

Submission to the IMF on Financial Sector Taxation

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Jubilee Australia supports a tax on financial transactions for the following reasons:

- (1) An appropriately designed FTT could make markets more stable and reduce the risk of further financial crises by helping to curb the excessive liquidity and volatility of prices in financial markets, both of which have helped caused the instability seen in markets since the late 1990s.
- (2) The tax could raise revenue from the financial sector to see it help to share the financial burdens resulting from government interventions to shore up the global financial system. The revenue could also be used for other necessary global public goods.

(1) Bringing Stability and Efficiency to the Global Financial System

The instability in financial markets

Incredible growth of financial markets trading in recent years has led to the situation where the volume of financial transactions is now many times higher than nominal world GDP. While in 1990 financial transaction volumes were 15 times higher than GDP, they are now 73 times higher. Additionally, the volume of foreign exchange transactions is around 70 times higher than world trade. Almost entirely, this increase in trading is a result of an enormous boom in the derivatives markets.

According to economic theory the presence of arbitrage in the financial markets helps to keep asset prices right and markets efficient. However, it is generally accepted that the size of the derivatives market today allows speculative trading to far outweigh its use for hedging and insurance purposes. Furthermore, it is accepted that, given the volume and nature of these transactions, they have gone beyond the positive role they play in the price discovery process.

In recent years, as the size and the speed of financial transactions has increased, so has the tendency of asset prices for commodities, exchange rates and even stocks to fluctuate around underlying trends (their fundamental

equilibria) without converging towards these trends. Finance economists have defended the growth of the new finance facilities by reference to the Capital Asset Pricing Model (CAPM), building on Fama's efficient markets hypothesis. However, the assumptions of this model have not been unchallenged, most notably by Shleifer and Vishny (1997), who found that anomalies in financial markets are likely to appear, and that arbitrage is not likely to eliminate them.

This recent global financial crisis has been linked to the increase in the volume of financial transactions:

- The creation of new financial products, which repackaged sub-prime mortgages for trade on the secondary markets, was a factor contributing to the real estate bubble of 2004-2008.
- The development, and subsequent bursting of a commodities bubble (the view that this commodity price instability was the result of exogenous forces is not supported by evidence), and the simultaneous exponential growth of the exchange-traded commodities derivatives market - suggesting a causal link between the commodities derivatives trading and the commodities bubble.
- The bursting of these two bubbles led directly to the current financial crisis.

Stephen Schulmeister provides an explanation as to why the growth of these new finance facilities corresponded with the recent boom and bust cycle that we have just experienced. According to Schulmeister, trading to take advantage of asset price fluctuation has progressively become faster as a result of changes in technology, in the sophistication of the software, and in the speed of information exchange generally. Instead of improving the efficiency of the price discovery process, this 'technical trading' in fact helps to produce the very thing that it exists to exploit: an exacerbation of the trends of asset prices and increased price volatility. Further, this short-term volatility has the even more serious impact of worsening long-term price distortions: what should be smaller price runs become longer-term trends, resulting in the sort of unstable booms and busts which we have seen in the housing and commodities markets in recent years (Schulmeister 2009). Schulmeister's work complements older studies which link market volatility to increases in trading. Such work posits that the volatility is due to the propensity of traders to respond to market momentum rather than fundamentals (French and Roll, 1986).

The effect of a FTT

A FTT would reduce the excessive liquidity in the market stemming from short-term oriented financial transactions, this being one of the main purposes of the tax. Short-term trading would be effected more by a FTT more than long-term trading, given that a small taxation fee would be more significant on the cost of high volume, high speed transactions characteristic of short-term trading rather

than on longer-term trading. As a result, once an FTT is in place it is predicted that:

- Price runs would become less pronounced and the boom and bubble economy that we have seen in recent years should become less marked.
- Conversely, the effect on necessary hedging transactions would be negligibly small.

In summary, it could be predicted that a FTT would reduce those financial transactions that lead to market instability without reducing those core transactions that play the key role in the market's price-setting function.

The possibility exists that a FTT could be set at different rates for different markets. For example, one proposal for the US suggests a 0.5% rate on stocks (the same levy already applies in the UK stock market) but a smaller 0.1% rate on bonds and swaps (Baker et al., 2009). Likewise, the possibility exists that the foreign exchange market could be taxed at a lower rate than other types of financial trades. Research on the effect of a transactions tax on the foreign exchange markets has shown that at a rate of 0.005%, trade would decrease by a mere 14 per cent (Schmidt, 2007).¹ Thus it is possible to envision a scenario where the currency markets could be taxed at 0.005%, while other markets were set a higher rate (0.01 and 0.05% are often suggested).

A FTT, it has been argued, would even bring market efficiency gains by reducing noise trading and the harmful impacts of trend-exacerbating 'technical trading'. But even if a FTT delivered less stability gains than expected, the reverse argument - that markets would be unable to respond to changes in market fundamentals due to a drop in trade volume - seems a difficult argument to maintain. The same could be said about fears of a loss of liquidity (and a slowing down of trade): a return to 1980s level of trading would not be a disaster (moreover, the UK stock exchange already has a tax on shares and has not suffered). At worst, a FTT would reproduce the efficiency levels of the 1980s. The vibrancy of the capital markets in the 1980s puts paid to any suggestion that any return to that speed of trading or market efficiency would be problematic or otherwise undesirable (Baker, 2010). A reduction in the overall volume of trading would improve the role of the financial sector in servicing the economy, as long as the reduction in volume does not undermine the sector's core role in setting prices.

A less bloated financial sector, performing its role with less rather than more capital, would lead to net efficiency gains for the entire economy. That money could be put to other productive uses within the economy.

¹ This is a comparatively small change on a market which is still the largest in the world in terms of volume of transactions.

(2) FTT Revenues

In regard to the amount of money raised by a FTT were it implemented in some or most of the main trading centres, estimations vary. Relevant factors include the tax rate decided upon, the size of the reduction in trading (if any) and the number of implementing countries/jurisdictions. In the US it has been estimated that between US\$177 and \$353 billion could be raised annually (Baker et. al., 2009). Rodney Schmidt estimated in 2007 that 'a CTT of 0.5 basis points (0.005%) in the major currency markets would reduce transaction volume by 14 percent. Post-CTT spreads and transaction volumes would be well within the range of recent observations and would not be disruptive. A 0.5-basis-point CTT would raise at least US\$ 33 billion every year, probably more.' (Schmidt, 2007).

The division of revenues would be a matter for major multilateral negotiations. The revenues could be divided and allocated to domestic government burdens post-financial crisis, as well as being allocated toward important global public goods. The importance of raising money for domestic uses (i.e. to cover the costs of the bail-outs), one of the main reasons for this IMF consolation, hardly needs further expansion here. Globally, revenue could be allocated toward the pursuit of social and environmental goals including global health programs, reducing greenhouse gas emissions and adapting to climate change. In each case, the need is great while a financing shortfall exists.

Clearly some sort of multilateral process would be required to determine:

- (1) what proportion of the funds went to domestic, to regional (eg Germany and the UK might want to share their revenues with other EU countries for domestic uses) and to global purposes; and
- (2) how to make decisions about which global goods could be financed by the FTT and to what extent.

This process would be an important part of the debate in the lead-up to any global implementation of a FTT.

Fears are unwarranted that clever speculators would be able to avoid taxes. By levying a tax (perhaps at different rates) on all types of financial transactions, no financial transactions would be left untaxed. It is unlikely that speculators would move to tax havens, as such places provide little security; moreover, wealthy countries could easily cut off tax havens from access to the international banking system if they so desired. The threat of loss of banking and other licenses of financial enterprises would be such a risk that no substantial financial corporations would be likely to attempt to avoid the tax.

References

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