

# THE STRUGGLE OVER THE FINANCIAL TRANSACTIONS TAX

## A POLITICO-ECONOMIC FARCE<sup>1</sup>

**Stephan Schulmeister**

*WIFO*

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The struggle over the FTT has developed in three phases. In the first phase (2009 to 2011) the supporters of the tax went on the offensive, supported by the “shock effects” of the financial crisis. This phase ended with the (preliminary) “victory” in the form of the FTT proposal of the European Commission (EC) in September 2011.

The second phase was shaped by the search for ways how to implement the FTT within the EU. It ended with the publication of a modified FTT proposal by the EC in February 2013 as basis for the implementation in 11 Member States.

The last phase has been marked by a strong counter-offensive of the financial lobby which succeeded in playing off FTT supporting countries against each other, in particular Germany and France. This phase ended with a defeat of the FTT supporters. Not even in a group of EU Member States will a general FTT be implemented in the foreseeable future.

The struggle over the FTT was mainly carried out in two “battlefields”, the intellectual disputes between economists at universities, research institutes and international organizations, and the political controversies between NGOs, political parties, governments and pressure groups, in particular the finance industry.

*Keywords:* boom and bust of asset prices, speculation, Financial Transactions Tax.

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1. I dedicate this essay to Jernej Omahen, Chris Turner, Jean-Francois Neuez and Luca De Angelis from Goldman Sachs Research representative for all economists who sell their intelligence in the market for interest justifications.

*e-mail:* [stephan.schulmeister@wifo.ac.at](mailto:stephan.schulmeister@wifo.ac.at)

## 1. Introduction

The conflict between recognition and interest, explanation and justification, analytical and normative thinking shapes the work of economists to a much larger extent than the work of any other types of intellectuals. The reason is given by Keynes at the end of his “General Theory”: “... the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else.” (Keynes, 1936, p. 383). If economic theories “rule the world” then the distribution of power, income and wealth depends on which economic theory becomes a “paradigm”. This is so because economists then derive from this “Weltanschauung” the “navigation map” for policy.

The thinking of economists is therefore driven by the interaction of three forces/motives/activities: Analysis and recognition of “true” relationships (science), justification of interests (ideology), and elaboration of concepts for “improving the world” (ethics). Any output of economists’ reasoning is a “mixture” resulting from the interaction of these three activities. Even though one cannot exactly quantify the contribution of each of these activities (as they are closely interlinked), the following rule of thumb helps to gauge the importance of the ideological component of an economic theory or proposal: The higher is the degree of abstraction of their model, and the less its basic assumptions are derived from empirical research/experience, the more plausible is the suspicion that assumptions as well as methods were chosen to arrive at certain conclusions.

Classical economists, notably Adam Smith, David Ricardo, and Karl Marx, were well aware of the conflicting economic and political interests of different classes in society. As a consequence, they embedded their theories in the context of the interaction of these interests. Conceiving themselves as members of the society, those economists took clear positions in favour of certain classes and against other classes. Their economics was devoted to analysing the “political economy” and to formulate proposals for its improvement – the idea of a “value-free” economic science would have seemed absurd to the classics. Related to this understanding is

their methodological approach: As they try to explain the most important economic developments like economic growth, specialization and trade, the distribution of income and wealth, the role of government in a market economy, etc., they try to base their assumptions on observations and to reach general conclusions carefully in an inductive way (taking into account the historical and regional context).

Even though the content of the – genuinely macroeconomic – theory of Keynes is very different from the – market-oriented – classical theories, Keynes shared the attitude of the classics in many respects: Also Keynes thought concretely and problem-oriented, based his reasoning rather on experience than on abstract models, and as a “political philosopher” he put his theory in the context of the conflict of interests of entrepreneurs, workers and (financial) rentiers. Last but not least, Keynes elaborated many concrete proposals for a better organization of the domestic and of the global economy.

In complete contrast to this attitude, neoclassical economics, which has become the predominant school since the late 19<sup>th</sup> century, assumes that there exist “eternal truths” about the functioning of a capitalistic market economy. Economics is conceived as a value-free science, which aims at finding out these “economic laws” (they are assumed to be valid beyond time and space). Establishing economics as a value-free and, hence, non-ideological science is itself the most important ideological component of the neoclassical school of thought. Such a self-image enables economists to “sell” their conclusions as objective truths and to repress the simple question: Which groups/classes are favoured or put at a disadvantage by the neoclassical “truths”.

The denial of the interaction between economic theory and economic reality calls for a specific methodological approach: One sets assumptions about the agents (“homo oeconomicus”), ideal market conditions, permanent market clearing, etc., all of which are not supported by the empirical evidence. Based on these assumptions, one constructs highly abstract models from which those results are (tauto)logically deduced which are already contained in the assumptions: All markets should be “liberalized”, governments should refrain from an active economic policy, irrespective whether it regards business cycle fluctuations, social

security, income distribution or the regulations of the financial sector, etc. All these prescriptions favour certain groups in society over others.

I term the first – classical and original Keynesian – approach to analysing economic relationships “realistic economics” (RE) and the neoclassical approach “idealistic economics” (IE). The key differences between both approaches concerns the way of thinking:

- “Realistic economics” (RE) addresses concrete economic problems, collects empirical observations and tries to arrive at general conclusions about the relevant relationships in a predominantly – yet not exclusively – inductive manner. RE acknowledges the importance of contradictions in the economy, which should therefore be incorporated in economic theory. Policy recommendations are problem-oriented, pragmatic and, hence, embedded in the context of historical time.
- “Idealistic economics” (IE) aims at modelling the universe of economic relationships in an ideal world – free of contradictions. To this end, IE has to make assumptions which “abstract away” essential properties of human beings and of their interaction in society like the role of emotions or of uncertainty. From the general equilibrium models based on these assumptions, one deduces a “navigation map” for economic policy – again valid beyond time and space.

The two different approaches to economics do not only shape the activities of economists at the academic level, but also economic policy. E.g., the New Deal of Roosevelt or the full employment policy of the 1950s and 1960s are typical examples of the RE approach, strict rules for monetary and fiscal policies like the fiscal compact of the EU or deregulation as a general guideline are typical for the IE approach.

The sequence of prosperity and depressions is interconnected with the sequence of RE and IE paradigms. One specific reason for that lies in the influence of economic paradigms on the incentive conditions of the overall system. IE paradigms favour deregulation in general and of financial markets in particular so that striving for profits shifts gradually from the real to the financial economy. The

“production” of “fictitious capital” (Karl Marx) in the form of over-valued assets, in particular the government debt, leads inevitably into a deep crisis. After a long lasting learning period (the bottom phase of the “long cycle”), an RE paradigm leads to changes in the incentive structure and in economic policy: Striving for profits is again focused on activities in the real economy, leading to prosperity.

The long cycle since the 1920s is a good example for this interaction: The finance-capitalistic framework conditions and the related stock market boom led to the crash of 1929, the subsequent recession was transformed into a depression due to the austerity policy prescribed by the IE paradigm. The learning from the crisis, in particular in the form of a new RE theory provided by Keynes, laid the ground for the real-capitalistic system of the 1950s and 1960s. Since then, the restoration of the neoclassic paradigm, completed by the most unrealistic assumptions ever made in the history of economic thought (rational expectations, financial market efficiency, real business cycle, etc.), served as the scientific legitimation of the interest of finance capital in a complete deregulation of asset markets. The related change in the incentive conditions paved the long way into the current crisis.

At present, the European economy is in a state of depression (external demand is the only growth component), typical for the bottom phase of the long cycle: The IE recipes continue to weaken domestic demand, yet, the elites remain stuck in the neoliberal paradigm which has been dominating longer than ever before. In such a situation where a new RE paradigm is not in sight, single RE proposals are put forward which could/should change the course of events (e.g., the Glass-Steagall act of 1933 to restrict – as Roosevelt put it – “speculation with other people’s money”). In the present situation in Europe, the proposal of a general Financial Transactions Tax (FTT) has become the most important proposal of this kind.

The struggle over the usefulness of a FTT on the academic level, in the media and in politics, between EU member states as well as within each country, reflects the fundamental differences between the “realistic” and “idealistic” approach to economics. As the crisis deepens, this struggle will extend to other problem fields like unemployment or the public debt. These struggles are part of the process

of destructing the old paradigm and developing a new one (in part by trying new ways in practice as done by the New Deal). Such a process is most typical for the trough phase of the “long cycle”.

In this essay I shall elaborate upon the most important arguments/weapons of the proponents of and the opponents to a FTT. I’ll try to show that the arguments of the proponents are typical for RE reasoning, whereas the arguments of opponents are derived from the “idealistic” economic paradigm. I shall further document how the arguments against a FTT, derived from extremely abstract axioms, legitimate the extremely concrete interests of banks and hedge funds which have been specializing in “finance alchemy” for so long.

## **2. “Finance alchemy” and a general transactions tax: A personal remark**

In 1982, the debt crisis of developing countries broke out which hit Latin America most. The standard explanation attributed the crisis to mismanagement, corruption and political instability in these countries – but these (“structural”) factors had already been in effect over the 1970s when Mexico, Brazil and Argentina were considered the “tiger economies” of that time. Hence, I started to look for other, more concrete explanations.

First, I looked at the currency structure of the foreign debt – it was almost exclusively held in US-dollars. The global key currency had appreciated by almost 30% since 1980 (mainly due to a policy change in the US). As a consequence, the dollar debts were drastically revalued – unsustainable for debtor countries. But why had they accumulated high dollar debts in the first place? The main reason was: Between 1971 and 1980, the dollar had lost 50% of its value, incurring dollar debts seemed rational (the real interest on an international dollar debt was markedly negative over the 1970s due to strongly rising world trade prices in dollar terms). And why had the dollar so strongly depreciated? First, because the US government under president Nixon broke away with the gold convertibility of the dollar in 1971, causing the Bretton Woods system to collapse (this decision was “scientifically” legitimated by the monetarists’ call for moving to a system of “flexible” exchange rates). Second, currency speculation caused the subsequent dollar

depreciation to overshoot (as it caused an overshooting appreciation in the first half of the 1980s).

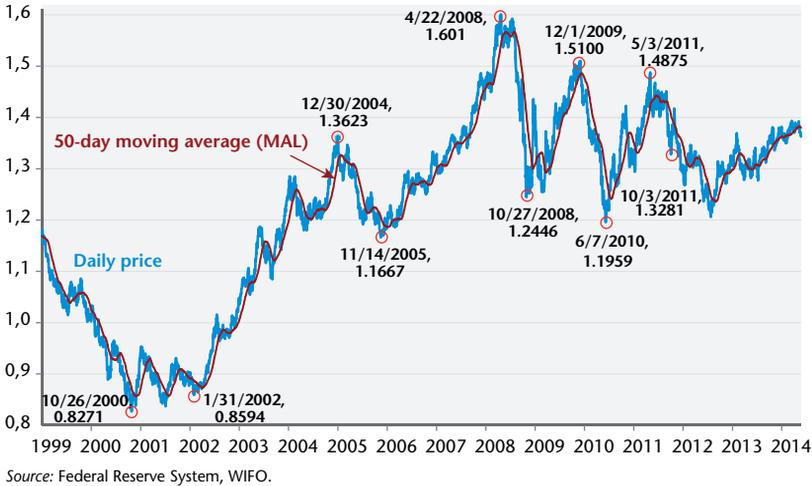
I arrived at the following (hypothetical) conclusion: From their respective point of view and interest, each group of actors had acted rationally, the monetarists, the US government, the currency traders, the developing (debtor) countries, the lending countries and intermediating institutions (in particular London banks “recycling petrodollars”), yet, the interaction of their behaviour led into a rather “irrational” event, the debt crisis of 1982 (the subsequent “lost decade” of Latin America can be conceived as a “silent catastrophe” – if only 1% of the population died earlier than they would have otherwise then roughly 3 million people were concerned).

Could it be that striving for profits through financial speculation causes systematically sequences of “bull markets” and “bear markets” which in turn dampen entrepreneurial activities in the real economy, in particular through the asset valuation effects of overshooting? How are “bulls” and “bears” brought about? In more general terms: Does the “invisible hand” in financial markets produce systematically disorder instead of order? Through which channels do asset price fluctuations impact upon the real economy?

Over the subsequent 30 years, my research program was shaped by the attempt to find concrete answers to these questions.

I began with an analysis of the DM/dollar exchange rate movements since the early 1970s. As conventional exchange rate theory could not explain the persistence of the overshooting process downward (1971/80) as well as upward (1980/85), I turned to an inductive/exploratory approach. First, I tried to find out which types of trading behaviour could – in the aggregate – bring about the pattern of daily exchange rate movements as a sequence of (underlying) short-term trends, interrupted – comparatively rarely – by non-directional movements, called “whipsaws” in the traders’ jargon (Figure 1 displays daily movements of the dollar/euro exchange rate – their “Gestalt” is the same as in the case of the DM/dollar rate and – as it turned out later – of all asset prices traded in financial markets). Second, I started with some field research in trading rooms.

Figure 1. Trading system for the daily dollar/euro exchange rate



Already at my first “excursion” to banks in Frankfurt in 1986 I got to know the importance of trading systems, be it qualitative (“chartism”) or quantitative (“trend-following” as well as “contrarian”) systems of technical analysis. Until today, these systems are omnipresent in trading rooms (traders have to watch so many screens because trading systems are applied to different data frequencies). As one trader told me: “You have to take into account the trading signals of technical models even if you don’t subscribe to them – too many traders are using them” – unconsciously alluding to Keynes’ “beauty contest” – Keynes, 1936, p. 156).

During my Frankfurt field research, the chief currency trader of “Citibank” (then the most active bank in the foreign exchange market) proudly showed me the profitable sequence of one of their trading systems. I was shocked: Technical models use exclusively the information contained in past prices, if they were profitable then the forex market would not even be weakly efficient!

All trading systems aim at exploiting the phenomenon of “trending” of asset prices (“the trend is your friend”): Trend-following systems produce a buy (sell) signal in the early stage of an upward (downward) trend, contrarian systems produce a sell (buy) signal in the late stage of an upward (downward) trend. The (underlying) trends are filtered out by simple statistical transformations of

the original price series (mostly by calculating moving averages or first differences). Figure 1 shows the functioning of the simplest form of a MA-model (it uses only one MA): Buy whenever the price series (i.e., the dollar/euro exchange rate) crosses the MA-line from below, and sell, when the opposite occurs. Figure 1 demonstrates that even such a simple model would have exploited profitably the downward and upward exchange rate trends (the euro depreciation – bear market 1999/2002 – as well as the tremendous euro appreciation – bull market 2002/2008 – were the result of the accumulation of several downward and upward trends, respectively).

Figure 2. “Bulls” and “bears” in the US stock market and technical trading signals



Source: Yahoo Finance.

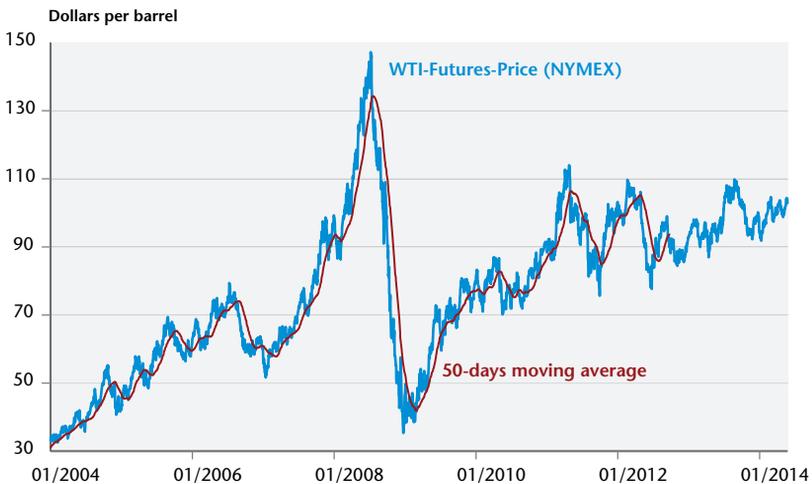
Figure 3. Intraday asset price dynamics



Source: Fed, Olson.

On the academic level, the 1980s were the heydays of “idealistic economics”, it became common sense to believe that under any circumstances would “the market” stabilize the economy – provided it is kept free. Confronting the simple fact of the widespread use of technical model in practice would have meant confronting an unsolvable dilemma: Either these models are not profitable, then the assumption of rationality of market agents has to be dismissed, or they are profitable, then the “freest” markets would not even be weakly efficient. As a consequence, academic research completely ignored technical trading or declared it as irrational “noise trading”.

Figure 4. Trading system for the daily oil futures price



Source: NYMEX.

To clarify this issue, I devoted much of my research efforts over the subsequent 20 years to analysing the profitability and price effects of technical trading systems in the foreign exchange markets (DM/dollar, yen/dollar, dollar/euro – Figure 1), the stock markets (DAX, S&P 500 – Figure 2) and in the commodity futures markets (corn, rice, WTI crude oil and wheat – Figures 4 and 5), using not only daily but also intraday data (Figure 3). I analysed some thousands models, which were selected *ex ante* according to objective criteria (in order to dismiss the suspicion of “model mining”). The results are qualitatively the same for all markets and data frequencies (Schulmeister, 2002, 2006, 2008a, 2008b, 2009a,

2009b, 2009c, 2012; the main results are summarized in Schulmeister, 2010):

- The great majority of the models would have produced profits over the entire sample as well as over sub-periods (not only *ex post* but also *ex ante*, i.e. when selecting the best performing models of sub-period A and following them over sub-period B).
- The number of single losses is always greater than the number of single profits. The overall profitability is exclusively due to the exploitation of relatively few, yet persistent price trends (“cut losses short and let profits run”).
- There operates an interaction between the trending of asset prices and the use of technical models in practice. On the one hand, many different models are used by individual traders aiming at a profitable exploitation of asset price trends, on the other hand the aggregate behaviour of all models strengthen and lengthen price trends.

**Figure 5. Trading system for the daily rough rice futures price**



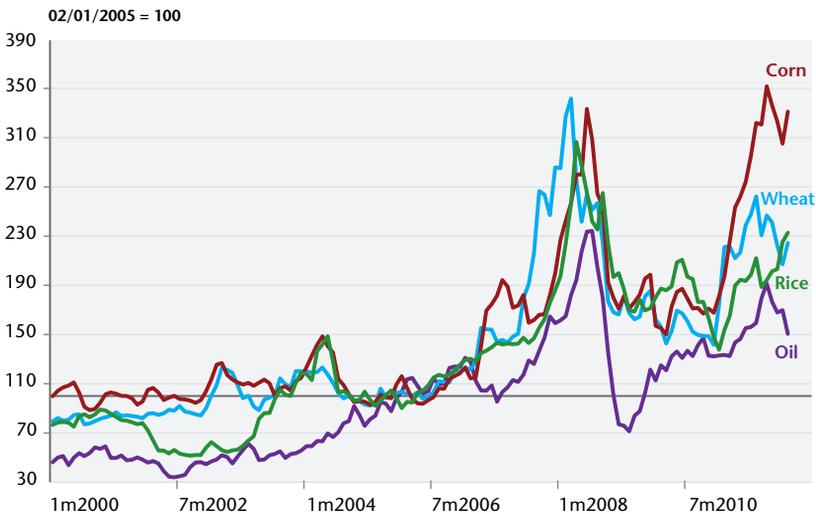
Source: CBOT.

In order to explore the relationship between (very) short-term trends (“runs”) and (very) long-term trends (“bulls” and “bears”), I analysed the slope and the duration of monotonic price movements in the foreign exchange markets, the stock markets and the

commodity futures markets (for the main results see Schulmeister, 2010; see also figures 1 to 5):

- Over the short run, asset prices fluctuate almost always around “underlying” trends which can be filtered out through calculating simple moving averages.
- The phenomenon of “trending” repeats itself across different time scales, e.g., there occur trends based on tick data or 1-minute-data as well as trends based on daily data.
- During bull (bear) markets upward (downward) runs last on average longer than counter-movements, the accumulation of the runs brings about the long-term trend in a stepwise manner (the average slopes do not differ significantly during “bulls” and “bears”).
- There prevails a self-similarity pattern: Several runs based on minutes or five minutes data add up to one trend based on hourly data, many hourly trends add up to one trend based on daily data, several daily trends result in one trend based on monthly data, etc.

Figure 6. Commodity futures prices



Sources: WTI, NYMEX, CBOT.

Combining these results with the analysis of technical trading systems led me to the following hypothesis about trading behaviour and asset price dynamics (“Bull-Bear-Hypothesis”):

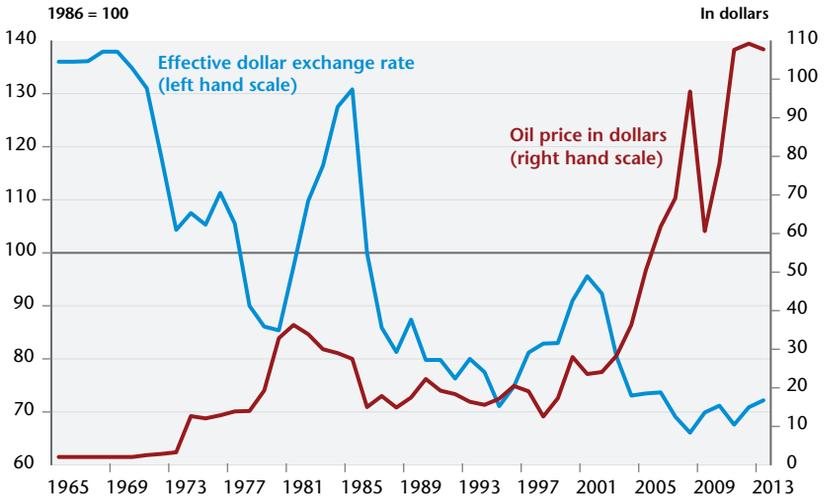
- Price runs are usually triggered by news, in particular about market fundamentals. Traders will then have to gauge within seconds how the majority of other traders might react to the new information (Keynes' "beauty contest").
- In order to reduce the complexity of trading under extreme time pressure, traders form only qualitative expectations in reaction to news, i.e., expectations about the direction of the imminent price move (but not to which level the price might rise or fall).
- Subsequent to an initial upward (downward) price movement triggered by news follows a "cascade" of buy (sell) signals stemming from trend-following technical trading systems. As a consequence, this feed-back-mechanism will often transform the news-induced price change into a trend.
- In many cases the price trends continue after (almost) all technical models have already opened a position congruent with the trend. This trend prolongation is mainly due to a bandwagon effect on behalf of amateur traders (hence, as a group, amateurs end up as the losers in this zero-sum game).
- When the trend finally loses momentum, contrarian models together with news cause the trend to tilt into a counter-trend.
- Most of the time there prevails either an optimistic or pessimistic "market sentiment", called "bullishness" or "bearishness". These "regimes of biased expectations" influence the traders' behaviour in three ways: First, they react much stronger to news, which confirm the prevailing sentiment than to news, which contradict it. Second, traders put more money into a position congruent with the prevailing sentiment, and, thirdly, they hold these positions longer than "counter-positions" (traders do not follow blindly a technical model, this is only the case in "automated" trading like high frequency trading).
- This behaviour causes in the aggregate short-term upward (downward) trends (runs) to last longer when the market is bullish (bearish) than counter-movements. Over several months or even years, the accumulation of the short-term trends results in an over-appreciation (over-depreciation) of the respective asset.

- The more the asset becomes over(under)valued, the greater becomes the probability of a tilt in the market mood and, hence, in the direction of the long-term asset price trend. First, because market participants know from experience that any bull/bear market comes to an end (in contrast to a “rational bubble” in “idealistic economics”), second, because there operate long-term “contrarians” in the market who sell (buy) in an “overbought” (“oversold”) market (like George Soros – see his “Alchemy of Finance”, 1987), third, the effects of an over(under)valuation on the real economy progressively strengthen corrective forces (e.g., the deterioration of the current account and the related decline in economic growth in the case of an persistently overvalued currency).
- “Overshooting” is not an exception due to some “shock” (as IE assumes) but the most characteristic property of long-term asset price dynamics. Exchange rates, stock prices and commodity prices fluctuate in a sequence of “bulls” and “bears” around their fundamental equilibrium without any tendency of convergence towards this level (Figures 6 to 8).

The analysis of trading systems and of the dynamics of asset prices as well as its interpretation (in part based on interviews with traders) contradict completely the assumptions of “idealistic economics“, in particular about perfect information, market efficiency and rational expectations.

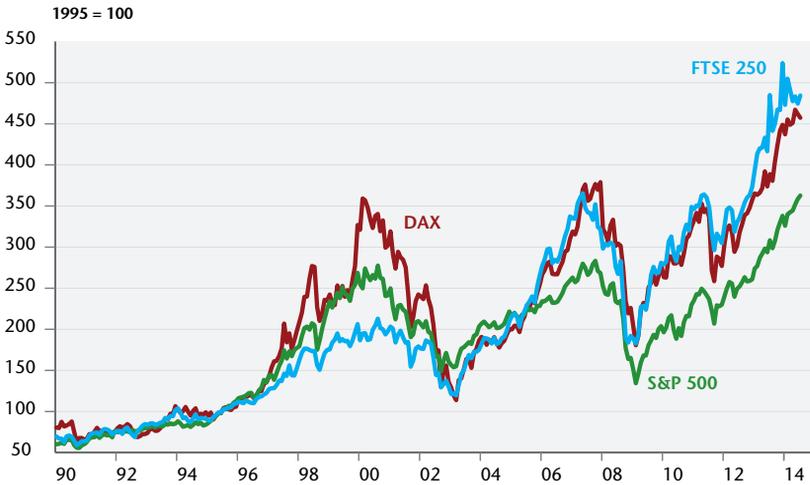
At the same time, the “Bull-Bear-Hypothesis” (BBH) is to a much higher extent in line with the empirical evidence than the “Efficient Market Hypothesis”. In particular, the BBH can explain the following puzzle: On the one hand, asset trading has become progressively more short-term oriented (“faster“), on the other hand, also the phenomenon of long-term trends (“bulls” and “bears”) has become more pronounced. This coincidence can be explained by the fact that long-term trends are the result of the accumulation of very short-term price runs which are exploited and strengthened by the use of ever “faster” trading systems.

Figure 7. Dollar exchange rate and oil price dynamics



Source: IMF, OECD.

Figure 8. Stock prices



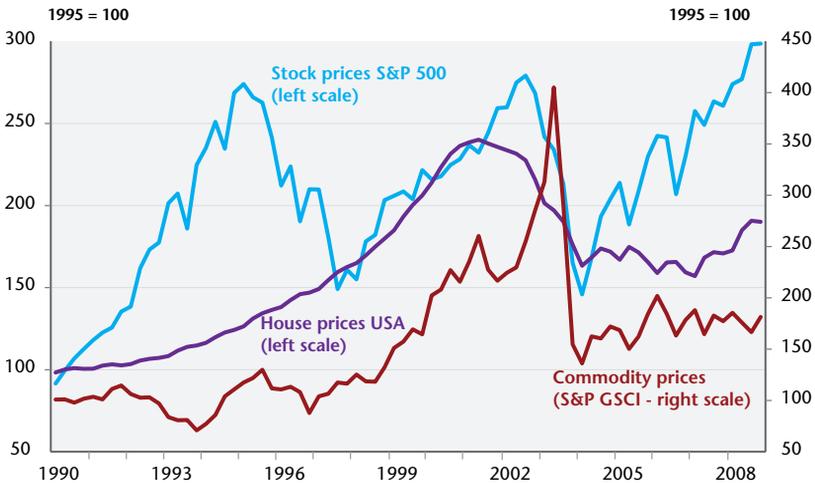
Source: Yahoo Finance.

The rising importance of progressively “faster” asset trading was confirmed by the spectacular rise of transaction volumes. Between 1990 and 2007, the overall volume of financial transactions rose from 15.5 to 72.4 times world GDP. As short-term speculation is concentrated on exchange-traded derivatives, trading volumes in these instruments expanded by far most strongly (Figure 10).

Based on the results of my research, but also motivated by the rather precarious fiscal stance of almost all EU member states, I started in 2007 to work on a comprehensive concept of a general financial transactions tax (FTT). In contrast to a Tobin tax which covers only (spot) currency trading (accounting for only 14% of all transactions – Figure 10), the FTT should be levied on all transactions with any type of financial asset. The essential features of the WIFO proposal were as follows<sup>2</sup>):

- The FTT is levied on all transactions involving buying/selling of spot and derivative assets. These instruments are traded either on organized exchanges or over the counter.
- The tax base is the value of the underlying asset, in the case of derivatives their notional/contract value.
- The tax rate should be low so that only very “fast” trading with high leverage ratios will become more costly due to the FTT (in the original study a rate of 0.05% was used as benchmark).

Figure 9. Three bulls, three bears and the crisis

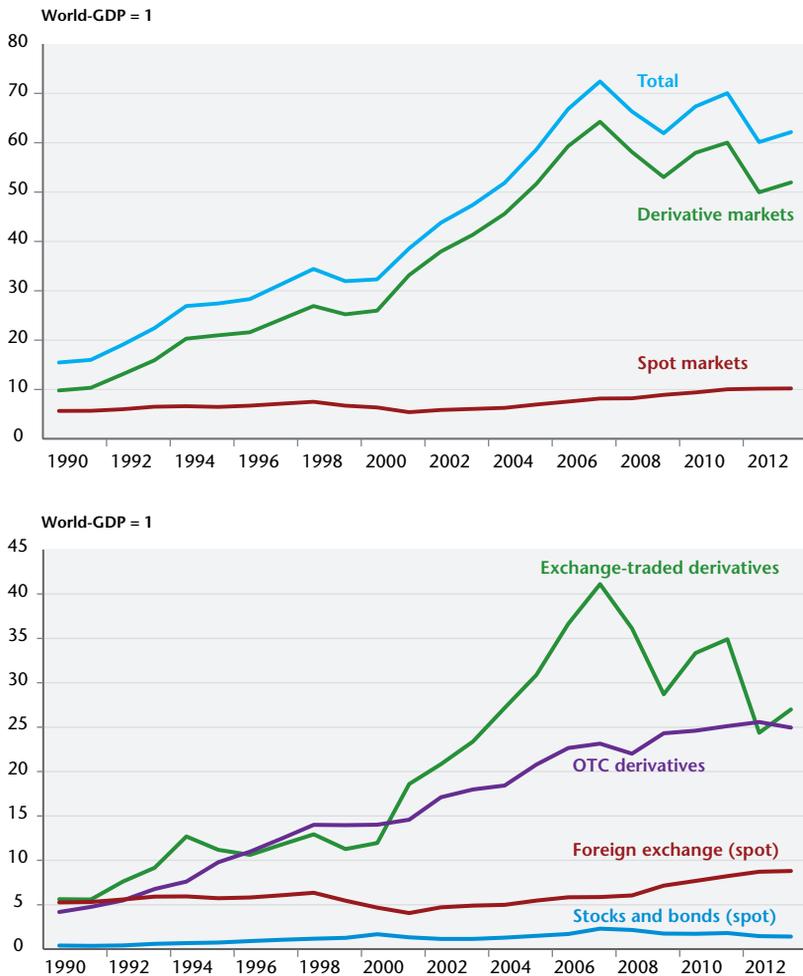


Source: Yahoo Finance, S&P, Case-Shiller.

2. The WIFO concept was not the first one, which would propose a general FTT (Pollin, Baker and Schaberg, 2003, proposed a “securities transaction taxes” for the US markets; Summers and Summers, 1989, had made “a cautious case” for such taxes). However, the WIFO concept was the most detailed concept as regards the reasoning of the usefulness of a general FTT, the revenue potential as well as the implementation issues.

This concept ensures the following: The “faster” an asset is traded and the riskier it is (the higher the leverage ratio is), the more will the FTT increase transactions costs. At the same time, holding a financial asset (including hedging) will not be burdened by the FTT. Hence, a FTT with a uniform rate will specifically dampen very short-term speculation in derivatives because the effective tax burden relative to the cash (margin) requirement rises with the leverage factor.

Figure 10. Financial transactions in the global economy



Source: BIS, WFE, WIFO

“High frequency trading” would become unprofitable even at a tax rate of 0.01%. Other forms of short-term speculation, in particular in derivatives, would be dampened. As a consequence, asset price runs would occur less frequent and would become less persistent. Since long-term trends are the result of the accumulation of short-term runs, a FTT would also dampen the “long swings” of exchange rates, commodity prices and stock prices.

### 3. The struggle over the introduction of a FTT

The WIFO concept was published in February 2008 in Schulmeister, Schratzenstaller, and Picek (2008). At that time I did not expect that a general FTT would become a major topic in European politics, I only hoped that the proposal might draw (a little) more attention to asset trading in practice and their destabilizing effects on the most important prices in the global economy. As a matter of fact, it was the shock triggered by the collapse of Lehman Brothers and the sharp deepening of the crisis in the financial and in the real economy which drew the attention to the instability of asset markets.

The financial crisis was directly related to the pattern of asset price dynamics as sketched by the BBH. Between 2003 and 2007, the simultaneous bull market of stock prices, commodity prices and house prices built up the potential for their simultaneous collapse, causing the US mortgage crisis to develop into a global economic crisis in 2008/2009 (Figure 9). Even though the importance of “bulls” and “bears” for the valuation of wealth and its impact on final demand and the real economy was (and still is) not fully understood yet, the deepest crisis since the 1930s caused the political elites to call for a comprehensive regulation of financial markets. In this atmosphere, the concept of a general FTT got more attention than ever before.

The struggle over the FTT has developed in three phases:

- In the first phase (2009 to 2011) the supporters of the tax went on the offensive, supported by the “shock effects” of the financial crisis. This phase ended with the (preliminary) “victory” in the form of the FTT proposal of the European Commission (EC) in September 2011.

- The second phase was shaped by the search for ways how to implement the FTT within the EU. It ended with the publication of a modified FTT proposal by the EC in February 2013 as basis for the implementation in 11 Member States joining an “enhanced cooperation procedure” (EU11).
- The last phase has been marked by a strong and well organized counter-offensive of big “finance alchemy banks” like Goldman Sachs or Morgan Stanley and the subsequently deepening conflicts among the EU11 group, in particular between Germany and France. This phase will end with a defeat of the FTT supporters. Not even in a group of EU Member States will a general FTT be implemented in the foreseeable future.

The struggle over the FTT was mainly carried out in two “battlefields”, the intellectual disputes between economists at universities, research institutes and international organizations (IMF, OECD, EC), and the political controversies between NGOs, political parties, governments and pressure groups, in particular the finance industry.

### **3.1. Fight for public opinion 2009 to 2011: Grassroot movements against mainstream economics**

Practically all NGOs active in the field of development aid and of fighting poverty – including the respective organizations of churches – had for many years called for the Tobin Tax. The same is true for NGOs engaged in proposing new ways of organizing the economy, in particular the network ATTAC. In some countries, special campaigns in favour of the Tobin Tax had been successfully organized (e.g., “Stamp-out-Poverty” in the UK). All these NGOs and currency tax movements switched from calling for a Tobin Tax to demanding a general FTT. In the aftermath of the financial crisis, these civil society organizations strongly intensified their campaigns for a fundamental change in the financial system and for the implementation of a FTT as the first and most important step.

Until 2009, there was no strong Pro-FTT-movement in Germany (in contrast to France and the UK). At the same time, Germany is the biggest economy in the EU and should enlarge its political power during the euro crisis. It was therefore crucially important for the offensive of the FTT supporters, that Jörg Alt, a Jesuit,

founded the campaign “Steuer-gegen-Armut” (“tax against poverty”) in fall 2009. This campaign expanded very fast, comprising a broad spectrum of civil society organisations – almost 100 organizations support the campaign, including the most important catholic, protestant, humanitarian and political NGOs.

The campaigning for the FTT was so successful that already in November 2010 61% of the respondents of a “Eurobarometer” poll supported the introduction of a FTT (European Commission, 2011a).

The political elites did not remain unimpressed by the success of the campaigns for the FTT. In particular the leaders of the two (politically) most important EU Member States, Germany and France, began to endorse such a tax. President Sarkozy proposed (unsuccessfully) the introduction of a global FTT to the G20 leaders in 2011. Chancellor Merkel had already in 2010 declared her support for the tax which she previously had rejected. This change in her mind was certainly influenced by the fact that Jörg Alt (as a priest) was able to carry the FTT campaign into the ranks and files of the Christian-Democratic Party.

In 2010, the most important counter-attacks against the FTT were carried out by economists of the IMF and the EC (IMF, 2010; EC, 2010a and 2010a). Instead of a FTT, they proposed a bank levy on certain balance sheet positions and/or a “financial activities tax” (FAT) on (certain components of) the value added of financial institutions. Their reasoning was motivated by the purpose to discredit the FTT. At the same time, this “recognition interest” was hidden in the usual way of “idealistic economics”: One presupposes the empirical validity of a certain theoretical model and derives then the (desired) conclusions in a logical manner. By contrast, the counter-arguments are derived from the empirical evidence in an inductive manner, typical for “realistic economics”. In the following, I shortly summarize the main objections against the FTT and the respective counter-arguments as examples for the two approaches.

*Objection 1:* An FTT reduces liquidity and therefore hampers the price discovery process.

This reasoning assumes that financial markets are efficient: Rational traders drive the asset price to its fundamental equilib-

rium value the level of which is known to everybody. Hence, the more transactions are carried out, the faster is the market equilibrium reached after a short deviation due to some shock. Hence, liquidity is *per se* positive.

In reality, the widespread use of ever “faster” trading systems, the related explosion of trading volumes, the “abnormal” frequency of persistent asset price runs, their accumulation to long-term trends, the “long swings” of asset prices as sequences of bull and bear markets, all that is enough circumstantial evidence for the inefficiency of asset markets.

*Objection 2:* It is impossible to distinguish between harmful speculation and beneficial transactions.

This argument is a good example for how a strong interest in specific conclusions hampers coherent reasoning. According to mainstream “efficient market theory” the distinction is clear-cut: Beneficial transactions are based on market fundamentals, transactions based only on the information contained in past prices, are harmful. One has therefore to distinguish between “good” liquidity (i. e., fundamentals-based trading) and “bad” liquidity (i. e., technical trading in a broad sense, including high-frequency trading).

*Objection 3:* The FTT does not specifically increase the costs of harmful trading.

By construction, a FTT with the notional value as tax base increases the tax burden the more the faster transactions are carried out and the higher their leverage is.

*Objection 4:* The distortive effects of an FTT will be higher than those of other kinds of taxes, in particular of a VAT because the FTT is a turnover tax which burdens transactions between businesses several times.

This reasoning suggests that financial transactions between financial institutions and non-financial corporations can be perceived as intermediate inputs and outputs. This analogy is misleading. Buying an asset does not represent an (intermediate) input and selling an asset does not represent an (intermediate) output. A more precise analogy to an FTT would be taxes on gambling where usually any bet/transaction is taxed.

*Objection 5:* An FTT would raise the cost of capital because it has the same effect as taxes on future dividends. As a consequence, the present (discounted) value of an asset will decline in reaction to the introduction of an FTT.

The assumption that an FTT has the same effect as a tax on dividends is misleading because the latter would affect any stock, whereas the FTT would affect only those stocks which are (frequently) traded.

*Objection 6:* Most financial transactions are not driven by (destabilizing) speculation but stem from managing and distributing risk.

Before something can be distributed, it has to be produced. The production of risk and uncertainty in financial markets has risen due to the increasing use of (automated) trading systems. All these systems disregard market fundamentals and are therefore “by construction” destabilizing.

*Objection 7:* Derivatives should not be taxed, in particular because this would increase hedging costs.

If a “Standard Classification of Financial Transactions” (SCFT) is introduced in connection with the FTT implementation so that any transaction is assigned a specific code, it would be easy to exempt from the FTT the hedging of counter-positions in the real economy.

In addition, since a hedger is holding a (counter-)position in a derivative, only two transactions are involved. At a FTT rate of 0.01% (as proposed by the EC for derivatives), the additional hedging costs would be 0.02%.

*Objection 8:* Ultimately, the burden of an FTT will largely fall on consumers.

The tax incidence issue is at least clearer in the case of an FTT than in the case of a bank levy or a financial activities tax. As the latter two tax certain balance sheet positions or (components of) the value added, banks could/would easily shift the tax burden on their clients. By contrast, the FTT would levy certain activities irrespective of who carries them out. Banks, which do not engage in proprietary trading, would pay no FTT at all. Hedge funds, would shift the tax burden on their (wealthy) clients. Amateur speculators would pay the tax, their (internet) brokers would not (they also would shift the tax burden on their clients).

*Objection 9:* The introduction of an FTT will lead to a considerable relocation of trading activities to tax-free jurisdictions, in particular to offshore markets.

This is already the case today. Many funds operate from offshore places since these jurisdictions serve as tax havens. Many of them engage in short-term trading which is largely done on organized derivatives exchanges. To the extent that they (have to) trade on exchanges in FTT countries, they will have to pay the FTT.

Finally, if an FTT would be implemented according to the “residence principle” as (later) proposed by the European Commission all financial transactions carried out in a non-FTT-country (e.g., the UK) the orders of which stem from an FTT-country (e.g., Germany) would be taxed in the latter country.

If one weighs up the arguments in favour and against the FTT, then it seems rather clear that the former are primarily based on the empirical evidence whereas the latter are derived from that economic (“idealistic”) paradigm which has been the mainstream in economics and politics over the past decades. If one assumes that the “freest” markets, i.e., the financial markets, cannot produce systematically wrong price signals – as would be the case if trending is conceived as the most characteristic property of asset price dynamics – then one has to reject even a very modest taxation of financial transactions.

In spite of the rejection of the FTT by mainstream economists, the European Commission changed its position towards the tax fundamentally between August 2010 (when it still rejected such a tax – see EC, 2010b) and September 2011 (when it proposed the “Council Directive on a common system of financial transaction tax” – see EC, 2011b and 2011c). The reasons for this turn were predominantly political: NGOs continued to campaign intensively for the FTT, the support of the majority of the EU population remained strong (see the Eurobarometer commissioned by the European Parliament and published in June 2011 – EP, 2011), the European Parliament supported the tax in two resolutions in March 2010 and in March 2011 (based on the Podimata report) with an overwhelming majority, and last but not least, the governments of the key EU Member States, Germany and France, called for the introduction of the FTT.

### 3.2. Searching for ways to implement the FTT 2011 to 2013

The main features of the FTT concept of the EC (in the following abbreviated as ECP) are as follows (I refer to the modified version of February 2013 – EC, 2013).

The tax base is defined very comprehensively. Almost all transactions in financial instruments carried out by financial institutions (FIs) are subject to the tax except for currency spot transactions, for transactions of/with the European Central Bank, the European Stability Mechanism and the European Union itself and for transactions on primary markets (both for shares and bonds).

As regards the country to which the tax revenues accrue, the ECP adopts the “residence principle” and completes it – in the modified version of February 2013 – with the “issuance principle”. The residence principle means that all transactions of FIs established in one of the 11 FTT countries (FTTCs) are subject to the tax wherever they are carried out. If both parties to a transaction are established in a FTTC the tax revenues go to the respective states, if a FI established in a FTTC trades with a FI established in a Non-FTTC the revenues for both sides of the trade go to the respective FTTC.

The issuance principle means that also transactions in financial instruments, which are issued in a FTTC, are subject to the FTT even if none of the parties is established in a FTTC.

For the minimum tax rates the ECP proposes 0.1% as regards financial instruments other than derivatives (i.e., spot transactions of stocks and bonds), and 0.01% as regards derivatives transactions. Each party has to pay the tax at the respective rates, i.e., 0.1% or 0.01%, respectively.

The second phase in the struggle over the FTT (September 2011 to February 2013) was characterized by many attempts to find political ways how to implement the tax in the EU as a whole or at least in a group of Member States. I summarize only the most important steps in this process.

At first, the EC and the finance ministers of the “coalition of the willing” under the leadership of the German finance minister Schäuble tried to find compromises with the EU Member States which opposed most strongly the FTT, in particular the UK and Sweden. The main objective was to get the FTT implemented in the

EU as a whole. These attempts failed as the British finance minister was not willing to deal with a compromise proposal put forward by Schäuble at the ECOFIN in Copenhagen in April 2012.

As a consequence, the “coalition of the willing” aimed at implementing the FTT in their jurisdictions in the form of an “enhanced cooperation procedure” (ECOFIN in Luxemburg in October 2012). This intention was approved by the EC and supported by a resolution of the European Parliament in December 2012.

In February 2013, the EC published its modified proposal for an FTT implementation in the 11 EU Member States joining the “enhanced cooperation procedure”. Finally, it seemed as if the FTT would soon be implemented, even though only in 11 countries. But it should come quite differently.

### **3.3. The successful counter-attack of the financial lobby since 2013**

Even though the modified FTT proposal of the EC did not differ essentially from the original (the issuance principle should complement the – still dominant – residence principle), the reaction of the financial lobby and its supporters in central banks and the media to the publication of the modified concept was completely different from the situation in fall 2011. This time, the economists and managers in the respective institutions had had enough time to prepare and organize the most powerful campaign ever.

The specific targets of the attack were as follows:

- Bomb the public and politicians with as many assertions about the disastrous effects of a FTT as possible within a short period of time. What counts is quantity, not quality.
- Pretend that the interests of the national finance industry are national interests.
- Pretend that the interests of governments to finance their debts stay in conflict with the FTT proposal of the EC.
- Pretend that a FTT harms the interest of the (little) private investor in having his/her money “work”, in particular for his/her retirement.
- Ignore all arguments of FTT proponents concerning trading practices, “manic-depressive” asset price fluctuations and their impact on the real economy.

- Ignore all arguments of FTT proponents concerning the systemic risk of transnational repo financing.
- Declare the willingness of the financial sector to carry its fair share of the costs of the crisis.

Like in any war the most important intermediate target was to split the front of the enemies, in other words, to play off groups of actors and their interests against each other: National interests against the interests of “Brussels bureaucrats”, national interests of EU Member States against each other, government’s interest in easy debt financing against the interests of the civil society, the interests of the latter against the interests of the (little) private investor, etc.

Demonstrating to the majority of the EU population and to the governments of the key Member States Germany and France that they were wrong and act against their own interests seemed to be a mission impossible. Yet, the “total war” of the financial lobby was successful: In a blanket-bombardment on the whole area of governments, civil society, media and EU-institutions the concept of a comprehensive FTT (“all institutions, all markets, all instruments”) was destroyed within a few months.

Crucial to the success of their attack was the combination of well-prepared activities and their concentration on the period immediately after the publication of the EC proposal (March to June 2013):

- Mobilization of all important banks and financial lobby organizations to flood the public with a concentrated load of the already previously discussed objections against a FTT.
- Organizing the (discrete) backing of the counter-offensive by important central banks.
- Concentration of all forces on a decisive breakthrough on a new front where governments (of the FTT-supporting countries) are most vulnerable, the repo front.

The mass mobilization of financial institutions materialized primarily in press conferences and publications of practically all big banks (Goldman Sachs, Morgan Stanley, Deutsche Bank, JP Morgan, Citigroup, etc.) and lobby organizations (International Banking Federation, the ICMA European Repo Council, the European Fund and Asset Management Association, etc.). In all their

messages, the financial lobby repeated over and over again the standard arguments against a FTT: The tax would hamper liquidity, the cascading effects would increase the cost of capital, in particular the costs for financing government debt, the tax would reduce the profits of banks and consequently their tax payments, hedging costs would rise, as a consequence overall financial stability would be reduced.

These assertions were then used to drive a wedge between members of the “coalition of the willing”, in particular between France and Germany: “Indeed, we think the FTT would de facto be a transfer of French taxes (on, e.g., derivative transactions of the French banks, which are the market leaders in Equity Derivatives) to other jurisdictions.” (Morgan Stanley, 2013, p. 2).

The intention to play off governments of the “coalition of the willing” against each other was facilitated by the fact, that France and Italy introduced their own FTT in 2012 and 2013, respectively. The French tax is essentially a “stamp duty” on the change of ownership of French stocks, the scope of the Italian tax is wider as it also covers derivatives.

Once there were national FTTs introduced, the respective governments did no longer stick to the FTT proposal of the EC but wanted the latter to be changed according to their national FTT concepts. E.g., the French government wanted the residence principle to be removed and derivatives to be excluded from the tax as both measures would hurt the competitiveness of their national banks (in France, all big banks have specialized in “finance alchemy” through short-term derivatives trading whereas in Germany this is mainly the case for Deutsche Bank). At the same time the Italian government insisted in leaving out government bonds from the FTT.

In an extremely important manoeuvre, the financial lobby mobilized the central banks, in particular the ECB (even though Draghi had officially to declare his support of the FTT “in principle”): Between March and July 2013, the “consultations” between the ECB and the financial lobby on the FTT issue intensified. In May 2013, the then Governor of the Bank of England stated bluntly about the FTT in a press conference: “Within Europe, I can’t find anyone in the central banking community

who thinks it's a good idea." At the same time, the Governor of the Banque de France and the President of the German Bundesbank criticized the FTT explicitly in the public (see Corporate Europe Observatory, 2013).

The attack of the financial lobby would not have been so successful had it not opened a new front, the repo front (with a repurchasing agreement, a bank raises cash by selling a security – usually a government bond – to the lender, and commits itself to repurchase the security when the repo expires – in most cases just after one day). The assertion that the FTT would damage in a disastrous way one of the most important markets for collateralized finance turned out to become the most effective weapon against the FTT proposal of the EC. There are several reasons for that:

- Until spring 2013 the question, how the repo market might be affected by the FTT had not attracted much attention. Hence, the lobby could pretend that the proponents of the FTT, the European Commission and politicians in general had just overlooked the damage such a tax would cause to one of the most important instruments of the European financial system.
- Politicians who had supported the FTT proposal became uncertain as they were in fact not familiar with repos, the greatest component of the European shadow banking system.
- At first glance, it does indeed seem inconsistent that unsecured credits remain FTT-free whereas collateralized borrowing is taxed (legally, the lender gets ownership of the security).
- The most important types of collateral in repos are government bonds. According to the financial lobby, the FTT would strongly dampen liquidity in the repo market. As a consequence, the costs of financing the government debt would rise. Even though this reasoning just repeated the (wrong) argument that a high turnover in the secondary market lowers capital costs, it hit a very salient issue of finance ministers.
- In a similar manner it was argued that also pension funds would see lower returns as consequence of higher repo costs.

- Central banks would remain the largest provider of liquidity once the repo market dries out – and this will make it much more difficult to withdraw from measures of unconventional monetary policy (a particularly great concern of German central bankers).

All this reasoning hides the core properties of repo transactions and of the repo market as the core component of the shadow banking system:

- Most repo transactions finance short-term trading activities, in particular proprietary trading of banks.<sup>3</sup> Intraday trading is financed by so called tri-party repos where purchasing and repurchasing takes place within hours.
- Repos facilitate leveraged trading to the extreme in the sense that one can purchase an asset (almost) without cash by borrowing money to buy the asset and simultaneously posting the asset as collateral.
- Short-selling is fostered by the repo market. One lends money in the repo market, takes the security one intends to short as collateral, and then sells the security.
- The extremely high leverage of repo transactions strengthen boom-bust-cycles of asset prices and increase systemic risks: Rising asset prices stimulate repo financing which feeds back onto the bull market and conversely in the case of a bear market.
- The possibility to re-use the collateral produce “repo chains” (e.g., bank A sells a security to bank B in return for cash, bank B sells the security to bank C, etc.), increasing systemic risk: Strong and persistent movements of securities prices cause “chain reactions” feeding back on the bull or bear market.<sup>4</sup>)

It is no surprise that the increasingly short-term repo transactions developed in tandem with the increasingly short-term proprietary trading of (certain) banks. This type of trading is predominantly unrelated to market fundamentals (it is to a large extent driven by trading systems).

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3. According to survey studies of the Bank of England two thirds of repo turnover concern overnight deals (Hördahl and King, 2008).

4. For the different channels through which the repo market produces (avoidable) systemic risk see the excellent paper by Gabor (2014) and the literature quoted there.

The financial lobby rightly expects (very) short-term repo financing to become unprofitable due to the implementation of a FTT. This, however, might not be a disadvantage but an advantage to the economy as a whole insofar as these transactions finance predominantly short-term and destabilizing asset speculation.

To put it differently: If banks were focused on financing activities in the real economy like real investment, production and trade of enterprises as well as housing and durables of private households, there would be no need to shortly raise millions through overnight repos. It is one objective of a FTT to change the incentive conditions in favor of real world activities at the expense of the profitability of “finance alchemy”.

The “production” of systemic risks by short-term repos is confirmed by their role in the recent financial crisis (e.g., Hördahl and King, 2008; Gorton and Metrick, 2010; Tuckman, 2010; for a summary see Gabor, 2014). Before the outbreak of the crisis, banks and their “special purpose vehicles” created securities from loans which often were backed by subprime mortgages. These securities were then used as collateral for repos. At the same time also the main segment of the repo market where government securities serve as collateral, boomed. In this way “securitized banking” created liquidity which further fuelled the bubbles in the stock markets, housing markets and in the commodity (futures) markets.

When the confidence in the real value of mortgage backed securities became weaker and weaker and house prices started to decline, the confidence crisis spilled over to the repo market as a whole. The subsequent “run on repo” caused interbank interest rates to shoot up, the bankruptcy of Lehman Brothers in September then accelerated the simultaneous fall of stock prices, house prices and commodity prices dramatically, turning the liquidity crisis into a solvency crisis of the banking system (Figure 9). The strong and simultaneous devaluation of the three types of wealth in turn was a main factor for the spill-over of the financial crisis to the real economy.

All these aspects were – of course – neglected in the attack of the financial lobby on the FTT. It focused on the rising costs of banks, governments, pension funds and private investors which would be caused by the FTT. One needed, however, some kind of “scientific”

documentation of these assertions. The most influential “study” became a research report of Goldman Sachs, in the following termed “GS study” (Goldman Sachs, 2013).

This study is a perfect example how economists develop research methods guided by the interest in reaching certain results. In the case of the GS study this interest consisted in “blowing up” the costs of the FTT to the maximum extent. This interest was so overwhelming that the GS researchers accepted making absurd assumptions and calculating meaningless “effective annual tax rates”. In addition, the researchers changed their own method whenever convenient for the purpose of their exercise.

The GS study summarizes the main results right at the beginning: “On a 2012 pro-forma basis, the FTT would amount to €170 bn for the 42 European banks we have analysed. By affected balance sheet category, the bulk of the impact stems from the European banks’ REPO books (€118 bn), followed by derivatives (€32 bn), equities (€11 bn) and government bond books (€4 bn). By bank, the impact extends across business models – investment, universal, global and domestic retail banks. Similarly, by geography, it has a reach well beyond the EU-11. Indeed, we show some of the most affected banks would be those in the UK and Switzerland.

Individually, we show that the most affected banks are the French and German institutions. The six French and German banks show a 2012 pro-forma FTT as a percentage of 2015E PBT (i.e., profits before taxes) ranging from 168% (BNP), up to 362% (DBK) and finally 423% (Natixis). But even pure-play retail lenders – the Italian/Spanish domestic banks for example – stand to be significantly impacted (16%-130% of 2015E PBT).” (Goldman Sachs, 2013, p. 4).

The messages are clear:

- Just for the 42 banks analysed, the overall FTT costs are five times higher than estimated by the EC for all financial institutions.
- Also banks outside the EU11 are heavily affected by the FTT.
- The two countries pushing strongest for the FTT, France and Germany, would inflict the biggest damage to their own banks.

— Also Italian and Spanish banks - which engage much less in investment banking – would be heavily affected by the FTT.

In a few lines – written in a sober tone – the researchers sent messages to all types of banks of different countries within and outside the EU11 calling for standing up against the FTT.

In order to arrive at these “magic” figures, the GS researchers invented a new estimation procedure: “... we attempt to gauge what the 2012 FTT (theoretically) payable by individual banks would be, were they asked to apply FTT retroactively, to 2012 balances. This is a theoretical, ‘all else equal’, exercise. The results, however, allow us to identify the business areas/product lines where the FTT impact would be most pronounced...” (Goldman Sachs, 2013, p. 16).

In other words: When calculating the costs of the FTT, GS researchers assume that transaction volumes remain unaffected by the tax – they call this the “pro-forma-effect”. On other occasions, however, the report of GS Research stresses the effect that transaction volume will be the more reduced the more frequently an instrument is turned over.

The degree of seriousness of this procedure can be illustrated using the following example. Trading volume in UK financial markets amounted to 563 times the British GDP in 2010 (even without repo transactions which are not covered by the BIS data base).<sup>5</sup> On a “pro-forma” base, a general and uniform FTT rate of 0.1% would generate tax revenues of 56.3% of GDP, at a rate of 1% the British government might even receive revenues amounting to 5.6 times the British GDP.

The GS researchers justify the “pro-forma” estimation arguing that “the results allow us to identify the business areas/product lines where the FTT impact would be most pronounced...” This is simply wrong: The structure of activities differ markedly between European banks (as the report itself stresses). Banks which are specialized on short-term trading and repo financing (“finance alchemy banking”) will therefore reduce these activities in reaction

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5. Based on data from the World Federation of Exchanges (WFE) and the BIS overall transaction volume in 2010 on UK markets is estimated at 1,270,4 tn. \$.

to the FTT implementation to a much greater extent than the more traditionally operating banks (“boring banking”).

For the same reason, the calculations of the distributions of the “pro-forma” FTT payments by types of banks and by countries are flawed. However, the publication of these numbers should strengthen the resistance of banks against the FTT and should deepen (potential) conflicts between EU governments: “French banks are the largest contributors, at €61 bn (36%). Germany (this includes only DBK and CBK) absorbs the second highest hit with €35 bn, mainly driven by Deutsche Bank (€26 bn)” Goldman Sachs, 2013, p. 28).

To serve its “research interest”, GS researchers introduced the concept of an “effective annual tax rate”. This means that the estimated *annual* FTT payments are related to the *average* repo value. In this way one can document astronomically high “tax rates” as these rates becomes the higher the shorter the financing period of the REPO is. For tri-party-REPOS which are turned over 3 to 5 times per day, GS Research arrives at an “effective annual tax rate” of the FTT of 360% (Goldman Sachs, 2013, exhibit 12 on p. 19).

The problematic of this procedure becomes evident if one considers the following example: An US household spends every day on average 100\$ on consumption for which it has to pay 5\$ in sales tax. What sense does it make to calculate an “annual effective sales tax” of 365 times 5% = 1,825% instead of speaking of a general sales tax rate of 5%?

Another example for the predominance of the “research interest” in the reasoning of GS researchers: When discussing the FTT impact on the profits of European exchanges the researchers does not stick to their “pro-forma” estimation but applied the assumption of the EC about the FTT-induced reduction of trading volumes. In this way, the GS report arrives at the following conclusion: “... we estimate that the average European Exchange & IDB (i.e., interdealer brokers) under our coverage would see pre-tax profits decline by 22% as a result of the tax. Our analysis suggests that Deutsche Börse would see the largest impact to earnings, with a potential 51% reduction in our forecast pre-tax profits for 2014.” (GS Report, p. 44). Again: stupid Germans harm themselves.

An exquisite example of manipulation concerns the impact of the FTT on retail investors: “Our analysis suggests that much of the burden of the FTT... would fall on retail investors rather than institutional investors we estimate that a typical retail investor from the Euro area-11 could expect to incur an annual FTT charge of 33 bp, while a similar institutional fund manager would incur 11 bp in tax. On this basis, a 30 year-old retail investor in the Euro-11 area who invested €1,000 a year until retirement at 65 could expect to see 14% of the principal investment consumed by the FTT.” (GS Report, p. 54).

These calculations are biased in three respects. First, it is assumed that investors would not reduce the turnover of their portfolio due to the FTT. Second, it is – unrealistically – assumed that the retail portfolio returns over 35 years 6% p. a. on average. Both assumptions result in a high sum of cumulative tax payments (4.875 €). Third, this sum is then related to the cumulative cash invested (35.000 €) leaving out the interest-compound effect. If one takes the latter – correctly – into account, the cumulative tax burdens amounts to only 4.1% of the closing portfolio (this ratio is documented in exhibit 34 but not mentioned in the main text).

The “dirty” campaign of the financial lobby, designed by economic researchers as their intellectual servants was successful: The tensions between members of the “coalition of the willing” rose, in particular between Germany and France, and the EC proposal is no longer the common base of the “enhanced cooperation procedure.”

In order to make some statement on the FTT issue before the elections to the European Parliament, 10 finance ministers of the EU11 (Slovenia did not sign up) declared on May 6, 2014: “...The Council Working Group has reviewed the Commission’s proposal during the past months. It is evident that complex issues have arisen. As a result, more technical work needs to be conducted. Our commitment to the introduction of a financial transaction tax remains strong... We agree on the following key elements: The work on the introduction of a harmonized financial transaction tax is to be based on a progressive implementation of the tax. The progressive implementation will first focus on the taxation of shares and some derivatives.”

In plain language this passage should read: “The campaign of the financial lobby during past months was too strong. This forced us to give up the ‘all institutions, all markets, all instruments’ approach proposed by the European Commission. Instead, we shall introduce a tax on shares like the British ‘stamp duty’, but with much lower tax rates. We commit ourselves to call it ‘financial transaction tax’”.

To tax only spot transactions in shares in a first step means (no important derivatives will be included as the French government does not want to disturb “their” banks’ business): Out of all instruments the “FTT” would tax exactly only those which are less used for short-term speculation and more for holding wealth (compared to derivatives). It won’t be too difficult for pension and investment funds to carry out a campaign against such a one-sided “FTT”. But even if such a tax is implemented, it will soon be suspended since the revenues will fall short of projections – trading will shift to stock (index) derivatives and new forms of derivative “stock hybrids”.

As project of the “enhanced cooperation procedure” this type of “FTT” will probably never be introduced because there won’t be the minimum of 9 Member States available. It simply does not pay off for politicians to support such a tax as proponents of a true FTT conceives such a support as mockery of their engagement and opponents reject any kind of transaction tax.

#### **4. Outlook**

The defeat of the FTT proponents did not come as a surprise. It just reflects the power of “big finance” which has been growing over the past 40 years in tandem with the transformation of the economic system from “real capitalism” in the 1950s and 1960s to “finance capitalism” afterwards. The key difference between both types of capitalism concerns at which activities is striving for profits – the “core energy” of capitalism – focused on.

In real capitalism, the framework/incentive conditions promote entrepreneurial activities in the real economy because under stable exchange rates, stable commodity prices and interest rates stabilized at a level far below the rate of economic growth it is hardly possible to “make money out of money”. Under these conditions,

banks play an important, yet modest role by channelling private savings to investments (“boring banking”).

The “scientific” legitimation of a real-capitalistic system is provided by theories which stress the inherent (financial) instability of capitalism and, hence, the necessity of strict regulations of the financial sector and of an active economic policy. In more general terms, in real capitalism one strives for an integration of the great contradictions: Between governance through politics and governance through market forces, between cooperation and competition, between individual self-interest and social coherence/social self-interest, between (real) capital and labour.

The real-capitalistic phase of the 1950s and 1970s was shaped by the predominance of Keynesianism as the theoretical/ideological basis, by stable financial conditions, by building-up the welfare state, by strong expanding real investments (the main form of profit-seeking), and consequently by high economic growth and full employment. These conditions strengthened over the 1960s trade unions and social-democratic parties, the institutions of the welfare state helped to secure their power, intellectuals moved to the left.

All these developments provoked the offensive of a counter-movement by the late 1960s. The core demands of neoliberalism, i.e., fighting trade unions, weakening the welfare state and liberalizing financial markets, were strongly supported by “big business” and scientifically legitimized by the monetarist theory.

The stepwise realization of the monetarists’ demand for de-regulation of financial markets transformed the system from a real-capitalistic to a finance-capitalistic regime over the 1970s. Unstable exchange rates, commodity prices, interest rates above the rate of growth, booms and busts in the stock market together with financial innovations – in particular the emergence of financial derivatives – progressively fostered “finance alchemy” at the expense of entrepreneurial activities (figures 1 to 8). These systemic changes have strongly contributed to the decline of economic growth from decade to decade, and to the related increase in unemployment as well as in the public debt. This process has caused (many) banks and hedge funds to transform themselves from institutions serving the real economy to special-

ists in “finance alchemy” (some aspects of this transformation process is discussed in Boot and Ratnovski, 2012).

However, economic history shows that this type of profit-seeking is self-destructing since it produces progressively more financial assets which are not backed by real values – “fictitious capital” in the form of overvalued stocks and government bonds. The simultaneous devaluation of stock wealth, housing wealth and commodity wealth through the coincidence of three bear markets deepened the financial crisis and was the most important systemic cause of the most severe crisis of the real economy since the 1930s (Figure 9 – the stock market crash 2000/2003 can be conceived as a “foreshock”). The European elites could not recognize this cause, mainly because the neoliberal “Weltanschauung” has been dominating already for more than 30 years – first at the universities, then in the media and – at least since the early 1990s – in politics.

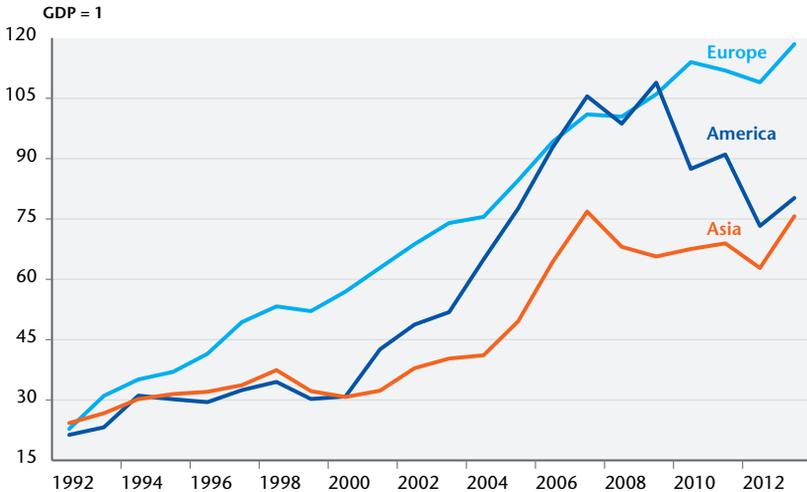
As a consequence, the European elites resorted to “more of the same”: “Finance alchemy” was completed by a new game, the speculation against sovereign states, austerity policy has been strengthened, labour markets liberalized, real wages cut. All these measures only deepened the crisis: Unemployment is higher than ever before in post-war Europe, the public debt has risen tremendously. Whereas the real economy is depressed, stock prices boom again, fuelled by a pseudo-Keynesian monetary policy (conventional Keynesianism cannot work under finance-capitalistic framework conditions).

The US policy followed a much more pragmatic course: “Finance alchemy” was somewhat dampened by the Frank-Dodd act, in particular by the restrictions on proprietary trading (“Volcker rule”) and no strict austerity measures were imposed on the economy. In the US, “realistic economics” has been to a much lesser extent marginalized in academia, media and politics as compared to Europe where – under German leadership – “idealistic economics” has almost completely obsessed the heads of the elites.

These differences are also reflected by the development of financial transactions (Figure 11). In 2007, overall trading volume amounted to 105.5 times GDP in the US and to 101.1 times GDP in Europe. Until 2013, trading volume fell in the US to 80.2 times GDP whereas it rose to 118.5 times GDP in Europe (based on data

from the “Triennial Survey” of the BIS and the data base of the “World Federation of Exchanges” – the data do not comprise repos and CDSs).

Figure 11. Financial transactions in the global economy



Source: BIS, WFE, WIFO.

To sum up: Since the outbreak of the crisis six years ago the resistance of the European elites to learning from the crisis and to reconsidering their neoliberal “Weltanschauung” and the “navigation map” derived from it, has not been weakened but strengthened. As a consequence, the long-term divergence between a booming financial economy and a progressively depressed real economy has been sharpened since the crisis. In such an environment, the proposal of a comprehensive FTT had finally to be rejected. The real surprise is that the idea of a general FTT made it up to an official proposal of the European Commission.

If elites are unable to learn from a crisis they have to repeat it. This will happen in the near future, once again triggered by the tilt of stock prices from a bull market to a bear market. Even if stock prices fall “only” as strongly as in 2000/2003 or 2008/2009 (they could fall stronger as the recent boom was also stronger – see Figures 2 and 8) will the related worldwide devaluation of stock wealth dampen final demand. It will dampen directly consumption and investment because many households and enterprises are

already in a precarious financial situation. The situation will be aggravated by the fact that governments – certainly in Europa – will not be willing and able to stabilize the economy through expansionary fiscal policy measures. The situation could worsen further if the extremely high bond prices fall in tandem with stock prices.

In other words: The next bear markets and the thereby induced crisis will accelerate the process of self-destruction of finance capitalism during the trough phase of the long cycle<sup>6</sup>). The depression will only be overcome if framework conditions are changed in such a way that entrepreneurial activities are much more rewarded than “finance alchemy”. A general FTT could serve this purpose, but more radical solutions will probably be necessary.

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6. Arrighi (2010) analyses the changes between real-capitalistic and finance-capitalistic regimes since the 15<sup>th</sup> century. In his interpretation, an economic and political system becomes the hegemon during a real-capitalistic upward phase, then moves to “high finance” and by doing so finances the upward phase of its successor. In this way, the Republic of Genoa financed the expansion of the Dutch Republics during the 17<sup>th</sup> century which then financed the industrialization of Great Britain. When London moved to “high finance” in the 2<sup>nd</sup> half of the 19<sup>th</sup> century it financed the US expansion. When the Wall Street became dominant in the late 1970s, the US started to finance the expansion of the Chinese economy through joint ventures which also provide a continuous technology transfer. Note, that the Chinese economic system is characterized by real-capitalistic conditions (e. g., exchange rates and interest rates, the two most important prices intermediating between the real and the financial sphere, are controlled by economic policy). Note further, that in China stock prices have fallen between 2009 and 2014 by almost 50% whereas they have doubled in the West (in the meantime, however, stock markets in China have boomed like never before indicating a chance to “export” finance capitalism there). At the same time, the real economy continues to boom in China, whereas it is still stagnating in the West, especially in Europe. (“Wall Street culture” is one of the most powerful allies of China on its long way to hegemony over the real economy). In this context, one should also consider the fact that the French economy has been to a much greater extent “financialized” than the German economy. Note also the recent attempts of US policy to re-industrialize the US economy whereas in Europe the financial sector continues to dominate.

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