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A Step into the Wrong Direction

The German federal government wants to introduce a financial transaction tax – a tax on the trading of certain shares. For several reasons, this is a bad idea.

Against the backdrop of years of negotiations at the European level about financial sector taxation, the German federal government now wants to introduce a tax on the trading of certain shares. The tax is intended to apply to sales of shares in companies that have their headquarters in Germany and whose market value exceeds EUR 1 billion. It is to be set at 0.2 percent.

This tax is a perfect example of a policy that claims to solve problems, but actually exacerbates them. Financial transaction taxes are popular. Many people believe that they can be used to fight harmful speculation and claw money back from those who lined their pockets before the financial crisis at the expense of the general public.

In fact, these goals call for other instruments, as a closer look at the financial sector's problems makes clear.

Banks Need More Equity Capital

For one thing, while there are undesirable forms of speculation that ultimately contributed to the financial crisis, the share transactions that are now to be taxed are not among them. The main cause of the crisis was the low level of equity capital of many banks, combined with the need to bail out collapsing banks with government money. This fatal combination created strong incentives for bank managers to take excessive risks. As long as things were going well, they made fantastic profits and awarded themselves astronomical bonuses. When things went wrong, the state had to bear the losses. This privatization of profits and nationalization of losses was rightly criticized.

The right response is to require banks to significantly increase their equity capital. In addition, many countries have introduced levies on debt financing by banks. A tax on share transactions, however, does not address this problem.

Now, people suggest that the planned tax will curb other undesirable forms of speculation that destabilize financial markets and cause major price fluctuations. This, again, is not true. First, some important speculative instruments such as derivatives don't come under its scope at all. Second, a financial transaction tax reduces stock market turnover, making it easier for individual speculators to influence prices. Consequently, a financial transaction tax may even strengthen unwanted price fluctuations as a result of speculative trading.

Taxing Part of the Payroll

Another argument put forward in support of this tax is that certain financial services are not covered by VAT. This is a fair point. But a financial transaction tax isn't a good way to compensate for this, because it is not a tax on financial services. The answer to this problem has been undisputed for years: a tax should be imposed on parts of the value added in the financial sector, with the easiest method being the payrolls and bonuses of companies that provide financial services. Denmark is one country with just such a tax.

The claim that the International Monetary Fund (IMF) is in favor of a financial transaction tax is also misleading. As long ago as 2010, the IMF released a lengthy paper explaining that a financial transaction tax was not the best tool for compelling the financial sector to help cover the costs of the financial crisis. The IMF advised against taxing financial transactions. One of its suggestions was to impose a tax on the profits and remuneration of financial companies, known as the financial activity tax.

The Proposed Tax Will Be Damaging

Not only will the tax on share transactions now planned do nothing to solve the financial sector's problems, it will in fact cause additional damage. First, it makes equity financing more expensive. Exempting new share issues from the tax does little to change this, because the tax on future trading of those shares will already be priced in. This creates incentives to switch to debt financing. Our tax system already discriminates against equity financing; a tax on share transactions will only intensify this.

But that's not all: in times in which savings accounts no longer yield interest and demographic change is pushing pay-as-you-go pensions to their limits, it is actually desirable for broad sections of the population to supplement their retirement provision with equity savings. For example, anyone who saves EUR 100 per month in the form of shares – i.e., invests EUR 1,200 per year – will face EUR 2.40 in additional taxes in the future. That might not add up to much, but it's still a burden. At the same time, the state uses subsidies to promote private retirement provision. These two approaches are at odds.

One should not exaggerate the impact of the new tax on share transactions, but tax policy steps in the wrong direction are no less wrong for being small.

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