Should financial products be taxed?

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The question as to whether financial transactions should be taxed is on the international agenda. Though originally proposed by Keynes during the Great Depression and subsequently supported by Nobel economist James Tobin in the 1970s, the idea has never been raised so insistently on the international agenda as at present. Many politicians and economists are now proposing that all securities traded in the markets (capital or debt instruments, currencies, and all types of derivatives) should be taxed. At the instances of some members of the G-20, the IMF is considering such a tax, among other options, in order to finance the debt that has been created by the financial crisis and also to improve the global financial architecture.

The financial system is oversized, hyperactive and unstable

Many things have changed since Tobin proposed his tax. The number and range of instruments, intermediaries and markets have increased greatly in the last 20 years, resulting in markets of great complexity. Such complex globalised markets are at the core of the current crisis. The cost of rescuing and redesigning the financial system and of saving the economy from a depression is proving to be very high, in terms of both money and government effort. Citizens worldwide are understandably indignant at the increase in unemployment and government debt at a pace that is without precedent (barring the two world wars).

In the mid-1980s, the financial sector began to expand at a pace that defies common sense. The ratio between financial assets and GDP in the advanced economies rose from slightly over 50% in 1980 to 350% in 2006. In the US, as in many developed countries, the financial sector's earnings rose from 10% of earnings in the national income in 1950 to 22% in 1980 and an incredible 34% in 2005. Moreover, the volume of financial transactions worldwide reached 73 times world GDP in 2007, compared with just 15 in 1990. This hypertrophy and hyperactivity in the financial sector contributes little to society but is capable of generating episodes of financial instability with severe

consequences for economic growth and employment, as observed in the last few years.

Pros and cons of a tax on financial transactions

Prestigious economists, and prominent politicians and financial supervisors in Germany, the UK, China, the USA and France have called for a tax on financial transactions. Others, including US Treasury Secretary Timothy Geithner, oppose the idea.

The arguments in favour can be summarised as follows:

- There is excessive activity in the market in financial assets because short-term speculation predominates. Over-reactions (upward and downward) in asset prices denote what Keynes referred to in 1936 as a "predominance of speculation over enterprise" and affect economic growth and employment. Constant sharp movements created by short-term speculation cause prices to diverge excessively, and in a volatile way, from their fundamental equilibrium levels.

- A uniform tax on financial transactions (TFT) would make speculative transactions more expensive, the cost increasing in proportion to the shortness of the term and the degree of leverage. Therefore, a TFT would have a stabilising impact on financial asset prices and would improve economic growth and employment.

- A TFT would compensate for the distortion caused by the fact that financial transactions are exempt from value added tax. Moreover, it would provide governments and multilateral authorities with considerable revenues that could be used to palliate fiscal imbalances and/or to finance major objectives of social and economic policy worldwide.

The arguments against are set out briefly below:

- The large volume traded in the financial markets is merely the liquidity needed for price discovery and pricing mechanisms to work smoothly and for financial asset prices to oscillate around their fundamental equilibrium levels.

- A TFT would increase transaction costs and reduce liquidity, resulting in greater short-term volatility in financial asset prices.

- A TFT would be hard to manage and financial market participants would find ways to evade it.

The arguments for and against derive from two very different views of market efficiency, a concept that has been battered by the crisis.

How the tax could be structured and how much could be raised

The success of such a tax hinges on its design. The TFT would pursue two goals: curtail hyperactivity and hypertrophy in the markets, and raise funds. It is vital to get the right definitions for the tax, the taxable event, and the tax collector. It would also be necessary to decide what to do with the funds. To be efficient, a TFT would have to be global, since the financial markets are global. An agreement on a TFT within the G-20, with the participation of the IMF, would result in a negligible risk of evasion or arbitrage, since the G-20 member countries account for 90% of all transactions in the financial markets. Moreover, financial transactions always leave a trail. They take place in organised markets or through financial intermediaries and are generally cleared and settled through a clearing house. It would be harder to evade the TFT than VAT (which is actually evaded in practice).

The various proposals overlap in many but not all respects, and some are still very sketchy. A TFT should apply to all financial transactions with securities, whether conducted on organised markets or otherwise (OTC). Securities should be understood as meaning shares, bonds, currencies and all their derivatives, as well derivatives on commodities and indices, and ETFs of all types. Some issues have yet to be resolved: should central banks' securities transactions with the financial system be taxed?

The taxpayer should be the final consumer of the financial product: households, companies and financial intermediaries. Some financial intermediaries are extremely active, often appearing to be addicted to the consumption of financial products. What is the real economic function of buying and selling x% of a company several times an hour using sophisticated software?

The tax would be collected by financial intermediaries and/or financial markets and/or clearing houses, which would then pay the proceeds to the respective governments. The design of the TFT would have to cover how the tax revenues are divided up at national and/or international level.

The proposed tax rate varies from 0.01% to 0.05% of the transaction value (in derivatives, it would be referenced to the notional value of the underlying asset). This would produce sizeable amounts of revenue. A rate of 0.01% is reasonable. It is estimated that this rate would raise revenues amounting to

0.6% of world GDP, assuming the application of the tax leads to a 25% reduction in trading volume. In Spain, the tax could raise around 6 billion euro per year, which is in line with the proportion of 0.6% of GDP mentioned above. To put that figure into perspective, it should be compared with the total amount of wages, bonuses, pensions and profits in the financial sector (not just banks).

Conclusions

To make the financial system more stable and efficient and enable it to serve society better requires action on several fronts: improve capital requirements for the various financial intermediaries; establish bank insurance systems financed by the parties that generate risk; improve the transparency and soundness of the markets and the products traded in them; improve supervision and governance of the financial system; and increase consumers' and companies' financial education.

All these goals are compatible with a properly-designed universal TFT that would tend to rebalance the size and activity of the global financial system while raising funds through which the elements that contaminated the financial system contribute to offsetting the huge resources that governments have allocated to bailing out the system. Since the TFT will only be efficient if it is global, an agreement of this type should be adopted by the G-20 in cooperation with the IMF. The vast majority of citizens would view such an agreement as a magnificent sign that a global government is not impossible. And as consumers of financial products, we would be willing to pay a small tax (which would become significant in the case of compulsive consumers). If the funds are used properly, the outcome would be superb.