BRIEFING PAPER

Why We Need a Financial Transaction Tax: A Proposal for the G20

At the forthcoming G20 Summit (Cannes, 3-4 November 2011), the summit leaders are expected to address several policy issues concerning world economy and financial markets, many of which remained unresolved since the Toronto Summit in June 2010. Against the backdrop of a weak global economy and the ongoing eurozone sovereign debt crisis, G20 leaders will have to take some hard decisions. Failure to do so would undermine the effectiveness and credibility of G20 as the "premium forum" for international economic cooperation.

One of the key policy issues to be tackled at the Cannes Summit is the introduction of a global financial transaction tax (FTT). The Interim Report of the G-20 on Fair and Substantial Contribution by the Financial Sector (2010) had proposed a flat rate levy on all financial institutions and "financial activities tax" on profits and remuneration in order to pay for future financial clean-ups and reduce systemic risk. But the proposal got diluted at the G-20 meeting held at Busan in June 2010, which called for implementation of the levy taking into account individual country's circumstances and options.

The policy objectives for a FTT are essentially two-fold: to raise revenue; and to restore stability and integrity in the financial markets. According to estimates made by Bill Gates (founder of Microsoft) in a forthcoming report to the G20 on new sources of finance for development, a tax on financial transactions could generate about $50 billion from G20 member-countries. Some other estimates claim that a global

financial transaction tax could generate as much as $250 billion if a wide range of transactions are included. The resources raised through FTT could be better utilized to support programs to fight hunger and poverty, and pay for climate mitigation and adaptation costs.

The European Tax Proposal

On 28 September 2011, European Commission President José Manuel Barroso announced the adoption of an EC proposal to implement a FTT in all 27 member-states of the European Union. He also underlined the need for Europe to collectively push for a global FTT at the Cannes Summit.

The European proposal consists of a 0.1 percent tax on trading bonds and shares and a 0.01 percent tax on derivatives trading. These are minimum tax rates and member-states can impose higher rates if they wish. According to the official statement, the tax would be levied on all transactions on financial instruments between financial institutions when at least one party to the transaction is located in the EU.

It is estimated that the proposed tax could generate around $78 billion a year. If unanimously approved by all member-states, the EU-wide tax will come into force on January 1, 2014. Despite resistance from powerful financial services lobby, the proposed European tax transpired in response to growing public anger against the massive bailouts and costly public recapitalizations of banks and financial institutions since 2008.

The proposed tax enjoys considerable public support within Europe. Germany and France have strongly backed the EU proposal while the UK insists that it would only back a financial transaction tax if it were applied globally. The City of London, lobby groups (such as European Banking Federation) and conservative think-tanks (such as Adam Smith Institute) have strongly opposed the European tax proposal. The critics argue that the proposed tax would trigger a liquidity squeeze and increase the costs of trading for financial institutions and other market participants. The UK's support to the EU-wide tax proposal is vital as City of London is the world's leading financial center. There are apprehensions that the UK could mobilize other European countries, particularly Sweden and Ireland, against the proposed tax in the coming months.

The Growing Opposition

At G20, the idea of a global FTT has been strongly resisted by Canada, US and Australia. In particular, Canada has been a vocal critic of a global FTT for many years. During the Toronto Summit, the Canadian leadership did not encourage any serious discussions on the FTT.

The Tobin Tax

The idea of a financial transaction tax is not new. Professor James Tobin in his Janeway Lectures at Princeton first proposed a tax on global foreign exchange transactions in 1972, it came to be popularly known as Tobin tax. In the subsequent years, James Tobin had modified and further elaborated his earlier proposal. Realizing the need for "throw(ing) some sand in the wheels" of global financial markets, he advocated the tax as a mechanism for discouraging speculation in short-term foreign exchange dealings. James Tobin proposed a 0.25% tax on currency transactions in order to control volatility in the global currency markets and to preserve some autonomy in national monetary policies. Essentially a Keynesian proposition, the underlying logic of a Tobin tax is to slow down speculative, short-term capital flows, as they will be taxed each time they cross the border. In the wake of Mexican and Southeast Asian financial crises, a number of civil society groups also launched campaigns urging for a Tobin tax. Some economists have also proposed a Pigovian tax (named after economist Arthur Pigou) to address negative externalities generated by global finance.

Canada is opposed to the tax on the grounds that its banking system remained strong during the global financial crisis and no bailouts were sought. Canada also perceives that the FTT would be counterproductive during the weak economic conditions. “We will continue leading that charge against a transactions tax and I am confident that our allies on this point, who are the emerging economies, will stay with us and join us in opposing what we view as a counterproductive tax,[1]” said Mr. Jim Flaherty (Canada’s Finance Minister) in a speech to the US financial industry in response to the European proposal. “I am actually confident that we have enough of them in the G20 that we will be successful on that initiative,” he further added.

With the tactical backing of US, Australia, China and India, Canada could generate enough political support within G20 against a global STT at the Cannes Summit.

India’s Position on FTT

At the G-20 Ministerial Meeting at Busan (June 2010), India expressed its reservations against a global FTT on the grounds that there was need for better and well-placed regulations rather than imposing taxes on the banks and financial transactions.

India also pointed out that its conservative approach towards banking regulation helped in protecting national banking system. There is no denying that India’s regulatory framework (often criticized as “outdated” and “inward looking”) acted as a key factor in protecting the domestic banking system from the global financial crisis, yet India’s official position on FTT at the G20 is questionable on three counts.

Firstly, transaction taxes are an integral part of the armoury that policymakers deploy to regulate the financial sector. No one has claimed that transactions taxes are a substitute to well-placed regulatory and supervisory measures. Rather taxation and regulations are complimentary tools used by policymakers to address externalities.

Secondly, not long ago, India had strongly argued in favor of a global financial transaction tax to meet social and developmental needs of the poor countries at various international forums. While addressing the Non-Aligned Movement Business Forum in Kuala Lumpur (2003), the then India’s Prime Minister, Mr. Atal Bihari Vajpayee stated, “I believe there is another initiative, which NAM can spearhead for the reform of the international financial architecture. We know that unstable capital flows can severely disrupt

The History of Financial Transaction Taxes

The taxes on financial transactions have a long history. Taxes on various kinds of financial transactions have been imposed in several countries including the US, Germany and the UK. During 1963-74, the US imposed the Interest Equalization Tax to discourage residents from investing in foreign bonds. Germany followed the ‘Bardepot’ regulation till the 1970s. The UK still imposes a 0.5% stamp duty (a form of financial transaction tax) on share transactions. Since the mid-1970s, Argentina, Brazil and Venezuela have imposed taxes on bank transactions. Taxes on securities trading are still prevalent in G20’s emerging economies (India, Brazil, China and Indonesia). Post-crisis, some developed countries have proposed or established levies to deal with cost of future crises. In January 2010, the US had proposed a Financial Crisis Responsibility Fee on banks and financial institutions to recoup the taxpayer’s money involved in bank bailouts. The UK and France have also imposed a levy on bonus payments.

[1] Quoted in John Greenwood, “Clark Sings Praises of Basel Rules on Capital,” *Financial Post*, October 5, 2011.

developing economies. There is less ready acceptance of the idea that such flows should be regulated by an international levy. I believe this is a reform whose time has come.[2]"

Thirdly, India itself introduced a Securities Transaction Tax more than six years ago with the twin objectives of raising additional revenue and maintaining market integrity. By not lending support to the idea of a global FTT at G20, India has lost an opportunity to build tactical alliances with the poor countries and global civil society to reforms the financial markets.

Securities Transaction Tax in India

In 2004, India introduced a Securities Transaction Tax (STT) in equity markets. Currently, STT is charged at the rate of 0.125 percent on a delivery-based buy and sell transactions and 0.025 percent on non delivery-based sale transactions. The rate is 0.017 percent on F&O sale transactions. Imposed on both foreign and domestic investors, the STT is collected by the stock exchanges from the brokers and passed on to the exchequer, thereby enabling the authorities to raise revenue in a neat and efficient manner.

Termed as "Terminator Tax," the STT was strongly opposed by a lobby of speculators, day traders, arbitrageurs, and "noise traders." Many of them had predicted that the introduction of STT would bring Indian financial markets to a standstill and would dry up liquidity.

Since its implementation, all apprehensions related to STT have proved erroneous. The fact that there is too much liquidity in the Indian markets is also admitted by the critics of STT. The implementation of STT has also reduced some loopholes in the existing tax regime. For instance, foreign investors who used to take undue advantage of the bilateral direct tax avoidance treaties (such as India-Mauritius tax treaty) are now taxed under the STT regime.

Since 2004, Indian authorities have collected sizeable revenue from the STT. During the fiscal year 2009-10, the government's revenue from STT was Rs. 59940 million ($1.3 billion), a substantial amount in the present times when tax revenues are under severe pressure. The tax authorities have set a target of Rs. 75000 million ($1.6 billion) for the fiscal year 2011-12. However, the trading trends reveal that the STT did not help much in reducing the volatility in the Indian equity markets, as anticipated by many proponents.

Rather than further widening the scope of STT, Finance Ministry is planning a complete or phased withdrawal of it with the expectation that it may substantially increase market turnover.

The Rationale behind FTT

Apart from revenue potential, there are several other justifications for the adoption of a global transaction tax. Such a tax could facilitate the monitoring of international financial flows by providing a centralized database on such flows, which is the need of the hour. This could be particularly valuable to the poor and developing countries where large information gaps exist.

Unlike many other services, no value added tax (VAT) is imposed on financial transactions in many jurisdictions. By taxing diverse financial transactions, a strong message would be conveyed that private banks and financiers must share the costs of the global financial crisis.

Given the fact that majority of transactions carried out by speculators and high frequency traders are short-term and speculative, this tax can curb speculative tendencies that induce excessive volatility and fragility in the financial markets. While a small tax is unlikely to discourage long-term investors such as pension funds. The argument that the FTT would trigger a liquidity squeeze in financial markets lacks

[2] Prime Minister's Speech at NAM Business Forum on South-South Cooperation, Prime Minister's Office, New Delhi, February 23, 2003.

evidence. As argued by Avinash Persaud, "During calm times, when markets are already liquid, high-frequency traders are contrarian and support liquidity, but during times of crisis, they try to run ahead of the trend, draining liquidity just when it is needed most, as we saw with the Flash Crash on 6 May 2010. If a transaction tax limits high-frequency trading it may even provide a bonus in improving systemic resilience.[3]"

Is a FTT Feasible?

Much of the criticism of the FTT is centered on the question of its practicability and technical feasibility. It is often argued that the imposition of such a tax is a difficult proposition since the volumes traded are too high. If the modern electronic system can enable large-scale financial transactions within and across borders, why can't the same technology be used to collect taxes?

Critics also argue it is almost impossible to get all the countries to agree on a common global tax. Nevertheless, a beginning can be made with a few countries coming together on this issue even if a strong consensus across territories is not possible immediately. Europe can take the lead and introduce the FTT at the European level. The G20 member-countries could also impose such a tax unilaterally or collectively. An agreement among the leading financial centers could also contain the threat of relocation of financial activities to other places.

The issues raised by FTT are more political than technical. Its adoption requires strong political will, particularly among the G20 member-countries. The recent experience (for instance, money laundering related to drug trafficking) shows that international cooperation among countries is possible if there is a political will. A similar cooperative initiative is required to address myriad implementation issues related to FTT.

[3] Avinash Persaud, "*EU's Financial Transaction Tax is Feasible, and If Set Right, Desirable,*" VoxEU.org, September 30, 2011.

Another common criticism of FTT is related to evasion. All taxes (e.g., income tax and property tax), for that matter, are open to evasion but this is not sound enough reason for not having them. Concerted efforts should be made to check loopholes, as no policy measure can be foolproof.

While supporting the case for a global financial transaction tax, no one argues that all problems related to global financial markets would be resolved. In the present times, no single policy instrument alone can fix global finance. Nevertheless, such a tax could serve as a first step towards building international cooperation on global financial reforms. If it is used in conjunction with other policy instruments (for instance, capital controls), FTT does offer an attractive mechanism to reform the global financial markets.

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