocate them. Nor do FTTs seem particularly apt for the task some economists envisage for them—namely, as instruments to reduce volatility in financial markets by driving out “socially useless” traders with a short-term orientation. Betting on an FTT seems particularly risky during the present, pandemic-induced economic crisis, as it would raise the cost of capital to businesses already struggling with uncertainty and weak demand. And if the goal is to punish financial firms or reduce that sector's size, an FTT is a poor instrument for achieving it.

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