



# **Financial Transaction Taxes Necessary, Feasible and Desirable**

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## EXECUTIVE SUMMARY

This conference paper lays the context in which the discussion on financial transaction taxes is taking place. The world has been rocked by the most major financial and economic crisis in recent history. This crisis has exposed several aspects of financial market dysfunction which not only increase the instability of the markets but also impede their normal functioning as tools to allocate economic resources throughout the economy.

The decades before the crisis were characterized by an exponential growth of the financial sector, the number of financial transactions in particular, beyond what can be considered to be socially or economically optimal under any circumstances. Moreover, the market became increasingly short-termist, was dominated by noise traders and comprised of increasingly opaque and complex transactions.

Market actors funded themselves on ever shorter horizons practicing a just in time kind of finance which proved to be immensely destabilizing. While financial market actors creamed off hundreds of billions of dollars of profits and bonuses every year, the real economy suffered with asset prices put beyond the reach of ordinary people and wages that stagnated at the bottom and in the middle. The financial sector failed in its function to support sustainable growth in the real economy.

When the problems inherent in the functioning of the sector did build up to breaking point, governments around the world found themselves held hostage to the financial sector since many of the institutions had become 'too big' or 'too interconnected' to fail and their bankruptcy would have decimated the larger economy because finance plays such a critical role in modern economies.

Between \$1 trillion and \$2 trillion was spent on bailing out the financial sector around the world though the real costs of the crisis was much higher. The collapse of economic confidence and the drying up of credit led to deep recessions in most of the world's major economies. Governments were forced to pump record amounts of money to stimulate their economies. This extra expenditure came at the same time as tax revenues collapsed in the face of recession leading to several governments facing record and unsustainable fiscal deficits.

In response to these developments, countries around the world have embarked on the biggest set of reforms to the financial system seen for a generation. Efforts are underway on three fronts 1) instituting a fair fiscal burden sharing with the financial sector 2) ensuring that a crisis of this kind does not happen ever again 3) making the financial sector work better.

On all of these fronts, small taxes levied on financial transactions – FTTs for short, can provide an invaluable policy tool. Many such taxes are already operational in countries as varied as the UK, Taiwan and India. The G-20 have are talking of a massive expansion of these taxes to several if not all financial markets and financial products around the world.

The high profit and compensation levels in the financial sector mean that the sector is capable of bearing a substantial burden of these taxes. If applied internationally these taxes can generate as much as \$400bn-\$500bn in tax revenue much of it new and additional. Customizing tax rates to different markets, instituting exemptions for retail customers and controlling compensation levels can be used by policy makers to ensure that it is the financial sector not the real economy that pays the bulk of the taxes. These taxes are likely to have a highly progressive incidence.

Excessive short term orientation, increasing complexity and growing opacity in the financial sector were major contributors to the financial crisis. By penalizing excessively short term oriented transactions and levying higher rates of taxes on complex and opaque transactions, the financial transaction tax regime can help ensure that a crisis of this magnitude does not ever happen again.

Reforming finance is not just about minimising the threat of financial crisis. It is even more important about making sure that finance plays a useful allocation rule for the real economy channelling money from unproductive uses to where opportunities for sustainable investment and growth lie. This requires a long term planning horizon which financial markets increasingly lack. By shifting the incentive of financial transactions towards the longer term, FTTs would help improve market allocation and efficiency. By varying tax rates in the face of overheating and excessive speculation prudential regulators can ensure that markets continue to discharge their support role for the real economy. Penalizing churning through FTTs will make the market work better for investors, especially those with a long term orientation.

Bank levies have been portrayed as a competing initiative while in actual fact these levies and FTTs are complementary in nature. Bank levies target leverage and will be paid mostly by commercial banks. FTTs target short termism and speculation and will be paid mostly by hedge funds and **investment** banks. Hence the two together would be effective tools for improving finance.

The time is now ripe to introduce a differentiated financial transaction tax regulatory regime.

## BACKGROUND AND CONTEXT

We are still in the midst of the biggest financial and economic crisis in a generation. The crisis which originated in the financial sector, spread to the real economy and has resulted in steep recessions, sharp reversals in trade and large scale unemployment. Large taxpayer funded bailouts of financial institutions were necessary as were large doses of public stimulus packages.

Juxtaposed against this is the fact that as a result of the public bailouts and loose monetary policy many of the same financial institutions which would have faced the prospect of bankruptcy without government aid are now registering near record levels of profits. They have also benefited from the turbulence they have created in the economy as their trading businesses flourish during times of economic uncertainty.

At the same time as they have cut back on credit to the real economy, including the all important Small and Medium Enterprise sector, they are set to pay as much as a \$100 billion in bonuses to the very same employees whose actions dragged these institutions and the rest of the economy into an abyss.

No wonder then that both the general public and leaders are worried and angry. They are angry, because those responsible have gotten away with huge rewards whereas the rest of us have been left to pay the price. They are worried, because the structures which enabled financial market actors to take excessive risks and the incentives that made it immensely profitable for them to do so are still very much in place.

While the enormous financial sector rescue and economic stimulus packages enacted have helped stop the world economy going into freefall they have decimated public finances and those in both the developing and the developed world who were hit the hardest by the economic recession now face the prospect of sharp welfare and public service cuts.

This is the context in which the debate on the desirability and feasibility of financial transaction taxes (FTTs) has shot to the top of the international political agenda as evidenced by this important conference, the recent European Parliament resolution and the forthcoming IMF report on the subject. Such taxes are also being discussed in the US congress, the German Finance ministry, the Dutch government, the UK treasury, the Austrian government, the leading group of countries working on innovative sources of funding for development, the G-20 and others.

Regulators, bankers, parliamentarians, central banks, prime ministers, finance ministries other policy makers, academics and think tankers are all weighting in on the discussions. Amongst all these voices one fact stands out. The financial crisis, the biggest in living memory, has massively tilted the political and financial landscape in a direction that makes such taxes not just more desirable also much easier to implement.

Keynes was an early proponent of FTTs and the idea got a new lease of life when James Tobin extended it to currency markets. The Asian crisis helped revive the discussion and after falling off the agenda yet again the idea was brought back to life as a potential source of revenue for funding development. Each time it died a slow death. The opponents of FTTs won those battles but they are coming round to the positive aspects of the idea one by one. It is now more likely than ever that broad-based financial transaction taxes will be adopted.

Even before the crisis hit, the 'markets always work efficiently and know best' school of thought was losing the battle of evidence to those that believed that while financial markets mostly worked well, they were often prone to excesses and sometimes failed with bad social consequences. The crisis has picked the winning side in a dramatic way. Those who opposed FTTs with the argument that any interference with what they regarded to be well-functioning markets would be ill advised have now rightly gone quiet. Their case, which was already based on unrealistic assumptions about the behaviour of markets and financial market actors, has become even weaker.

Everyone agrees that even a small tax would penalize short term transactions over longer term ones. For example, at a 0.01% rate those trading 100 times a day will end up with a tax rate of 240%/year and those that hold on to their securities for 5 years will pay 0.002%/year.

Automated computer trading based on mechanistic rules which sometimes buys and sells the same security hundreds of times a day would become untenable. Given the risk such trading poses to the financial system as highlighted by its total breakdown in August 2007 that would be no bad thing. A reduction in trading patterns which threaten financial stability without delivering much in the form of social benefits would reduce the likelihood of financial crisis. This aspect of FTTs appeals both to regulators and politicians irrespective of their political leanings.

It is good policy to tax polluting activities which have a negative footprint on society. An increasing number of financial transactions served no underlying social purpose and in the case of trades in complex derivatives and credit default swaps significantly increased systemic risk. Ever higher volumes of financial trades (churning) have been driven by the prospect of increasing fee based incomes. Ever increasing complexity was driven by the prospect of juicier profit margins. While privately profitable to the financial sector both churning and complexity have imposed costs on the wider economy. It is good public policy then to impose a sin tax that penalizes churning and complexity and internalizes the costs of the negative impact they have on the real economy. Financial Stability regulators are taking serious note and the intervention of Lord Turner the chief UK regulator was based partly on this understanding.

This systemic risk which has crystallized in the shape of the ongoing crisis necessitated the allocation of trillions of Euros of scarce taxpayer funds to bail out the financial sector. Recovering the costs of these bailouts from the financial sector is not only fair but is also the only sensible policy option in line with the 'polluter pays' principle. The many existing transaction taxes raise substantial amounts of tax revenue. Extending these taxes to recover bailout funds from the financial sector is an idea that has snowballing political support behind it. Another use for the revenues from FTTs would be to build up a future crisis fund that could be used to help stabilize the financial sector in future crisis without imposing unfair burdens on ordinary tax payers. Because the financial sector has garnered an ever greater share of income, it is only right that those who have lost out in the globalization of decades past should be allocated part of the proceeds of the tax.

The crisis depressed tax revenues and necessitated stimulus spending. Governments are now saddled with the highest debt and deficit levels seen in a generation. These debts need to be repaid and the money will need to come from higher taxation. While no tax is perfect, the FTT stands heads and shoulders above other feasible options such as increasing VAT or social security contributions. In

contrast to these taxes, a FTT will have a progressive incidence and will tax activities that at best offer little social utility and at worst pose serious systemic risk. Increasing the tax burden on 'the little people' while ignoring the role of the under-taxed financial sector in facilitating tax avoidance would be political suicide. Politicians including Chancellor Merkel, Prime Minister Brown and President Sarkozy have already taken note.

For those sceptical about the dual revenue and stability goals of the tax, it might be instructive to look at sin taxes on smoking or pollution which marry substantial revenues while at the same time depressing harmful activities.

To address the concerns of those who think the tax may harm markets, tax rates could start out very low and ratchet up annually once it is clear that the markets can bear the load.

The regulatory response to the crisis has settled any remaining doubts about feasibility for good. The G-20 response of driving derivative transactions on to exchanges, making centralized clearing compulsory, introducing enhanced registration and reporting requirements and expanding the regulatory boundary to include hedge funds as well as off shore jurisdictions has all made it cheaper and easier to collect financial transaction taxes and will make it next to impossible to avoid them.

While international co-ordination is desirable, the success of existing taxes such as the UK Stamp Duty indicates that it is not necessary. The electronic audit trails, greater cross-border regulatory co-ordination, action against tax havens and greater oversight of derivatives has made implementation much easier both at a unilateral and multilateral level.

In recent months, the idea of a levy on bank balance sheets has started to creep up the agenda of G-20 governments. The US, Sweden and Austria have already announced the introduction of such a levy. The media and politicians have unfortunately both fallen into the trap of presenting such bank levies as a rival to the idea of implementing a broad-based financial transaction tax. In actual fact, the FTT and Bank levies are very different policy tools and are best seen as complements not substitutes. Bank levies, as even the name implies will fall mostly on the banking sector. Financial transaction taxes, on the other hand, will fall most heavily on the shadow banking sector comprising mainly of hedge funds and broker dealer 'investment banks' such as Goldman Sachs. Financial transaction taxes will discourage short termism while bank levies are expected to discourage excessive reliance on short term funding.

They are both essential parts of the toolkit governments need to address the lessons learnt from this financial crisis.

## INTRODUCTION AND OBJECTIVES

A Financial Transaction Tax is a small tax payable every time a financial security changes legal ownership. The tax rates of existing taxes range from a maximum of 2% to rates as low as 0.0001% and are levied on a whole range of financial securities from shares and bonds to futures and options in a number of countries around the world.

Financial transaction taxes have a very old heritage. The most well-known example is perhaps the Stamp Duty in the UK, which applies to purchases of shares in companies with a UK stock register. This has existed in one form or another since 1694 and in its current form is levied at a rate of 0.5%, though certain ‘qualifying intermediaries’ such as market makers at large banks are exempt. The UK Stamp Duty Reserve Tax, as it is now called, raises close to £3bn in revenue every year.

Several other European countries including Ireland, Greece, Finland and Switzerland also levy some form of financial transaction taxes, as do non-European countries such as India, South Africa, China and Taiwan. Both in the UK and Ireland they raise about 1% of the total tax revenue whereas for Taiwan, which levies a broader range of taxes, the revenue raised reaches 5%-8% of all tax revenues. Even the United States levies a ‘Section 31 fee’<sup>i</sup>, currently set at a rate<sup>ii</sup> of 0.00169%, which applies to financial transactions and the proceeds from which fund the SEC (the financial market regulator).

What is new about the current discussion on financial transaction taxes is that a much broader range of taxes is being discussed which if plans go ahead will apply across several (all) financial markets. The discussion thus far has not gone too much into the detail of whether the tax rate would be uniform or not, but that depends in part on which of the many possible objectives of financial transaction taxes are emphasized. The top three reasons for expanding the financial transaction tax regime are

- To raise revenue in order to recoup some of the costs of the financial bailouts and the crisis from financial sector actors
- To raise revenue to finance urgently needed public goods in areas such as climate change and ending world poverty
- To address some well-recognized behavioural and structural problems in financial markets namely, excessive short-termism, churning, opacity, complexity and a size that is beyond what is socially optimal.

This author’s organization, Re-Define, has argued for a differentiated financial transaction tax regime<sup>iii</sup>. This is already applied in some form in a few countries. Taiwan, for example, applies a sophisticated system of differentiated rates of taxation on shares (0.3%), bonds (0.1%), futures (between 0.000125% and 0.06% depending on the kind of contract) and options (between 0.1% and 0.6%). Finland, Italy and Malta have a transaction tax regime in place but exempt securities traded on stock exchanges. Such a tax therefore penalizes the opacity that comes with transactions that are over the counter and encourages more securities to be traded on exchanges.

Policy makers should fine-tune the use of these policy tools not just through the introduction of differential rates across different product markets but also by keeping open the possibility of

changing the rates if circumstances justify. This would offer an additional set of policy tools to prudential regulators who face the tricky task of controlling systemic risk without jeopardizing growth in the economy.

For example, once the regime is in place, markets that are overheating can be slapped with higher rates of taxes in order to cool down developing bubbles. Countries such as China have often used their variable security transaction tax regime to this effect. Markets where speculation becomes rife and where noise traders threaten to drown out those who trade on the basis of fundamentals would also benefit from the introduction of higher rates of taxes to penalize speculation.

## STATE OF THE DEBATE

Especially since the financial crisis hit, there has been a growing upsurge of demands to expand the financial transaction tax regime at an international level and several G-20 leaders have spoken of the desirability of having a globally co-ordinated FTT. There have also been discussions of a pan European tax in case a global agreement is not forthcoming. In November 2009 UK Prime Minister Gordon Brown came out strongly in favour of introducing an internationally agreed tax on financial transactions as a way of raising substantial revenue from the financial sector.

Chancellor Merkel of Germany and President Sarkozy of France are other heavyweights who have strongly supported this idea, along with Chancellor Faymann of Austria. Other countries such as Belgium have also voiced strong support. In the United States, bills to levy financial transaction taxes were introduced in both the House and the Senate. However, US Treasury Secretary Gietner expressed some scepticism about the idea at the St. Andrews meeting of G-20 finance ministers in November 2009, though he is since reported to have muted his initial criticism.

Towards the end of 2009 it therefore seemed that the idea of levying internationally agreed financial transaction taxes had a growing and critical momentum behind it. Since then, however, a rival idea has gathered political momentum – a levy on banks.

The turning point came in January 2010, when President Obama used a clause in the TARP (the financial bailout package passed by the US congress) asking the administration to “recover the costs of the financial bailout from the financial sector” to announce a new levy on banks in the US to raise close to the \$100 billion figure estimated to be the direct fiscal costs of US financial sector bailouts.

This announcement of a bank levy came as a surprise to many other G-20 leaders, whose initial response was lukewarm. While they applauded the move to recover costs from the financial sector, leaders such as Chancellor Merkel and Prime Minister Brown were critical of US insistence that the levy should be replicated internationally.

They reiterated support for the financial transaction tax and triggered a series of “what’s hot and what’s not” reports in the international media. The press has portrayed the bank levy and financial transaction taxes as an either-or option. We believe that such a dichotomy is not only fundamentally and analytically incorrect, but actually puts the potential of making substantial progress on financial reform at serious risk.

*It would seem that discussions on getting the financial sector to pay a contribution have gone from both financial transaction taxes and bank levies as being ‘two options to be considered’ to ‘ok let us do financial transaction taxes’ to ‘hey these people across the Atlantic are going for bank levies now’ to ‘but we reaffirm our commitment to financial transaction taxes and say that bank levies are for them not us’ to ‘well ok since they are doing it anyway maybe we should do it too’ to ‘ok let us pick one of the two’ to ‘what the hell...who really cares...let us go with bank levies then’.*

This paper and a companion Re-Define policy paper show how this thinking is seriously flawed and that far from being either-or options or competing proposals bank levies and financial transaction taxes are actually complementary ideas that need to be implemented in conjunction with each other. It is only by doing so that the G-20 and other governments can expect to get the whole of the financial sector to make a “fair and substantial” contribution and also address the serious incentive and regulatory problems in the financial sector that have been exposed by the crisis.

## THE NEED FOR FTTs – PLUGGING FISCAL DEFICITS

Governments throughout the developed world are facing near record fiscal deficits. The ongoing problems in Europe, where the precarious state of public finances in countries such as Greece is generating headlines every day, are a serious and growing cause for concern. Others such as Spain are also vulnerable; Iceland and Latvia have already seen their economies decimated by the financial crisis. The UK and the United States both have reported record fiscal deficits in excess of 10% of GDP and face the prospect of a growing and increasingly unsustainable debt burden.

The standard prescription for and response to the problems of public finances has been austerity and even more austerity. Wages have been frozen or cut, essential services including health and education are being pared back and state assets are being readied for privatization in a desperate bid to minimize fiscal deficits.

These fiscal problems have been driven in large part by the

- Large allocation of funds needed to bail out the financial sector
- Stimulus packages needed to stop the economy from collapsing altogether
- The recessionary drying up of tax revenues at the same time as increasing funds were needed

Faced with these record fiscal deficits governments need to be looking at all possible measures of tackling them urgently. Austerity measures of the kind already taken by countries such as Latvia and now being prescribed for Greece are one option. These measures come at a great social and economic cost where the adjustment costs of the crisis which was triggered by those at the top of the income spectrum will be borne primarily by those at the bottom. Moreover a sudden withdrawal of government spending might well lead to an economic slump and possible further collapse in tax revenues.

Faced with such a prospect, it is imperative for governments to look beyond these austerity measures especially at policies which can help expand tax revenues. Imposing new forms of taxes, in particular, of the kinds that have a progressive incidence and are unlikely to impede economic growth is an attractive alternative. Taxing the financial sector, such as through expanding financial transaction taxes is thus a highly appealing policy.

## THE NEED FOR FTTs – TACKLING CHURNING, VOLATILITY AND NOISE

While the case for broadening the financial transaction tax regime so as to increase tax revenue is very strong, their use as regulatory and prudential tools makes them even more attractive. There are several problems in the way that financial markets currently function and as the discussion here shows, financial transaction taxes can help improve many of the most harmful aspects of current market behavior.

Churning, or deliberately carrying out far more transactions than necessary in order to earn higher fee income from clients, is widespread in the financial industry. This is despite the fact that regulators have frowned upon it or in some jurisdictions made it illegal. It is widespread because many brokers and fund managers earn an income on each transaction, so it is in their interest to churn to maximize income. It is mostly retail investors who end up paying this excessive fee<sup>iv</sup>.

Trading in most securities has also become increasingly short term, with average investment horizons shrinking from years to days. For high frequency traders, who now account for an increasingly large share of trading across several asset categories, the average holding period for securities is often a few minutes or even seconds.

*Lord Myners, a former fund manager and present City Minister, has said that he fears companies could become “playthings” of speculators because of super-fast automatic share trading. He said that such practices risked destroying the relationship between an investor and a company. He also said that “the fact that people can own shares for nano-seconds seems completely divorced from the concept of a joint stock company”. – BBC Interview<sup>v</sup>*

Lord Myners succinctly captures what is an increasing problem in capital markets: their role as information markets, providers of capital and overseers of investments is being undermined by an ever-shrinking investment horizon and corresponding increase in the volume of transactions.

In September 2009, the widely respected Aspen institute in the United States released “Overcoming Short-termism”, a policy document urging the government to address the issue. One of the report’s central proposals is to levy an excise tax on financial transactions. Warren Buffet, the legendary investor, John Bogle, the founder of the Vanguard group of investment companies and James Wolfensohn, the ex-president of the World Bank were some of the prominent signatories of this call<sup>vi</sup>.

Another disturbing trend in financial markets is their increasing volatility. While new information on companies or relevant macroeconomic variables emerges rather infrequently, market prices are highly volatile and transactions far more frequent than can be justified by reaction to new information alone. A Financial Times report registered 90 trades and 72 price changes in the stock of Vodafone in less than a minute on a typical day<sup>vii</sup>.

In surveys of traders in foreign exchange markets, two thirds of them say that for time horizons of up to six months, economic fundamentals are not the most important determinant of trading prices. Instead they point to speculation, herding and ‘technical trading’<sup>viii</sup>.

In technical trading ‘the trend is one’s friend’ - traders buy when the price of the security is going up and sell when the price is falling, based on certain market patterns<sup>ix</sup>. Most algorithmic trading (high frequency trading) also follows similar patterns. Taken together these practices amplify the ‘noise

element' of financial markets and by relying primarily on the actions of other market actors and price moves as an information source, can seriously reduce the informational efficiency of financial markets. Such behavior exaggerates price swings, results in markets overshooting, can significantly increase market volatility and eventually amplifies boom-bust patterns observed in financial markets.



## THE CASE FOR FINANCIAL TRANSACTION TAXES

### ***Improving investment horizons***

Financial transaction taxes increase transaction costs on short-term trading and so penalize those with excessively short-term investment horizons. Their introduction could significantly improve the functioning of financial markets by reducing the churning, excessively short-term focus, excessive volumes and volatility in these markets. This is also likely to significantly increase the informational efficiency of financial markets. FTTs have the potential to generate billions of dollars in cost savings and efficiency gains, which would be additional to revenue raised by the tax itself. As suggested by the Aspen institute, an FTT will create an incentive for more stable, long-term investments<sup>x</sup>.

Retail and institutional investors pay billions of dollars of excessive brokerage fees and charges which are the direct result of brokers directing client money into more volatile securities since these are likely to be traded more often and thus generate a greater fee for brokers and an excessive amount of trading in securities in order to maximize fee generation even when the fundamentals do not justify such trading<sup>xi</sup>

The excessive volatility that results from an increasingly short-term focus in the market and the growing dominance of technically driven traders over those who trade on the basis of economic fundamentals means that both long-term investors as well as corporations that raise capital in the markets lose out. Long-term investors can lose substantial sums of money because of the higher volatility of the securities they invest in and also lose billions in trading costs due to having to trade more frequently in response to greater volatility than they otherwise would. Users of capital markets can lose out because the market signals they receive, which influence their investment decisions, are based less and less on economic fundamentals and driven increasingly by technical trading strategies.

### ***Ensuring the primacy of fundamental driven economic transactions***

Turnover in across all financial markets has grown by leaps and bounds in the past few decades. 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 derivative, 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. The liquidity that existed in financial markets disappeared exactly when it was most required. It is far better then to have lower transaction volumes which provide more robust liquidity. Imposing financial transaction taxes will help remove the superfluous transactions from the market which serve no economic purpose and will ensure that the transactions that remain are driven more by fundamental economic motives.

### ***A source of revenue and fairer burden sharing***

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.

The need to consolidate the fiscal situation, whether through cutting expenditure or increasing tax revenues or a combination of both, is acute. Cutting expenditure by much in the midst of a fragile recovery, high and rising unemployment and widespread economic pain is difficult and perhaps politically unpalatable.

Raising tax revenue is thus at least part of the answer. There are only a limited number of options here. Increasing VAT or income taxes when the need of the day is to stimulate consumption and increase aggregate demand can be seriously counterproductive. Moreover, it is also manifestly unfair to impose additional burdens on ordinary citizens when they are suffering and when the responsibility for the crisis lies in the financial sector.

Taxing the financial sector in this context is thus both fair as well as good economic policy especially when one considers the need to get the sector to bear the cost of the externalities it imposes on the real economy and the need to recover the actual costs of the bailouts. Taxing the sector is also important in order to build up a fund for future rescues involving capital support from the government.

While various kinds of revenue estimates exist, the range of 0.5% to 2.0% of GDP seems to be gaining acceptance. The various rates of tax being discussed are in the order of 0.005% to 0.1%. On this basis, a figure of \$150bn - \$250bn at the level of EU and \$400bn - \$500bn globally seem to be realistically achievable. As a comparison, direct debit taxes in Latin America raise revenue in the range of 0.6-1.6% of GDP for effective tax rates in the range of 0.2-0.38%. We are skeptical of tax revenue claims that exceed these estimates significantly. If the point is to tax the financial sector, then the total profitability (including compensation) of the sector provides some form of a notional cap as to how much more revenue can be generated through FTTs without the tax burden spilling over too much into the real economy.

While a single rate of tax may be helpful in gauging tax capacity, differentiated rates across various financial instruments are a better approach from the regulatory perspective.

It has been suggested that the US, for example, levy the following tax rates on different instruments.

*Bonds*--0.01 percent per each year until bond's maturity

*Futures*--0.02 percent of the notional value of underlying asset

*Options*--0.5 percent of the premium paid for the option

*Interest Rate Swaps*--0.02 percent per each year until maturity of swap agreement.

### ***From the winners of globalization to the losers – Towards global public goods***

It is clear that 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, there is an obligation on the part of these participants to allocate at least part of their wealth towards those who have suffered as a result of globalization or those that globalization has left behind.

Financial markets are international in scope and operation. So a significant part of the tax revenue from financial transaction taxes would have an international dimension. This would be the case when financial institutions located in one country trade in markets located in another or when financial investors are based in other jurisdictions. Much of the FTT revenue that will be collected in financial centres such as the UK for example will have an international dimension.

It makes sense then to allocate part of the FTT revenue towards international public goods that help alleviate the suffering of those at the bottom of the income spectrum. Allocation of proceeds to provision of health and education services to citizens in poor developing countries or towards climate adaptation in vulnerable economies would be a good use for this money. In a world of volatile and unpredictable aid budgets the constant predictable revenue steam from FTTs would be particularly well-suited to financing teacher and health worker salaries.



## WHAT WOULD A GOOD FINANCIAL TRANSACTION TAX REGIME LOOK LIKE?

An effective transaction tax regime would seek to fulfil as many of the following goals as possible

- Raise significant revenue
- Be difficult to avoid
- Reduce market churning
- Have a progressive incidence
- Not destroy market liquidity
- Encourage financial actors to have a longer term horizon
- Penalize contribution to systemic risk
- Serve as a good prudential tool

To achieve this, such a tax should 1) have a relatively low rate 2) apply across as many financial markets and jurisdictions as possible 3) arise at the point that a financial transaction is agreed 4) be levied electronically in a way that minimises avoidance – at the point of settlement or on exchanges 5) apply in the first instance to all market actors, with possible refunds for small investors and/or governments 6) have a differentiated rate across markets so as to penalize socially useless transactions and those that contribute to systemic risk through complexity or opacity 7) have a variable rate so that it can be flexibly used as a prudential tool

The rate of tax should depend on public policy views on the importance and usefulness of the market; prevailing average transaction costs; levels of profitability in the market; the profile of market participants and the contribution to systemic risk for example through complexity, leverage or opacity.

Financial transaction taxes could be phased in over a period of, say, three years on a predictable schedule, but have a provision for annual impact assessments and policy fine tuning. This would be useful to detect and correct any unintended negative consequences and to use the market response to the initial introduction in fine tuning the nature of the tax in the second phase, so as to minimise avoidance and ensure that market liquidity is not damaged.

The revenues raised from such a tax can then be allocated towards reducing fiscal deficits; building up a fund for financial stability and funding public policy goals domestically and internationally – for example job creation, international development or fighting climate change.

## **JUDGING FTTs AGAINST THE CRITERIA FOR GOOD TAXES**

In tax policy, a good tax is usually defined in accordance with the following principle of Equity, Simplicity and Efficiency. The FTT passes all of these tests with flying colours. It also has several other highly attractive features.

### ***Equity***

Imposing FTTs will mean that there will be a fairer burden sharing of the costs of the crisis. Recovering the costs of the crisis from the sector that caused is the only equitable option and all other possibilities of imposing the burden on non financial sectors or consumers are highly inequitable.

In addition to this, FTTs are vertically equitable (in the sense that they impose a higher burden on those with a higher capacity to pay) because 1) the financial sector has been amongst the most profitable 2) financial sector actors have been and continue to be very well compensated 3) the richer segments of society use the financial sector disproportionately more than those at the poorer end of the spectrum 4) the financial sector has been one of the prime users of tax arbitrage meaning that it has paid less than its 'fair' share of tax contributions.

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. The FTT is likely to have a highly progressive incidence.

FTTs are also horizontally equitable when the rate of the tax is applied uniformly across a particular financial market and produces nearly equivalent tax burdens across financial products that are close substitutes.

### ***Simplicity***

Taxation is notorious for being hugely complex. Income tax, VAT and corporate tax legislation runs into thousands of pages and is replete with exemptions, exceptions loopholes and ambiguities. The cost collecting and enforcing these is large. In the UK it costs about 1.2 pence to collect every pound of the income tax. Tax legislation is getting increasingly complex by the day.

Financial transaction taxes, which will be imposed, calculated and collected electronically, are amongst the simplest of taxes to understand and implement. In the UK for example, it costs less than 0.02 pence to collect every pound of the Stamp Duty Reserve Tax. This is more than 50 times cheaper than collecting an equivalent amount of revenue through the income tax. No market participant has ever criticized the Stamp Duty for being complex, a criticism levelled all the time against corporate and personal income taxes. The pages of tax law devoted to the Stamp Duty pale in significance to the reams of pages devoted to other kinds of taxation.

### ***Efficiency***

A tax is efficient if it raises a certain unit of revenue with the minimum possible distortion. All taxes are distortionary to some extent so the benchmark that the efficiency of the FTT should be measured against is whether rising money through the FTT would be less distortionary than raising a similar amount of money through other taxes.

Increasing VAT reduces consumption and increasing income taxes directly harms growth and income generation. On the other hand, the relationship between financial transactions and real productivity

and growth is much more tenuous. In fact some of the financial transactions have been shown to be actively harmful for the real economy by imposing externalities. So taxing financial transactions is in principle better than taxing consumption or income.

Another criteria for efficiency is to have as low a rate and as broad a base as possible. The FTT achieves is very successful on this criteria too.

### ***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. INTL, a UK brokerage which pioneered a financial transaction tax on currencies reported that all it took them was 'adding a line of software code'.

### ***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.

The recent international moves to expand the perimeter of regulation bring derivative trading on exchange; introduce centralized clearing parties and institute a register of financial transactions will make it next to impossible to avoid FTTs.

### ***No tangible impact on market liquidity and 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'.

In actual fact, by reducing the proportion of noise traders in the financial markets they are applied to, FTTs have the potential of increasing the information efficiency of financial markets.

Turnover in financial markets is a poor measure of liquidity. True liquidity comes from a diversity of opinion not the number of transactions in a market. As the crisis evidenced, turnover in markets that were supposedly highly liquid collapsed just when liquidity was most needed. Imposing FTTs can help separate 'true liquidity' from 'illusory liquidity' and thus make the markets function more accurately reflecting true risk and return and return and avoid 'nasty surprises'.

### ***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

### ***The response to 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.

## WHY NOT INCREASE OTHER FORMS OF TAXES TO RAISE REVENUE?

Since one of the core purposes of the proposed expansion of financial transaction taxes in the current discussion is to raise additional public revenue, it is fair to ask why we even need to consider an FTT. Would it not be easier and simpler to simply increase the rate of taxes which are already levied rather than having to introduce new types of taxes altogether?

Another question that is often raised in the context of levying additional taxes on the financial sector is whether in the end it would simply not be the users of financial services who will end up paying.

It is true that eventually corporations do not pay taxes, people do. However, to suggest that this implies that it is futile to tax corporations or banks is disingenuous.

Taxation of all kinds finally feeds through to individuals in the form of

- Income taxes
- Wealth taxes
- Transaction taxes
- Consumption taxes
- Higher prices for goods and services

But who pays what proportion of tax depends primarily on the design of the tax system.

Tax systems are extensively used for

- Raising revenue
- Redistributing its proceeds
- Rewarding or punishing actions, activities or behaviour

Now imagine that a fixed amount of revenue needs to be raised by the government. It could

- Increase income taxes
- Increase wealth taxes
- Increase transaction taxes
- Increase consumption taxes

Under current economic circumstances, when national economies in many countries are struggling under the weight of record fiscal deficits and faltering growth, it is clear that new tax revenue is essential but also that such taxation should as far as possible

- Avoid burdening those who are already suffering most due to the crisis
- Avoid discouraging consumption or investment, which are needed to stimulate growth

This means that increasing value added taxes is not a good option since

- They have a regressive incidence so will hurt those at the bottom of the income strata who have suffered most as a result of the crisis

- At this point in the economic cycle, governments need to encourage and any increase in VAT will have the exact opposite effect. The UK government, for example, had actually cut VAT to stimulate consumption.

Increasing income taxes on individuals and corporations would be a viable option. However

- Many governments have already increased the top income tax rate recently, so the scope for further increase at the top may be limited at present.
- While increasing corporate income taxes in the long term may be a good idea, in the short term we need to be careful since the economic crisis has left several real sector companies in a somewhat fragile shape.
- A targeted income tax on the financial sector or another form of tax such as levies on bank balance sheets which are currently being discussed may be a good idea and these are discussed in a forthcoming Re-Define paper by the author.

That leaves us with wealth taxes and transaction taxes, both of which may be good policy measures. A discussion of wealth taxes of the kind that countries such as Norway levy deserves a paper to itself, so here we will continue our focus on transaction taxes.

Well designed financial transaction taxes can fulfil the three main purposes of tax policy

- Raise substantial tax revenue
- Penalize certain kinds of behaviour such as excessive short-termism
- Redistribute revenue to those most in need

**Box: Will the financial transaction tax not eat into other forms of tax revenues?**

The fact that levying additional taxes can eat into the tax revenue from existing taxes is well-known in tax policy circles. This will also happen to some extent when new financial transaction taxes are introduced. However as the discussion below shows, FTTs will generate significant 'additional' tax revenue even after the loss of revenue through existing taxes is accounted for.

Financial transaction taxes will reduce the profitability of financial institutions which pay the tax. This would result in lower corporate taxes being paid by these institutions. So the real tax revenue for say every \$100 million face value raised by financial transaction taxes would not be \$100 million but less. Let us assume that a financial institution currently generates a profit of \$100 million and at a taxable rate of 30% so pays \$30 million in income tax<sup>xii</sup>. Now assume that the institution pays \$10 million in financial transaction taxes out of its pocket. Its new profit is then only \$90 million so the income tax payable is now \$27 million not \$30 million.

However the total tax paid by the institution is now \$10 million FTT + \$27 million Income tax = \$37 million as compared to the original tax payment of \$30 million.

So it is true that financial transaction taxes will 'cannibalize' some existing tax revenue and hence generate somewhat less net additional tax revenue than the headline figures on financial transaction tax volume alone would suggest. However, as long as the current tax rate is less than 100% substantial additional tax revenue would still be generated.

Based on prevailing tax rates in the UK, a back of the envelope calculation would suggest that of every \$100 in revenue generated by financial transaction taxes at least \$70 would be additional revenue.



## BUT WHO WILL REALLY END UP PAYING FINANCIAL TRANSACTION TAXES

The first incidence of a broad-based financial transaction tax will fall on those institutions that trade in financial markets in rough proportion to the volume of trading for which they are responsible. Each financial market has its own set of dominant players and there is no single comprehensive data source which attributes overall shares of financial market activity to different kinds of financial market actors.

However, some things are clear

- Banks are major actors across most financial markets
- Investment banks in particular have a propensity to trade more often across a greater number of financial markets
- Banks are being overtaken by other actors such as hedge funds in financial market trading volume
- Regulatory changes currently being implemented or actively considered will mean that the contribution of banks to trading volume is set to decline further.

A quick review of publicly available data sources<sup>xiii</sup> shows that

- High frequency traders (often part of hedge funds), now account for a significant and ever increasing share of market volume in an expanding array of on exchange financial market
- Hedge funds (even excluding high frequency traders) are playing an ever more important and fast expanding role in many financial markets both on and off exchange.
- Hedge funds dominate trading activity in equity markets, account for more than 50% of the volume in certain kinds of OTC derivatives<sup>xiv</sup>, are by far the biggest players (by volume) in certain fixed income markets, are fast increasing their market share in foreign exchange markets and are prominent actors in commodity markets

While the first incidence falls directly on the financial sector actors, including banks and hedge funds, the financial transaction taxes will finally filter through to individuals through a number of mostly indirect channels including

- Lower profits for owners of capital invested in financial markets and bank shareholders. Since the point of first incidence of the tax will be on institutions active in these markets, the burden of the tax would at least partly have to be absorbed by these institutions themselves. This would reduce profits for entities such as investment banks and hedge funds in particular, so reducing the dividend payouts to investors who own banks and who put their money into hedge funds.
- Lower compensation for employees of financial institutions. The compensation of employees of hedge funds and investment banks in particular is an order of magnitude higher than that of ordinary workers. Typically, financial market actors pay their employees a set percentage of revenues so the payment of transaction taxes that depress profits will result in lower payouts. Given the intensity of the ongoing debate on bonus practices in the financial sector, this would be a step in the direction that public policy as well as public opinion is leaning towards.

- Somewhat higher transaction fees for users of financial institution services. As the discussion below will show, financial institutions have the capacity to absorb the majority of the tax burden. However, they will definitely pass on part of the burden of the tax to their customers, most of whom are large corporate entities. The extent to which this is done would depend on the competitive landscape within which the institution operates - a higher degree of competition leading to lower pass-through to end users.

For example a tax on foreign exchange transactions would reduce gross revenues for investment banks which will 1) report lower profits and hence disburse lower dividends to their shareholders 2) reduce the compensation ratio (the percentage of revenues paid out as compensation) for employees to reduce the effect on net profit and 3) try and increase the fees they charge to their (mostly large corporate) customers somewhat to earn additional revenue.

Who finally pays how much of the tax and how progressive its final incidence would be will depend on a number of factors which influences what channels the tax passes through and where it gets absorbed .

The shape of the pass through channels will be determined by

- Which institutions the initial incidence falls on
- Who the stakeholders in these institutions are
- Who uses their services most

The absorptive capacity at each stage will be driven by

- How profitable they are
- How much they pay their employees
- How competitive their operating landscape is

The initial incidence of the tax would fall perhaps most heavily on hedge funds, investment bank proprietary trading desks and in some market segments on commercial banks.

Hedge funds were traditionally used as investment vehicles by ‘high net worth individuals’ or those with more than \$1 million in liquid assets. Even now, a significant proportion (if not majority) of hedge fund capital comes from these super-rich individuals and families. Institutional investors such as some pension funds and endowments have in recent years started to put increasing amounts of money into alternative asset classes including hedge funds, but even now pension funds account for less than 25% of investments in hedge funds<sup>xv</sup>.

Hedge funds are reported to have between \$2 trillion and \$3 trillion in assets under management and in most years have delivered between 15% and 20% return on these assets which points to profits of between \$300 billion and \$600 billion annually<sup>xvi</sup>.

The world’s top 1000 commercial banks have reported profits of between \$700 billion and close to \$1 trillion in recent years with the exception of last year when the financial crisis cut deep into these profits<sup>xvii</sup>.

Investment banks have been earning substantial amounts of revenue with Goldman Sachs alone having reported accumulated revenues (gross income) of over \$250 billion since 2000<sup>xviii</sup>. Typically

institutions such as Goldman pay nearly half of this revenue to employees as compensation, more than half of it in the form of bonuses.

Looking at investment banks including European actors together, the profits of investment banks have exceeded \$100 billion in several of the past years are now set to go back to levels seen before the crisis<sup>xix</sup>.

Compensation levels in the finance industry have been in the news recently, where the contrast could not be greater between the suffering of those at the bottom rung of society who have suffered most as a result of the crisis and the celebration of financial industry actors who despite their contribution to precipitating the meltdown, are already back to their business-as-usual excessive compensation levels. In London alone, more than 10, 000 bankers are now each in line for more than £1 million in compensation this year<sup>xx</sup>.

Bankers earned nearly \$100 billion a year in bonuses in the boom years. Compensation levels in the hedge fund industry put even these excessive bank compensation levels to shame. In 2007, the top 25 hedge fund managers on average took home \$892 million *each*<sup>xxi</sup>. Even a lowly average portfolio manager in a hedge fund earns about \$7 million<sup>xxii</sup>.

Clearly, the financial sector has ample capacity to absorb a significant proportion of the transaction tax through a combination of lower profits and lower compensation for employees. While some of the costs will be passed through to the real sector of the economy, the bulk of the tax burden will fall within the financial sector itself, primarily on hedge funds and investment banks.

## **FTTs OR BANK LEVIES**

Bank levies, in the form being discussed by policy makers now are a small annual charge that applies to certain parts of the balance sheet of a bank. In their most common form bank levies will apply to the liability (or funding) side of a bank balance sheet. A bank raises its funds from several sources of which equity; deposits and debt are the three major sources.

Over the past several decades the proportion of funds raised by banks in the form of equity and deposits has decreased with the percentage of debt funding having increased significantly. Moreover, within this category of debt funding, the proportion of funds raised by banks in the form of short term borrowing increased significantly mostly because borrowing for shorter duration is cheaper than borrowing long term.

This meant that when the crisis hit, banks such as Northern Rock were borrowing overnight in order to lend to customers seeking 30 year mortgages. While this model works well as long as the short term lending market is liquid, it breaks down completely in the face of market stress. This increase maturity mis-match between the borrowing and lending of banks was a major destabilizing factor and a key contributor to systemic risk.

It was partly in response to the role of debt funding in the crisis and partly because of the need to recoup the costs of the bailout from the financial sector that the Obama administration announced that it would impose levies on bank balance sheets. Under the US proposals, only the levy would only apply to the part of the funding that is raised in the form of debt.

Banks in more than a 100 countries are already liable for a levy on another part of their liabilities – retail bank deposits. Typically these charges are assessed in proportion to the size of these deposits and governments undertake to ‘insure’ these deposits in return.

While both the idea of making banks pay and penalizing debt based funding are in themselves sound, the US, Swedish and Austrian proposals for bank levies fail to distinguish between long term and short term funding, a critical distinction. A differentiated rate should apply with short term borrowings liable for higher rates.

Another problem with the bank levy proposals is that the tax will fall mostly on commercial banks. These are the institutions that create credit and are responsible for lending to the real economy including SMEs. It is likely that the imposition of levies being discussed will lead to a higher cost of credit.

Financial transaction taxes perform complementary functions whereby their incidence will fall mainly on investment banks and hedge funds. Also, they are very effective in addressing short-termism as well as other problematic aspects of market behaviour that bank levies do not affect. That is why, instead of being seen as competitive either-or options bank levies and financial transaction taxes need to be seen as compliments which affect different parts of the financial sector, address different sides of the balance sheet and improve different aspects of dysfunctional financial market behaviour.

## A HIGHLY FLEXIBLE TOOL FOR POLICY MAKERS

It is clear that financial transaction taxes, applied well, are an excellent tool to address the increasingly serious problem of short-termism in financial markets. They have a significant potential to improve the informational efficiency of financial markets and will encourage a long term investment horizon more compatible with sustainable and productive investments

It is also clear that such taxes could raise significant additional revenues of the order of \$400bn - \$500bn with minimal impact on the real economy or retail consumers. The tax will have a highly progressive final incidence that falls mainly on the top income earners and wealth holders in society.

What is more, policy makers are in an enviable situation of having a number of tools at their disposal so both the incidence of the tax and its impact on behaviour in the financial markets can be customized so as to maximise the positive footprint of the tax and minimise any negative side effects.

Policy makers can make sure that the final incidence of the tax is most progressive and is borne to the greatest extent by actors within the industry by

- Levying a higher tax on market segments where hedge funds and investment banks are the main actors
- Increasing competition in the financial services industry. For example, high barriers to entry and low competition are one reason that investment banks are able to earn excessively high profits
- Introducing restrictions on employee compensation in the financial services industry which would increase the amount of revenue available to absorb the additional costs of the tax
- Tougher controls on excessive charges for end users
- Using an exemption and refund regime that reduces the burden of the tax for certain segments such as pensioners

In parallel, they can make sure the equally important impact on market behaviour is positive by

- Penalizing socially harmful (or less useful) market segments with higher rates of taxation
- Levying higher taxes on more complex transactions now that complexity itself has been shown to contribute to systemic risk
- Levying higher taxes on over the counter derivative transactions, which as we now know increase uncertainty and systemic risk. On exchange transactions should be taxed a lower rates
- Levying lower rates on market segments that have a significant price discovery role ('price discovery' is the process of determining the price of an asset in the marketplace through the interactions of buyers and sellers).
- Varying the rate of the tax to serve prudential goals such as reducing overheating in asset markets and penalizing excessive speculation

In summary, the diversity of products in the financial markets and their contribution to the real economy, combined with the presence of different actors who trade in these financial markets, provide policy makers with a highly flexible set of tools with which to design financial transaction taxes in a way that

- Maximises revenue raised

- With the most progressive incidence
- Encourages long term investment horizons
- Discourages socially harmful or useless transactions
- Penalizes complexity and opacity
- Serves prudential goals

This makes the family of financial transaction taxes a highly useful set of policy tools for both raising significant additional revenues and addressing well-recognized problems in financial markets.



## POLICY MAKER NEXT STEPS

Overall, the financial transaction tax is likely to generate significant revenues net of any cannibalization of other forms of taxes. This effect will be enhanced especially because the primary burden of tax will fall on hedge fund investors, hedge fund managers and investment bank employees. Investment banks are very heavy users of tax planning schemes and tax avoidance strategies and often pay much lower effective rates of taxes compared for example to companies in the real economy.

Hedge funds are mostly located in offshore tax havens with managers as well as the high net worth individuals who invest in them being heavy users of tax avoidance schemes. So taxing them through financial transaction taxes would both be highly efficient in terms of generating additional tax revenue and progressive in terms of its incidence, since these are amongst the highest earners in the world.

Revenues through financial transaction taxes are likely to be more progressive than any alternative form of taxation to generate an equivalent amount of tax revenue, with the possible exception of wealth taxation. Moreover, such taxes also help address some of the endemic problems associated with the current operation of financial markets. Reducing churning, excessive short-termism and volatility may generate substantial efficiency gains for the economy.

In addition to the fact that the natural incidence of the tax falls substantially on those most able to afford it, governments can take policy measures to ensure that the pass through of the additional costs of the financial transaction tax to retail customers, consumers, real economic activity and institutional investors such as pension funds is minimised.

As a next step, policy makers should introduce differential rates of taxes across different product markets using the suggestions we have put forward in the last section. We will continue to address key issues for policy makers through a series of Re-Define policy briefs.

## FURTHER READING

“Bank Levies AND Financial Transaction Taxes NOT Bank Levies OR Financial Transaction Taxes”, a Re-Define Policy Brief by Sony Kapoor, 2010: <http://www.re-define.org/publications>

“Financial Transaction Taxes: Tools for Progressive Taxation and Improving Market Behaviour”, a Re-Define Policy Brief by Sony Kapoor, 2010: <http://www.re-define.org/publications>

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“Financial Transaction Taxes: Desirable, Feasible and Necessary”, Re-Define Managing Director Sony Kapoor Testimony at the European Parliament Committee of Economic and Monetary Affairs, 2009: <http://www.re-define.org/blog/2009/12/04/re-define-testimony-european-parliament-hearings-financial-transaction-taxes>

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“Transaction Taxes: Raising Revenues and Stabilizing Markets”, Report for a Stamp out Poverty project financed by the Co-operative Bank, Sony Kapoor, 2004

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<sup>i</sup> <http://www.sec.gov/answers/sec31.htm>

<sup>ii</sup> <http://www.sec.gov/news/press/2010/2010-29.htm>

<sup>iii</sup> See “Financial Transaction Taxes: Tools for Progressive Taxation and Improving Market Behaviour”, Re-Define, Sony Kapoor, 2010 and previous publications. Also see the European Parliament testimony of Re-Define Managing Director Sony Kapoor: Available at <http://www.re-define.org/blog/2009/12/04/re-define-testimony-european-parliament-hearings-financial-transaction-taxes>

<sup>iv</sup> <http://www.sec.gov/answers/churning.htm> ,  
[http://www.stockbrokerfraudblog.com/2009/04/churning\\_accounts\\_by\\_brokers\\_i.html](http://www.stockbrokerfraudblog.com/2009/04/churning_accounts_by_brokers_i.html)

<sup>v</sup> <http://news.bbc.co.uk/2/hi/business/8338045.stm>

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- <sup>vi</sup> <http://www.aspeninstitute.org/policy-work/business-society/corporate-programs/cvsg/public-policy>
- <sup>vii</sup> <http://www.ft.com/cms/s/0/b0ec7222-819e-11de-9c5e-00144feabdc0.html>
- <sup>viii</sup> Cheung Y. and M.D. Chinn (2000) "Currency traders and Exchange rate dynamics. A survey of the U.S. market." Department of Economics, University of California, Santa Cruz, mimeo.
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- <sup>ix</sup> Lehman Brothers Technical Trading Manual
- <sup>x</sup> <http://www.aspeninstitute.org/policy-work/business-society/corporate-programs/cvsg/public-policy>
- <sup>xi</sup> [http://en.wikipedia.org/wiki/Churning\\_\(stock\\_trade\)](http://en.wikipedia.org/wiki/Churning_(stock_trade)), <http://www.sec.gov/answers/churning.htm> , [http://www.stockbrokerfraudblog.com/2009/04/churning\\_accounts\\_by\\_brokers\\_i.html](http://www.stockbrokerfraudblog.com/2009/04/churning_accounts_by_brokers_i.html)
- <sup>xii</sup> Financial institutions for the most part pay nowhere near the headline rates of tax. They have specialized in using elaborate tax planning and tax avoidance strategies to minimise their tax liabilities. Hedge funds are often located offshore for tax advantage with more than 75% of the world's hedge funds registered in tax havens.
- <sup>xiii</sup> [www.ft.com](http://www.ft.com), [www.wsj.com](http://www.wsj.com), [www.aima.org](http://www.aima.org), [www.hedgefundsworld.com](http://www.hedgefundsworld.com), [www.hedgefund.net](http://www.hedgefund.net) etc.
- <sup>xiv</sup> Over-the-counter (OTC) or off-exchange trading involves [financial instruments](#) such as [stocks](#), [bonds](#), [commodities](#) or [derivatives](#) traded directly between two parties. This contrasts with 'on-[exchange trading](#)', e.g. [futures exchanges](#) or [stock exchanges](#)
- <sup>xv</sup> Hedge funds are typically financed 50% through investments by individual investors such as high net worth individuals and about 50% by 'fund of funds' institutional investors. Typically only a third of this institutional investment comes from pension funds putting their total share in hedge funds well below 25%. ([www.ifsl.org.uk](http://www.ifsl.org.uk))
- <sup>xvi</sup> <http://www.ft.com/cms/s/0/d875cbc6-f571-11de-90ab-00144feab49a.html>
- <sup>xvii</sup> [www.thebanker.com](http://www.thebanker.com)
- <sup>xviii</sup> annual reports on [www.gs.com](http://www.gs.com)
- <sup>xix</sup> compiled from profits reported on [www.ft.com](http://www.ft.com)
- <sup>xx</sup> <http://www.dailymail.co.uk/news/article-1250647/10-000-City-bankers-hit-1m-jackpot-Grotesque-payouts-set-double.html>
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