Lost jobs, costlier mortgages and pensions ... the person in the street will feel the ill effects

In the run-up to last week's G20 summit in Cannes, a number of eminent figures, including Bill Gates and the Archbishop of Canterbury, lent their support to a proposal for a global financial transaction tax (FTT). In doing so, they joined the leaders of France and Germany and the European Commission, who are advocating a European FTT as a precursor to a global version.

In the event, the language that the leaders of the G20 agreed in their communiqué was notably lukewarm on the proposal for a global tax. This is not surprising, since the balance of opinion among the member governments is firmly against. With the chairmanship of the G20 soon passing to the Mexican Government (which is sceptical), the immediate momentum behind a global tax is likely to slow. Nonetheless, the proposal for an FTT in Europe retains significant support.

It could be argued that European leaders have more immediate concerns to address now. However, it is not merely a question of timing. A financial transaction tax would be the wrong choice for Europe at any time; and particularly now.

To understand the impact of FTT, we need to answer four essential questions. Is it an efficient means of raising tax revenue? Would it benefit the end-users of the financial markets, both businesses and consumers? Would it enable the creation of economic growth and jobs? And would it make financial markets more stable?

First, financial services is a mobile, global and highly competitive sector. The European Commission's suggests that Europe would lose 10 per cent of its securities market, 40 per cent of its spot currency market and 70 to 90 per cent of its derivatives market if FTT were introduced.

These are alarming numbers and economically very damaging — and they are not mere conjecture. Sweden’s FTT (from 1984 to 1991), resulted in between 90 and 99 per cent of traders in bonds, equities and derivatives moving from Stockholm to London. This was an expensive lesson for Sweden. Its experience should prevent Europe from making a similar mistake.

Second, what will be the impact on users of financial markets, including ordinary consumers? Economic theory suggests that a transaction tax would largely be passed on to end-users, whether they are savers, investors or businesses. The European Commission itself makes this point.

The European proposal for an FTT seeks to shelter companies and consumers from the direct effects of the tax, but it cannot avert the indirect effects. While people taking out car insurance or a mortgage or investing in their pension would not pay extra tax directly, they would bear the impact of the tax because of the transactions earlier in the chain that were subject to the FTT. Similarly, pension funds across Europe would pay the tax when they buy or sell investments or use derivatives to hedge against inflation.

So an FTT would reduce the value of pensions for Europe’s citizens. Borrowing costs would also increase, since the providers of credit to households and to small and medium-sized businesses would pay the tax when using the financial markets to secure funding.

Third, the European Commission estimates that in the long run an FTT would reduce Europe's total output by between 0.5 and 1.8 per cent — and reduce total EU employment by up to 0.2 per cent, or nearly half a million jobs, because of the loss of certain markets, such as derivatives, in Europe.

Moreover, the big gaps in the commission’s economic modelling — which, for example, does not take account of the financial services and ancillary jobs that would leave Europe — suggest that these projections are likely to be significant underestimates.
Finally, there is the impact of the tax on financial stability. Evidence suggests that a transaction tax risks exacerbating the volatility that some FTT supporters claim will be reduced. Having reviewed the evidence, the European Commission concludes that “many studies show that a financial transaction tax could aggravate volatility (due to a reduction in the number of transactions), creating more room for speculators”.

And we should be clear about the impact on companies across Europe, many of which buy financial products such as derivatives in order to hedge important business risks. For example, airlines use futures contracts and derivatives to hedge their exposure to the price of jet fuel.

A transaction tax would simply penalise companies for basic transactions, such as hedging against fluctuating raw material prices or exchange rates. This effect, in turn, could result in reduced levels of hedging, exposing companies to greater financial risk. The onus is on the advocates of an FTT to demonstrate a clear benefit to financial stability. The evidence suggests the opposite.

Taking account of the negative consequences that would flow from an FTT — in terms of growth and jobs, the cost burden on business and consumers and financial stability — the case for the financial transaction tax simply cannot be made. We urge Europe’s leaders to focus instead on completing the necessary process of regulatory reform, and taking real steps to promote growth and recovery.

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