By Robert Pollin

ECONOMIC PROSPECTS

A U.S. Financial Transaction Tax: How Wall Street Can Pay for Its Mess

As we continue to suffer the consequences of the 2008-2009 global financial crash caused by casino capitalism, one idea for bringing some measure of control over speculative financial practices that has gained worldwide support is to impose a tax on financial market transactions. This has been variously termed a financial transaction tax (FTT) and, more vividly, a "Make Wall Street Pay tax," an "anti-speculation tax," and a "Robin Hood tax."

Over the past year, a movement to establish such a tax in the United States has been energized by the National Nurses Union under the theme "Heal America, Tax Wall Street." The Occupy Wall Street movement has also strongly supported the idea as one of the few specific policy measures they are willing to endorse. Last November, Senator Tom Harkin and House Representative Peter DeFazio introduced a bill in the U.S. Congress for an FTT, although, as I discuss later, the tax rate they are proposing is far more modest than it needs to be. There is also strong support for an FTT throughout Europe as, among other things, one crucial new way for the European Union to raise public revenues and oppose the austerity agenda now engulfing the region. In Europe, this proposal is not only being supported by traditional progressive communities, but also by the Archbishop of Canterbury in the U.K., the Pope, and French President Nicolas Sarkozy, among others.

FTT BASICS

In its essentials, the idea of a financial market transaction tax is simple. It would mean that financial market traders would pay a small fee to the government every time they purchased any financial

New Labor Forum 21(2): 96-99, Spring 2012

ISSN: 1095-7960/12 print, DOI: 10.4179/NLF.202.0000013

market instrument, including all stock, bond, options, futures, and swap trades. This would be the equivalent of sales taxes that Americans have long paid every time they buy an automobile, shirt, baseball glove, airline ticket, or pack of chewing gum, eat at a restaurant, or have their hair cut.

The financial transaction tax can be used to address two distinct but equally important concerns. First, the tax discourages financial market speculation because it raises the costs—and thus reduces the profit opportunities—for speculators. But assuming the tax rate is not set high enough to shut down financial market trading altogether, the tax can also be a large new source of government revenues. The tax rates could be adjusted higher or lower, depending on whether the primary aim is either to shrink speculative market trading or to raise revenues, or to try to hit a sweet spot that achieves both aims to some meaningful degree.

EXPERIENCES WITH FTTS

It is important to recognize that the proposals now being advanced in both the U.S. and Europe by no means represent exotic flights into uncharted policymaking territories. In fact, financial transaction taxes have been a commonly used and generally effective policy tool throughout the world. Under financial market conditions closely comparable to those in the U.S., stock trading in the United Kingdom is subject to a 0.5 percent tax. This U.K. tax raises about $6.5 billion per year in revenues. Roughly forty other countries are either now operating with some version of such a tax or have done so in the recent past.

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Even the United States has long operated with a small transaction tax whose revenues, to this day, finance the operations of the Securities and Exchange Commission. Moreover, in the aftermath of the 1987 Wall Street crash, such a tax or similar measures were endorsed by then-House Speaker Jim Wright, a Democrat, as well as the Republican Treasury Secretary Nicholas Brady and the Director of the Office of Management and Budget Richard Darman, serving under President George H.W. Bush.

HOW A U.S. FTT COULD WORK

For stocks, the buyer could be charged, for example, 0.5 percent of the sale price, which had been the amount suggested by former House Speaker Jim Wright when he proposed a bill in 1987, and is the current rate in the U.K. stock market (the buyer and seller could also split the total fee). The tax could then be scaled for bonds, options, futures, and other derivative instruments based on the 0.5 percent rate on stocks. For example, to reflect the fact that bonds, unlike stocks, have a limited amount of time until they mature, the tax rate could be 0.01 percent for every year to maturity of the bond. Thus, the rate would be 0.1 percent on a bond that matures in ten years and 0.5 percent—the same as with stocks—on a bond maturing in fifty years.

A trading tax of this size would have virtually no impact on anyone who bought an asset and did not promptly resell it for a quick profit. For example, if someone bought shares of stock at $50 and sold them ten years later at

$100, this trading tax would be fifty cents per share (0.5 percent of $100) on a $50 capital gain (i.e., bought at $50, sold at $100).

On the other hand, a 0.5 percent tax would seriously reduce the profit prospects for short-term speculators, who now account for about 70 percent of all market activity. It is not uncommon for speculators to buy a stock or other financial asset, hold it for a day (or even hours), and then resell it for a small gain. If someone bought a share for $99 yesterday, then sold it for $100 today, the transaction would net a $1 capital gain, a good return on a one-day investment. But the tax in this case would again be fifty cents, wiping out half the earnings from the trade.

A financial transaction tax at a 0.5 percent rate on stocks and scaled appropriately for other instruments is not high enough, acting on its own, to adequately discourage speculation and channel credit to productive purposes. An FTT at this rate would be most effective as one measure among several others within a broader package of policies coming out of the 2010 Dodd-Frank financial regulatory law, assuming that Dodd-Frank is enforced seriously. Of course, one could use the tax to dramatically cut financial speculation. That would only entail raising the tax rate until the point where traders see little incentives to trade at all. But the aim of the tax should not be to shut off financial market trading altogether. For one thing, shutting down trading totally would mean that the tax revenues from trading would fall to zero. Also, to my knowledge, nobody has developed a coherent plan for operating today's U.S. economy in the total absence of financial market trading.

The FTT has the unique feature that even if it is set too low to dampen speculation, the revenues generated from the tax would provide major fiscal benefits at a time when new sources of government revenue are badly needed. Working with 2009 figures, Dean Baker and I estimate that a 0.5 percent tax on stock trades and the sliding scale described earlier for bonds and derivatives would raise on the order of $350 billion if trading did not decline at all after the tax was imposed. By this estimate, even if trading declined by 50 percent as a result of the tax, the government would still raise $175 billion.

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On its own, this level of revenue could cover about 15 percent of the entire U.S. federal deficit for 2012. These funds could also be used as a major new source of revenue for public investments in infrastructure and the green economy, and, as such, a major new engine of job creation. Crucially, the burden of the tax would fall most heavily on Wall Street speculators, who are almost entirely upper-income people. A U.S. FTT is thus fully in the spirit of the Occupy Wall Street movement.

SETTING THE TAX RATE HIGH ENOUGH TO MATTER

Of course, an FTT can neither generate large amounts of revenues nor discourage excessive speculative trading if the tax rate is set too low. The proposal now in the U.S. Congress by Senator Harkin and Rep. DeFazio would set the tax rate on all financial market trades—stocks, bonds, and all forms of derivatives—at 0.03 percent of the value of a trade. That is, the tax on a $100 trade would be three cents. This is one-seventeenth as large as the 0.5 percent tax that now operates on stock trading in the United Kingdom. Supporters of Harkin-DeFazio justify this low rate for the U.S. on the grounds that

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setting the rate higher—for example at 0.5 percent—could render financial market trading prohibitively expensive. Revenues generated by the 0.5 percent tax could then end up lower than at the 0.03 percent rate, since trading volume would fall excessively.

However, James Heintz and I recently examined a wide range of evidence on financial market trading patterns in the U.S. and elsewhere. We found that there is no scenario within a reasonable range of assumptions about market activities in which a 0.03 percent FTT will end up generating more tax revenues than a 0.5 percent tax. Rather, considering the full range of alternatives, we found that a 0.5 percent tax will produce between three and seventeen times more revenue than a 0.03 percent tax.

Beyond such specific issues, the major challenges for successfully implementing an FTT in the U.S. are not technical but political. Predictably, the Wall Street titans are vehemently opposed. Despite having been the main culprits causing the 2008-2009 global financial meltdown, and despite having been rescued from the consequences of their excesses through a U.S. taxpayer-funded bailout, Wall Street continues to exercise tremendous political power, in both the Obama administration and among Republicans. The FTT will therefore not possibly become law unless a large mobilization of political progressives follow the example of the National Nurses Union to fight hard to support it. Implementing the FTT would be one important tool for forcing these high-rollers to pay for cleaning up the mess they created. More broadly, the financial transaction tax can make major positive contributions toward forcing the financial markets away from the logic of the casino, thereby reordering the market's priorities on behalf of long-term productive investments and job creation.