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A Financial Transactions Tax: The One  
Essential Reform

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# A Financial Transactions Tax: The One Essential Reform

Ross Buckley

## **Abstract**

The financial markets have changed quite fundamentally in the last a few decades, yet the measures we use to regulate them have not really changed at all. The market patterns of high frequency trading, computer generated activity and short-termism are now well entrenched, and will be difficult to change. Of the various ways available to seek to encourage this change, the best, in my view, is a financial transactions tax (FTT). When one analyses most of what has been written of late about the EU's proposed FTT one finds it to be riddled with myths, inaccuracies and untruths. This paper analyses seven most common myths of FTT.

## A Financial Transactions Tax: The One Essential Reform

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The Great Recession has sparked major regulatory reform in Europe and the US. Yet most reforms have been attempts to improve the types of regulation that pre-dated the recession. There are some exceptions to this, such as the Volcker rule in the US and the measures to limit bank executive compensation in Europe. However, in broad terms the type of thinking that delivered the recession has lived on in devising responses to it.

Yet capital markets have changed fundamentally in the past two decades. The ratio of financial transactions relative to nominal world gross domestic product (GDP) in 2010 was about 70, compared to 15 in 1990.<sup>1</sup> This dramatic increase in financial market volumes was driven by derivative trading, as spot transactions of stocks, bonds and foreign exchange grew roughly in line with nominal world GDP.<sup>2</sup> Derivatives accounted for 88 percent of transactions in 2007.<sup>3</sup> Furthermore, an ever increasing proportion of market trades are short-term and technically driven. In 2009, algorithmic<sup>4</sup> or computer-driven trading accounted for at least 60 percent of equity market trading volume in the US and 30-40 percent of European and Japanese equity trading.<sup>5</sup>

Many transactions involve “high frequency trading” (HFT) aimed at exploiting minor price fluctuations.<sup>6</sup> HFT typically involves the generation of massive numbers of orders for very short periods (often less than a second), many of which are subsequently cancelled to mask the true intent of the trader.<sup>7</sup> Estimates of the proportion of trading classed as HFT vary but generally fall within the 50-75 percent range.<sup>8</sup> HFT is founded on an ability to transact rapidly. To enable faster processing speeds, market participants are now relocating their systems beside

or within the building of the relevant exchange. Co-location reduces latency: the time it takes for data to transact across electronic trading systems. French hedge funds moved their trading computers to London because the time it took electronic messages to travel from Paris was placing them at a disadvantage. Goldman Sachs moved its computers beside those of NASDAQ because each millisecond gained, by their calculations, added more than US\$100 million to company profits.<sup>9</sup>

So the financial markets have changed quite fundamentally, yet the measures we use to regulate them have not really changed at all.

The market patterns of high frequency trading, computer generated activity and short-termism are now well entrenched, and will be difficult to change. Of the various ways available to seek to encourage this change, the best, in my view, is a financial transactions tax (FTT).

A FTT is a tiny impost of perhaps between 0.01% and 0.1% on all wholesale capital market transactions. It is advocated not primarily as a measure to raise funds, although of course it does do that, but as a measure to redress some of the fundamental, unhelpful changes in financial markets, and to enhance the operation of such markets in accurately setting prices and thereby allocating resources.

A FTT specifically falls upon short-term speculative transactions. Its impact on longer-term transactions is minimal. For instance, a hedge fund buying \$1,000,000 of stocks, holding them for 8 seconds and then selling, would incur the same tax as an individual buying these stocks to hold long-term. At a rate of 0.05%, the tax either way is \$500. This impost is unlikely to deter the longer term investor, while making the ultra-short-term trade, and much high frequency trading, unprofitable.<sup>10</sup>

The ever faster trading we have witnessed in recent years tends to make exchange rates and stock and commodity prices less accurate, ie. less close to that which would be dictated by economic fundamentals. This is because short-term price runs, fuelled by very rapid trading and strengthened by the impact of algorithmic trading programs, accumulate to long-term

trends and distortions in prices. The resulting over-shooting of prices favours speculators over longer-term investors and thereby feeds into the ever-higher levels of trading which we are seeing.<sup>11</sup>

The European Commission (EC) is seeking to implement a FTT in the EU by early 2018.<sup>12</sup> The tax will apply to shares and bonds, and derivatives on shares and bonds. The proposed tax rates are 0.1 percent on shares and bonds, and 0.01 percent on the derivatives of shares and bonds. The tax base applying to derivatives is the nominal value of the underlying assets. The proposed tax will be levied according to the fiscal residence of the seller of an asset (country of origin principle). The tax is expected to raise more than thirty billion euros by 2020<sup>13</sup> and up to fifty billion euros if currency transactions are included. The revenues from the tax are to go to the general EU budget.<sup>14</sup> The proposal requires ratification by all member states to become effective. A unanimous decision would have to be taken on the final form of the 2014-2020 EU budget by the Council after consulting the European Parliament. As the UK remains firmly opposed to the tax, it is only likely to be implemented across the twenty-seven EC countries after a long tussle between national governments, the EC, and the European Parliament.<sup>15</sup> Civil society has played a major role in bringing the idea of a FTT to prominence, and its work in this regard is clearly very far from done.

Implementation of a FTT would satisfy multiple policy objectives. An appropriately structured FTT would improve market function and reduce systemic risks by dampening or discouraging ultra-short-term trading and trading of derivatives and leveraged instruments. The tax could also meaningfully reduce sovereign debt levels and the associated risk that is so limiting many developed nations, and would ensure a fairer contribution from the finance industry to the public purse.

We need to reweight our markets in favour of longer-term investment and away from rewarding short-term speculation.<sup>16</sup> A FTT:

- Is a credible measure to mitigate the entrenched culture of short-termism in markets;
- Is likely to reduce levels of highly speculative trading;
- Will result in a progressive incidence;



- Could reduce opacity and excessive counterparty risk by imposing higher tax rates on OTC transactions and trading in specified complex derivative instruments.
- Would assist policy makers and regulators to monitor market trends; and
- Would enable more effective oversight of market trading and potential risks on a domestic and global basis.

In an ideal world, a FTT base should be as broad as possible to minimise avoidance issues and distortions across security classes and markets. The FTT should apply to all traded securities including equity, debt, currency, and commodities. The taxed securities should include spot and derivative transactions through exchanges and over the counter. However, the tax should not apply to new security issuances or offerings or financial services provided by financial institutions to customers.

The tax should be implemented at a low rate initially, with an agreed review period of five years. The tax, in my view, should be a small impost of between 0.005 percent and 0.05 percent. Differential rates should be applied to instruments or asset classes to reflect the varying transaction costs and the extent to which the tax is intended to discourage trading in particular instruments or classes. The tax should be calculated on the notional values of the underlying security and should be adjusted for the term of the security.

The tax should be collected where possible by the relevant exchange or central clearing house. Its collection should be designed as a required part of the clearing process to minimise avoidance.<sup>17</sup> The cost of the tax should be shared between the buyer and seller.<sup>18</sup>

In an ideal world, the tax would be implemented across all jurisdictions. While the asymmetry of revenue across individual countries may be an issue,<sup>19</sup> the potential benefits of more stable, efficient and fair global markets and financial systems provide compelling reasons for the successful negotiation and implementation of this tax.

Much of the resistance to this tax is a testament not to its weaknesses as an appropriate policy response to the new world of globalised capital, but to the political power of the finance industry that has grown so large in the richer nations. When one analyses most of what has

been written of late about the EU's proposed FTT one finds it to be riddled with myths, inaccuracies and untruths. The seven most common myths are analysed below.

*Common Myth 1: James Tobin devised the FTT*

Forty years ago, the Nobel Laureate, James Tobin, proposed a tax on currency transactions in an effort to improve the workings of the foreign exchange markets. A FTT is a much more broadly based tax than one just on currency and is thus far more difficult to transact around and avoid. In fact, a FTT was first proposed by Keynes in 1936 when he wrote, “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 enterprise in the US.”<sup>20</sup>

*Common Myth 2: Tobin's idea is old hat – never implemented because impractical*

When Tobin proposed his idea most trading was done on proprietary systems and implementation of the tax would have been difficult. However, there has been a revolution in settlement and clearing systems that has since seen a category of financial products typically traded on one of two or three massive competing clearing houses, so that the industry is today perfectly adapted to assess and collect this tax. This is why when, in August 2011, the IMF considered the administrative feasibility of levying a FTT it concluded that a FTT “is no more difficult and, in some respects easier, to administer than other taxes”.<sup>21</sup>

Yet, strangely, when I discuss the FTT with the media, the fact that Tobin proposed a related idea 40 years ago is often held against it. If this were a new idea it would receive a better hearing but because it was first proposed almost 80 years ago, and resurrected in a different guise 40 years ago, many commentators seem to see it as old hat. However, we live in radically different times. Computer driven trading began less than 30 years ago. The short-termism of today's trading was unknown even 10 years ago.

It is now broadly accepted that Australia's and Canada's financial systems weathered the 2008 crisis so well because their banks had remained primarily service businesses whereas Europe's and America's banks suffered so much because "they had become the business".<sup>22</sup> The essential business of banking is intermediating capital to borrowers able to put it to good use. When the business of banking becomes speculating and trading, which viewed across the system is a zero-sum game, we are in a new world which calls for new regulatory responses. An idea that was good 80 and 40 years ago, is even better, and more needed, today.

*Common Myth 3: This tax will mean the financial sector will shrink and the sky will fall in*

The tax will tend to mitigate the growth in the financial sector at the expense of other sectors of an economy. Bankers see this as a negative. Anyone else should be questioning the social usefulness of the growth of transactions that boost the relative and absolute size of the finance industry. Financial services have become such a significant part of the total economy in some countries that too many of the best-educated individuals in these countries may be trading paper assets rather than creating real wealth.<sup>23</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>24</sup>

*Common Myth 4: The EU cannot impose a tax alone as all trading will flee to untaxed jurisdictions*

This myth is wrong on two counts. Firstly, Hong Kong and London have both long had securities transactions taxes in place substantially larger than the scale proposed for a FTT and securities are still traded in these centres. Secondly, to the extent the tax falls on currency transactions, all transactions in Euro are cleared in Europe and are thus taxable there. It may well be that continental Europe will lack the political courage to impose a tax without London

following suit, as there is a real risk of trading migrating across the Channel. However, the UK has a veto over new taxes at the EC level, so presumably it will be on board if the EC imposes a tax.

*Common Myth 5: This is just another cash-grab by Brussels*

When anyone says ‘tax’ everyone thinks ‘revenue’ and, of course, raising revenue is the primary purpose of most taxes. Yet raising revenue is not primarily why taxes are imposed on alcohol or tobacco. These are primarily imposed to enhance citizen’s health and reduce long-term medical costs. The revenue is a bonus. And so it is with this tax. Keynes and Tobin both proposed their taxes in response to markets that they saw would operate more efficiently and effectively if so taxed. Neither ever mentioned the revenue that would be raised. Their concern was the welfare-enhancing effects of better markets.

The EU is, of course, interested in the revenue. A quick glance at sovereign balance sheets in Europe shows how badly it is needed. However, today’s advocates are seeking the other benefits it offers. Lord Turner, Chairman of the United Kingdom’s Financial Services Agency, 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>25</sup> and suggests that, “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>26</sup>

*Common Myth 6: This is a tax on consumers and their retirement savings*

The British finance minister, George Osborne, claims that there “is not a single banker in this world that is going to pay this tax ... The people who will pay this tax are pensioners”.<sup>27</sup> Yet this statement is demonstrably false.

The claim that most of the burden of the tax will fall on pensioners assumes that pension fund managers are initiating most of the short-term trades. While global data on trading participants is limited, this is deeply improbable. Most short-term trades are initiated by hedge funds, and

the hedge-fund-like proprietary trading desks of the major banks. Accordingly, this tax will impact the profits of hedge funds and many of the major banks – its impact on retirees will be many orders of magnitude less. Indeed, to the extent that pension managers are involved in consistently high levels of short-term derivative trading, one might well question whether this is a sound investment policy and in the interests of their members. Pensioners are ultimately more likely to derive a net benefit from a FTT that encourages a longer-term investment horizon, and more stable and efficient markets.

*Common Myth 7: This tax will dry up the supply of capital*

The argument that an FTT will be an additional burden on banks and reduce the banks' proclivity to lend is industry-generated spin. The tax would apply to secondary trading of securities and not to mortgages, bank loans or primary capital issues.

The EC is right to be pushing for the imposition of a FTT within Europe by 2018. The tax is relatively simple to implement and provided it remains very broadly based, is difficult to avoid. The tax will tend to reward longer term investments over ultra-short-term trades and thus nudge markets towards better fulfilling their traditional roles and away from serving as financial casinos. The end result will be markets that more accurately price assets, and thus better allocate resources, while also facilitating a more appropriate contribution by financial firms to the societies from which they derive their profits.

The best words with which to end, come from a 2011 letter to the G20 from 1000 economists: "the financial crisis has shown us the dangers of unregulated finance, and the link between the financial sector and society has been broken ... It is time to fix this link and for the financial sector to give something back to society ... this tax is technically feasible. It is morally right."<sup>28</sup>

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<sup>1</sup> Stephan Schulmeister: A General Financial Transactions Tax: Motives, Effects and Implementation, Summary of a Presentation at the Brussels Tax Forum 2011, 29 March 2011. The volume of financial transactions in Europe and the US is closer to 100 times nominal gross domestic product (GDP).

<sup>2</sup> Stephan Schulmeister: A General Financial Transactions Tax: A Short Cut of the Pros, the Cons and a Proposal, Austrian Institute of Economic Research Working Paper No. 344, October 2009, p. 5.

<sup>3</sup> Zsolt Darvas & Jakob von Weizsacker: Financial Transaction Tax: Small is Beautiful, in: Bruegel Policy Contribution, Feb. 2010, p. 5. See Timothy Canova: Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model, in: Harvard Law & Policy Review, Vol. 3, No. 2, 2009, pp. 369, 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, 10 March 2008, available at: <http://www.marketwatch.com/story/derivatives-are-the-new-ticking-time-bomb>.

<sup>4</sup> Algorithmic trading uses high-speed computer programs to generate, route and execute orders. The Australian Securities and Investments Commission define algorithmic trading as “computer-generated trading activity where trading parameters are determined by strict adherence to a predetermined set of rules, aimed at delivering specific execution outcomes”: Australian Securities and Investments Commission, Market Assessment Report: ASX Group 23, Report 222, November 2010. See also Securities and Exchange Commission, Concept Release on Equity Market Structure 45, 17 CFR Part 242, 14 Jan. 2010; Australian Securities and Investments Commission, Australian Equity Market Structure Proposals 21, Consultation Paper 145, November 2010.

<sup>5</sup> Thornton Matheson: Taxing Financial Transactions: Issues and Evidence, International Monetary Fund Working Paper WP/11/54, Mar. 2011, p. 19. See also Sony Kapoor: Re-Define, Financial Transaction Taxes: Tools for Progressive Taxation and Improving Market Behaviour, February 2010, p. 6, available at:

[http://www.oekosozial.at/uploads/tx\\_osfopage/ReDefine\\_FTTs\\_as\\_tools\\_for\\_progressive\\_taxation\\_and\\_improv...](http://www.oekosozial.at/uploads/tx_osfopage/ReDefine_FTTs_as_tools_for_progressive_taxation_and_improv...).pdf; Sony Kapoor: Re-Define, The Financial Crisis – Causes and Cures, 2010, p. 96, available at:

[http://re-define.org/sites/default/files/Re-Define%20Book%20The%20Financial%20Crisis%20-%20Causes%20and%20Cures%20by%20Sony%20Kapoor\(1\).pdf](http://re-define.org/sites/default/files/Re-Define%20Book%20The%20Financial%20Crisis%20-%20Causes%20and%20Cures%20by%20Sony%20Kapoor(1).pdf). Kapoor highlights that a review of trading in Vodafone shares showed 90 trades and 72 changes to the price each minute of each day with most of this trading generated by automatic algorithms.

<sup>6</sup> Matheson, *supra* note 5, p. 19.

<sup>7</sup> Some parties estimate the cancellation rate at more than 90 percent: James Brigagliano, Co-Acting Director, Division of Trading and Markets U.S. Securities and Exchange Commission (SEC), Address at the Trader Forum Fall Workshop, 8 Oct. 2009, available at: <http://www.sec.gov/news/speech/2009/spch100809jab.htm>.

<sup>8</sup> Brigagliano, *supra* note 7. See also International Organization of Securities Commission (IOSCO): Regulator Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency Consultation, IOSCO Doc. CR02/11, July 2011, available at [www.securitiestechologymonitor.com/news/iosco.php](http://www.securitiestechologymonitor.com/news/iosco.php).

<sup>9</sup> T. Williams: Oh dear! I’m Queued! It’s Latency!, October 29, 2008, available at: [http://www.mondovisione.com/exchanges/handbook-articles/oh-dear-im-queued-its-latency/#\\_ftn1](http://www.mondovisione.com/exchanges/handbook-articles/oh-dear-im-queued-its-latency/#_ftn1).

<sup>10</sup> Schulmeister, *supra* note 1, p. 1.

<sup>11</sup> Schulmeister, *supra* note 1, p. 1.

<sup>12</sup> European Commission: Proposal for a Council Decision on the System of Own Resources of the European Union, 29 June 2011 at p. 5.

<sup>13</sup> European Commission, *supra* note 12, p. 5.

<sup>14</sup> European Commission, *supra* note 12, p. 5.

<sup>15</sup> Quentin Peel, Gerritt Wiesmann: Schauble Calls for EU Lead on Tobin Tax, in: Financial Times (online at [ft.com](http://ft.com)), 31 October 2011; Robert Preston: How Scary is a Financial Transaction Tax?, in: BBC News (online at [bbc.co.uk](http://bbc.co.uk)), 10 October 2011. The German Finance Minister, Wolfgang Schauble, has indicated that if agreement cannot be reached between the 27 eurozone countries, the EC will consider introducing it initially in some member states.

<sup>16</sup> The Aspen Institute: Overcoming short-termism: a call for a more responsible approach to investment and business management, 9 September 2009, available at:

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

<sup>17</sup> Robert Pollin et al: Securities Transaction Taxes for U.S. Financial Markets, in: Eastern Economic Journal, Vol. 29, No. 4, 2003, p. 542.

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<sup>18</sup> See European Commission: Innovative financing at a global level, Commission staff working document, 1 April 2010, p. 19. The report indicates that collecting taxes through central clearing mechanisms is straightforward and cheap.

<sup>19</sup> Schulmeister, *supra* note 2. More than 97 percent of the EU spot and derivative transactions currently occur in the UK and Germany. Elsewhere a large portion of the trading occurs in the US.

<sup>20</sup> John Maynard Keynes: *The General Theory of Employment, Interest and Money*, New York 1936, p. 156.

<sup>21</sup> John D. Brondolo: *Taxing Financial Transactions: An Assessment of Administrative Feasibility*, IMF Working Paper 11/185, August 2011, p. 5.

<sup>22</sup> Peter Isaac: *Tobin Tax*, in *Chartered Accountants Journal*, Nov. 2011, p. 55.

<sup>23</sup> Joseph Stiglitz: *Using Tax Policy to Curb Speculative Short-Term Trading*, in: *Journal of Financial Services Research*, Vol. 3, No. 2–3, 1989, p. 109. See also Lawrence Summers & Victoria Summers: *When Financial Markets Work Too Well: A Cautious Case for a Securities Transaction Tax*, in: *Journal of Financial Services Research*, Vol. 3, No. 2–3, 1989, p. 270; Dean Baker: *The Benefits of a Financial Transaction Tax*, Dec. 2008, available at: <http://www.cepr.net/documents/publications/financial-transactions-tax-2008-12.pdf>; Margaret Blair: *Financial Innovation and the Distribution of Wealth and Income*, Vanderbilt University Law School, Working Paper 10-32, June 2010, p. 29; *Financial Crisis Inquiry Commission: The Financial Crisis Inquiry Report*, 2011, pp. 64–65, available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

<sup>24</sup> *Commission of Experts of the President of the UN General Assembly on Reform of the International Monetary and Financial System: Report of the Commission*, 21 September 2009, p. 47.

<sup>25</sup> Angela Monaghan: *Tax “Socially Useless” Banks, Says FSA Chief Lord Turner*, in: *The Telegraph*, 27 August 2009.

<sup>26</sup> Adair Turner: *Address at the City Banquet, The Mansion House, London*, 22 September 2009.

<sup>27</sup> Ralitsa Kovacheva: *Pros and Cons of a European Tax on Financial Sector*, in: *euinside.eu*, 11 Nov. 2011, available at: <http://www.euinside.eu/en/news/pros-and-cons-a-european-financial-transaction-tax>.

<sup>28</sup> The letter is available at <http://www.guardian.co.uk/business/2011/apr/13/robin-hood-tax-economists-letter>.

