Financial Transaction Taxes – Burden Sharing to finance the costs of the bailouts

A Concept Note

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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 substantially 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 number of trades being only one part of it.

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

Taxing financial transactions for a fairer burden sharing arrangement

One of the answers to this question no doubt has to be the taxation of financial transactions. This clearly has 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.

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 or less ambitiously 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 is either non-existent or can be contained.

Many other countries, including several other EU members such as Austria, Ireland, Greece, France and Finland still levy such a tax. 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.

The advantages of financial transaction taxes

Financial transaction taxes have several things going for them which make implementing them widely highly desirable. Some of these things are discussed below

- **Easy and cheap to collect**: As an increasing number of financial transactions are done electronically and even OTC derivates 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 conduced 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. Financial transaction taxes will have a highly progressive incidence as opposed for example to the value added taxes which are regressive in nature.
- **Difficult to avoid and evade**: 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, the rate we have proposed for currency transactions -0.1 basis point- is below the radar screen of currency 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*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 generation**: 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 easily edges into the trillions of dollars territory. 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.