

# EUROMONEY

## Tobin tax would raise volatility, not revenue

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**EU's proposed financial transaction tax is unlikely to produce much revenue and may have harmful effects on market volatility, experts say**

The EU's proposed financial transaction tax, nick named the Tobin tax, is unlikely to generate much revenue and may have harmful effects on market volatility, according to a number of analysts. Critics also point out that the tax would have to be implemented globally to be successful and avoid regulatory arbitrage.

"Such a tax is likely to have a negative impact for exchanges – trading value will go down. If a transfer tax is implemented, then to be effective it will need to have a wide ambit or banks will try to avoid it. It is particularly important for the UK to be part of the scheme," says Olaf Kayser, an analyst at Landesbank Baden-Württemberg.

José Manuel Barroso proposed the tax on financial transactions to help rebuild public finances across the eurozone, calling the implementation of such a tax "a question of fairness."

"It is time for the financial sector to make a contribution back to society," said Barroso.

The tax would levy a percentage on all financial transactions conducted in the European Union. It has received some noisy public support.

Barroso stated that the proposed tax would raise around €55 billion a year in revenue by levying 0.1% on stock and bond transfers and 0.01% on derivatives. A European Commission study found that such a tax could dent EU GDP by as much as 1.76%.

Investors reacted poorly to French-German talks regarding a tax in August, with NYSE Euronext dropping some 8% in response. Such taxes often draw criticism for their potential to reduce profits in the banking sector and that they might also encourage financial institutions to divert business away from jurisdictions that apply them.

A similar tax was implemented in Sweden in 1984 with disappointing results. Tax revenues were far lower than had been expected (on average the revenue was less than 5% of the projections) and the tax caused a noticeable decline in trading volumes. The tax was abolished in 1991, deemed a failure.

The Swedish experience suggests that a financial transaction tax may not have the revenue raising effect that Barroso hopes. Indeed, new research put out today by Credit Suisse indicates that the long-term annual decline in GDP that will result from the tax will amount to €62 billion – about €5 billion more than it is projected to raise.

According to Sam Bowman – head of research at free-market think-tank The Adam Smith Institute – to think of a Tobin tax as a revenue increasing measure is to misunderstand its purpose.

"James Tobin always rejected the money-raising efficacy of a financial transaction tax. Such taxes will cause huge reductions in trade volume, meaning they are not an effecting revenue creating measure," says Bowman.

Rather, Tobin's idea was to use such a tax on FX trades to reduce the level of volatility in the market. Bowman also disputes the efficacy of a transaction tax in keeping volatility low, saying that such a tax is more likely to increase market volatility.

"Whenever you make a spot trade, you tend towards a fundamental, real-world price. You 'win' in the trade by getting closet towards that price. The more trades that are conducted, the more accurate a representation you get of the actual real-world value of a commodity being traded. A transaction tax reduces the number of transactions being made, therefore meaning that you get a less accurate representation of its value, leading to increased volatility."

If Bowman's analysis is accurate, then there is no logical reason to implement a financial transactions tax. It will harm bank profitability and cause financial institutions to move their operations to other jurisdictions, while simultaneously increasing the level of volatility in the market.

However, not all experts agree.

Christophe Nijdam, an analyst at AlphaValue, is in favour of a transaction tax. He argues that only high-frequency traders would feel the sting.

"The institutions whose profitability will be most affected are those dealing in high frequency trading. Even if the tax encourages businesses to move away from the EU – which I find unlikely, we have yet to see such an exodus from London to Switzerland despite more favourable Swiss tax laws – this may not be the end of the world. HFT can bring negative externalities to the general public, having the potential to increase systemic risk," says Nijdam.

In contrast, Credit Suisse estimates around 40% of London Stock Exchange volume derives from HFT transactions.

The consensus is that HFTs will be the hardest hit, likely meaning a damaging effect on market volatility and transaction volume – causing the reality of revenue to undershoot the estimate, just as in Sweden.

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