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International taxes on financial transactions: Responding to global challenges - towards a fairer sharing of costs



A CIDSE Position Paper



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Financial transaction taxes are back on the international agenda

The global economic crisis has put the idea of taxation on financial transactions back on the political agenda. Governments faced with massive budget deficits and huge public debts after financing bailouts and economic stimulus packages are in search of funding. They are also keen to meet public demands that the financial sector should pay its fair share, but that cuts in social spending, environment and public goods or rising tax burdens on citizens should be minimized.

Developing countries are facing additional problems of tackling multiple crises with limited resources to avoid negative impacts on efforts to meet the Millennium Development Goals (MDGs).

In this context financial transaction taxes are seen as a possible innovative mechanism to ensure stable and predictable flows of complementary development finance to meet these additional needs.

In addition, excessive trading in unregulated financial markets and the predominance of short-term speculation have contributed to volatile assets prices as well as large fluctuations in exchange rates, stock prices and commodity prices, reinforcing the effects of the financial crisis.

Taxes on financial transactions are a way of dampening these effects by reducing speculation and downsizing financial markets to stabilize the economy.

Political support for FTTs

Taxes on financial transactions (FTTs) have been debated widely in the wake of the global financial and economic crisis:

- The UN General Assembly's Commission of Experts on Reforms of the International Financial and Monetary System (the "Stiglitz Commission") mentioned a financial services tax as a way of providing more stable and sustainable development finance that would also help to stabilize markets.
- The European Parliament and the president of the European Commission Jose Manuel Barroso have spoken out in favour of taxing financial transactions.

- A number of European countries including Belgium, France and Austria made clear political decisions to support currency or financial transaction taxes. The chairman of the British Financial Supervisory Authority, Lord Turner, has also supported the idea, initiating a debate in the UK in August 2009.
- In the run up to the G20 summit in Pittsburgh European leaders including German chancellor Angela Merkel and French President Nicolas Sarkozy promoted the idea of a tax on financial transactions or some kind of “Tobin tax”. As a result, G20 leaders tasked the IMF *“to prepare a report for our next meeting with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system.”*
- The Leading Group on Innovative Financing for Development - an intergovernmental forum with representation from all continents – recently established a Taskforce on International Financial Transactions for Development. An expert group is currently examining the feasibility of financial transaction taxes, including currency transaction taxes and will present proposals for political decisions by May 2010.

CIDSE welcomes these opportunities to revive ideas that it has long supported. CIDSE was among the pioneers to promote a tax on currency transactions as a response to the Asian crisis in the late 1990s. CIDSE developed a more comprehensive position on taxation as means to finance development for the UN Follow-up International Conference on Financing for Development in Doha last December. CIDSE has updated its position to reflect recent developments and makes the following recommendations to promote an international financial transaction tax.

Objectives of an international tax on financial transactions

CIDSE believes that international taxation has the potential to contribute to global justice and development objectives by fulfilling key functions of taxation: revenue raising and regulation as well as redistribution of wealth to contribute to global justice not only within states but also at the international level.

Taxing currency transactions, or more broadly financial transactions is one way in which the fast-expanding financial sector could contribute towards sharing the burdens on governments and the poorest people of the multiple global crises – financial, economic, food and climate. Revenues generated by such taxes should be used to support global efforts to achieve internationally agreed development goals. At the same time, this type of taxation would play a role in the stabilisation of the global economy.

Although action at the national level is possible, highly interlinked global financial markets on the one hand and the high concentration of activities on the other, suggest regional and international cooperation. Joint action through regional and international taxes could contribute to the strengthening of representative democratic global institutions and a sense of global responsibility.

What kind of tax?

CIDSE supports a step by step introduction of a general and uniform Financial transaction tax which should cover all spot and derivate transactions on organized exchanges (shares, bonds, securities and derivatives, including trade of futures and options related to stocks, interest rate securities, currencies and commodities). In the long term the tax should be extended to “over-the-counter” (OTC) transactions directly related to asset prices, in particular to exchange rates and interest rates including derivatives.

The tax would be automatically collected at the exchanges and borne equally by buyers and sellers using the electronic settlement systems. This would be easy to implement in organised markets and involve little administrative costs.

It would be limited to transactions between financial market actors while transactions between customers and financial institutions, for example the purchase of goods, labour market transfers and so on, would be exempted. Thus the tax would have minimal direct impact on the real economy.

Based on academic research, CIDSE believes that even a small tax rate, e.g. between 0.01%-0.1% ¹, has the potential to generate substantial revenues amounting to several hundred billion US dollars per year. Alternative FTT rates, including higher ones, are also being discussed. A commonly cited reference is the UK stamp duty of 0.5% levied on all stock transactions - an example which demonstrates the rationality and feasibility of introduction of a tax at somewhat higher rate than those suggested above.

¹ Schulmeister, Stephan: A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal; WIFO Working Papers, No. 344; October 2009

The potential effects of different tax rates on transaction volumes and revenues should be explored within further studies, including in the IMF and the Leading Group Taskforce studies (mentioned above), in order to identify the optimal scenario of implementation. A phasing-in approach could be considered as a possible option, that is the introduction of a FTT at a low rate and a gradual increase of the latter in order to augment revenues and improve the counter-speculative and market-stabilizing effect of the tax.

From Currency transaction tax to Financial transaction tax – two possible options

CIDSE has consistently promoted a Currency transaction tax ² (CTT, also often referred to as “Tobin tax”) which is a special form of financial transaction tax (FTT) targeting cross-border trade of currencies and resulting consequently in exchange rates effects. This was of special concern following the Asian crisis in the late 1990s where speculative attacks on currencies were among the root causes ³.

With the rapid expansion of financial markets and increasingly disproportionate trade in derivatives beyond currency transactions playing a major role in creating financial instability, the idea of introducing a general financial transaction tax emerged. A general FTT, as described above, can be more attractive than a CTT for the following reasons:

- A general FTT is more comprehensive as it covers all types of financial markets.
- Due to the enormous volume of the multitude of financial transactions the tax could yield significant revenues even at a low rate.
- It could be introduced step by step (starting with domestic exchanges and exchanges on organised markets).

Nevertheless, both types of transaction taxes, FTT and CTT should be explored in detail within the current studies conducted by the IMF and the Leading Group on Innovative Financing for Development.

Arguments to promote a tax on financial transactions:

- *Contribution to global justice:* A tax on financial transactions is a measure of political fairness and social justice as it will ensure contributions by the financial sector, which was at the core of the crisis, towards crisis resolution and global recovery. It would also shift the burden of taxation from wages and consumption to capital thus making the overall tax system more equitable. Using the ensuing revenues for financing development and global public goods would contribute to more just international distribution of wealth and to the reduction of inequalities between North and South.
- *Revenue generation:* Possible revenues depend on the rate and scale of introduction. All estimates suggest that substantial revenues can be achieved with a rather low tax rate. Even when assuming a reduction of transaction volumes due to taxation in North America and Europe, estimated tax revenues would range between 0.5% and 2.4% of world GDP if all transactions are covered. At the European level even a tax at a minimal rate of 0.01% would generate income of about EUR100 billion per year (up to EUR500 billion for a rate of 0.1%) ⁴. Globally more than double the amount could be expected with the major part stemming from derivative transactions on organised exchanges which are the easiest to collect.
- *Regulation:* According to the Austrian Institute for Economic Research (WIFO), a general and uniform FTT on all kinds of financial asset transactions would have a stabilising effect on financial markets, even if introduced at a low rate. The FTT would increase the cost of speculative trading and thus help mitigate fluctuations of asset prices in stock markets, of exchange rates and commodity prices. At the same time it will have minimal effect on the real economy (especially compared to other measures such as an increased VAT) and thereby improve the general macroeconomic performance.
- *Feasibility:* A general FTT is technically feasible because of the use of standardized electronic settlement systems. Circumvention of electronic platforms would be very costly and hence unlikely. The FTT could be introduced step by step both in terms of geographic expansion and coverage of types of financial transactions. Regional introduction is possible. Due to high concentration of trading, in the short run

² http://www.cidse.org/Area_of_work/Development_finance/?id=281

³ CIDSE supported a two-tier (two-rate) CTT (based on the model of Professor Paul-Bernd Spahn) which is a version of the proposal popularised by James Tobin in the 1970s. According to this concept, a low rate tax would be applied on ordinary foreign exchange transactions, while a higher “normalization” duty would be levied during periods of high currency *volatility* resulting from speculation with the aim of stabilizing the respective exchange rates. Thus such a CTT would simultaneously moderate the effects of rapid speculative runs on currencies, thus contributing to the prevention of major currency crises, and generate substantial revenue for development financing.

⁴ Based on figures from Schulmeister, Stephan: A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal; WIFO Working Papers, No. 344; October 2009

it would be sufficient to get a few major players on board, such as the UK and Germany in Europe (which account for over 90% of European financial trading). Emigration of trading is not expected because other factors such as network externalities of market places are most important. The British stamp duty on stock transactions of 0.5% did not harm the City of London as major financial centre. In the medium run, the FTT could be introduced within the European Union (as well as Switzerland and Norway, as major non-EU financial centres in Europe), while in the long run global implementation should be considered.

- *Use of revenue:* CIDSE believes that the global dimension of the economic crisis demands international burden sharing. Poor countries are especially badly hit by the crisis, which they were least responsible for, and have the fewest resources to counteract or take meaningful steps for its resolution. Therefore collected funds should be used to finance global development, especially achieving the Millennium Development Goals and delivering global public goods. Such an approach would ensure equitable global redistribution both of resources to offset the immediate effects of the crisis and of accumulated wealth in the long run.
- *Governance of funds and representation:* The ensuing tax receipts need to be administered in a responsible and accountable manner whereby representative democratic governance of funds is imperative. Decisions with respect to the administration and allocation of revenues should be placed in a multilateral setting and taken based on equal rights of all actors and inclusion of a wide range of stakeholders to ensure joint ownership, transparency and accountability. CIDSE believes that the UN, being universally representative, is the only institutional framework which would have the required legitimacy to administer funds dedicated to global purposes. Additionally, with its extensive expertise in the area of international development, the UN would be best placed to make informed decisions about effective fund allocation and the respective channels to be used for this purpose.
- *Additionality:* The commitment to the additionality of the FTT-generated resources to traditional sources of development financing needs to be reaffirmed, while principles of effectiveness and coherence should be observed.

CIDSE believes that international taxes on financial transactions would represent a meaningful tool for a fair burden sharing of the multiple global crises and joint response to emerging global challenges. The introduction of financial transaction taxes at regional level is feasible and the window of opportunity should not be missed.

Further research should focus on issues of concrete implementation and lead to next steps towards the introduction of such a tax.

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CIDSE is an international alliance of Catholic development agencies. Its members share a common strategy in their efforts to eradicate poverty and establish global justice. CIDSE's advocacy work covers global governance; resources for development; climate justice; food, agriculture & sustainable trade; and business & human rights

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Its common long term objectives are to increase and sustain resources available for developing countries to finance and decide in an inclusive manner upon their development and to increase the decision-making voice of countries which are most affected by global policies which impact on their development.