Comment on Possible Tax on Trading of Financial Assets

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January 28, 2010

Introduction

Over the years, proposals to tax the trading of financial assets have been suggested by many leading economists. Keynes proposed such a tax on trading of equities, James Tobin on trading in currencies and President Barack Obama's chief economic advisor, Larry Summers, has advocated such a tax in the past. More recently, Nobel Laureate Paul Krugman has raised the issue.

The Chicago Political Economy Group (CPEG) and the Democratic Socialists of America (DSA) strongly endorse the concept of a financial transaction tax (FTT) on the trading of financial assets and urge the IMF and other international bodies to actively work to develop models of an FTT that could be applied by their various member states.

I. Scope of a FTT

To be effective, a financial transaction tax (FTT) should have the following characteristics.

(1) Levied on all three classes of financial assets: equities, currencies and interest rate products;
(2) Levied on all instruments by which these assets are traded, both in the cash and derivative markets;
(3) Levied on transactions in all markets where these assets are traded, both exchange and over the counter (OTC); and
(4) The levels established for an FTT should be set such that no single trading instrument and no market is unfairly advantaged or disadvantaged, thus causing a shift in volume from other instruments or markets.

II. Possible Revenue generated by an FTT

Obviously the level of revenue generated by an FTT will be determined by the rates established for various instruments and the value of trading in these instruments. CPEG has analyzed the potential revenue that could have been generated for the U.S. federal government during 2007 and 2008 using the following FTT rates:

(1) Equities: 0.25%/side of value traded;
(2) Equity derivatives (index futures and options): 0.1%/side of value traded;
(3) Currency and currency derivatives: 0.1%/side of value traded; and
(4) Interest rate derivatives: 0.1%/side of value traded.

Using these FTT rates and the trading values in the various asset classes and markets traded during 2007 and 2008, the revenue generated would have exceeded $800 billion in each year (detailed calculations and sources may be found at www.cpegonline.org; see Working Paper 2010 - 2). Equity and equity derivative trading would have generated the largest amount with interest rate products providing the second highest revenue. This revenue estimation is, in all probability, an underestimate. We have not included separate calculations for swaps and certain other derivatives. Nonetheless, we believe that the potential revenue is such as to justify serious consideration for an FTT.

III. The Economic Rationale for an FTT

It has been widely recognized that a major cause of the current financial crisis is the role and actions of the finance sector in the leading political economies of the world. Excessive risk taking, incentives that encouraged a focus on short term profit/loss statements, and insufficient regulation, the latter of which was urged by the very entities seeking to maximize short run returns combined to take the world political economy to the edge of an abyss.

The process of financialization that drove the crisis is rooted in the huge increases in trading of financial assets unrelated to any underlying productive activity. For example, in the 1998 – 2007 decade, the value of equity trading in the U.S. increased almost 250% while the actual capitalization of listed issues increased by less than 50%. This dramatic increased in the frequency of trading has not resulted in any corresponding increase in the economic well being of most of the U.S. population. However, what has happened is a major shift in the structure of the U.S. political economy. Thus, over the last three decades, the share of total corporate profits accruing to financial corporations in the U.S. has almost doubled. Financialization has not, of course, been limited to the world of equity trading nor to the U.S. For example, the most recent BIS report on currency trading notes that the ratio of traded value to international trade is more than 25:1 and that short term technical trading dominates the currency and currency derivative markets.

We recognize that an FTT alone will not return the political economies of U.S., Europe and Japan to greater balance between financial and non-financial activities. However, we believe that, to the extent an FTT deters short term, low profit trading, often from highly leveraged positions, it will have a very positive impact in shifting towards a more balanced political economy.

A second rationale for imposing an FTT is the use of revenues generated by such tax to finance much of the recovery expenditures needed to bring the world out of the current economic crisis. Revenues generated by a well constructed FTT can finance the employment, health care, and other programs that are necessary to spread the benefits of economic growth to the population at large and to counter the serious, long term human and economic impact of the current economic crisis.

IV. Would an FTT have a Negative Impact on Financial Markets?

We are aware that many financial interests and financial economists may oppose an FTT, arguing that such a tax will decrease liquidity and efficiency of world financial markets. There is not space to respond to this argument in detail. However, it is worth emphasizing one important point here.

There is no evidence that a reduction of trading in financial asset markets of even 50% would negatively impact the capital raising and allocation functions of these markets, as distinct from the financial profit generation capability. U.S. markets in equities and debt were judged by most financial economists to meet the efficiency test some 20 or more years ago, a time when trading was less than 25% of that today. The rapid increase in trading activity over the past two decades has not noticeably reduced the cost of capital not improved the economic well being of the general population.

There are, of course, other arguments that opponents of an FTT may make such as the issue of enforceability, loss of jobs in a high unemployment environment, etc. We do not find these arguments persuasive. Nations regularly enforce rules and laws across national boundaries – that is what commercial treaties are about. Any job loss in the financial sector resulting from a reduction in trading would be more than compensated for by using the revenues generated by an FTT to expand job opportunities in other areas of the economy. Of course, any reduction in trading that might result from levying an FTT would result in a roughly corresponding reduction in the revenue raised. However, even under the extreme scenario of a 50% decline in trading, halving the FTT revenue to the $400 – 450 range would leave ample funds to develop jobs outside the financial sector.

V. Conclusion

The Chicago Political Economy Group and the Democratic Socialists of America appreciate this opportunity to comment on the potential for an FTT. The underlying principle in our support of an FTT is the proposition that economies are for the service of the population as a whole, that the goal of economic life is not simply the amassing of wealth but the ability for more and more people to live, as Keynes expressed it, “wisely, agreeable and well”. The revenues generated by an FTT can significantly help to achieve this goal without unduly burdening those who will pay most of the FTT.