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AN EU FINANCIAL TRANSACTION TAX: A THREE-FOLD ASSESMENT

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ABSTRACT

In the paper we discuss the proposal from the European Commission to introduce in 2014 a European financial transaction tax (FTT). The assessment is three-fold. First, we do assess an FTT with the criteria the Commission has come up. Second, we do assess an FTT from the point of view of public finance. Third, we do assess an FTT from the point of view of entrepreneurship. On all three criteria, we do get a negative verdict: (1) the choice for an FTT is an ad hoc one, (2) an FTT is not intended to be a future-oriented quid pro quo, and (3) entrepreneurship is stifled.

INTRODUCTION: EU BUDGET REFORM

At the start of the European Union (EU) in 1958, direct Member States' contributions financed the EU. The goal of the EU, however, has always been to have sources of finance separate and independent of the Member States. The EU, indeed, got its own resources; in the beginning of the eighties of the last century, the EU was financed by agricultural levies, custom duties and a percentage of a harmonized VAT-base. At present, because of a growing budget and dwindling custom duties due to free trade, the EU is financed for 15 percent by own resources. EU's revenues are mainly Member States' contributions: a percentage, 1.12 percent, of their Gross National Income (GNI). The total budget for 2012 is 147.2 billion euro.

Direct contributions, however, stimulate the Member States in so-called *juste retour* behavior (Richter, 2008). They look at what they get and what they give to the Union. Expenses with a real added value to the EU as a whole are stifled, e.g., energy security, European infrastructure, and a knowledge-led service economy. The bulk of the expenses, almost 80 percent, are agricultural subsidies and income redistribution among Member States. The last is done by the so-called structural funds and the cohesion fund. They aim to reduce regional disparities in terms of income, wealth, and opportunities. Europe's poorer regions receive most of the support. In general Member States tend to favor instruments that improve their net position rather than those with the greatest value added for the EU as a whole.

To curtail the Member States' focus on their net contributions, the EU wants new, so-called, true own resources. The European Commission (2004), or simply Commission, the executive arm of the European Union, which proposes and disposes, and the European Parliament (2007), which exercises legislative and budgetary functions jointly with the Council, do endorse the idea of a European tax. In 2010, on the list of proposed EU taxes, were six taxing options: (1) taxation of the financial sector; (2) revenues from auctioning under the

greenhouse gas Emissions Trading System; (3) a charge related to air transport; (4) VAT; (5) energy tax; and (6) corporate income tax (Commission, 2010, cp. Open Europe, 2011). In 2011, the Commission (2011a) selected a financial transaction tax (FTT) and a European VAT as the two most likely candidates for a Euro tax. An FTT (Commission 2011b, cp. Henkow, 2012) is a tax on stocks, bonds, derivative products, and possible also currencies. The last is also the reason an FTT is also called, after its intellectual roots, a Tobin tax. James Tobin suggested in 1972 to tax all spot conversions of one currency into another. Financial institutions, at both sides of the transaction, do pay the tax. They are collected nationally but transferred to the Union budget. The Commission suggests an indicative reference tax rate for bonds and shares of 0.1% and of 0.01% for derivative products. With and FTT, countries will contribute 2/3 of the nationally-collected revenue to the EU budget, which will reduce their contribution based on GNI (Commission, 2012a). Just as, based on a single EU rate, an EU VAT would require national tax authorities to transfer a share of national VAT receipts to the EU budget. The Commission suggests a 1% rate, which would lead in 2010 to revenue for the Union of about 50 billion euro. This amount is the same as an FTT would raise.

EU CRITERIA AND AN FTT

Over the years, the EU has developed criteria to assess new EU taxes, so-called own resources (Begg et al., 2008; Commission, 1998 and 2004; European Parliament, 2007). The criteria can be rubricated as budgetary: sufficiency, stability; efficiency: visibility, operating costs, efficient allocation of resources; equity: horizontal and vertical, fair contributions of the Member States; and political: will consensus be possible among the Member States?, will the fiscal sovereignty of the Member States be maintained?, does an EU tax create a Leviathan? Though it could also be maintained the EU budget is just the oil that makes other more important decisions possible (Figueira, 2008). In a cynical sense, we also do have to add this criterion to the list. All the, often contradicting, criteria, the Commission has to add-up somehow for an overall assessment. With the shopping list of criteria, the probable result of the choice for a new EU tax will be an *ad hoc* political one.

Visibility

As an example of the just-said, we look at the visibility criterion. With an EU tax, a visible link between citizens and the EU should be established. Over the years, the Union has evolved from a bond between states to a bond between states and the citizens thereof. The tax should be the expression of this idea. In all just-mentioned EU studies, however, the lack of visibility of an FTT, as an implicit tax, for EU citizens is noted. Its invisibility for EU citizens should also be a reason not to assign an FTT to the Union. Moreover, of a FTT, it is unclear who in the end does pay (Worstell, 2011). An FTT also does not create a bond between the EU and the citizens. As was to be expected, the Commission chose an FTT with an *ad hoc* argument: to let the financial sector pay for its part in causing the financial crises in 2008 (Commission, 2011b; Gapper, 2012). Hence, it is called a fair, so-called 'Robin Hood' tax.

Opinions, however, differ if invisibility is a disadvantage. For governments it could be the opposite. Because an FTT is an implicit tax, it may be politically easier for Member States to assign the tax to the EU than to do this for a more overt tax (Begg and Grimwade, 1998: 135). Of all the proposed EU taxes, only an EU VAT, able to be seen on every sales slip, will be clearly visible to all EU citizens. It is also fair to say the EU shows courage if it wants to introduce a visible tax. For centuries the goal and wisdom of governments was to collect taxes as invisible as possible. Indirect taxes not direct taxes were to be preferred. Custom duties and a contribution that depends on the GNI of a Member State, the current way of EU financing, are the old ideal. Both revenues are unrelated to daily life. Also, an FTT is based on the wisdom of the past. This would give a hidden assessment criterion, notwithstanding the Commission's public rhetoric stating the opposite. In sum, an FTT for sure has nothing to do with creating a visible link with EU citizens.

Policy conclusion: back to theory and politics

To solve the situation of the unworkable, long list of criteria and to make possible a systematic choice, the Union has to come up with a manageable list. In addition, the manner in which the criteria are defined and (explicitly or implicitly) weighted predetermines analytical results (Heinemann et al. 2008: 4). For that reason, Friedrich Heinemann et al. do come up with a more systematic list related to four explicitly stated theories: fiscal federalism, public choice, European Integration and more traditional principles of taxation (Heineman et al., 2008: 143-153). Another possibility, as is suggested by Ian Begg (2011: 8), is to introduce a two-stage methodology for choosing. "This approach would depart from the conventional one of identifying a potential instrument and then assessing its merits. Instead, it is proposed that the first stage should involve a political discussion about the characteristics that a revenue source should exhibit. Such a discussion would culminate in a set of weights for the different criteria against which the various contenders would be judged. In a second stage, potential resources would be scored on the criteria and the weights applied to determine how much each criterion mattered in the overall assessment."

FTT AND PUBLIC FINANCE

Even if the Commission solves the problem of the many criteria, what does it mean to introduce direct EU taxes? Is the just-mentioned *juste retour* thinking blameworthy, in other words *quid pro quo* thinking, and what really involves a link between citizens and the EU? First, we look at the history of the EU budget. Not solidarity but looking at national net positions made the start of the EU in 1957 possible. Second, we look at an EU tax not from a collective but from a more individualistic perspective. *Juste retour* thinking was not only the workable thing for Member States in the past to do but is also for sectors of society and citizens the natural thing to do in the present (Leen, 2011).

Collective net positions in the past

At the start of the Union from 1957 until the late sixties, planting a national flag on expenditures and then setting up the balance between contributions to and expenditures from the EU was the institutionalized practice. Otherwise, it was generally accepted, States would have been unable to agree. The goal was not to deny interests, but to make use of them. There was an administrative budget, a social budget and a separate budget for research and development of the European Atomic Energy Community. In addition, there were distinct budgets for development programs in the former colonies and a separate budget of the European Investment Bank (Druker, 1975).

As history shows, to think in costs and benefits does work. To trust solidarity, on the other hand, is no solution. Notwithstanding that in the preambles of the Treaty of Rome of 1957 and that of Lisbon of 2007 solidarity is confirmed and desired to be deepened. For current net contributors, however, it wrings that, given the structure of the present expenditures, a reciprocal solidarity is never to be expected. Conversely, current net recipients do say their solidarity will subside if the solidarity of the present net contributors falters. Probably, as is said of love, we have to minimize the use of that scarcest of all resources (Buchanan, 2001: 96).

From collective net positions to the net positions of the financial sector

Just-retour thinking, as a political justified thing to do, is not a new idea. In 1896, Knut Wicksell argued that taxes in principle should never be assessed without the spending that goes with them. The same is upheld in modern times by James Buchanan ([1967], 1999). Paying taxes is not, as Italian authors wrote, similar to a hailstorm, of which the government must distribute the injury as fairly as possible. In the last vision, it all comes down, to a need for funds that are exogenously determined and are funded by minimizing the effects on the allocation. Expenditures relate to the overall outcome for society, not to the direct benefit of a particular individual or group of people. However, regardless of the technical difficulties of dividing the common benefit, to justify public expenditures the last must be done.

It will not work to leave the balancing act of costs and benefits to governments, i.e. the Commission, or to the European Council, which comprises of the heads of state or the government of the Member States and provides overall political direction to the Union. For Wicksell it became clear the government lacks the knowledge thereof. Besides that, the government is no benevolent ruler working for the general welfare. “[T]he members of the representative body are in the overwhelming majority of cases, precisely as interested in the general welfare as are their constituents, neither more nor less”. (1896, 87). A tax must become like a market price: each individual voluntarily pays to get. The fiscal process is a *quid pro quo*.

The *quid pro quo* perspective on an FTT

In sum, we should not contest the *just retour* behavior. “It is not the business,” says Wicksell, “of the science of public finance and of tax legislation to do away with the egotism of the social classes, but to assign it its proper place as a safeguard of legitimate particular interests” (1896: 118). Wicksell argues for a system of earmarked taxes and expenditures. Also, to let the financial sector pay for the bailout money of the past is in line with *quid pro quo* thinking. The point, however, is the EU, in the future, wants to have an FTT as a stable new revenue but not wants to help anymore the financial sector. Though, at least once, the Commission (2011b: 3) did mention as a specific objective of an FTT to cover the budgetary costs of potential future financial crises. However, see, e.g., in the U.S. where the explicit aim in view of the implementation of the Frank-Dodd legislation, is that no future, taxpayer paid, bail-outs are necessary any more (Volcker, 2012). Just as this is the aim of the EU’s regulatory reform programme for the financial services sector (Commission 2012b).

Policy conclusion: a future *quid pro quo*

As history shows, to think in costs and benefits not only works for Member States but also for sectors of society and individual citizens. For a bond between citizens and the EU it is the natural thing to do. “It would,” says Wicksell, “be strange indeed if taxation by interested parties should not result in taxation according to interest.” (1896: 77). We conclude an FTT, *mutatis mutandis*, puts the EU, in principle back to the workable first years of its existence. However, what, at present, does the financial sector get back for an FTT---a future no-bailout clause; to be consistent, a *quid pro quo* (bailout) would be necessary. This, since, an FTT is no one-time tax for past wrongdoing of the financial sector.

FTT AND ENTREPRENEURSHIP

In what way does an FTT influence the perception of entrepreneurial profit to be gained by a financial transaction? In other words, “What tax system suits entrepreneurial entry in the market process, a decision to buy

or sell, the best?" We do answer the question from the Austrian perspective. The perspective is to be contrasted with the mainstream neoclassical point of view. If the market—as the Austrians do say—is a process of discovery, the first effect of a tax system is not its effect on the relative preferability for the decision-maker of already-perceived alternative courses of action. The effect we have to take into account is, first and foremost, the possibility that the tax may have significant impact upon the very perception by the prospective taxpayer of what array of opportunities are available for his choice.

The core of Austrian economics

We look at tax systems in the tradition of Ludwig von Mises, Friedrich Hayek, and Israel Kirzner. In other words, we examine a tax system that fits the market economy. This, since the essence of the market economy—from the perspective of the modern Austrians—is that it is a system of *competitive-entrepreneurial discovery*. What characterizes the market economy is competition, what drives the market is entrepreneurship, and what constitutes the steps in the market process are discoveries (Kirzner, 1997). In the market process we discover new ends and means. We look at the ultimate unseen: we even do not know what we do not know. Accordingly, we have to assess a tax with respect to the ability to promote creative acts of entrepreneurship.

Mises and Hayek made it possible to describe market adjustments as a systematic sequence of decisions. Mises describes the individual decision unit not only as maximizing, but also as finding out the relevant ends-means relationship. This opened the way for incorporating learning into our understanding of market processes. Hayek describes the process as one of learning by discovery: competition as a discovery procedure (Hayek, 1982: 67-69). Endogenous change in the ends-means relationship—says Kirzner—is possible with the entrepreneurial element in each individual market participant: alertness. Alertness is "the propensity [...] toward fresh goals and the discovery of hitherto unknown resources" (1973: 34). A disequilibrium situation points to market ignorance, from it emerge profitable opportunities that are exploited by alertness. Alertness gives a more realistic image of human action (and hence real choice) and makes possible the description of the market as a unified discovery process. "[The] 'alertness' view of the entrepreneurial role rejects the thesis that if we attribute genuine novelty to the entrepreneur, we must necessarily treat entrepreneurially generated market events as not related to earlier market events in any systematic way. The genuine novelty [...] attribute[d] to the entrepreneur consists in his spontaneous *discovery* of the opportunities marked out by earlier market conditions (or by future market conditions as they would be in the absence of his own actions)" [...] "[These] entrepreneurial discoveries are the steps through which any possible tendency toward market equilibrium must proceed" (Kirzner, 1985: 11-12).

The un- and counter expected

Modern Austrianism, defines entrepreneurship as the perception of the ends-means framework within which allocation and economizing is to take place (Kirzner, 1973: 33). A neoclassical defines entrepreneurship as combining individual-specific ability with an up-front investment to generate an uncertain return (Gentry and Hubbard, 2000: 283). The risk neoclassical economists do speak of is the risk of a known alternative. Indeed, if that is the situation, to look at relative preferability is the right (economic) thing to do. We, e.g., look at the changing relative gains of higher taxes on buying and selling. However, if it is utter ignorance (uncertainty) we are speaking about, taxation robs the entrepreneur of the incentive to come up with promising investments (with or without a high risk). In other words, for Austrian economics fundamental uncertainty is of the essence of the situation the entrepreneur faces. His situation is not one of uncertainty over given alternatives. The entrepreneur has, first, to come up with those alternatives. He has to come up with a framework of ends and means (Kirzner, 1973: 82-84). Afterwards he can assess the riskiness of the ends and means. The influence, also, of taxation on risk is a different one for each of these two problems: known uncertainty of "given" means and ends versus fundamental uncertainty as far as what are the means and ends in the first place. Neoclassical economics hints at the influence of taxation concerning the first form of risk. Austrian economics hints at the influence of taxation concerning the second. Fundamental ignorance and hence an ultimate error stands against a situation of given

alternatives involving risk: a situation we do know of the probability distribution of incomes attached to each alternative.

Also, what influence does the tax system have on the market's competitive-entrepreneurial discovery process? If the market is a process of discovery, the first effect is not its effect on "the relative preferability for the decision maker of already-perceived alternative courses of action" (Kirzner, 1985: 94) as the neoclassical tells us. The effect we have to take into account is "the possibility that the tax may have, perhaps, significant impact upon the very perception by the prospective taxpayer of what array of opportunities are available for his choice" (o.c.: 94). To answer our question, we do have to distinguish between the truly unexpected and the counter-expected. For Austrians uncertainty (risk) is first and foremost illustrated in the appearance of something completely unexpected. "[T]he situation holds unknown possibilities unconstrained by known constraints. It is the entrepreneur's awareness of the *open-endedness* of the decision context that appears to stimulate the qualities of self-reliance, initiative, and discovery" (o.c.: 109). For the neoclassical, however, only counter-expected things do happen. He thought to be 99 percent sure the sun would shine tomorrow. But the counter-expected did happen: it rained! In other words, in neoclassical economics the entrepreneur is "the ultimate bearer of irreducible, non insurable risk" (Kanbur, 1982: 2).

Why an FTT is wrong

Why are entrepreneurs not to be taxed? For the Austrian, the entrepreneur spots a new opportunity that is available for choice. Something we did not even know it existed. This is something completely different as to speak of an uninsured idiosyncratic risk. An error (utter ignorance) in a market economy does unveil itself by showing up as an opportunity for monetary profit. To stimulate the discovery process it is the producer-entrepreneur we do have to look at. If this is the case, we can say any form of taxation that lowers prospective profits goes against the market's entrepreneurial process of discovery. For in this way an error shows itself and provides the incentive that inspires entrepreneurial discovery of unnoticed opportunities: the bread and butter of the producer-entrepreneur. This is our first reason to exempt the producer from taxation.

A second reason to exclude the entrepreneur from taxation is that demand is not the desire of the consumer, i.e. other traders who do buy the financial products, for a hypothetical product not yet produced. "[T]he demand that is expressed in the demand curve for a product means the quantities of it that consumers will be prepared to buy, at given prices, when offered the opportunity of doing so" (Kirzner, 1973: 178). Consumer sovereignty means that production patterns are dictated by the pattern of consumer demand. To be more specific "production decisions are determined by entrepreneurial anticipation of the patterns of demand that will be evoked by alternative production plans" (o.c. p. 176). Consequently, if the distortions of taxation—that is the impact on the discovery process—should be minimized, taxes should not be levied on the entrepreneur. Since he is the first, the *conditio sine qua non*, to come up with something new (correcting an error) in the causal market process.

The third reason is that if it is entrepreneurship we do focus on, profits have to be as visible and as promising as possible. Entrepreneurship has to be stimulated. Entrepreneurship involves fundamental uncertainty in general but also, and of particular relevance of here, uncertainty as far as the complexity and instability of the tax code goes: legislative changes and tax court rulings. Often, because of either the sheer size or instability in the tax code, it is impossible to predict (there is fundamental uncertainty) the tax consequences of a particular activity. This uncertainty leads to a loosening of the entrepreneurial grip on pure profit. This since profits or losses arising from tax changes, by a fortunate or unfortunate change in the tax system, do appear after the entrepreneur has taken up his position. A potential and in fact superior vision may be highly stifled. We do remove much of the incentive—to "purposeful alertness, the alert purposefulness" (Kirzner, 1999: 39)—for paying attention to the unknown. Hence a tax system has to be as simple and predictable as possible.

Fourth, Austrians emphasize the division of knowledge and its growth. Entrepreneurial opportunities tend to appear within the context of a specific time and place. A decentralized economy allows individuals to act on their entrepreneurial insights, and rewards them for doing so (Hayek, 1960). The institutional setting of the

market is especially fitted to stimulate discovery. It produces an environment where entrepreneurship is stimulated. And since entrepreneurial insights lay also the foundation for additional entrepreneurial insights the growth process of the economy is sustained. The market system encourages the full use of (decentralized) human knowledge. There is no efficient non-market, e.g., governmental, resource allocation. This was the insight the Austrians tried to bring to the fore in the socialist-calculation debate that raged in the interwar period in the last century. A debate that began with the question, “Is an efficient non-market resource allocation possible?” For the Austrian, market based prices are necessary to signal scarcity, to transmit knowledge, and to stimulate discovery. Hence, the government cannot be trusted to do this job for society: guiding the discovery process, by changing the relative preferability of outcomes and means of production. As Mises concludes: “Inasmuch as money prices of the means of production can be determined only in a social order in which they are privately owned, the proof of the impracticability of socialism necessarily follows. [...] [T]his proof is certainly the most important discovery made by economic theory” (1981: 15). A discovery (that is using decentralized instead of centralized knowledge) a consumption tax tries to live up to. Hence, a simple uniform consumption tax system comes up as a logical corollary. There simply is no efficient governmental resource allocation by means of taxation.

Policy conclusion: no EU FTT but an EU VAT

By taxing pure profit, the discovery process is hampered. By lowering profits (especially since risk is at hand), impeding on the first one—that is the producer-entrepreneur—in the discovery process, and changing by a central government relative preferences with unknown consequences, discovery is seriously stifled. Taxing consumers without changing relative prices seems to be the least intrusive way to collect taxes in the competitive-entrepreneurial discovery process of the market. An EU-VAT is, next to being a visible tax for almost all EU individuals, the preferred new EU tax. Just as Milton Friedman said: “...the ideal tax system...ought to be a flat rate tax on consumption” ... “it has a great virtue which is also the reason it will never exist, [it] limits what Congress can do to mess things up from year to year” (Friedman, 2005).

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