The Regulatory Road Not Taken
The Proposed Financial Transaction Tax in a Historical Context

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Summary: Post-crisis proposals for financial sector regulation reflect an unresolved tension between a "thin" and a "substantive" conception of regulation. Tracing these shifting approaches historically – beginning with John Maynard Keynes and the American New Deal – helps understand why the European Commission proposed a financial transaction tax but simultaneously assessed that it would be bad for economic growth. This article was originally published in September 2012.

In the aftermath of the financial crisis, the need for greater and tighter regulation of the financial sector has become almost a matter of consensus. But the various reform proposals and new legislative measures reflect a tension between two competing conceptions of the problem and potential solutions. On the one hand, there is an emerging conviction that market mechanisms are deeply inadequate for ensuring the proper functioning of the financial system. This view sustains a "substantive" conception of regulation: regulatory measures should be designed to ensure that the financial system fulfills its role in the service of the real economy, including by identifying what specific types of market behavior should be encouraged, impeded, or even prohibited. On the other hand, there is a lingering hold of a "thin" conception that became dominant in the 1980s: this view presumes financial markets to be efficient until proven otherwise, and circumscribes the role of regulation to facilitating market transactions and correcting diagnosed instances of market failure by relatively unobtrusive means. The current European debate on the financial transaction tax (FTT) suffers from a generally unacknowledged oscillation between these conceptions.

Shifting Regulatory Conceptions

Among the various arguments in support of the FTT, it is the economic rationale for it that poses a direct challenge to the faith in market mechanisms. Simply put, the idea is to throw sand in the wheels of the overly-liquid financial markets, increase the cost of transactions, and discourage some forms of market activity. The European Commission's proposed directive for an FTT (September 2011) indeed explicitly aims to limit "undesirable market behavior". It is commonly observed that the greatest impact of the tax would be on automated high-frequency trading, for which the 0.1 percent tax rate (or, in the case of derivatives, 0.01 percent) would be more often prohibitive and shrink the market dramatically. The proposal therefore appears to signal a sober departure from the basic commitments that undergirded the massive wave of financial deregulation, which began gradually in the 1970s and continued up until the recent crisis. But the tenets of deregulation are more resilient than they appear.

The central imperative in the deregulatory period was to deepen capital markets and reduce transaction costs, trusting market innovation to produce instruments for spreading and managing risk. This approach carried with it a deep suspicion toward the regulatory measures of the New Deal and branded them as relics of a bygone era. The clearly "substantive" New Deal reforms, which included the establishment of federal deposit insurance and supervisory institutions, and the fundamental structural changes of the industry mandated by the Glass-Steagall Act, had radically altered the relationship between government and the market. By 2007 that legacy was all but dismantled, sustained by a pervasive belief was that only complete markets would lead to the efficient allocation of capital and to long-term economic growth. But the new deregulatory paradigm quickly accommodated the perception that financial institutions could not be entirely left to themselves, giving rise to a new, "thin" conception of regulation. Within this conception, regulation was appropriate only where a default presumption of market efficiency was overridden, and only by "thin" measures. Thus, proponents of deregulation acknowledged that unencumbered financial markets would tend toward excessive risk-taking due to identifiable incentive problems and information asymmetries, and understood this to justify some supervision and the imposition of capital ratio requirements. The Basel capital accords are the cornerstone of this conception.

By contrast, the proposal for an FTT originally stemmed from a "substantive" conception. John Maynard Keynes first proposed a transaction tax in his famous "casino" passage in the General Theory (1936), as a way to restrict stock market speculation. He defined "speculation" in contradistinction to "enterprise", to denote trading that is not based on the assessment of how the underlying assets would perform in the long run, but on predictions concerning the psychological patterns of behavior of the rest of the market. Often short-term, and disconnected from the perception of real future yield, excessive speculation prevented the stock market from fulfilling its "proper social purpose" of directing "new investments into the most profitable channels." Key to Keynes' analysis was the insight that market mechanisms could not resolve the problem, because widespread speculation was precisely the "scarcely avoidable outcome of our having successfully organized 'liquid' investment markets."

Before the 1929 crash, calls to curb stock market speculation had been frequently met with *laissez faire* objections – the earlier version of the "thin" conception. This was especially the case with the attempts to limit "margin trading" – stock purchases financed by broker loans. Early proposals to impose limits on margin trading had been rejected as both arbitrary and paternalistic, that is, illiberal. True, said the members of the New York state government commission following the 1907 panic, the availability of credit for stock trading did increase the volume of speculative trading, and it seemed risky. But how could one distinguish legitimate investment from useless or harmful speculation? As late as 1928, with alarming rises in broker loans, the chairman of the Federal Reserve also refused to intervene, asserting that the Fed was not in a position to judge whether the level of margin loans was too high or too low.

The Roosevelt administration gave a resolute answer to these conceptual and normative issues. Despite objections from Wall Street, the Securities Exchange Act of 1934 authorized the Federal Reserve to impose tight restrictions on margin trading. The terms "speculative credit" and "naked speculation" were made workable by deferring to the discretion of the Fed in setting the precise margin limits. Rather than addressing the concern with market freedom and liquidity, the Congress cast its objectives on substantive economic grounds, focusing on the need to enhance the nation's productive capacity and to ensure that financial markets fulfilled their social function of channeling resources to productive uses. This confident act of legislation embodied a fundamental shift in the burden of proof: instead of demanding that the regulator defer to markets, a prima facie case had been made that financial markets could not be trusted to act as "servants" of the economy, and regulation became the new default rule.

Does the European Commission's proposal revive this approach? On first glance it appears to espouse a "substantive" conception, stating explicitly that the tax aims to create "appropriate disincentives for transactions that do not enhance the efficiency of financial markets". However, this is undermined by the Commission's own impact assessment which forecasts that the FTT would have a negative impact on GDP (1.76 in the long run). The Commission thereby fails to take account of the substantive argument for the FTT, as developed by prominent economists in the late 1980s.

Speculation and Economic Growth

In 1989 both Joseph Stiglitz and Larry Summers concurred with Keynes' FTT proposal, casting it in the more updated vocabulary of economic efficiency, or social welfare. They have identified that much of what goes on in Wall Street is far from contributing to the stock market's performance of its ultimate functions, those of "spreading risks, guiding the investment of scarce capital, and

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processing and disseminating the information possessed by diverse traders". Indeed, ongoing increases in "transactional efficiency" – the facilitation of free trade in an ever-growing array of securities – have resulted in an overall reduced efficiency in the allocation of capital. Stiglitz emphasizes that a large part of short-term trading is a wasteful zero-sum game with no social welfare benefits, conducted by people who believe (irrationally) that they can beat the market. Summers' work identifies the harmful, rather than merely wasteful, outcome of "noise trading": trading that is not based on fundamentals (similar to Keynes' "speculation"). Although such trading can act as arbitrage and may correct for mistakes in share prices, patterns of "mistakes" are not random but cumulative, and arbitrage is insufficient to correct them. The result is that market prices become increasingly distant from fundamentals, thereby distorting signals for investment decisions and creating bubbles destined to burst.

While the effects of noise trading on volatility is still debated, the inefficient allocation of resources can hardly be. Both Stiglitz and Summers stress that the financial sector is much too big, and lament the brain-drain from more welfare-enhancing fields into Wall Street. They also point out the troubling effect of short-term-trading on the behavior of firms, as corporate managers committed to shareholder value align themselves to the market's attention span, and operate increasingly on shorter horizons of profitability – to the detriment of longer-term projects. These dimensions of the problem have only grown in recent decades, as both the array of traded securities and the size of the financial sector have been expanding, with trading in international derivatives exchanges reaching a turnover of about a hundred times US GDP in 2006.

The gist of these ideas is echoed in part in the current discourse on the FTT. Even strong objectors, such the British House of Lords, have examined closely the question of the economic impact of high-frequency trading, and taken evidence from experts on matters such as spurious liquidity and endogenous dynamics of price bubbles. The presence of such analysis is already a retreat form the "deep markets" dogma. But there remains a puzzle: how is it possible that a measure designed to increase the efficient allocation of capital would have a negative impact on GDP? If the Commission stands behind its statement that the targeted transactions "do not enhance the efficiency of financial markets" then it should have predicted that curbing them would mean less waste, better allocation of resources, improved corporate strategy; in short, increased productivity.

Economic Sense Versus „Fairness"

The prediction of a negative impact on GDP seems to be based, at least in part, on the assumption that the tax would result in increased cost of capital. The premise here is that, like other taxes, the FTT would be a distortion of pre-tax behavior and transactions, which are assumed to provide the efficient baseline. This fails fully to register the point that some forms of market transactions are themselves the cause of inefficiencies, with their reduction via taxation being a contribution to increased efficiency, rather than a "cost" of pursuing various other aims through the tax. Further, while the Commission states that the FTT would reduce "excessively risky" transactions, its impact assessment does not seem to factor the risks of instability in the calculation. If speculation were perceived as responsible for financial instability even minimally, how could the Commission's predictions not take recognition of the devastating impact on GDP that crises themselves tend to have (in 2009 the EU27 GDP took a 4.3 percent hit), and the vast bailout expenditures that often ensue? The impression is that the Commission analysts were compelled to provide a prediction and a number for the foreseen effects of the tax, which translated into ignoring fundamental aspects of the analysis that remain under debate or are hard to quantify.

The very use of the GDP measure for assessing the FTT is not at all obvious. While financial transactions themselves do not register in GDP, brokers' fees do. If the post-FTT decrease in the volume of financial services would show as a decrease of GDP, any analysis that saw some of these services as socially useless should have expressed some reservation about the merits of GDP in this context. The Commission's reliance on it exhibits the continued force of the "thin" conception, wedded to a presumption of market efficiency.

Failing to take full account of the substantive foundations of the economic rationale for the FTT has appreciably weakened the case for the tax. Most of the advocacy in favor of an FTT is framed not on principled economic grounds but in terms of its revenue-raising potential and, centrally, the need to have the financial sector contribute its fair share to the costs of stabilizing the system. These arguments do not support an FTT specifically, but rather could apply equally to any form of bank levy. Further, they tend to be met by objections from bankers and economists who advance arguments couched in the language of efficiency, while still espousing an agenda of deepening markets and reducing transaction costs. The result, then, is an unfortunate tendency for the debate to be framed in well-worn terms of an ostensible tradeoff between "fairness" arguments and economic sense. No doubt there exist other reasons why the proposal for a Europe-wide FTT has failed so far; but the tepid economic case made for it has not helped.

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