Why A Financial Transaction Tax Will Not Hurt Anybody

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ABSTRACT

A financial transaction tax (FTT, also known as Tobin Tax) has been discussed extensively at least since the latest financial crisis. Liberal economists condemn it as hurting the economy as "every tax does." Social economists praise it for taking from the rich and irresponsible financial moguls. Both argue that it is necessary to introduce it worldwide or at least with a large economic region as e.g. the EU. (Else trading will go to tax free countries)

We show that neither side is right. We distinguish between value creating financial transaction (rare) and financial transaction using market price fluctuations (almost all). The later ones are identical to gambling. They do not produce any (conserved) value. These kinds of transactions may hurt individuals or even entire nations in the same way gambling does. Therefore there should be a tax to minimize it like a tax on alcohol or tobacco.

A Tobin tax will reduce the number of not value creating financial transactions dramatically. Because they produce no value vanishing will not have any effect on the economy. Even if the non-value creating financial transactions will go to Tobin tax free countries, there will be no negative economic effect.

INTRODUCTION

The introduction of a financial transaction tax (FTT) also called a Tobin (1978) tax, named after the Nobel laureate James Tobin, is wildly discussed[1]. Some see it dampening growth while others see it as (quite literally) payback from those who caused the recent financial crisis and thus sometimes called the tax a Robin Hood tax. Others take a more pragmatic stance, estimating the potential revenue of such a tax and how that could pay for the damages caused by the financial crisis. For another point of view one might take a look with the methods of economics. From micro economics we know that taxes reduce output. More precisely, taxes reduce the consumption of the taxed goods or services. Governments have recognized this mechanism as they not only use taxes to generate revenue, they also use it to influence behavior. E. g. , the Alcopop tax in Germany and Australia, which is a tax on mixed alcoholic drinks, was introduced as a typical sin tax to lower consumption as these beverages particularly appeal to a younger audience.

So besides looking at FTT as a revenue source (and to recover damages) one could look at it as a mechanism to influence behavior. In particular, it can be used to reduce non-value-adding activities. As shown by Klinkova (2013), financial transactions are identical to non-value-creating gambling. And it is even worse for two reasons. Firstly, financial transactions may lead to crises and the necessity of a costly bailout. Secondly, an albeit small amount of financial transactions is useful and absolutely necessary for the economy. But the non-value-creating financial transactions distort prices and therefore hurt the real economy. To argue this case, first, the common definition of value is reconsidered. We also present some general facts about today's financial markets. Thirdly, the general idea of an FTT and common arguments for and against the introduction of such a tax are discussed. Finally, we will argue that the implementation of a FTT even locally, will be beneficial in the long-run.

[1] Tobin initially suggested the tax for only foreign exchange transactions

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MARKET PRICES VERSUS VALUE

Given the many definitions and quotes about what constitutes value one can easily see, that there is no basic universal definition and the difference to other things such as price. We all have some idea about value which lets us function in the real world, but it is hard to pinpoint a precise definition based on that notion let alone come up with any one measurement method that experts can agree on. In his shareholder letter Warren Buffet wrote: "Price is what you pay; value is what you get." While this quote makes obvious that the price of an item is not its value, it does not get us any closer to a practical definition. Accounting, unlike many other applications (such as grocery shopping), requires workable agreeable definitions in order to present the value of assets and liabilities in financial statements. The concept of conservatism and for its verifiability historical cost, i. e. the price at a past date, was used as a proxy for value. Standard setters have recognized the shortcomings of this method and have introduced extensive guidelines (SFAS 157, IFRS 13) on the measurement of (fair) value. Still, given the lessons from the latest financial crisis, even this measurement is neither easy to implement, nor perfect. The complete effect on accounting value can be found in Dziergwa (2013).

Grabinski (2004) and Appel (2011) took a different approach to solve this problem. Physics teaches us that certain quantities are conserved, i. e. energy is neither created nor destroyed, however the amount in a system can change when there is some other change happening. Grabinski (2004) and later Appel (2011) applied this idea to the business world. Conserved value can be created or destroyed, however this cannot happen spontaneously, there always is another effect in the physical world. Let's consider this for a moment. We will start with the destruction of value. If there is a natural disaster and one of three production plants of a company is destroyed, clearly value has decreased. If simply the stock price drops, without any changes to the company, the value has not changed. In this example one can already see the disconnect between price and value as also stated by Buffet. The creation of value can also take place e. g. when somebody develops a better production process or discovers a new application for existing technology. One could argue that this value was already there before, as in the potential the person had. Depending on what one considers the status quo, one can create value by applying a person's skills and knowledge to create something of value.

Now that we have discussed how conserved value behaves we still need to review what conserved value is. Something is valuable if it has a use. This can be straight forward, as a car getting me from point A to point B, or more subtle such as the boosts to my self-esteem (cf. Maslow's hierarchy of needs) I get from driving a Porsche, with the limitation that these benefits are conserved. My joy in riding a gas guzzler will change, when I do not get the desired reactions from my surroundings. This can happen when the public opinion changes due to new discoveries about the ecological effects of our actions. One can see, that the value depends on the use of the asset, i.e. I can waste value-in-use just the same as I can destroy value by destroying a physical object. A very extensive and complete discussion can be found in Appel (2012).

In the previous examples it is very clear that market prices typically do not coincide with values. For many items though prices are a fairly accurate approximation but they are exceptionally bad for financial products.

FINANCIAL MARKETS AND FINANCIAL TRANSACTION TAXES

First of all, we apply the before mentioned definition of value to activities in financial markets. Financial markets are a system where investors can spend additional cash they not currently need while issuers can get financing for their business both in the form of ownership claims and debt. These kind of transactions are rarely short term. Stock and debt issuance take a lot of effort and time, and there are not a quick financing alternative. Investing on the other hand can be short-term (though not on a daily basis or even within milliseconds), though companies typically manage their cash needs with less risky investments (GAAP does not even recognize an instrument as a cash equivalent, if it is too risky). Further, companies can conduct business transactions such as buying commodities, foreign exchange and hedging risks resulting from their business activities. All these add value (assuming that the business activities add value). Finally, there are strategic investments which can add value, such as the partial ownership of a supplier. Any other transactions that have no business need, do not add value.

In the equity, commodity and foreign exchange (FX) market, the ownership of the asset transfers in exchange for a cash payment. If the market price of the asset keeps rising, everybody seems to be making a profit and is better off. A continuous increase in prices leads to ever apparently rising wealth. When looking at the underlying company (or claim) though, there might not have been any changes at all, and thus the apparent increase in wealth is not backed by any real economic changes and thus no additional value.

One may wonder now about how some people make a fortune trading stocks (speculatively) when overall there was no change in the economy. This is quite simple: The creation of additional money without any economic backing is called inflation. It has been a tool in expropriating people many times. When everybody still has the same amount of money but for a few people, who have a very large additional amount of money, everybody else's money is slightly worth less and the collective wealth is redistributed. When suddenly the stock market bubble crashes, whoever is holding the stock at the moment (like in the card game old maid) loses. Overall, the real economy and the production of goods and services has not changed, only the distribution of wealth has been altered.

Now there are also other traders in financial market that make a profit. There are a number of companies employing high frequency trading (HFT). HFT is trading in and out of positions at very short intervals while exploiting minimal statistical arbitrage opportunities. In essence, they buy stock and sell it at a slightly higher price shortly after the initial purchase. The profit, if not for the HFT traders, would be split in some proportion between the initial seller and the final buyer, and thus again there is a redistribution of wealth. In other words, HFT is a legal form of salami slicing or penny shaving.

Many derivatives are cash settled; depending on some underlying value (financial or otherwise) a certain amount of cash changes hands, thus making the transaction a zero-sum-game. Unless there is a value-creating reason (e. g. hedging) there is yet again just a redistribution of wealth.

Initially Tobin suggested a tax on foreign exchange transactions. The FTT suggested not only in Europe but also the US though are not limited to one financial product. They propose a fixed percentage to be paid on most financial transactions. The rate of the tax depends on the type of the transaction; some are exempt (e. g. depositing money in a bank account) for the others the tax rate depends on the traded product.

Even some politicians in the UK, a major financial center, have called for a FTT. The industry has lobbied against this introduction, pointing out that investors and pensioners would pay the price. As mentioned before, we can ask, how often does a pension fund need to trade and how often do investors, who do not speculate on short-term fluctuation, will have to pay the proposed tax? Probably not that often. Further, the percentage charges as a tax is particularly small in comparison with typical management fees that are charged. Also, other products and services are subject to VAT, with the financial markets as an exception.

There have been some experiences with FTT in various forms in past. The UK and Hong Kong both require a stamp duty to be paid on certain transactions (not limited to financial markets). Sweden has introduced a tax in 1984. After a few adjustments to the tax they abandoned the idea in 1991. The US also has experience with FTT both on a local and a federal level. One of the main lessons is that financial transaction taxes can influence the before mentioned behaviors and mechanisms. The case of Sweden has shown (cf. Wiberg 2013, Umlauf 1993) and basic economics dictate that trading volume will decrease due to the additional cost. Wiberg (2013) notes the *large* drop of trades by 30 % - 60 % in equities, 85 % in bond trades and even up to 95 % in bond derivatives. The reduction was not only caused by reduced speculation but also the result of relocation to other trading locations and providers.

The data from Sweden gives some indication about a potential drop in trading volume. The way trading works though has changed with technology in the last 30 years. Today industry estimates (Narang 2010, McEachern Gibbs 2009) for the share of HFT range from 30 % - 70 %. This estimate does not include other short-term speculative trading with overnight exposure. Other transactions figures include the notional of foreign exchange transactions of 4.7 tn USD per day in October 2011. The gross global product for the same year is estimated at 80.6 tn per year. The amount exceeds global economic output by a factor of 14.

CONCLUSIONS

The introduction of a financial transaction tax will lead to a lover turnover in financial markets. Most of this turnover was never value-creating to begin with. This non-value adding activity is not only not benefiting the economy, it also gives rise to a number of problems (cf. Appel 2011, Klinkova 2013) such as bubbles and financial crises including a large number of side effects. This is the main reason why a financial transaction tax is necessary; the fact that it is an additional revenue source for governments is just a bonus. Avoiding FTT by going to a tax free country does not cause any problem. Then the other country has to deal with all the corresponding problems. It is however necessary to tax financial transactions done in other countries if the transaction is included in the local financial reporting.

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