

# FINANCIAL TRANSACTIONS TAXES

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# Overview

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# Background – Financial Crisis and Fiscal Consolidation

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- ❑ Affected countries experienced severe economic contraction – reduction in or negative growth in GDP
- ❑ Accompanied by decline in revenue/GDP and rise in expenditure/GDP
- ❑ Revival of economic activity anchored on quantitative easing which did not work fast enough since the injected money sat with collapsed money multipliers
- ❑ Focus then turned to fiscal stimuli through tax reductions and mainly current expenditure enhancements but the size of the fiscal multiplier was not known either. Hence the dilemma as to the role of fiscal policy in crises
- ❑ The already rising fiscal deficit/GDP was further exacerbated and public debt/GDP in some countries almost doubled
- ❑ Stock markets and rating agencies did not appreciate these indicators and strategies had to be reformulated

# Background – Pace of Fiscal Consolidation

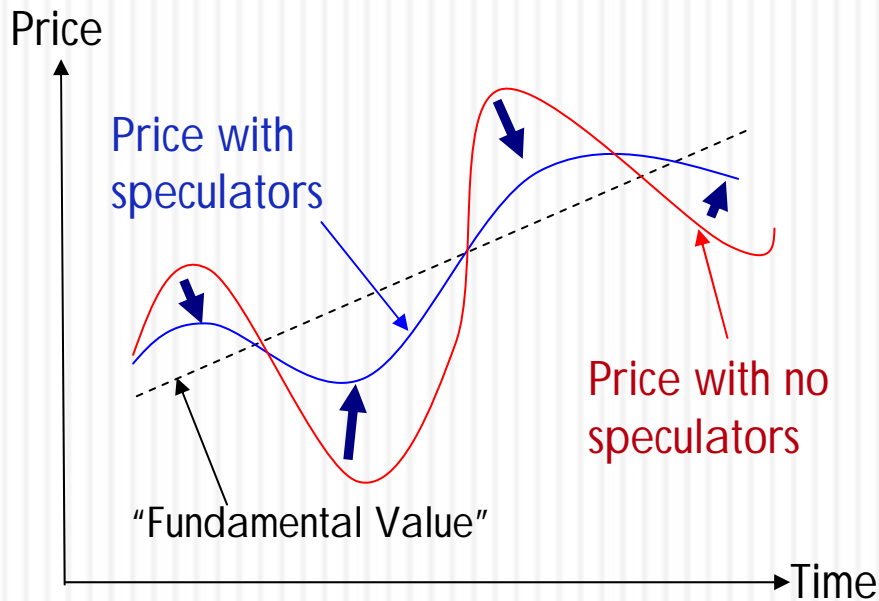
- ❑ Strategies were refocused on fiscal consolidation and its pace was debated
- ❑ One view was that fiscal loosening should continue; another was that fiscal policy should be tightened; a third view was to go somewhere in-between. Elections were won and lost on this issue
- ❑ In the UK for example, pre-election (March 2010) and post-election (June) positions viewed corrective policies very differently. Further, the final Spending Review (October) further recomposed expenditure components in favor of investment over consumption, cutting back on untargeted direct consumption subsidies and reducing the length and pattern of unemployment coverage
- ❑ Thus the choice made was one in favor of fast fiscal consolidation through lower consumption, over the earlier demand driven (consumption plus investment) strategy
- ❑ In India in the last February 2011 central Budget, the net tax measures yield a negative amount. Fiscal consolidation will be achieved through economic growth
- ❑ One concept that was widely discussed was a tax on financial transactions.

# Theoretical Premise – Prices and Transactions

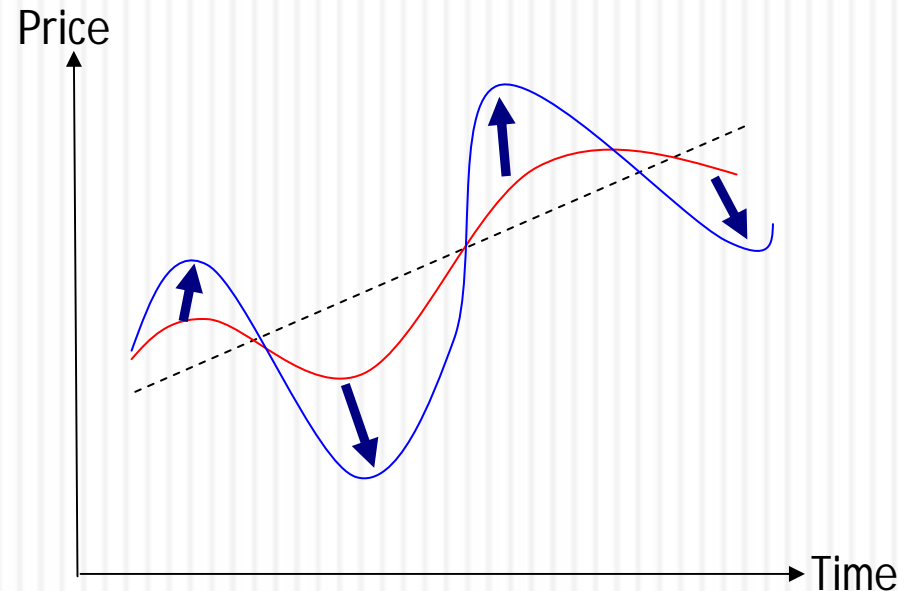
- There is a general theoretical consensus that transactions taxes:
  - Cause a fall in asset prices (or in exchange markets, an increase in the bid-ask spread)
  - Cause a fall in the long-run number of transactions
- Empirical studies have, over a range of years, provided supporting evidence for this, for example those based on data from the London Stock Exchange include:
  - Share prices fall by 0.2% and transaction volumes fall by 1.65% for every 1% increase in transactions costs (Jackson & O'Donnell, 1985)
  - Those shares with the highest turnover rate (effectively incur the highest Stamp Duty on share transactions) demonstrated the greatest price decrease in response to changes in Stamp Duty rate (Bond, Hawkins & Klemm, 2004)

# Theoretical Premise - Volatility

- There are conflicting theoretical views about whether we should be concerned with financial market volatility (Shome & Stotsky, 1995)



Are short-term speculators rational, "fundamental" traders that identify price discrepancies and push the market towards equilibrium?



Or, are short term speculators irrational "noise" traders that push the market away from fundamental values for private gain?

# Theoretical Premise - Volatility

- This lack of consensus stems from fundamental evidence gaps:
  - Is volatility a market failure that needs addressing?
  - What is the correct level of volatility? How is this traded off with market efficiency?
  - Are short term speculative trades disruptive or do they help the market reach fundamentals?
  - How “perfect” are financial markets? Are traders rational? Does it matter that the market is not a “Walrasian Auction”?

# Theoretical Premise - Volatility

- Econometric evidence has been mixed with many studies concluding insignificant relationships or a lack of correlation between transaction costs and volatility
- However, newer approaches for exploring the problem have been developed:
  - Mannaro, Marchesi & Setzu (2008) use a computer based simulation model to find that financial transactions taxes increase price volatility
  - Bloomfield, O'Hara & Gideon (2009) use a series of laboratory experiments to conclude that such taxes reduce the numbers of transactions by an almost equal proportion for both rational "fundamental traders" and irrational "noise traders" therefore even if noise traders are disruptive it is unlikely that they can be targeted using a transactions tax

# Theoretical Effects - Wider Economic Impacts

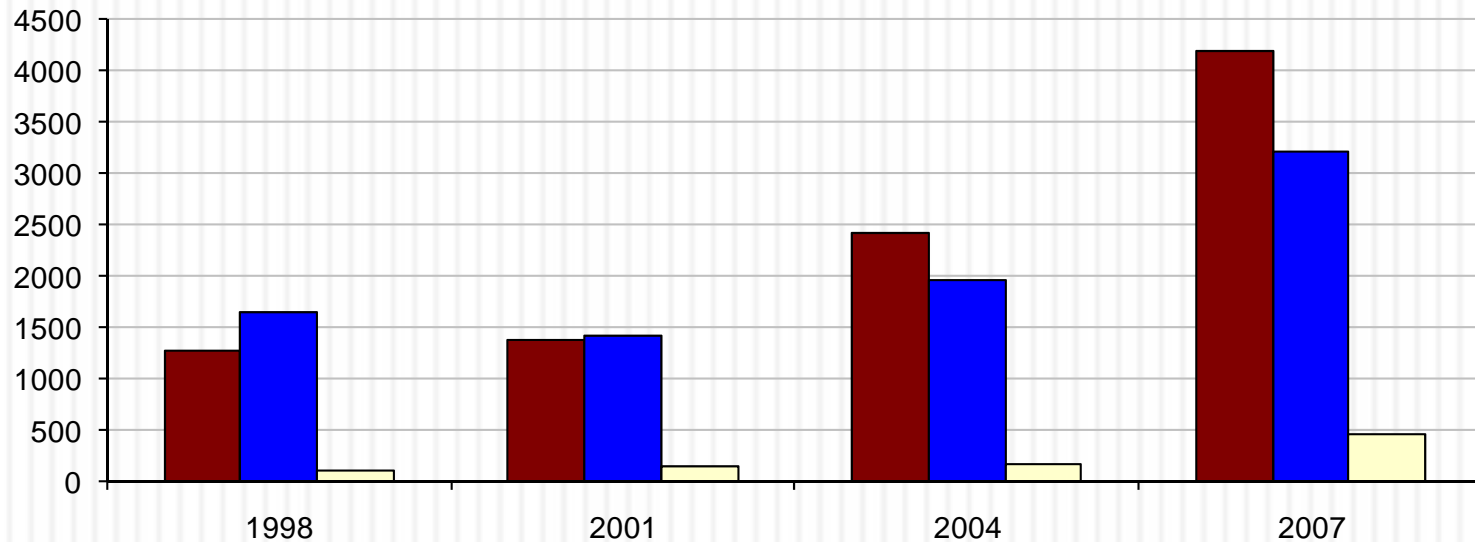
- A tax on financial transactions could effectively increase the cost of capital to firms:
  - ▣ This could distort input choices (for example, from equity towards debt) with efficiency costs
  - ▣ The increase in costs could reduce investment and subsequently GDP growth rates

## **Views on this impact vary significantly, for example:**

- ▣ Suescún (2004) uses a General Equilibrium Model to suggest that financial transaction taxes may be less distortionary than a capital earnings tax or even a labor income tax under certain growth assumptions
- ▣ However, there are many policy studies that suggest that such taxes are particularly burdensome and should be abandoned: Coelho et al. (2001), IMF (2000)

# Theoretical Effects – Revenue Productivity

**Financial Transactions Daily Average Turnover (Nominal USD Billion)**



- Foreign Exchange Derivative Turnover (Bank of International Settlements)
- Traditional Foreign Exchange Transactions (Bank of International Settlements)
- Global Equity Markets (World Federation of Exchanges)

# Theoretical Effects – Revenue Productivity

## 2.2. Cost of collection of major Inland Revenue taxes, 2000–01

	Cost of collection (pence per pound collected)
Stamp duties (shares and property)	0.09
Income tax (including tax credits)	1.56
Corporation tax	0.98
Petroleum revenue tax	0.15
Capital gains tax	1.33
Inheritance tax	1.23
National Insurance contributions	0.59
<b>All taxes</b>	<b>1.11</b>

*Note:* Including Head Office overhead allocation.

*Source:* Inland Revenue, 2001.

# Theoretical Effects – Revenue Productivity

- However, there are some important challenges and limitations to consider:
  - Many financial markets operate on an extremely fine margin (in the order of 1 basis point for Forex markets) so the rate must not be prohibitive
  - A derivative is a financial instrument that is *derived* from some other asset, index, event, value or condition (known as the underlying asset) – they pose key problems for any financial transactions tax:
    - To what extent can traders substitute into derivative markets?
    - Can derivative markets be taxed effectively?
    - Will the constant innovation of new forms of derivatives enable further avoidance in the future with a cost in transparency?
  - Substitution between countries:
    - How strong are incumbent/agglomeration advantages?
    - Is the tax base on a national or international basis?

# Examples of Financial Transactions Taxes in Practice

- Selected examples of countries currently using some form of a Financial Transactions Tax

	Equity Transactions	Derivatives	Corporate Bonds	Government Bonds	Currency Transactions	Consumer Account Transactions	Consumer Credit Transactions
Argentina	✓	✓	✓	✓		✓	
Belgium	✓		✓	✓	✓ <sup>1</sup>		
Brazil	✓		✓	✓	<sup>4</sup>		
Chile						✓ <sup>2</sup>	✓ <sup>2</sup>
China	✓						
France	✓				✓ <sup>1</sup>		
Hong Kong	✓						
India	✓				<sup>3</sup>		
South Korea	✓		✓				
United Kingdom	✓						
United States	✓						

1) Established in legislation although only comes into effect if all EU countries introduce a currency transactions tax

2) Rate temporarily reduced to 0% for 2009

3) Recently removed tax on cash withdrawals

4) CPMF was not renewed in 2007

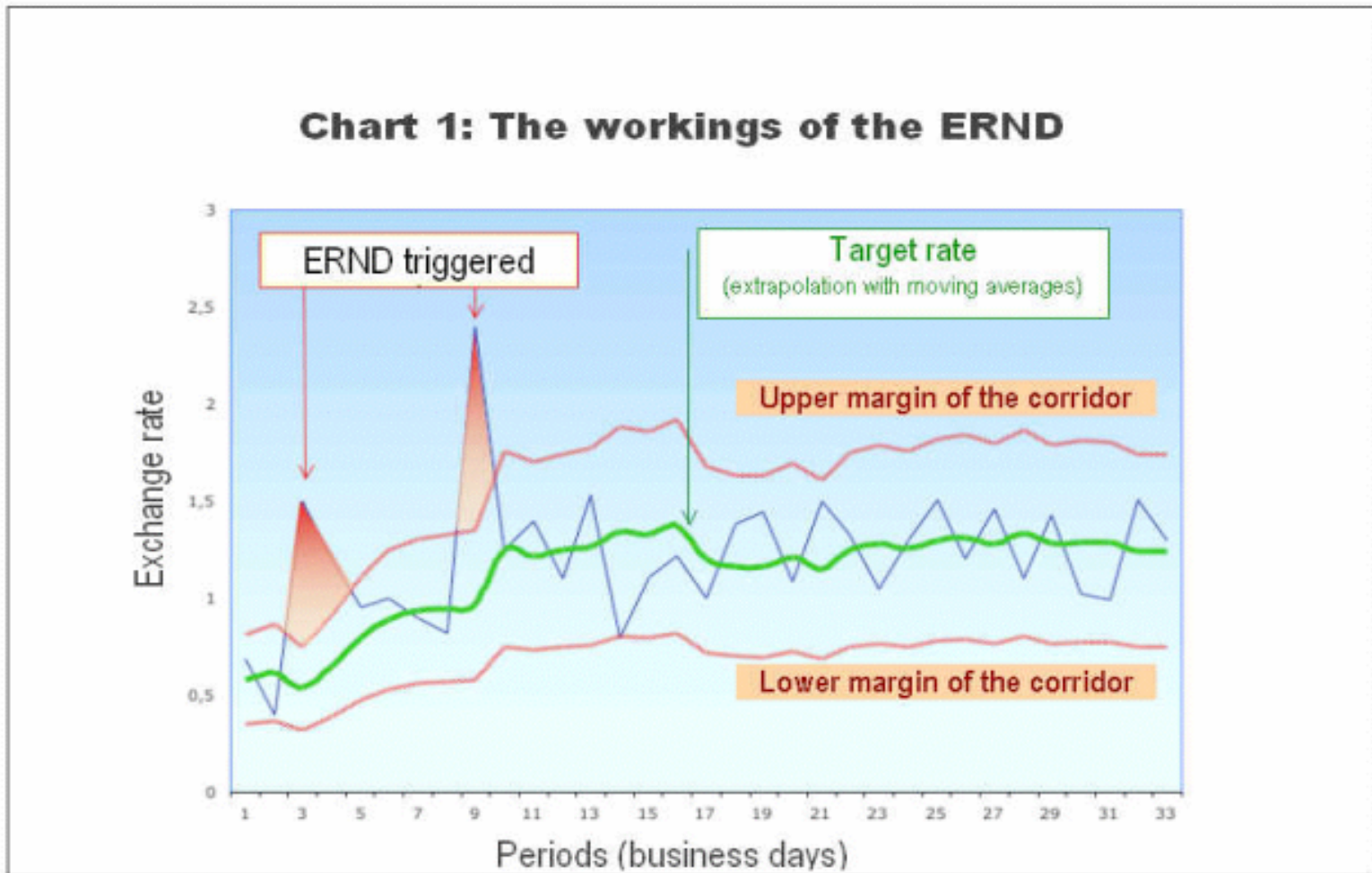
# Rationale 1 – Revenue Productivity

- In 1999 Brazil reinstated the Contribuição Provisória Sobre Movimentação Financeira (CPMF):
  - A bank debit tax at 0.38% on all debits except if transfer is within a bank from and to a similar account (not, for example, from current to savings account)
  - Revenue is earmarked for National Fund for Health (0.2%); to combat poverty (0.1%); and social assistance (0.08%)
  - The tax was introduced on a temporary basis and renewed each year until 2008 when the tax was abolished
  - Revenue accounted for around 8% of federal taxation or 1.5% of total government revenue

# Rationale 2 - Stabilisation

- In 2004 Belgium introduced legislation on a two tier “Spahn tax” on foreign exchange transactions:
  - The tax will only come into effect if enacted by all other EU states
  - It introduces a flat rate of 0.02% on all transactions with an 80% surcharge for the value of any transaction that falls outside some “predetermined fluctuation margins”
  - The Private Members Bill explicitly states that the opinion that “speculators activities have an important destabilising effect” and that the tax would “solve this situation”
  - Revenue raised would be explicitly allocated to an EU development, social and ecological conservation fund

# Rationale 2 - Stabilisation



Source: Spahn (2002)

# Rationale 3 – Administrative Transparency

- In 2005 India introduced the Banking Cash Transactions Tax (BCTT):
  - A levy of 0.1% on all cash withdrawals in a single day totalling to more than Rs 50,000 (approx. \$1000) for individuals and Rs 1,000,000 (approx. \$20,000) for others
  - The levy was introduced to track unaccounted money and trace its source and destination
  - BCTT was withdrawn from April 2009 with the Finance Minister stating that “the information is also being gathered through other instruments introduced in the last few years”

# Conclusions

- There are still significant evidence gaps concerning the effects of financial transactions taxes, in particular:
  - What impact do they have on volatility of financial markets?
  - What is the long-term revenue potential of such taxes?
- However, despite this there are many examples of such taxes across the world
- In general it appears that revenue productivity is the key driver behind these taxes, however, other objectives such as market stability or provision of administrative information have also been cited

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