

The deficit-reducing potential of a financial speculation tax

Dean Baker [Center for Economic and Policy Research, USA]

Copyright: Dean Baker, 2011

You may post comments on this paper at

<http://rwer.wordpress.com/2011/03/11/rwer-issue-56-dean-baker/>

While a number of commissions and organizations around Washington have produced plans for reducing the projected deficit in the decades ahead, most have not included a financial speculation tax (FST) in the mix.¹ This seems peculiar since an FST has several features that could make it attractive as a revenue source.

First, it would help reduce the economic rents earned by the financial sector. A tax on the turnover of stocks, options, credit default swaps and other financial instruments would make it less profitable to trade these assets. To a large extent current trading patterns reflect rent-seeking behavior with little or no economic benefit.

For example, the complex computer algorithms that can allow sophisticated traders to purchase assets ahead of ordinary investors – and therefore gain at their expense – provide no obvious benefit to the economy. In fact, the use of algorithms to jump ahead of ordinary investors reduces the expected gains from long-term investment. If an FST can reduce this sort of trading, it will impose no loss on the economy. This is one of the reasons that even the IMF, an institution generally friendly to banks, has advocated increased taxation of the financial sector.²

In addition, this sort of short-term trading can be enormously profitable. The large banks and hedge funds that engage in this trading are the source of many of the country's highest salaries. In an economy where inequality has soared over the last three decades, a tax that will reduce the high-end salaries in the financial sector can be an important factor in reducing inequality.

It is also important to recognize that the tax will be borne almost entirely by the financial sector, not by ordinary investors. The financial sector is likely to bear almost the entire burden of the tax since investors are likely to respond to an increase in trading costs by reducing the number of trades they make. Most research suggests that trading volume is relatively elastic, meaning that investors will sharply reduce the frequency of their trades if the cost of a trade goes up.

For example, if the cost of an average trade of a share of stock were to double as a result of a tax, the evidence suggests that it would lead to a 50 percent reduction in trading volume. In this case, investors would be paying no more for their trades in total after the tax than they did before the tax. They would pay twice as much on each trade as a result of the

¹ There were at least three economic/budget plans put forward that did include a financial speculation tax as a revenue option: "Investing in America," by the Century Foundation, Demos, and the Economic Policy Institute, available at http://www.ourfiscalsecurity.org/storage/Blueprint_OFS.pdf; "Report and Recommendations of the Citizens Commission on Jobs, Deficits, and America's Economic Future," available at <http://www.ourfuture.org/report/citizenscommission>; and Bowles-Simpson Commission member, Andy Stern's "The 21st Century Plan for American Leadership," available at <http://www.safeandsecureig.org/sites/default/files/Stern%20Finalversion12-3.pdf>. These plans have received far less attention than proposals that do not mention financial speculation taxes.

² International Monetary Fund. 2010. "A Fair and Substantial Contribution from the Financial Sector: Final Report for the G-20." Washington, DC: International Monetary Fund, available at <http://www.imf.org/external/np/g20/pdf/062710b.pdf>.

tax, but since they make half as many trades, they would end up paying the same amount in total for their trades. This would mean that, on average, the tax would not increase the amount that investors pay for their trades. (It is worth noting that bills introduced in the last session of Congress exempted from the tax the vast majority of trades carried through by ordinary investors.)

The United Kingdom has long had a tax of 0.25 percent on each side of a stock trade. This tax raised an amount that was just under 0.3 percent of the U.K. GDP in 2007, before world stock markets plunged.³ An equivalent amount of revenue in the United States would be more than \$40 billion a year.

The U.K. experience is important for two reasons. First, it shows that a tax on financial transactions is collectable. The government has been able to collect a substantial amount of revenue through this tax with relatively little difficulty. In fact, the Board of Inland Revenue (now HM Revenue and Customs) reported that the administrative cost of collecting this tax is lower than for any other tax.⁴ While some amount of financial transactions has undoubtedly been shifted away from the U.K. to avoid the tax, there clearly is still a substantial amount of trading that is subject to the tax, as the London Stock Exchange remains the largest in Europe..

This raises the second reason why the U.K. experience is important. The existence of the tax has not prevented the U.K. from having a vibrant financial market. The London Stock Exchange is the fourth largest stock exchange in the world. Apparently investors view the benefits of trading on the London exchange as being valuable enough to outweigh the cost of the tax. Presumably this would be even more true in the case of the United States since the U.S. market is even larger. Furthermore, the U.S. government is better positioned than the U.K. government to use economic and political power to discourage countries from establishing havens for avoidance of this tax.

The revenue from the U.K. tax is based exclusively on the taxation of stock trades. Ideally a financial speculation tax would tax not only stock trades but also trades of options, futures, credit default swaps and other derivatives. A recent analysis that applied a scaled set of taxes to a range of assets showed that an FST could easily raise more than 1.0 percent of GDP (approximately \$150 billion in 2011) even assuming very substantial reductions in trading volume.⁵ Given the size of the potential revenue from an FST, there is remarkably little interest in Washington policy circles in implementing such a policy.

By comparison, the amount of revenue that could be raised from an FST is more than two and a half times the amount of money needed to pay for the extension of Unemployment

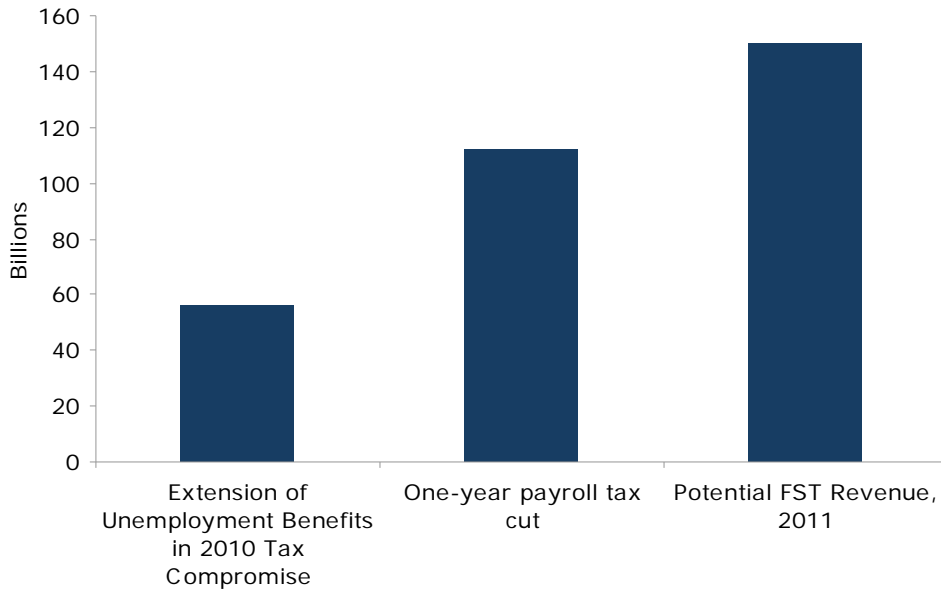
³ This calculation is derived from the U.K. Board of Inland Revenue's reported total revenue from its stamp tax of 14.1 billion pounds in its fiscal year running from 2006-2007 (available at http://www.hmrc.gov.uk/stats/tax_receipts/menu.htm). Of this revenue, 10.0 billion pounds was attributable to the stamp tax on property sales (available at http://www.hmrc.gov.uk/stats/stamp_duty/table15-3-0910.pdf), leaving 4.1 billion pounds from the tax on stock trades. This is equal to 0.28 percent of the GDP of the United Kingdom at the time.

⁴ See Bond, Steve, Mike Hawkins, and Alexander Klemm. 2004. "Stamp Duty on Shares and Its Effect on Share Prices." London: The Institute for Fiscal Studies, WP04/11 (p 4), available at <http://www.ifs.org.uk/wps/wp0411.pdf>.

⁵ Baker, Dean, Robert Pollin, Travis McArthur, and Matt Sherman. "The Potential Revenue from Financial Transactions Taxes." Washington, DC: Center for Economic and Policy Research, available at <http://www.cepr.net/documents/publications/ftt-revenue-2009-12.pdf>.

Insurance benefits in the recent tax agreement signed into law at the end of 2010, as shown in **Figure 1**.⁶ It is more than one-third larger than the size of the 1-year payroll tax reduction that will be in effect in 2011.

FIGURE 1
Yearly Revenue from a Financial Speculation Tax Compared with Other Costs



Source: Congressional Budget Office and Baker *et al.*

The potential revenue from an FST is also large relative to other budget items. At one percent of annual GDP, it would raise more than \$1.8 trillion over the course of the next decade. This is more than twice the size of the estimated cost of the stimulus package that Congress approved in 2009, as shown in **Figure 2**.

⁶ The estimate of the cost of the extension of unemployment insurance benefits and the payroll tax cuts were taken from the Congressional Budget Office's Cost Estimate for HR4853, "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," available at <http://www.cbo.gov/doc.cfm?index=12020&zzz=41468>.

FIGURE 2
Revenue from a Financial Speculation Tax 2011-2020 Compared with President Obama's Stimulus

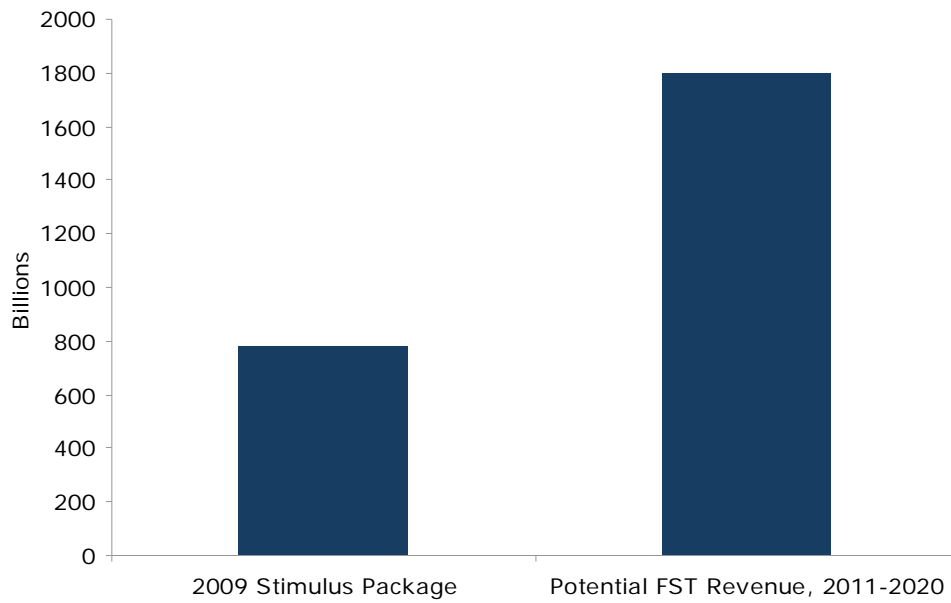
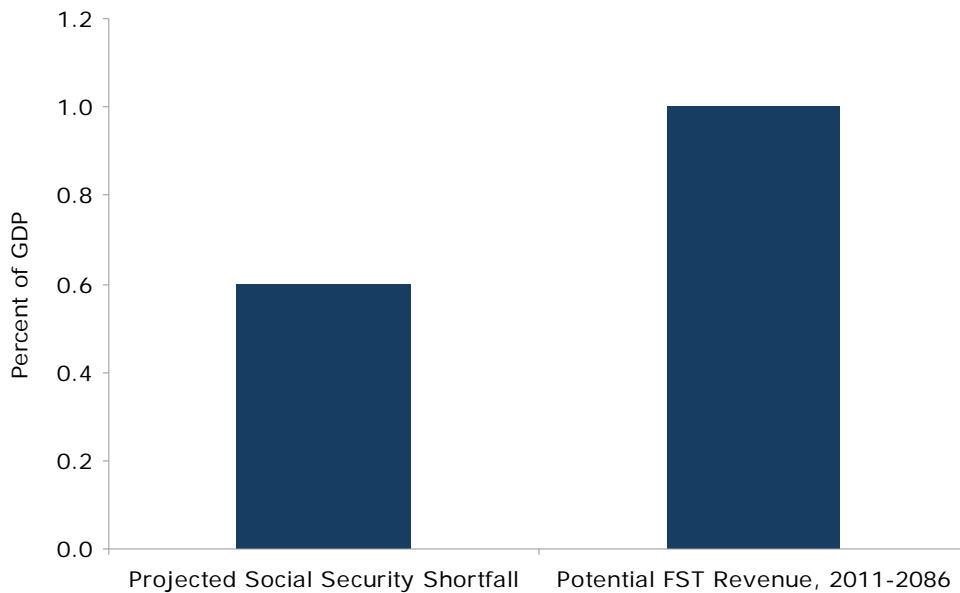


FIGURE 3
Revenue from a Financial Speculation Tax Compared with the Projected Shortfall in Social Security over the 75-Year Planning Horizon

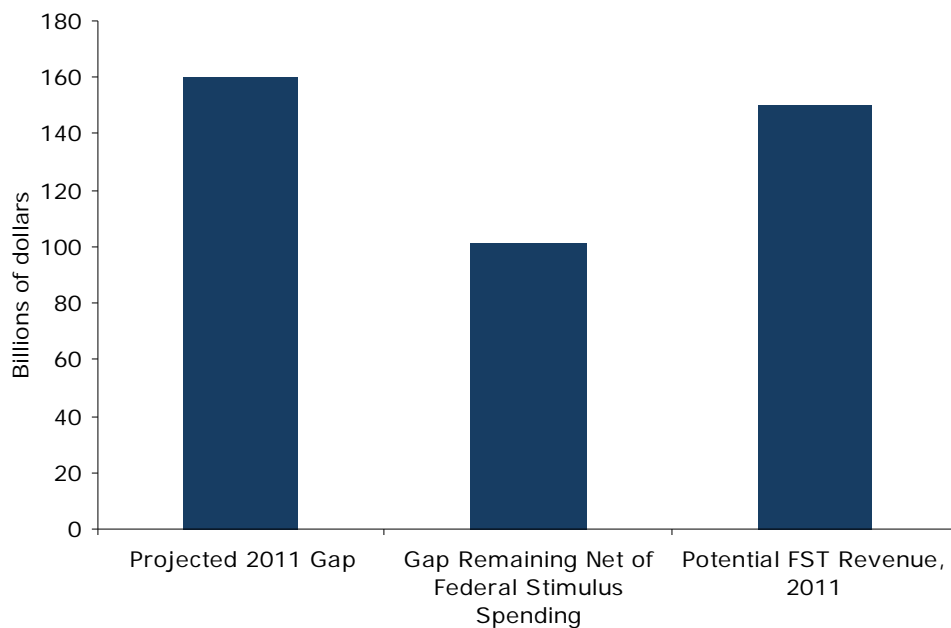


Source: Congressional Budget Office and Baker *et al.*

The projected shortfall in the Social Security trust fund provides another useful comparison with the potential revenue from an FST. The Congressional Budget Office projects that the shortfall over the program's 75-year planning horizon will be equal to 0.6 percent of GDP over this period.⁷ This means that at 1.0 percent of GDP, the potential revenue from an FST is more than 50 percent larger than the projected size of the Social Security shortfall as shown in **Figure 3**. In other words, the Social Security shortfall could be entirely filled with the revenue from a tax on financial speculation, with a substantial sum still available for other purposes.

Another item that provides a useful comparison to the revenue that could be raised from an FST is the projected gap in state budgets. The Center on Budget and Policy Priorities projects that the cumulative shortfall in state budgets in fiscal 2011 will be \$160 billion, with a gap of \$101 billion remaining after taking account of funds coming from federal stimulus programs.⁸ If an FST raised \$150 billion in 2011 then it could provide the federal government with almost enough revenue to fill the full gap and \$50 billion more than the amount of revenue needed to fill the remaining gap in state budgets, as shown in **Figure 4**.

FIGURE 4
Revenue from a Financial Speculation Tax Compared with the Projected Gaps in State Budgets for Fiscal 2011



Source: Center on Budget and Policy Priorities and Baker *et al.*

⁷ Congressional Budget Office, 2010. "CBO's 2010 Long-Term Projections for Social Security: Additional Information." Washington, DC: Congressional Budget Office, Exhibit 5, available at http://www.cbo.gov/ftpdocs/119xx/doc11943/SocialSecurity_SummaryforWeb.pdf.

⁸ McNichol, E, P. Oliff, and N. Johnson, 2010. "States Continue to Feel Recession's Impact." Washington, DC: Center on Budget and Policy Priorities, available at <http://www.cbpp.org/cms/?fa=view&id=711>.

Conclusion

In a context where deficit reduction is now playing a central role in Washington policy debates, it is striking that financial speculation taxes have received almost no attention. Calculations that assume sharp reductions in trading volume from current levels show that an FST can raise an amount of revenue that exceeds 1.0 percent of GDP. This is not just a hypothetical; the revenue collected by the U.K. on its more narrow tax on stock trades shows that it is possible to collect large amounts of money through such taxes. Furthermore, the incidence would be almost entirely on the financial industry and those involved in very active trading.

The potential revenue from such a tax far exceeds the amount of money involved in most items that are heavily debated in Congress, such as the extension of unemployment benefits or the tax breaks going to the wealthiest two percent of the population. The revenue from an FST also vastly exceeds the size of the projected Social Security shortfall. Given the amount of money potentially at stake and the progressivity of the tax, it is surprising that it does not feature more prominently in policy debates. It is not clear what possible downsides would be posed by such a tax, except for its negative impact on the income of people connected with the financial industry.

SUGGESTED CITATION: Dean Baker, "The deficit-reducing potential of a financial speculation tax", *real-world economics review*, issue no. 56, 11 March 2011, pp. 145-150,
<http://www.paecon.net/PAEReview/issue56/Baker56.pdf>

You may post and read comments on this paper at
<http://rwer.wordpress.com/2011/03/11/rwer-issue-56-dean-baker/>