Financial Transactions Taxes

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In the last three decades the financial sector has hugely expanded as share of the economy. The narrowly defined investment banking and security and commodities trading sectors have nearly quadrupled as share of GDP over this period. This growth has been associated with lax regulation, an explosion of speculative trading, and the creation of complex derivative instruments.

While successful traders and bankers can earn enormous rents in the financial sector, there is little obvious economic gain from the expansion of the industry. In addition, the growth of the sector has contributed to instability throughout the economy, creating the basis for the current downturn.

A financial transactions tax (FTT) can be an important force for constraining the financial sector. A modest set of taxes (e.g. 0.25 percent on a stock purchase or sale and 0.02 percent on the sale or purchase of a future, option, or credit default swap) would have almost no impact on productive use of these assets.

Individuals buying stock to hold for 10 years for their retirement or some other purpose will be little affected by a 0.25 tax on the purchase. Since the development of computers have led to plummeting costs over the last three decades This will just raise the cost of the transaction approximately to the same level as it was in the late 1980s, a period in which the United States already had very deep capital markets. Similarly a 0.02 percent transactions tax will not discourage a farmer from hedging her crop or an airline from hedging jet fuel.

However, taxes of this size will discourage speculation. An FTT will make it far more risky to buy a stock at 2:00 with the hope of selling it at a modest gain one hour later. FTT will also discourage the spread of complex derivative instruments, since the buyer could end up paying the tax at several different points. For example, someone buying an option on a stock would have to pay the tax when they bought the option and also if they ended up actually buying the stock. More complex instruments could lead to paying the tax even more times.

An FTT could raise an enormous amount of money. It could easily raise an amount equal to 1 percent of GDP, currently $150 billion a year or more than $1.8 trillion over the course of a decade.[1] This money would come primarily at the expense of short-term traders and of the financial sector. The financial industry would be forced to accept somewhat lower profits on its trades and of course would see a much smaller volume of trading as a result of the tax. With the exception of the estate tax, an FTT would almost certainly be the most progressive tax applied by the federal government.

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[1] Pollin, R., D. Baker, and M. Schaberg, 2002. "Financial Transactions Taxes for the U.S. Economy," Amherst: MA: Political Economy Research Institute, available at http://www.peri.umass.edu/236/hash/aef97d8d65/publication/172/.

The efficiency enhancing effects of an FTT (it will reduce the resources wasted in the financial industry), along with the enormous amount of revenue that could be raised, are the reasons that a long list of prominent economists have argued for FTTs. The list includes John Maynard Keynes, Nobelists James Tobin and Joe Stiglitz, and Larry Summers, the head of President Obama's National Economic Council.

It is also worth noting that the U.S. already has a very modest FTT. Both stocks and commodities are subject to very small taxes. The revenue is used to finance the Securities and Exchange Commission and the Commodity Futures Trading Commission. Prior to 1964, the U.S. had a considerably higher tax rate of 0.04 percent on stock trades and 0.12 percent on the issuance of new shares of stock.