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FINANCIAL TRANSACTION TAXES – THE TAXES OF THE FUTURE

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Background

We are in the midst of a financial and economic crisis brought upon us by excesses in the financial sector. Yet it is this very sector which has received more than a trillion dollars of government support in countries across the world because its functioning is so critical to the economy.

The combination of a recessionary squeeze in tax revenues and the money that governments have had to spend to rescue the financial sector as well as stimulate the broader economy has increased the prospects of a fiscal crisis with many rich and poor country governments facing budget deficits of an unprecedented magnitude.

These factors have led to a renewed interest in the Tobin Tax as well as the broader family of Financial Transaction Taxes. Rather unexpectedly, the chief UK regulator recently expressed support for a worldwide Tobin Tax to curb the size of the financial sector. Financial transaction taxes have also been talked about recently as a way of increasing revenue from the financial sector to 'make it pay for its rescue'. Another attraction is the potential positive impact these taxes might have on stabilizing financial markets by skewing incentives towards long term investments and away from short term speculation.

This concept paper lays out the case for a big expansion in this family of taxes and shows how the crisis has made it both more desirable and easier to implement financial transaction taxes.

Exponentially expanded financial markets

It is widely known that turnover in financial markets (the total value of financial instruments traded every year) has grown exponentially. This has been the case for almost all financial markets both on-exchange such as stock markets and off-exchange such as OTC derivate markets.

Currency market turnover for example rose from about \$4 trillion in the 70s to \$40 trillion in the 80s to more than \$500 trillion now. Turnover in equity markets registered a seven fold increase between 1993 and 2005 to about \$51 trillion and the wealth held in the global bond market is more than \$60 trillion now with turnover being higher. The notional value of OTC credit default swaps, just a single kind of derivate, rose to more than \$60 trillion from almost nothing a decade ago.

It is also well-understood now that this rapid rise in turnover is not unambiguously positive. Those who insisted that this rise in turnover was an indication of higher liquidity have been proven wrong by the financial crisis. Liquidity comes from having a diversity of participants and views in the financial markets with the volume of trades being far less important.

Clearly financial markets and financial market participants have been the winners of globalization and now are the recipients of hundreds of billions of dollars in tax payer bailouts. Having already not paid their fair share of taxes in the past and having generated enormous wealth for themselves, these financial market participants are again likely to

escape paying a fair share of their tax burden in the future with the 'little people' left to bear the brunt of the costs of the bailouts. The fast decent of the financial sector towards 'business as usual' complete with enormous bonuses shows how likely this scenario is.

Taxing financial transactions for a fairer burden sharing arrangement

One of the answers to the problems of fairer burden sharing no doubt has to be the increased taxation of financial markets. The financial transaction tax offers an attractive tool for implementing this.

Financial transaction taxes have a tremendous potential to generate revenue at even very low levels (a few basis points) of taxation simply because the volume of transactions is so high. Our first estimates show that such taxes could easily raise predictable, stable, easy to collect and equity enhancing revenues in the range of hundreds of billions of dollars annually. Figures of the range of 0.5%-2% GDP annually have been reported by several studies.

This money could then be used in a variety of ways – for example to reduce other taxes such as income taxes especially on the lowest levels of income, to repay the borrowings of governments which have expanded massively since the financial crisis hit, to recover the costs of the bailouts or merely as an additional tool in the portfolio of taxes that most modern governments levy. All of these would result in a fairer burden sharing across citizens belonging to various income groups.

Financial transaction taxes are a mainstream idea

Financial Transaction taxes have been around for hundreds of years with the Stamp Duty on the trading of shares in the London Stock Exchange being one of the oldest still around. This tax, which is now, levied electronically at 0.5% (50 basis points) of the face value of share purchases collects more than \$7 billion of revenue for the UK tax authority every year. The London stock exchange in the meantime continues to be the world's second largest exchange and in fact registers a higher turnover than the New York Stock Exchange which does not levy a stamp duty. Clearly any negative impact on the market can be contained.

Many other countries, including several other EU members such as Austria, Ireland, Greece, France and Finland still levy such taxes. Taxes on bond transaction are almost as common with Austria, Belgium, Germany and Greece levying such taxes.

Several other countries around the world such as India, Colombia, Brazil, South Korea, Ecuador, Hong Kong and Australia also have operational financial transaction taxes. Even the United States levies a transaction tax (called section 33 fees) on all share trades and uses the money to fund the SEC, the financial market regulator.

This is an interesting model where the financial markets pay for their own regulation and can be expanded also to include not only paying for all financial market regulation and supervision but also for rainy day financial bailout funds and past bailouts.

Cheap and Easy to Collect

As an increasing number of financial transactions are done electronically and even OTC derivatives and currency transactions move towards electronic settlement, financial transaction taxes are becoming cheaper and easier to collect. All that is really needed is the addition of a line of software code to existing messaging and settlement systems. In the UK, for example, the Stamp Duty is 100 times cheaper to collect than an equivalent amount of income tax.

Progressive Incidence

While it is true that institutional investors such as pension funds etc own a significant proportion of the financial markets, financial transactions are still disproportionately conducted by the richer segments of society either directly (through in house asset management) or through vehicles such as hedge funds or private equity. More than 25% of financial assets in the United States, for example, are owned by the top 1% richest population. Before the crisis hit, hedge funds were believed to be responsible for as much as 50% of trading volume in certain markets. Financial transaction taxes will have a highly progressive incidence as opposed for example to the value added taxes which are more regressive in nature.

Difficult to Evade and Avoid

Because financial transactions leave an electronic trail and/or are settled at a central clearing centre, financial transaction taxes are next to impossible to avoid. The other reason they are difficult to avoid is that they are collected automatically either at the point of the initiation of the transaction or at the point of their settlement. While there have been some fears of transactions moving offshore to avoid unilaterally implemented taxes, these are exaggerated. In fact, in Brazil, the information generated by the financial transaction tax was successfully used to reduce the evasion of other taxes. This evasion reducing effect could be easily replicated in other countries.

No tangible impact on market efficiency

Despite the fact that such taxes are often labelled as market unfriendly the wide variety of successful FTT regimes that operate around the world show that they are easy for markets to bear especially when the rates are low. Low rates also mean that few financial transactions undertaken for economic reasons would be effected. For example, at rates of a basis point or less these taxes are below the radar screen of most traders.

Compared to the transaction costs that arise from 1) brokerage fee 2) exchange fee 3) short term volatility of prices 4) market movement in response to transactions etc, the levels of taxation we propose remain negligible. In most instances, levying such taxes would take transaction costs back to the level they were at 3-4 years back at which point no one accused the financial markets of 'being distorted'.

Potentially market stabilizing

Being a turnover tax, the FTT will penalize shorter term trading and have hardly any impact on those with a longer term investment horizon. Consider a stock transaction tax of 0.2% for instance. A trader with a daily investment horizon would on average trade once a day and end up paying a $200 \times 0.2\% / 2 = 20\%$ (he only pays half and there are 200 trading days in a year) effective tax rate. A pension fund with a five year horizon, on the other hand, will end up paying only 0.02% or 1000th the rate of the daily trader.

This would discourage the kind of very short term (computer run) financial transactions that destabilized the markets in 2007 and leave the longer investment horizon investors unaffected. Hence FTTs are likely to have a market stabilizing impact. Differential taxation of systemically risky products such as complex derivatives is also likely to enhance the stabilizing impact of FTTs

Significant revenue potential

Financial transaction taxes levied across a broad range of financial markets can generate hundreds of billions of dollars of revenue world wide without too much of a distortion of the financial markets. Once bank debit taxes, which routinely collect as much as 2%-3% of revenue in many Latin American companies, are included, the revenue potential increases substantially. Stock, bond, currency and derivate market transaction taxation are likely to all produce between \$50 billion and \$100 billion of revenue each. Once bank debit taxes are included, the total revenue estimate easily doubles.

The crisis has made it much easier to impose FTTs

In the aftermath of the collapse of Herstatt Bank in 1974 regulators started looking for ways of reducing settlement risk in currency markets. This search ended with the establishment of the Continuous Settlement Bank which allows for the real time gross settlement of currency transactions. This system has proven its worth by being a sea of stability in otherwise stressed financial markets during the current financial crisis. As a consequence, regulators are in the process of pushing and increasing variety of financial transactions in the direction of increased on exchange trading as well as centralized clearing and settlement. Even for OTC derivatives where this may not be possible there will be a regulatory requirement to register all transactions with the regulators.

The electronic nature of financial transactions, the mandatory audit trail, the centralized clearing and settlement and the mandated reporting and recording of transactions will all make it much easier and cheaper to implement transaction taxes in most if not all financial. The expansion of the boundary of regulation to new institutions, markets and jurisdictions will make it even harder engage in already difficult evasion.

Financial transaction taxes are taxes of the future and the financial crisis presents both several reasons as well as several opportunities for a rapid expansion in the implementation of these taxes across an increasing number of financial markets.