

## **Opinion: features of a practical and effective Financial Transactions Tax**

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In my opinion, it is possible, and not very difficult, to design a Financial Transaction Tax that is practical and feasible, meaning that evasion will be minimal, and that is effective, meaning that it will raise a substantial amount of revenue without unduly disrupting financial markets.

A practical and effective FTT will have a number of core features. It will:

- have broad coverage, especially within an asset class;
- be largely centrally collected, by clearing and settlement agencies and by electronic trading platforms;
- have a low tax rate relative to underlying transaction costs; and
- be assessed on market rather than notional values of derivatives.

A practical and effective FTT does not need to cover all asset classes, and does not need to be implemented by all countries or even all major financial centres. For example, London currently successfully unilaterally collects a Stamp Duty on only equities traded on exchanges.

The ultimate burden (incidence) of the FTT will be borne mostly by large dealer banks and hedge funds.

### **Coverage**

It is possible to levy an FTT on a single asset class, as shown by the London Stamp Duty on equity trading. Nevertheless, to minimize economic distortions through asset substitution, it is prudent to tax a broad range of assets, including equities, commodities, derivatives, bonds, money market instruments, and foreign exchange. This also makes it easier to collect the tax, since it is no longer necessary to distinguish between these instruments. For example, it is more difficult, though still possible, to tax only foreign exchange transactions, than to tax both foreign exchange and domestic currency (money market) transactions, when both are settled in domestic Large-Value Payments Systems.

Within an asset class, such as equities, it is important to tax all transactions by all types of traders. It is easy for traders to exploit exemptions by adjusting trading strategies and disguising trading intentions. Concerns to minimize the tax burden on retail traders and for trades directly related to real economy transactions are more effectively addressed through tax collection mechanisms and the tax rate.

Closely related asset classes should all be taxed. For example, both equities and derivatives instruments should be taxed, because they are close substitutes. A given financial position can be taken by trading either equities or derivatives, or both. See below for more on taxing derivatives.

## Collection

The most effective and comprehensive way to collect an FTT is through, and by, the centralized clearing and settlement agencies and electronic trading platforms. These agencies and platforms appear in all financial markets, both on-exchange and off-exchange (over-the-counter (OTC)), and are the foundation for modern trading in financial instruments.

In most cases, such as on exchanges, a single agency, the central counterparty, clears and settles all trades occurring in that market. Sometimes a single agency settles all trades occurring on multiple exchanges. In major OTC markets, such as foreign exchange and most derivatives, it is also the case that a single agency settles most trades. In foreign exchange this agency is CLS Bank; in derivatives it is MarkitSERV.

However, in some markets, trades may be settled by more than one agency. For example, in foreign exchange, trading may be settled either in CLS Bank or in domestic Large-Value Payments Systems. Thus, the FTT has to be collected in both systems. Coordinating this is not a problem, since a single transaction will only pass through one of these systems.

Sometimes trading occurs on unofficial 'exchanges', electronic trading platforms, provided by large dealer-broker banks. These platforms also serve as unofficial settlement agencies, because the host dealer-broker banks net out the vast majority (up to 80 percent) of the trades against each other before sending the remaining payment obligations on to a settlement agency. In this case, the host dealer-broker bank would collect the FTT on trading on the platform. Only a few banks are large enough to host such platforms, so it is feasible to enforce tax collection through verification of records.

Trades of financial instruments are nearly always settled in one agency. That is, they are largely mutually exclusive, so that a single transaction will not normally pass through more than one of them. The potential to tax a transaction more than once is therefore not a problem in practice.

In principle, it is possible to evade a tax on equities collected at an exchange by shifting trading to an exchange outside of the tax jurisdiction. (This is not possible in the case of foreign exchange and some derivatives, since settlement is globally centralized.) However, such trade-shifting can be avoided by designing the tax appropriately, as shown by the London Stamp Duty. Specifically, the tax should be associated with legal payment finality. That is, unless the tax is paid on the transaction, payment to settle a trade does not have official, legal, recognition or protection.

Centralized clearing and settlement agencies and electronic trading platforms constitute the fundamental infrastructure of interbank (perhaps now a more accurate term would be 'wholesale') financial markets. Most retail trading in financial assets uses a different infrastructure, namely, local retail banks. Thus, using clearing and settlement agencies and electronic trading platforms as FTT collection points implies that the tax would not, in fact, be collected on most retail financial transactions, those most directly related to real economic activity.

## Tax rate

The FTT is, in effect, a transaction cost, similar to other transaction costs, such as broker fees and commissions and other trading and settlement costs. As in any market, there is a relationship between transaction costs and trading volumes – the higher the costs, the lower the volumes. The FTT raises transaction costs in financial markets, and will therefore reduce trading.

The FTT should be set at a rate that raises significant revenues without reducing trading too much.

Given a proposed tax rate, we can estimate the ensuing reduction in trading volume based on the normal response of trading to underlying (pre-tax) transaction costs. The key factor in such an estimation is the magnitude of the tax rate relative to underlying transaction costs. That is, the key is the percentage increase in transaction costs due to the tax.

Underlying transaction costs are different across financial asset markets. For example, they are significantly smaller in foreign exchange markets than in bond markets. This is because of differences in the size and organization of financial markets. As another example, transaction costs in equity trading organized as an auction market (such as the New York Stock Exchange) are generally smaller than in equity trading organized as a dealer market (such as the NASDAQ).

To avoid distortions and differential impacts across financial markets, the FTT should be set at a rate that is constant relative to (differing) underlying transaction costs. For example, it could be set at a rate of a third or half of underlying transaction costs in all markets. Then the absolute tax rate would be different across asset markets. Thus, for example, the most commonly proposed tax rates are 0,005% for foreign exchange markets and 0,05% for equity markets.

The absolute burden of the tax on a trader in a given period depends, of course, on how much, and how often, the trader trades. Transaction costs in large markets are very low because trading volumes are so high. Trading volumes in interbank (wholesale) markets, dominated as they are by high-frequency traders, are orders of magnitude higher than in retail markets. So, again, the burden of the tax will fall most on traders in interbank markets.

## Market values of derivatives

Some financial assets are more complex than others. On one hand, buying foreign exchange spot entails a one-time payment of cash. On the other hand, buying a derivative entails making or receiving a payment later, depending on intervening movements in price or value of an underlying asset. Taxing spot foreign exchange is straightforward. However, in the case of a derivative, does one only tax the purchase price of the instrument (if there is one) and the subsequent payment or receipt specified in the contract, or does one also tax the 'notional' value of the contract, the value of the underlying asset on which the stream of payments is based?

This is not a question of feasibility, but of potential distortions caused by the tax. If the intention is to minimize substitution in trading between derivatives and their underlying assets because of the tax,

then one should tax notional values of derivatives, since this is the equivalent basis for taxing trades in the underlying assets.

However, transaction costs in derivative markets, relative to the notional value of derivatives, are already a fraction of costs in the underlying asset markets, and yet both markets co-exist. This is so in part because derivatives depend for their valuation on well-functioning markets for the underlying assets. Therefore, if the intention is to maintain current market structures, one should not tax notional values of derivative contracts.

### **Incidence of the FTT**

Large dealer banks and hedge funds account for the vast majority of financial transactions, using computerized, high-frequency trading strategies. Because most financial markets, especially those dominated by high-frequency trading, are highly competitive and speculative, there is limited opportunity for dealers and hedge funds to pass on the cost of the tax to other, smaller, traders. That is, dealers and hedge funds compete heavily to trade with smaller counterparties, both to gain market share and to obtain market information on which to speculate subsequently. Therefore, ultimately dealers and hedge funds will likely bear most of the burden of the tax.