

Can a FTT make the Financial Sector function more efficiently?

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EU-Commission uses a General Equilibrium Model without a (realistic) financial sector

FTT is treated as an increase in corporate tax of 0,75 % = €90 bn

In this case you know the outcome in beforehand, because of the model:

→ GDP will fall according to calculations by – 1,76 pct (or - 0.53 pct), s. 52

Why?

Because higher corporate tax → smaller real investment → reduced GDP

This calculation is not relevant, because a General Equilibrium Models always give a negative judgment of higher taxes

The EU-Commission uses a questionable general equilibrium models, where

1. No realistic financial sector is modeled
2. Two period, Perfect foresight model- actors know the future except for random noise, which cancels out in equilibrium
3. Savings are transformed into productive investments.
4. Full employment

Instead we have to model reality

We live, unfortunately, in a real world where:

- Unemployment is persistent
 - The Financial sector is unstable due to gearing and short term profit-horizon
 - Financial savings is also used for speculative purposes, which drives financial markets astray and causes abrupt adjustments
- Hence, general equilibrium models are of little

use

We have to put forward realistic economic theory and models

John Maynard Keynes, 1936:

- *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', chapter 12*

Keynes continues:

- *It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges*
- *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, Chapter 12*

Hyman Minsky, 1983

Financial instability hypothesis:

Instability in the financial markets occurs, when

1. an increasing number of agents prolong the past asset price development into short term projections of the future price development – herd behaviour, limited foresight, animal spirit (Fisher and Akerlof, 2009)
2. Speculative positions can be (too) cheaply hold and corrected
3. And bank behaviour is deregulated – unlimited bank credit

James Tobins original proposal, 1979

The basic problems are these. Goods and labor move, in response to international price signals, much more sluggishly than fluid funds. Prices in goods and labor markets move much more sluggishly, in response to excess supply or demand, than the prices of financial assets, including exchange rates.

Tobin continues

future, i.e., the twentieth century. I therefore regretfully recommend the second, and my proposal is to throw some sand in the wheels of our excessively efficient international money markets.

**How to make the financial sector
more efficient!**

**Concentrate on the secondary markets, on
short term positions and derivatives, which
are not meant to finance real activities.**

**Short term transactions have mainly a
speculative purposes, i.e. short term gains
detached from real activity**

Stephan Schulmeister's, 2011 observations

Observation 6: Exchange rates, stock prices or commodity prices fluctuate in a sequence of upward trends ("bull markets") and downward trends ("bear markets"), each lasting several years in most cases. Hence, all important asset prices fluctuate in irregular cycles

Observation 7: The volume of financial transactions in the global economy was 67.4 times higher than nominal world GDP in 2010, in 1990 this ratio amounted to "only" 15.3 (the financial crises caused trading volume to decline for the first time since the 1970s). The

Observation 10: Financial market activities are highly concentrated on the most advanced economies. Hence, in Europe the volume of financial transactions is roughly 115 times higher than nominal GDP, in North America it is 90 times higher.

The aim of financial stability

1. Secure a more smooth financing of real business activities (bank regulation) and of real investment (pension funds and investment banks) – with less disruptions from financial market activities.
2. Less speculators is to be preferred make prices deviate less from fundamentals – increases policy effectiveness

Financial regulation – you can tax them or forbid them

Hence, there are many similarities to environmental regulation. You should combine a number of instruments – don't look for a panacea.

Glass-Steagall Act in the US, 1933 – dividing banks into different categories and limited their activities
Keynes solution & Bretton Woods agreement limiting speculative international capital

Did these regulations prevent growth and high employment in the 1950s and 1960s?

Deregulation of the financial sector
started in 1980s

(Big Bang in London 1986)

Increasing frequency and intensity of
financial crises since 1987

Japan

US

South East Asia

Europe

How to practice a Financial Transaction Tax?

1. Not difficult to control: All financial transactions are registered
2. Any financial capital traded where either the buyer or seller is a European domiciled has to pay the tax
3. In any case the financial capital should be taxed, when it leaves Europe and when it comes back

Main principle is that transactions in secondary financial markets and in derivatives (incl. CDS) should pay a FTT – does not harm real business

– I would recommend an equal tax on all financial activity to avoid a bias.

Concluding remarks

- FTT will reduce speculation and financial instability
- On the other hand the impact on GDP will be small, but positive, due to less instability
- Employment will be reorganized, less people sitting in front of computer screens, more people creating real value
- The tax incidence will be shared by the traders and the speculators (average trading fee: 0,6 pct)
- The revenue could be recycled by lowering other taxes

All in all – do not expect miracles, but only that the real economy will work a little better