

*University of New South Wales*  
University of New South Wales Faculty of Law Research Series  
2011

---

*Year* 2011

*Paper* 54

---

Financial Sector Levies and Taxes: Critical  
Choices for China Domestically and in the  
G20

Ross Buckley\*

\*University of New South Wales, ross.buckley@unsw.edu.au

This working paper is hosted by The Berkeley Electronic Press (bepress) and may not be commercially reproduced without the permission of the copyright holder.

<http://law.bepress.com/unswwps-flrps11/art54>

Copyright ©2011 by the author.

# Financial Sector Levies and Taxes: Critical Choices for China Domestically and in the G20

Ross Buckley

## **Abstract**

The Global Financial Crisis (GFC) sparked vigorous debate on the role of financial institutions and capital markets, and the extent to which such institutions and markets should contribute to the broader economy. Much of this debate has centred on what might be the appropriate mechanisms to enable governments to recoup taxpayer monies used to bail out failing institutions and to restimulate their economies in the aftermath of the crisis. Proposals that have been considered at an international level over the last couple of years have included financial institution levies (such as a financial stability contribution), a financial activities tax (FAT) and a financial transaction tax (FTT). This research project will therefore explore what positions China might most usefully adopt with respect to the global push, and provide an initial outline on global capital market trading and explain the general principles and concerns that underpin the need for an FTT.

---

**Chapter 3**

**Financial Sector Levies and Taxes:  
Critical Choices for China Domestically and in the G20**

*Ross P. Buckley*  
(Faculty of Law, University of New South Wales)

---

**Table of Contents**

<b>I.</b>	<b>Introduction</b>	48
<b>II.</b>	<b>Financial Market Trading - The Facts</b>	51
<b>III.</b>	<b>Proponents of a Financial Transaction Tax</b>	53
<b>IV.</b>	<b>European Commission's Review (April 2010)</b>	58
<b>V.</b>	<b>IMF Working Paper: Taxing Financial Transactions: Issues and Evidence (August 2010)</b>	60
	1. Asset Valuation and Cost of Capital	61
	2. Turnover	62
	3. Liquidity	62
	4. Price Discovery	63
	5. Volatility	63
	5.1 Short Term Volatility	64
	5.2 Long Term Volatility	64
<b>VI.</b>	<b>Conclusion</b>	66



## I. Introduction

The Global Financial Crisis (GFC) sparked vigorous debate on the role of financial institutions and capital markets, and the extent to which such institutions and markets should contribute to the broader economy. Much of this debate has centred on what might be the appropriate mechanisms to enable governments to recoup taxpayer monies used to bail out failing institutions and to restimulate their economies in the aftermath of the crisis. Proposals that have been considered at an international level over the last couple of years have included financial institution levies (such as a financial stability contribution), a financial activities tax (FAT) and a financial transaction tax (FTT).

It is difficult to discern readily what China's position is on these potential measures although the common suggestion, based on hearsay, is that China is against all of them.<sup>1</sup>

The balance sheets of most rich nations are in tatters. According to the IMF, the G7 nations alone owe US\$30 trillion in debt. Funds must be raised from the finance industry to build up reserves to ensure that when the next financial crisis occurs, it is funded by the financial sector, not taxpayers. As the IMF has put it, "Expecting taxpayers to support the [financial] sector during bad times while allowing owners, managers and/or creditors of financial institutions to enjoy the gains of good times misallocates resources and undermines long-term growth."<sup>2</sup>

---

<sup>1</sup> Mark McKinnon, "Flaherty says China against bid for bank levy", *Toronto Globe and Mail*, Jun 2, 2010; and Jeon Hyo-Chan, "Global Financial Regulation and Korea's Financial Industry: The Introduction of Bank Levies", *SERI Quarterly*, October 2010, available at <<http://www.fags.org/periodicals/201010/2165371671.html>>.

<sup>2</sup> Staff of the International Monetary Fund, "A Fair And Substantial Contribution By The Financial Sector Final Report For The G-20", June 2010, p.9, available at <<http://www.imf.org/external/np/g20/pdf/062710b.pdf>>.

The G-20 leaders summit meeting in September 2009 discussed how the financial sector could make a fair and substantial contribution towards paying the costs of government interventions, including bail-outs and other support. The summit asked the IMF to prepare a report for their next meeting in June 2010. The IMF's report was entitled, "A Fair And Substantial Contribution By The Financial Sector: IMF Staff Final Report For The G-20 (June 2010)". In it IMF staff considered tax and levy options on behalf of the G-20 and concluded with a very qualified negative proposition: that an FTT 'does not appear well suited to the specific purposes set out in the mandate from G-20 leaders.'<sup>3</sup>

The IMF staff report called instead for two levies. A Financial Stability Contribution (a levy) to be levied on assets and accumulated to fund future bail-outs; and a Financial Activities Tax, to be levied on financial institution's profits and staff remuneration, and to have the delightful acronym, FAT. The staff suggest a FAT be set at levels to raise from 0.2 per cent to 0.4 per cent of a nation's GDP annually.<sup>4</sup> The FAT would be designed to work as a tax on rents in the financial sector if the base included only high levels of remuneration and the profit component of the tax excluded a normal return on capital.<sup>5</sup> It suggests that a structure that taxes excess returns would mitigate excessive risk-taking and would tend to reduce the size of the financial sector and the Fund could predict with more certainty its impact on the structure of financial markets rather than that of an FTT.<sup>6</sup>

---

<sup>3</sup> Staff of the IMF, above n.2, p.19.

<sup>4</sup> Staff of the IMF, above n.2, p.14.

<sup>5</sup> Staff of the IMF, above n.2, p.22.

<sup>6</sup> Staff of the IMF, above n.2, p.14.

The levy and FAT rates being discussed by the IMF, while certainly sufficient to build a reserve for future crises, are inadequate to plug the massive holes in national balance sheets resulting from the support given to financial institutions and the economic stimulus packages required to counter the damage done by the GFC.

At the time of writing, it seems that most G20 nations have either begun the process of implementing a bank levy (but not a FAT) or intend to do so, with the exception of Australia, Canada, China, India, Japan and Russia.<sup>7</sup>

We agree entirely with the IMF that requiring taxpayers to support troubled financial sectors in bad times misallocates resources and undermines long-term growth. We would, moreover, add that given the extent to which the shareholders and employees of the financial sector profit in good times, requiring that they be bailed out by taxpayers in bad times is breathtakingly unfair and unjust.

The primary reasons behind the need for one or more of these imposts (a bank levy, FAT or FTT) in most G20 nations simply are not present in China, so China's opposition to them, if it is indeed opposed, is entirely understandable.

But with China's growth, inexorably, comes a greater global leadership role for it, and a greater interdependence between China's and the global economies. So the question for China in this regard is not as simple, perhaps, as what is best for it domestically, but is the rather more complex question of what is best for it given its stake in a functional global economy.

This research project will therefore explore what positions China might most usefully adopt with respect to the global push for one or more of these imposts.

This first stage of the project will consider the most ambitious of the three measures, a FTT.

---

<sup>7</sup> Jeon Hyo-Chan, "Global Financial Regulation and Korea's Financial Industry: The Introduction of Bank Levies", *SERI Quarterly*, October, 2010, available at <<http://www.faqs.org/periodicals/201010/2165371671.html>>.

A financial transactions tax (FTT) grew out of the ideas of the Nobel laureate in economics, James Tobin, for a tax on foreign currency transactions, which is often still referred to as a Tobin tax. He first proposed the idea in 1972.<sup>8</sup> Tobin conceived of the tax not to raise revenue but to dissuade speculative short-term capital flows in particular and thus reduce volatility in such flows, i.e. to serve as sand in the cogs of international financial flows. In the 1970s Tobin's idea sank without trace, in the face of enthusiasm for the brave new world of floating exchange rates. However, as the 1980s and 1990s progressed, and the damaging effects of international financial volatility became ever more apparent, so did the benefits of a currency transactions tax.

A currency transaction tax (CTT), and a FTT for that matter, are a bit like the congestion tax London has imposed on cars entering its CBD that has done so much to cut congestion and speed travel times in that city. The reason for the congestion tax is to improve the functioning of a system, the revenue from it is a pure bonus. The primary reasons for a CTT or FTT are likewise to improve the functioning of a system, the international financial one, and the revenue generated would be a pure bonus.

The European Commission (Commission) and the International Monetary Fund (IMF) both considered a FTT in 2010. To properly assess the Commission and IMF commentary, an understanding of capital market developments is needed. Hence, we provide an initial outline on global capital market trading and explain the general principles and concerns that underpin the need for an FTT.

## **II. Financial Market Trading – The Facts**

---

<sup>8</sup> It was some years before Tobin wrote about it in any depth, in J. Tobin, 'A Proposal for International Monetary Reform' (1978) 4 *Eastern Economic Journal*, pp.153-159.

The ratio of the volume of financial transactions to nominal world GDP in 2007 was 75.3, compared to 15.3 in 1990.<sup>9</sup> The volume of financial transactions in Europe and the US is closer to 100 times nominal gross domestic product (GDP).<sup>10</sup> These levels of trading are reflected across most asset classes. In Schulmeister's words,

volume of foreign exchange transactions is almost 70 times higher than world trade of goods and services. In Germany, the UK and the US, the volume of stock trading is almost 100 times bigger than investment, and the trading volume of interest rate securities ... several hundred times greater than overall investment.<sup>11</sup>

Schulmeister highlights that the increase in global trading volumes is exclusively due to the boom in trading in derivatives, because spot transactions of stocks, bonds and foreign exchange grew roughly in line with nominal world GDP.<sup>12</sup> Darvas and von Weizacker confirm that 88 percent of the transactions in 2007 were derivative based with 64 percent of these in fixed income security derivatives.<sup>13</sup> In 2007, at the peak of credit default swap (CDS) activity, the value of outstanding CDS was \$62 trillion – nearly twice the value of all credit market assets held by the financial sector in the US.<sup>14</sup> Canova suggests speculative bets have become the tail wagging the dog.<sup>15</sup>

An increasing proportion of market trades are short term and technically driven. In 2009, algorithmic or computer-driven trading accounted for at least 60% of equity market trading

---

<sup>9</sup> Stephan Schulmeister, 'A General Financial Transactions Tax: A Short Cut of the Pros, the Cons and a Proposal', *Working Papers* No 344, Austrian Institute of Economic Research, October 2009, p.5.

<sup>10</sup> Schulmeister, above n.9, p.6.

<sup>11</sup> Schulmeister, above n.9, p.6.

<sup>12</sup> Schulmeister, above n.9, p.5.

<sup>13</sup> Zsolt Darvas and Jakob von Weizsäcker, 'Financial Transaction Tax: Small is Beautiful', *Working Paper*, Policy Department A, Economic and Scientific Policies, European Parliament, February 2010, pp.4 and 5.

<sup>14</sup> Margaret Blair, 'Financial Innovation and the Distribution of Wealth and Income', *Working Paper*, Vanderbilt University Law School, Law & Economics, Paper 0-22, June 2010, p.12, available at <<http://ssrn.com/abstract=1656451>>.

<sup>15</sup> Timothy Canova, 'Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model' (2009) 3 *Harvard Law & Policy Review* 369, p.388. See also, Paul Farrell, *Derivatives the New "Ticking Bomb": Buffett and Gross Warn: \$516 Trillion Bubble is a Disaster Waiting to Happen*, Market Watch, Mar 10, 2008.

volume in the US; 30-40% of European and Japanese equity trading; 10-20 percent of foreign exchange trading volume, 20 percent of US options trading by volume and 40 percent of US futures trading by volume.<sup>16</sup> Matheson of the IMF confirms that while some of this trading represents best execution of orders from institutional investors, a significant portion is “high frequency trading” driven by computer programs aimed at exploiting minor price fluctuations.<sup>17</sup> Thus, a substantial proportion of financial markets activity is now measured in seconds or less. Assets are often bought, held and sold in under a second. No human mind is brought to bear on these individual trades, and the underlying real economic value of the asset being traded is often not a factor in the trading programs.

It is hard to exaggerate the extent to which short term trading in financial markets has become obsessive. Some French hedge funds recently moved their trading computers to London because the time it took electronic messages to travel from Paris was placing them at a disadvantage. In the United States, Goldman Sachs moved its computers right beside those of NASDAQ, the online exchange, and each millisecond gained, by Goldman’s own calculations, is worth at least US\$100 million to it.<sup>18</sup> In January 2010, a project was discussed to build an optical cable through the Arctic Sea between the financial centres in London and Tokyo for US\$1.3 billion to cut latency times for data transmission from 140 to 88 milliseconds.<sup>19</sup>

### III. Proponents of a Financial Transaction Tax

---

<sup>16</sup> Thornton Matheson, ‘Taxing Financial Transactions: Issues and Evidence’, *IMF Working Paper*, August 2010, p.17. See also Sony Kapoor, *Financial Transaction Taxes: Tools for Progressive Taxation and Improving Market Behaviour*, February 2010, p.6; and Sony Kapoor, *The Financial Crisis – Causes and Cures* (2010), p.96, available at <<http://www.re-define.org/>>. (Accessed 27 Sept 2010)

<sup>17</sup> Matheson, above n 16, p.17.

<sup>18</sup> T. Williams, “Oh dear! I’m Queued! It’s Latency!”, available at <<http://www.wsws.org/articles/2010/apr2010/hedg-a02.shtml>>.

<sup>19</sup> Darvas et al, above n.13, p.9.

Keynes was one of the earliest proponents of a securities transaction tax to curb speculative bubbles. He suggested in 1936 that the ‘introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprises in the United States.’<sup>20</sup> He argued that when

the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez faire capitalism – which is not surprising if I am right in thinking that the best brains of Wall Street have in fact been directed towards a different object.<sup>21</sup>

Similarly, Stiglitz indicated in 1989 that

If, one thinks as I do, that the most important function (from the social view) of the stock market is raising new equity capital, one cannot but be struck by how, under current circumstances, it seems to do so little of this at great cost...In spite of the huge improvements in efficiency in the financial sector, the cost of running the financial sector are huge ... Of course, most of these resources are not spent in raising new funds but in rearranging ownership claims on society’s resources ... Resources devoted to gambling – and to short-term speculation in the stock market – could be devoted to more productive uses.<sup>22</sup>

Summers & Summers also expressed concerns about

excessive volatility in markets caused by destabilising speculation, the diversion of human and capital resources away from more socially profitable pursuits into the

---

<sup>20</sup> John Keynes, *The General Theory of Employment, Interest and Money* (New Delhi, Atlantic Publishers, this edition published 2006), p.143.

<sup>21</sup> Keynes, above n.20, pp.142-3.

<sup>22</sup> Joseph Stiglitz, ‘Using Tax Policy to Curb Speculative Short-Term Trading’ (1989) 3 *Journal of Financial Services Research* 101, p.109.

financial sphere, and the impact of rapid financial turnover on the way in which corporate investment decisions are made.<sup>23</sup>

Civil society has seized on the potential revenues from such taxes, as a potent source to fund the financing for development required if we are to achieve the Millennium Development Goals.<sup>24</sup> The MDGs are the goals to which all nations committed in 2000 to halve global poverty and hunger and the number of people without access to safe water, achieve universal primary education and a three-quarter decline in maternal mortality, to halt and reverse the spread of HIV/AIDS and other human development goals, all by 2015. According to a United Nations study, all of these goals can be achieved with an increase in annual aid funding of \$50 billion per annum.<sup>25</sup>

Supporters of a FTT argue that the tax would improve the price-setting capacity of the markets by removing hyper-speculative trading that obscures fundamental price signals, and removing some of the triggers for algorithmic/technical trading, and reduce the amount of algorithmic/technical trading, so that overall the prices set by the market would more closely approximate long-term economic fundamental values than is currently the case.<sup>26</sup>

Proponents of the tax also argue that it would reduce trading volumes without harming the ability of markets to allocate resources efficiently, thereby enhancing the operations of the market and allowing excess resources to be redeployed into more socially productive areas.

Financial market activity is highly concentrated in the most advanced economies. The highest absolute level and global market share of trading activity is in the United States.<sup>27</sup> In Europe, a large share of the capital market activity occurs in the United Kingdom. The financial

---

<sup>23</sup> Lawrence Summers and Victoria Summers, 'When Financial Markets Work Too Well: A Cautious Case For a Securities Transaction Tax' (1989) 3 *Journal of Financial Services Research* 261, p.263.

<sup>24</sup> United Nations, 'UN Millennium Development Goals (MDG)', available at <[www.un.org/millenniumgoals/](http://www.un.org/millenniumgoals/)>, 4 December 2007.

<sup>25</sup> United Nations, Report of the High Level Panel on Financing for Development, available at <[http://www.un.org/reports/financing/report\\_full.htm#appendix](http://www.un.org/reports/financing/report_full.htm#appendix)>.

<sup>26</sup> Stephan Sculmeister, "Short-term Asset Trading, Long-term Price Swings, and the Stabilizing Potential of a Transactions Tax", paper of October 2010.

<sup>27</sup> World Federation of Exchanges, Statistics, Key Market Figures – September 2010, available at <<http://www.world-exchanges.org/statistics/key-market-figures>>.

industry in these countries has become an increasingly significant part of the overall economy. So much so that some commentators argue that too many of the best educated individuals in these countries are trading paper assets rather than creating real wealth.<sup>28</sup> Dean Baker highlights that the share of private sector wages in the securities and investment sector increased from less than 0.6 % in 1977 to 2.3% in 2007.<sup>29</sup> Summers and Summers point to increases in the relative levels of employment in the securities industry in the US.<sup>30</sup> The Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System highlights that the measure of success of financial policy should not be the rate of growth or the size of the financial sector as a share of GDP. Indeed, an excessively large financial sector relative to the GDP of a medium to large economy should be a cause of concern to those interested in long-term economic growth because financial crises are often associated with unsustainable growth of the financial sector.<sup>31</sup>

Similarly, Lord Turner, head of the United Kingdom's Financial Services Agency,<sup>32</sup> argues that the City of London has grown 'beyond a reasonable size. He describes much of the current market trading as 'socially useless' activity'.<sup>33</sup> He suggests that

parts of the financial services industries need to reflect deeply on their role in the economy, and to recommit to a focus on their essential and economic functions ... not all

---

<sup>28</sup> Stiglitz, above n.22, p.109; Summers and Summers, above n.23, p.270.

<sup>29</sup> Dean Baker, Center for Economic and Policy Research, *The Benefits of a Financial Transaction Tax*, December 2008. Baker sourced these numbers from the Bureau of Economic Analysis, National Income and Product Accounts.

<sup>30</sup> Summers and Summers, above n.23, p.270.

<sup>31</sup> Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, September 2009, p.47. Available at [[http://www.un.org/ga/econcrisissummit/docs/FinalReport\\_CoE.pdf](http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf)]

<sup>32</sup> George Osborne, the Chancellor in the United Kingdom, has indicated there will be wide-ranging changes to UK's regulatory system, including the removal of some areas of responsibilities from the FSA. For example, the new government has proposed the creation of a new consumer protection and markets authority and a new economic crime agency. These proposed changes are, at the time of writing, subject to consultation: Her Majesty's Treasury, *A New Approach To Financial Regulation* (July 2010). An independent commission is also reviewing the banking system in the United Kingdom and is due to report by September 2011.

<sup>33</sup> Angela Monaghan, 'Tax "Socially Useless" Banks, Says FSA Chief Lord Turner', *Telegraph* (United Kingdom), 27 August 2009.

financial innovation is valuable, not all trading plays a useful role, and ... a bigger financial system is not necessarily a better one ... parts of the financial services industry have a unique ability to attract to themselves unnecessarily high returns and create instability which harms the rest of society ...<sup>34</sup>

In short, some leading nations have allowed their financial sectors to grow too large<sup>35</sup> and to devote too large a proportion of their activities to casino type speculation rather than the intermediation of capital, which is the core function of a financial sector. The globalisation of finance has made its taxation more difficult, as capital can so easily migrate to lower tax jurisdictions. And the relative undertaxation of financial sectors everywhere has contributed to their growth.

Hedge funds pay very little tax and investment banks pay less than their fair share. This matters on equity grounds. It matters more on efficiency grounds. If there is a sector of the economy that pays too little tax, resources should logically flow into it. And this is what we have seen over the past 30 years. As one example, the assets under the management of hedge funds in Australia increased by an extraordinary 30 times from 2000 to 2008.<sup>36</sup> These savings, that could be being put to productive uses, are in large measure going into socially useless and purely speculative trading.

Financial markets have grown disproportionately to the real economy. For example, today, Australia's financial market turnover is 81 times greater than real economic turnover (GDP). Before the global financial crisis the ratio was 98 times.<sup>37</sup> Speculation

---

<sup>34</sup> Adair Turner, (Speech delivered at the City Banquet, The Mansion House, London, 22 September 2009).

<sup>35</sup> IMF Staff of the International Monetary Fund, "A Fair And Substantial Contribution By The Financial Sector Final Report For The G-20", June 2010, p.14, available at <<http://www.imf.org/external/np/g20/pdf/062710b.pdf>>.

<sup>36</sup> Austrade, "The Australian Alternative Investment Industry", March 2010, p.8.

<sup>37</sup> Gillian North compiled these figures based on data sourced from the Australian Financial Markets Association (AFMA) and the Australian Bureau of Statistics (ABS). See FMA, "2009 Australian Financial Markets Report", p.2, available at

<[http://www.afma.com.au/afmav6wr/\\_assets/main/lib90024/afmr09-final.pdf](http://www.afma.com.au/afmav6wr/_assets/main/lib90024/afmr09-final.pdf)> and ABS, "Key National Accounts Aggregates: Annual", p.21, available at,

has become the dominant form of financial market activity and works against productive investment. Short term speculation distorts and damages the critical price-setting function of markets, and it consumes financial assets that could be invested long-term in the real economy.

We need to reweight our markets in favour of longer-term investment and away from rewarding short-term speculation. This not a radical idea. For example, in 2009, the Aspen Institute issued a paper entitled “Overcoming Short-termism”.<sup>38</sup> We need to slow our markets down to human time and encourage them to trade on the value of the asset being traded, not merely its market performance in the hours or minutes preceding the trade. And the best way to do this is a transactions tax, preferably a FTT but failing that a CTT.

Other parties that argue for a FTT are diverse, experienced and respected. The advisory committee of Re-Define, a policy think tank actively campaigning for such a tax includes top ranked global investment banking executives, policy makers and scholars.<sup>39</sup> Warren Buffett and George Soros also believe the tax would improve the operations of markets.<sup>40</sup>

Much of the growth in the securities and finance industries has been driven by ever increasing levels of global financial market activity relative to the real economy.<sup>41</sup>

Yet notwithstanding this broad general support for a FTT from among many of the most senior and respected figures in finance, the reports conducted by the European Commission and the IMF both prefer alternate ways of raising revenue. This may be because there are better

---

<[http://www.ausstats.abs.gov.au/ausstats/meisubs.nsf/0/8F24C4E60A3CE152CA2576DA0012BEA2/\\$File/52060\\_dec%202009.pdf](http://www.ausstats.abs.gov.au/ausstats/meisubs.nsf/0/8F24C4E60A3CE152CA2576DA0012BEA2/$File/52060_dec%202009.pdf)> .

<sup>38</sup> The Aspen Institute, “A Call to Action” (September 9 2009,) , signed by a spectrum of leaders of corporate America, including Warren Buffett, Pete Peterson, former Chairmen of IBM and Goldman Sachs, and others, and available at

<<http://www.aspeninstitute.org/policy-work/business-society/corporate-programs/cvsg/public-policy>>.

<sup>39</sup> Available at <<http://www.re-define.org/about-us>>.

<sup>40</sup> Center for Economic and Policy Research, “Support for A Financial Transactions Tax (FTT)” (January 2010) available at <<http://www.cepr.net/documents/ftt-support.pdf>>.

<sup>41</sup> Staff of the IMF, above n 2.

alternatives, or it may simply reflect the political power of the financial sectors in Europe and the US, a power that has risen commensurately with the ever-ascending levels of profitability.

#### IV. European Commission Review (April 2010)

In March 2010, the European Parliament adopted a resolution requesting the Commission to assess a financial transaction tax in comparison to other revenue raising options.<sup>42</sup>

This process took place as part of the international debate, including by the G-20, on new sources of finance:

1. To support fiscal consolidation;
2. To recoup the costs of bail-outs;
3. To fund future crisis intervention measures;
4. To finance global development and climate change measures.

The criteria used by the Commission for assessing instruments of innovative sources were:

1. The potential for increasing the efficiency and stability of markets;
2. The effects on equity and income distribution;
3. Legal and administrative aspects; and
4. Its political acceptability.

Upon the basis of these criteria, the Commission found against a FTT. The report notes that research finds that a decline in the number of transactions generally coincides with a reduction in liquidity. It suggests the effects of the decline in transactions and liquidity remain subject to debate.<sup>43</sup> It highlights that the effects of transaction taxes could depend on the microstructure

---

<sup>42</sup> European Parliament resolution of 10 March 2010 on financial transaction taxes – making them work. P7\_TA(2010)0056.

<sup>43</sup> European Commission, Commission Staff Working Document, Innovative financing at a global level, 1 April 2010, SEC(2010)409final, p.23. Available at [http://ec.europa.eu/economy\\_finance/articles/international](http://ec.europa.eu/economy_finance/articles/international)

of markets.<sup>44</sup> The products, traders and investors in markets are highly diverse. Thus, it is difficult to know how a tax might alter market trading on a global basis. The tax may effect the transactions in currency, bonds, derivatives traded through exchanges and derivatives in over-the-counter markets differently.<sup>45</sup>

Nevertheless, the report ultimately rejects the argument by proponents of the FTT that ‘the tax would reduce noise and technical trade, thereby linking trade more closely to the underlying fundamental economic market conditions and make financial markets less volatile.’<sup>46</sup> It questions the assumption that most short-term trading is highly speculative or based on technical trading. It suggests the time horizon of an investment is not a good predictor for the degree of speculation and points out that short term transactions are often related to trade or other commercial transactions. It highlights that ‘it has proven to be extremely difficult to make a meaningful and operational distinction between speculative and non-speculative transactions.’<sup>47</sup> The factors it identifies as resulting in the crisis are excess leverage and the taking of excess risk by financial institutions. The report suggests there is no evidence that the recent crisis was triggered by an excessive volume of transactions.<sup>48</sup>

The report argues that a FTT poses a risk of increasing the costs of capital for businesses and of financial risk distribution. Further, the tax would increase the hedging cost for all companies and the use of derivatives as insurance devices could be seriously affected.<sup>49</sup> It suggests the tax could also increase financial costs for governments because they might have to pay higher

---

/documents/innovative\_financing\_global\_level\_sec2010\_409en.pdf]

<sup>44</sup> Id. The report cites two papers that present theoretical models: Katuscia Mannaro, Michele Marchesi and Alessio Setzu, ‘Using an Artificial Financial Market for Assessing the Impact of Tobin-like Transaction Taxes’ (2008) 67 *Journal of Economic Behavior & Organization* 445; Paolo Pellizzari and Frank Westerhoff, ‘Some Effects of Transaction Taxes under Different Microstructures’ (Quantitative Finance Research Centre Research Paper 212, University of Technology Sydney, December 2007).

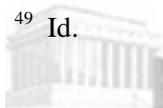
<sup>45</sup> Id.

<sup>46</sup> Id.

<sup>47</sup> Id.

<sup>48</sup> *Ibid.*, p.24.

<sup>49</sup> Id.



interest.<sup>50</sup> It concludes that the tax could have adverse effects on investment and economic activity. It highlights the risk of potential loss of whole market segments if the tax is not comprehensive in geographical and product scope.<sup>51</sup>

## **V. IMF Working Paper: Taxing Financial Transactions: Issues and Evidence (August 2010)**

The IMF's report is the most comprehensive discussion on the efficiency and economic effects of a tax on traded securities.<sup>52</sup> The analysis is primarily concerned with microstructure issues; and overall concludes that many aspects of the economic impact of FTT's remain largely unexplored.

### **1. Asset Valuation and Cost of Capital**

Matheson indicates that in accordance with economic theory, a steep decline in transaction costs over the past 35 years has produced an increase in financial transactions relative to real activity.<sup>53</sup> He confirms the figures published by the European Parliament, Schulmeister and others that the value of global financial transactions in 2007 was 70 times GDP compared to a ratio of 25 times in 1995. He agrees that most of the growth has been concentrated in derivative markets because they typically have lower transaction costs relative to notional

---

<sup>50</sup> Id.

<sup>51</sup> Id.

<sup>52</sup> Matheson, above n.16, p.5. Matheson defines the FTT as a securities transaction tax (STT) that applies to all or certain types of securities (equity, debt and their derivatives).

<sup>53</sup> Matheson, above n.16, p.16.

values than spot markets.<sup>54</sup> He suggests that in line with theory, the lower transaction costs have encouraged primarily short-term trading.<sup>55</sup>

Matheson highlights that the explosion of derivatives trading, particularly short-term security trading raises concerns. He argues that growth in derivatives trading ‘implies a corresponding growth in leverage, which increases liquidity and default risk, and may promote asset bubbles’.<sup>56</sup> He concedes that the increasing dominance of computer generated trading poses technical and systemic risks, particularly when these trades are correlated or are subject to herding behaviour, because this can potentially exacerbate price trends that are not fundamentally based. Matheson agrees that a tax that decreased short term trading could reduce these risks.<sup>57</sup>

Matheson indicates that theoretical models generally confirm that higher transaction costs, including those imposed by transaction taxes, are associated with lower asset prices.<sup>58</sup> The higher transaction costs therefore raise the costs of capital for companies raising funds through taxed securities.<sup>59</sup> Matheson concedes that the impact of an STT on securities value and capital costs would be partially countered by the lengthening of the average holding period of securities, particularly for securities with narrow bid-ask spreads.<sup>60</sup> He concludes that the ‘overall impact of a low rate (5 basis points or less) STT on the corporate cost of capital is ... likely to be quite modest.’<sup>61</sup>

We agree with this conclusion, the added cost of credit in a system in which there is a tax of 0.005% on wholesale capital market transactions could hardly be in any way significant.

---

<sup>54</sup> Matheson, above n.16, p.16.

<sup>55</sup> The theory Matheson refers to is not discussed.

<sup>56</sup> Matheson, above n.16, p.17.

<sup>57</sup> Matheson, above n.16, p.17.

<sup>58</sup> Matheson, above n.16, p.11. Matheson cites Paul Kupiec, ‘Noise Traders, Excess Volatility, and a Securities Transaction Tax’ (1996) 10 *Journal of Financial Services Research* 115; Julian McCrae, ‘The Impact of Stamp Duty on the Cost of Capital’ (Institute for Fiscal Studies mimeo 2002).

<sup>59</sup> Matheson, above n.16, p.11.

<sup>60</sup> Matheson, above n.16, p.12.

<sup>61</sup> Matheson, above n.16, p.13.

## 2. Turnover

Matheson concurs with Tobin that the imposition of a STT, which increases transaction costs in the form of a widening of the bid-ask spread, discourages short-term trading in particular.<sup>62</sup> By raising transaction costs, a STT would lengthen the average holding period of securities, particularly those with narrow bid-ask spreads.<sup>63</sup>

## 3. Liquidity

Matheson then considers the liquidity and price discovery effects flowing from lower trading volumes. He highlights that a reduction in trading volume driven by a STT also reduces liquidity, defined as the price impact from a given trade.<sup>64</sup> He suggests that lower liquidity can in turn slow the price discovery process that ensures that prices quickly and accurately reflect new information.<sup>65</sup> However, he notes that other models find that the effect of a STT on liquidity depends on the market microstructure.<sup>66</sup>

## 4. Price Discovery

The empirical studies that examine the impact of transaction costs on the price discovery process often investigate changes in the autocorrelation of market returns in response to

---

<sup>62</sup> Matheson, above n.16, p.12.

<sup>63</sup> Matheson, above n.16, p.11. Matheson cites James Tobin, 'A Proposal for International Monetary Reform' (1978) 4 *Eastern Economic Journal* 153.

<sup>64</sup> Matheson, above n.16, p.13, citing Yakov Amihud and Haim Mendelson, 'Transaction Taxes and Stock Values', in Kenneth Lehna and Robert Kamphius (eds.), *Modernizing US Securities Regulations* (Irwin Professional Publishing, 1992); Kupiec, above n.58.

<sup>65</sup> Matheson, above n.16, p.13, citing Kenneth Froot and Andre Perold, 'New Trading Practices and Short-Run Market Efficiency (1995) 15 *Journal of Futures Markets* 731; Alex Frino and Andrew West, 'The Impact of Transaction Costs on Price Discovery: Evidence from Cross-Listed Stock Index Futures Contracts' (2003) 11 *Pacific Basin Finance Journal* 139.

<sup>66</sup> Matheson, above n.16, p.13, citing Avaniidhur Subrahmanyam, 'Transaction Taxes and Financial Market Equilibrium (1998) 71 *Journal of Business* 81; D Dupont and G Lee, 'Effects of Securities Transaction Taxes on Depth and Bid-Ask Spreads' (2007) 31 *Economic Theory* 393.

changes in STT rates. Matheson refers to the studies that find the autocorrelation of returns increases (decreases) with an increase (decrease) in the rates of a STT. The study authors infer that the identified changes in autocorrelation of returns mean that an STT would slow the rate at which new information is incorporated into the security prices by reducing the level of trades.<sup>67</sup>

## 5. Volatility

Matheson indicates that a STT may affect short term price volatility and long term asset price swings that potentially develop into bubbles and crashes. He suggests that while both of these types of volatility are of concern because they distort fundamental price signals, the long term mispricing is of more concern because it can result in serious macroeconomic externalities.<sup>68</sup>

### 5.1 Short Term Volatility

Matheson suggests that theoretical models on the relationship between a STT and short-term price volatility are ambiguous.<sup>69</sup> He indicates that the empirical investigations that consider short-term price volatility show either no effect on volatility or a positive effect.<sup>70</sup> However,

---

<sup>67</sup> Matheson, above n.16, pp.15-16, citing Shinhua Liu, 'Securities Transaction Tax and Market Efficiency: Evidence from the Japanese Experience' (2007) 32 *Journal of Financial Services Research* 161; Badi Batalgi, Doug Li and Qi Li, 'Transaction Tax and Stock Market Behaviour: Evidence from an Emerging Market (2006) 31 *Empirical Economics* 393.

<sup>68</sup> Matheson, above n.16, p.17.

<sup>69</sup> Matheson, above n.16, p.18. Matheson cites J Bradford De Long, Andrei Shleifer, Lawrence Summers and Robert Waldman, 'Noise Trader Risk in Financial Markets' (1990) 98 *Journal of Political Economy* 703; Kenneth Froot, David Scharfstein and Jeremy Stein, 'Herd on the Street: Informational Inefficiencies in a Market with Short-Term Speculation (1992) 47 *Journal of Finance* 1461; Frank Song and Junxi Zhang, 'Securities Transaction Tax and Market Volatility' (2005) 115 *Economic Journal* 1103; Paolo Pellizzari and Frank Westerhoff, 'Some Effects of Transaction Taxes under Different Microstructures' (Quantitative Finance Research Centre Research Paper 212, University of Technology Sydney, December 2007).

<sup>70</sup> Matheson, above n.16, p.18. Matheson cites Richard Roll, 'Price Volatility, International Market Links, and Their Implications for Regulatory Policies' (1989) 3 *Journal of Financial Services Research* 211; Baltagi et al, above n.67; Charles Jones and Paul Seguin, 'Transaction Costs and Price Volatility: Evidence from Commission Deregulation' (1997) 87 *American Economic Review* 728; H Hau, 'The Role of Transaction Costs for Financial Volatility: Evidence from the Paris Bourse' (2006) 4(4) *Journal of the European Economic Association* 862; Christopher Green, Paolo Maggioni and Victor Murinde, 'Regulatory Lessons for Emerging Stock Markets from a Century of Evidence on Transaction Costs and Share Price Volatility in the London Stock Exchange' (2000) 24 *Journal of Banking & Finance* 577.

he notes that there is some evidence that trading activity itself generates short-term price volatility,<sup>71</sup> and on this basis, a transaction tax that dampens trading activity may reduce price volatility.

## 5.2 Longer Term Volatility

Matheson indicates there is a dearth of research on the relationship between transaction costs and long term price volatility. He highlights that economic literature generally links bubbles and crashes to excesses in the leverage cycle, and indicates there is a growing body of literature on measures to combat excessive leverage as a way to prevent bubbles.<sup>72</sup> However, Matheson suggests that transaction costs are merely one factor in determining market cycles, and not a decisive factor. While a STT might slow the asset cycle swings, it could also slow corrections back to fundamental equilibrium. While there is empirical evidence that short term trading tends to focus on technical trading, a practice associated with “noise trading”,<sup>73</sup> and short term trading can result in irrational herding behaviour,<sup>74</sup> some technical trading uses contrarian strategies and arbitrages price movements.<sup>75</sup> Matheson concedes that a STT may have a side effect of reducing leveraged trades but suggests that a more direct means to discourage leveraged purchases would be to increase margin requirements or collateralisation.<sup>76</sup> He concludes that further study is required to assess the impact of short-term trading on market function and asset prices.

---

<sup>71</sup> Matheson, above n.16, p.19. Matheson cites Kenneth French and Richard Roll, ‘Stock Return Variances’ (1986) 17 *Journal of Financial Economics* 5; Barclay (1990).

<sup>72</sup> Matheson, above n.16, p.18. Matheson cites Franklin Allen and Douglas Gale, ‘Bubbles and Crises’ (2000) 110 *Economic Journal* 236; Carmen Reinhart and Kenneth Rogoof, *This Time is Different: Eight Centuries of Financial Folly* (2009); Akerlof and Shiller, *Animal Sprits* (2008); John Geankoplos, ‘Solving the Present Crisis and Managing the Leverage Cycle’ (Cowles Foundation Discussion Paper No 1751, Yale University, Jan 2010); Tobias Adrian and Hyun Song Shin, ‘The Shadow Banking System: Implications for Financial Regulation’ (2009) 13 *Financial Stability Review* 1; Gadi Barlevy, ‘A Leverage-based Model of Speculative Bubbles’ (Working Paper 2008-01, Federal Reserve Bank of Chicago, 28 August 2009).

<sup>73</sup> Matheson, above n 16, 19. Matheson cites Thomas Gehrig and Lukas Menkhoff, ‘Extended Evidence on the Use of Technical Analysis in Foreign Exchange’ (2007) 11 *International Journal of Financial Economics* 327.

<sup>74</sup> Matheson, above n.16, p.19. Matheson cites Froot et al, above n.69.

<sup>75</sup> Matheson, above n.16, p.19.

<sup>76</sup> Matheson, above n.16, p.19.

So, on balance, the European Commission report is strongly against the tax, while the IMF's reports are more balanced and nuanced, preferring other measures, such as a FAT, to a FTT, and identifying issues relevant to a FTT upon which further research is needed.

The proponents of this tax are considerable. At the time of writing in late 2010 they included the German Chancellor, the French President and virtually all members of the French Cabinet, many hundreds of the world's leading economists, and many senior figures in the financial industry including George Soros and much of civil society.

They argue for this tax for some of the very reasons that the European Commission and others oppose it:

1. It would distort the markets. It would distort them away from their current preoccupation with hyper-speculative gambling, and provide an incentive for markets to devote more of their time and resources to their fundamental purpose: the effective intermediation of capital.
2. A FTT would cascade through complex transactions, those that are comprised of a number of related transactions. Tax purists see this as a weakness, but as commercial lawyers we see this as a strength. Securities regulation worldwide is premised on clear and effective disclosure. The premise underpinning all securities regimes is that if the regulator ensures disclosure is clear and effective the market will be well placed to assess and price the risks. The global financial crisis put this idea to the sword, at least in the context of the incredibly complex transactions, synthetic CDOs and the like, that had become common by 2007. A FTT would provide a real incentive away from complexity and towards simplicity in capital markets transactions which would assist, profoundly, the securities regimes in doing their job and ensuring efficient markets.
3. A FTT would thus shift markets into more socially useful and desirable activities, and allow them to perform their core functions of setting prices and allocating resources more effectively.
4. Of the measures being considered (including bank levies and FATs) only a FTT would raise money on the scale required to repair the GFC ravaged balance sheets of the G7 nations and also provide funding for the global fight against poverty and the climate change adaptation that will be required in developing countries. Conservative revenue



estimates for a global FTT of only 0.05% are at least US\$400 billion per annum, which is sufficient to repair rich country's balance sheets, fund the attainment of all the Millenium Development Goals and enable the developing world to address climate change.

No other measure offers the potential to raise revenue on this scale, and it is precisely for this reason that the opposition to this tax is so strong from the financial sector and from any body over which the finance industry has any influence.

## **VI. Conclusion**

At the time of writing, the German Chancellor and the French President support an FTT, but alas not US President Obama, not publicly, at least, since he was elected President. The opposition of the US to this tax is the biggest obstacle to its implementation.<sup>77</sup> As the review of the EU Commission and IMF Reports has revealed, there are plenty of arguments against the tax, and financial sectors are politically influential in all nations, so it will require real political courage for national leaders to support this tax. Without a US commitment to this tax, its imposition is probably simply too risky for other nations to pursue in the face of the arguments from their own financial sectors of losing trading business to the US.

Yet the tax is not a radical idea. The United Kingdom and Hong Kong (for instance) have both long imposed a stamp duty of ten times this magnitude on share sales, and the trading has not moved elsewhere.

---

<sup>77</sup> G Somerville, "Geithner: need stimulus, not financial transactions tax", *Reuters*, Nov 8, 2009, available at <<http://www.reuters.com/article/idUSTRE5A611320091108>>.

A FTT offers the real opportunity to reduce short-term speculation in foreign exchange and capital markets and render them more stable and efficient. A FTT would redirect market activity in beneficial ways away from excessive speculation and back towards the core functions of a financial sector. However, without the support of the US a FTT is politically risky for other nations to implement, due to the fear of trading moving to the US markets.

China has three options here. It could choose to support a FTT and lead the drive for one internationally. If East Asia and Europe were to implement a FTT it is very difficult to see the US staying out of the game. All foreign exchange transactions using US dollars would be taxed in the other country, and the absence of the US from the global scheme would mean it would not share in any of the waterfall of revenue thus generated. So option one is to lead an international push for a financial transactions tax, knowing the revenue on offer will virtually force North America to follow in due course.

Option two is to support a financial institutions levy and/or a financial activities tax in the G20 deliberations, and to implement a levy within China. In an economy in which overheating and speculative real estate bubbles appear a constant threat, a levy on financial institutions and a tax on the sector's profits and executive remuneration, would appear to be attractive restrictive measures, which would also raise considerable useful revenue.

Option three would be to oppose all of these measures, which seems to be China's current position. One can advance a few reasons as to why China might take this course. Historically China has been averse to international agreements which can be perceived to be restricting its freedom to govern itself as it sees fit from time to time, and has tended to perceive such international agreements as infringements of its sovereignty. China also has traditionally used its banking sector as a tool of economic policy to regulate the pace of the country's economic growth – promoting cheap money at some times and



restricting it at others<sup>78</sup> – and it may see a levy and/or a FAT as restricting its ability to do so, although of course such measures can be repealed or suspended at any time.

So there are traditional reasons China might be wary of measures promulgated internationally such as these, the question for China today is whether such traditional thinking is serving it.

---

<sup>78</sup> D McMahon, “China’s shadow loans swell”, *The Wall Street Journal Asia*, Dec 3-5, 2010, 1.