Financial transaction taxes

# A double dividend

**Getting governments to make firm commitments for the long-term funding of public goods is difficult. The solution may be a financial transaction tax, the funds of which would be managed by a supranational 'tax agency'.**

Ideally, public goods should be provided to all individuals who demand them, but these individuals should also contribute to the funding of these goods. In the case of global public goods (GPGs), the funding could come from global taxes. The idea of establishing a system of global taxes is gaining rapid support. But its success depends on concerted efforts to establish supranational agencies to coordinate and implement a global tax system.

The global tax discussion is focusing on the feasibility of taxing a wide range of goods, such as carbon emissions, international arms trading, aviation fuel or air transport, internet activity and international financial transactions. Taxing public *bads* to fund public goods (such as the United Nation's Millennium Development Goals) would even generate an efficiency-enhancing double dividend.

In issue 20/21 of *The Broker*, Inge Kaul, adjunct professor of the Hertie School of Governance in Berlin, Germany, looked at today's policy realities through a GPG lens. GPGs encompass political stability, sustainable economic development, preservation of the natural environment and biodiversity, food security and poverty reduction, for instance. But providing these GPGs efficiently requires cross-border policy coordination, multilateralism and supranational collective action. And that's the catch.

Taxing global public bads faces a similar dilemma. Public bads include climate change, ecosystem degradation, new communicable diseases, international terrorism and financial volatility. Some progress has been made in this area – for instance in research, communication and standard setting. But governments are still chiefly guided by national self-interest and have yet to embrace international policy interdependence.

Getting governments to make firm commitments for the long-term funding of public goods is difficult, especially given the impossibility of defining the national benefits of GPGs, and the impulse to get free rides on the backs of others, creating a so-called first-mover disadvantage.

So if a global tax is bound to conflict with the prerogatives of national parliaments, what is the solution? Perhaps it requires the transfer of sovereign powers (in the form of a supranational 'tax agency'), or at least coordinated and harmonized national tax policies and collective enforcement. Such ideas have met with fierce political opposition, however, especially in the United States.

The European Union has an advantage on this point since it already has supranational institutions in place, and it has successfully used them to coordinate indirect taxes (VAT, and excises), although tax legislation and collection remain national prerogatives.

More importantly, funding GPGs not only requires consensus on international policy objectives. Tax revenues need to be channelled to a supranational body. It could resemble any number of supranational bodies, such as the United Nations, the International Energy Agency, the World Health Organization, the International Monetary Fund or the World Bank.

Or it could take the shape of a new Global Solidarity Fund, which was proposed in 2010 by the Leading Group on Innovative Financing for Development, a body consisting of 61 countries, various international institutions and non-governmental organizations who promote the idea of innovative development financing mechanisms. It could also take on a shape of its own.

How to use the proceeds from a global tax is an additional source of political controversy. But a simple rule in public economics is that finance follows function. Therefore the aims of public spending should be clearly defined before tackling the equally complex issues of a global tax.

By **Paul Bernd Spahn**, emeritus professor of public finance at Goethe University in Frankfurt am Main, Germany. Spahn has also worked as a consultant for major organizations, including the International Monetary Fund, the World Bank and the United Nations.

### Financial transaction taxes revisited

The recent financial crisis has breathed new life into the idea of using financial transaction taxes (FTTs) to achieve market stability and mobilize funds for GPGs. John Maynard


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Keynes had already proposed ‘a substantial government transfer tax on all transactions ... with a view to mitigating the predominance of speculation over enterprise’ in his 1936 magnum opus, *The General Theory of Employment, Interest and Money*.

Developing this idea, James Tobin proposed a specific kind of FTT in his 1972 work *The New Economics, One Decade Older*, namely a currency transaction tax (CTT). The CTT was meant to curb exchange rate volatility after the failure of the Bretton Woods system for fixed-rate global currencies. Both Keynes and Tobin emphasize the stabilizing features of such taxes, rather than their revenue-raising potential.

Price volatility remains a major concern for economists who believe that the market is imperfect at finding the ‘right’ market price for assets – including foreign exchange. This is compounded by evidence that asset markets can be effectively manipulated by speculators and ‘herd behaviour’ prone to act on rumours rather than fundamental economic data.

While stock markets have long been regulated to shun speculation, no such rules exist for the world’s largest financial market: currency transactions. Losses in currency value can be dramatic for developing countries. The Asian financial crisis of the late 1990s, for instance, produced currency devaluations in the order of 40% against the dollar in Malaysia, Thailand and the Philippines, and 80% in Indonesia.

The damage ensuing from such devaluations hits poorer countries with additional vigour, not only due to the loss in purchasing power for imports, but also because it increases debentures in foreign currencies in terms of national currency. Moreover, smaller currencies have fewer defence mechanisms against exchange rate volatility than those that are better integrated into world financial markets.

The debate among economists on price volatility is likely to remain unresolved forever. There is a group that – following Keynes’ scepticism – emphasizes certain market deficiencies, while another group argues – in the extreme – that markets are always ‘right’. This controversy has a clear ideological tint to it. However, the former group has seen its ranks swell in the wake of the recent financial crisis. As for the general public, scepticism towards the world financial order is – perhaps not surprisingly – skyrocketing.

A tax on financial transactions has been consistently rejected by market players and policy makers. But it has been unremittingly promoted by civil society groups since the mid-1990s. Their policy objective has been mainly to raise revenue. France and Belgium are the only countries to have adopted CTT legislation, but its implementation is contingent on other EU countries following suit.

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### Concerted effort to fight poverty

The Leading Group was founded in France in 2006. Its mission stems from the joint declaration made at the United Nations in September 2004 by former French President Jacques Chirac and Brazilian President Luiz Inácio Lula da Silva to fight hunger and poverty.

The Leading Group has since become a leading international forum for discussions on innovative development financing mechanisms that generate additional resources for official development assistance and provide greater predictability. The Leading Group now has 61 country members, five observer countries, 15 international organizations and more than 20 non-governmental organizations.

For more information about the Leading Group, see: http://www.leadinggroup.org/rubrique20.html

The CTT discussion has moved in the last 15 years from emphasizing price stabilization to funding GPGs. Foreign exchange transactions may have reached an annual level of US$800 trillion in 2007, according to statistics from the Bank for International Settlements, which represents vast revenue potentials even for negligible tax rates.

The recent financial crisis has drawn attention to the idea of taxing the financial sector. The objectives of such a tax system include systemic stability and a reduction of price fluctuations for assets, and the idea is to use tax revenue to either recover taxpayers' lost finances or use it as an insurance against future financial vulnerability.

Examples include US President Barack Obama's Financial Crisis Responsibility Fee and the ongoing coordinated efforts to institute bank levies by France, the United Kingdom and Germany. These could be based on banks' balance sheets, payrolls, bonuses, profits and risk taking. Some schemes suggest allowing the proceeds to accumulate in a special fund, while others favour channelling them into general public revenue. The measures are not meant to directly finance GPGs, however.

The crisis has also revitalized the discussion on FTTs more generally. The focus has now widened to include all non-retail financial transactions of financial products, including foreign exchange, whether traded on exchanges or over the counter. Some proposals for FTTs suggest narrowing tax bases. There is now limited political support for FTTs – in whichever guise they emerge – from a number of governments, including those of Brazil, Canada, Germany, France and several other European countries, with the notable exception of the United Kingdom. The motives are once again mainly regulatory, looking to stabilize financial markets and put tax revenue in the national purse.

## Why a currency transaction tax?

James Tobin's argument in favour of a CTT is straightforward. He argues that a small tax would render high-frequency transactions relatively expensive. This, in turn, would deter speculative trading and reduce price volatility, without significantly affecting longer-term investments. The same reasoning applies to a general FTT, based on the assumptions that high-frequency trading is by definition speculative, and a reduction of frequent trading will stabilize prices. Both these assumptions are contentious, however, and have come under attack.

There is widespread agreement that short-term trading is not necessarily speculative, but useful in that it promotes market liquidity. Liquidity essentially means that a financial intermediary is able to meet its obligations in the requested currency at any time. If a bank, for instance, is considered 'illiquid', it not only undermines trust regarding its ability to pay, but it could also set off a chain reaction among other banks.

So liquidity is essential for financial sector stability. But even if short-term trading were speculative, a small tax would not deter a trader if the speculative gains are higher than the tax. Disruption of trading liquidity and ineffectiveness in curbing speculation still remain the chief arguments against a CTT.

The dilemma of the Tobin tax is easily resolved. A very small tax rate (0.005% or less) is unlikely to affect liquidity seriously. And there are ways of distinguishing between liquidity trading and speculation in practice.

In terms of speculation, it is perfectly feasible to distinguish between phases of customary liquidity trading and phases of speculation by monitoring the price of trades. This could conceivably drive a tax to curb speculation. As long as prices stay within predefined parameters, the tax would be dormant, but vigilant.

### Currency transaction tax (CTT)

First proposed by James Tobin in his 1972 book *The New Economics, One Decade Older*.

- The original goals of CTTs were to curb exchange rate volatility and deter speculative trade in foreign exchange. Raising tax money to fund development and other global public goods was added to the list in the mid-1990s.
- Preferably, a CTT would be implemented globally. Realistically, it will initially most likely be regional in scope, confined to the European Union or a currency-specific region, such as the euro area.

### Financial transaction tax (FTT)

An FTT could tax a large or small number of financial transactions. Examples include the first specific FTT, dating from 1694 and still in use, and the UK stamp duty, which taxes the transfer of shares and other securities. Many countries taxed stock market transactions in the past, but these taxes were abolished following the lead of the United States in 1966. China adopted a stock transaction tax in 1994. Other types of financial transaction taxes were introduced in South America in the 1990s.

- The main goal of FTTs is to raise revenue.
- FTTs are usually seen as taxes that would be implemented nationally, but some view this as a competitive disadvantage. More recently, economists have been exploring the idea of introducing such taxes globally or regionally at uniform rates.


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So customary trading would not be taxed. Once prices transcend the given parameters, a typical indicator of speculation, they will trigger the tax to act as a circuit breaker. This kind of stabilizing tax should not be confused with the Tobin tax, but the two could work in tandem. As a purely regulatory instrument, the stabilizing tax would not generate revenue, nor would it act as a funding instrument on its own. But it would remove one of the main arguments against CTTs.

Financial traders are less concerned with theoretical arguments against a CTT or FTT – the tax would simply be shifted onto end-users – but they do worry about tax competition. There are doubts about whether FTTs can be implemented universally. A regionally restricted CTT would undermine the global 'level playing field' as activities would move to non-tax financial centres. This brings us back to the basic dilemma of GPGs: first mover disadvantage with free riding.

While tax competition is a serious concern, FTTs are not necessarily an obstacle, which is why some politicians now encourage FTTs, claiming, however, that they have to be implemented globally. The Tobin tax is not only technically feasible, it could also work for a set of countries, like the EU.

### Why a financial transaction tax?

The recent debate on FTTs is ambitious. There is increasing support for of a supranational and coordinated tax on financial transactions. The political appeal is that it could be implemented through national legislation within a common international framework. The drawback is that the tax would be vulnerable to what the Leading Group dubs the 'domestic revenue problem', the erosion of tax proceeds for the funding of GPGs through pressing domestic needs.

True, electronic communication and centralized exchanges would facilitate the technical feasibility of such a tax, as it would a CTT. But its implementation in a multilateral framework raises formidable legal and procedural questions. Furthermore a more comprehensive FTT, including trading in several financial instruments, raises a number of arduous issues that are less salient for the CTT.

How broad should the tax base be, for example? Should the tax rate be uniform, or should it be differentiated by financial instruments? How can double taxation be avoided? Should certain transactions or institutions be exempt from taxes? What does that all mean for market efficiency?

Political consultation on FTTs could ultimately result in a multilateral treaty that applies such taxes on a subset of well-defined non-retail transactions, in particular the transaction of foreign currencies among financial institutions. These taxes would be collected whenever an official or certified private electronic trading platform is used.

Opportunities for tax evasion are also likely to be limited because financial markets are intrinsically linked and cannot be transferred easily geographically, although the relative importance of Asian and South American markets will increase – regardless of whether a tax is implemented. Evasion strategies could be controlled by indirect measures, such as higher capital requirements.

But whatever the outcome, FTTs are an inappropriate means of financing GPGs such as economic development. Initially, their proceeds are likely to be used to support national public budgets. As the world financial order evolves, these taxes could be transferred to supranational institutions for the funding of GPGs. In the meantime, they could provide greater financial stability and deter speculation, which would benefit developing countries indirectly as a result of less price volatility.

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## The way forward

The process of establishing an FTT is complex and likely to fail if addressed too ambitiously. A feasible path of political implementation could be to introduce a number of taxes (ideally at the same rate) for 'core' domestic financial transactions such as the trading of stocks and debentures. These taxes would be coordinated by a European Directive and comprise financial activities in all EU member states (not only members of the euro area).

These taxes do not necessarily have to be new taxes. For instance, the UK stamp duty and the stamp duty reserve tax could serve as an example for a European FTT. But tax legislation would remain in the hands of national parliaments, and the proceeds would be appropriated by national treasuries. The drawback of this cautious policy approach is that it would not allow resources to be reallocated for more ambitious global policy objectives.

An extremely low-rate CTT imposed exclusively on the euro leg of the trade would be an easier measure to implement and would avoid conflict with other currency-issuing states. It would also be more promising for the financing of global policy objectives, such as the Millennium Development Goals.

All currency transactions involving the euro would be taxed when settling accounts with the European Central Bank. This institution would act as a fiscal agent for all governments in the euro area. This would alleviate doubts about the measure's technical feasibility, because the wholesale market for currency trading would be well defined, highly concentrated and automated through electronic processing.

Using proceeds from taxes for global policies is an entirely different matter. The political will to levy supranational taxes is crucial, but so is the will to dedicate revenue to a common global cause. This option could potentially be more attractive for national governments than surrendering 0.7% of their gross national product to development, a pledge made by many governments at the United Nations 1970 General Assembly Resolution.

The chances of success are certainly higher with a CTT than with specific national FTTs. It would be the first time a supranational tax is used to finance global objectives. But the revenue may as well be distributed to governments according to their shares of the European Central Bank's capital, in which case the chance for a truly supranational funding scheme would be wasted. ■


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