



FINANCIAL TRANSACTION TAXES

Study by Profs. Stephany Griffith-Jones and Avinash Persaud

SUMMARY

1) The impact of the FTT on growth

In their impact assessment (IA) the Commission came up with an estimate of a total long run loss of GDP of -0.53% as a result of the FTT. The authors who did the original modelling recently updated the model used for the Commission's IA. This revised model gives a far lower estimate for the impact of an FTT on the level of GDP, equal to only -0.2%. However, the Commission estimates are based on a model that even in its revised form is incomplete and excludes some of the crucial positive impacts such as the reduction of systemic risk (thus the probability of further crises), the expansion of total aggregate demand for consumption, and the boost of the European real economy through fiscal consolidation. The positive effects not considered by the Commission are likely to more than compensate the negative effects. Therefore, the impact of introducing an FTT on level of GDP, all things considered, is likely to be positive, at around +0.25% as a minimum. The analysis suggests that the overall positive impact on GDP level could be higher, as a number of channels are identified through which the FTT could encourage higher level of GDP.

2) Who Pays? Pensioners?

Commentators sometimes argue that customers will ultimately pay the tax, which is correct, but not all consumers of financial products will pay equally: long-term investors like pension funds and insurance companies will pay least and short-term speculators like hedge funds or High Frequency Traders (HFT) will pay most. The average pension fund holds a stock on average for 2 years. If we assume then that there is a 0.1% transaction tax for buying and selling and every two years a pension fund has bought and sold 50% of its portfolio, it would pay transaction taxes equivalent to 0.05%. A High Frequency Trader will turn over its entire portfolio in a day, would pay transaction taxes of 50% per year, or hundreds of times more than an average pension fund. Therefore, high-frequency trading will most likely fall off dramatically. This is one of the most attractive features of the FTT: creating disincentives for short-term speculation, as opposed to long-term investment.

3) Technical issues

How to minimise tax avoidance and evasion:

By turning the undesired activity from a high return, low risk venture, into a low return, high risk one. In the case of FTT, this means a light tax rate to make avoidance a low-return venture, and enforcing heavy consequences of non-compliance, to make it risky.

The residence vs. issuer principle:

The Commission's proposal foresees that the FTT would be collected on the basis of the residence principle i.e. depending on where the investors are based, which is fraught with avoidance issues, according to the study. One way of covering this leak would be to follow the example of the "stamp taxes" which are paid by anyone - residents and non-residents, corporates or individuals - on the transfer of ownership of a security issued by an institution of a country. The main advantage of stamp duties is that a non-taxed and therefore non-stamped financial transaction cannot be legally enforced, non-enforceability of contract being a very high consequence (legal uncertainty, higher counter party risk, cost for higher capital adequacy requirements). The study finds that the Commission's model could be integrated into already existing mechanisms with automatic electronic stamping of certificates established by payment settlement agents (for derivatives the Regulation on clearing of OTC derivatives will ensure that even OTC derivative transactions will be traceable), combined with a wider FTT on foreign securities paid by residents in their annual tax declaration of investment activity.

Optimal size of the FTT:

To reduce substitution, not penalise one financial instrument over another and to maximise tax collection while minimising tax rates, the tax should be collected across all financial instruments. Analysis of different elasticities suggests that a reasonable range, erring on the side of caution, of the ratio of the tax in equities, bonds and short-dated bonds should be five to one for equities to long-dated bonds, and 2 to 1 from long-dated bonds to short-dated bonds.

L. Fossati

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