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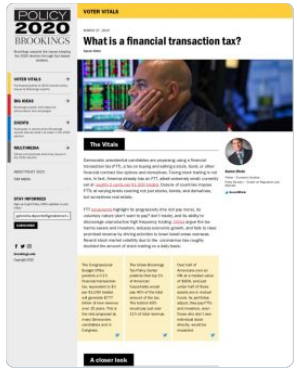
POLICY 2020 BROOKINGS

VOTER VITALS

What is a financial transaction tax?

The Vitals

A closer look

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What is a financial transaction tax?

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Economics / Financial Markets
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Take-Aways

- A financial transaction tax (FTT) is already in place in the United States.
- An FTT is a progressive tax, and raising it might curtail high frequency trading and rent-seeking activity.
- The biggest concern about a higher FTT is how the increase would affect US capital markets.

Recommendation

A financial transaction tax (FTT) as a new source of government income is a hot-button issue in the United States. In this focused, accessible overview, economist Aaron Klein explains how an FTT works, who pays it and what its potential revenues might be under different plans. He distills the debates about the ramifications of the tax and provides evidence from other countries of its possible impacts. Wall Street denizens and Main Street investors will find great value in this impartial report on a significant financial proposal.

Summary

A financial transaction tax (FTT) is already in place in the United States.

An FTT places a levy on the buy and sell orders of assets such as equities, credit instruments, derivatives and options. The United States already imposes a transaction tax of about two cents on every $1,000 traded.

> *"Everyone agrees that America's capital markets are essential to connect savers and investors to uses of capital and underpin our economy's ability to grow."*

Some supporters are recommending increasing the FTT to 0.1%, with some variations by type of asset. The US Congressional Budget Office estimates that, over 10 years, a 0.1% tax – roughly $1 on each $1,000 transacted – would raise $777 billion, equivalent to about 0.5% of GDP and to the total amounts collected via excise taxes in America.

An FTT is a progressive tax, and raising it might curtail high frequency trading and rent-seeking activity.

A higher FTT is progressive: The onus would fall mostly on the affluent. According to forecasts, the top 5% of income earners would pay 65% of the incremental tax burden. In addition, proponents note that it is a behavior tax – you can choose to trade or not.

> *"An FTT encourages longer term investments by emplacing a higher cost of trading. Indeed, this was the rationale that the late James Tobin, a Nobel laureate, used back in the 1970s when he proposed a transaction tax on currency trades that he called 'sand in the gears'."*

An increased FTT could curtail high frequency trading, which involves almost instantaneous buy and sell executions; such transactions might no longer be profitable under a higher FTT. Defenders of the FTT say that reducing high frequency trading could make markets less susceptible to wild price swings and discourage rent-seeking activity. Detractors of the FTT claim that high frequency trading supports a deep and well-functioning reservoir of liquidity that a greater levy would jeopardize.

The biggest concern about a higher FTT is how the increase would affect US capital markets.

Opponents argue that incremental revenue projections are too optimistic. They say that a higher FTT would harm the investing and trading community, and that it could make tapping the capital markets more expensive and thus diminish economic vigor. Millions of Americans hold equity wealth in their retirement accounts, and they would feel the financial impact through reduced returns.

> *"In...almost two decades there has been no observed impact on stock trading as a result of changes in the FTT. That said, the fee has always been so small that changes may not be relevant to what would occur at a higher level."*

Nonetheless, the existing FTT has not impeded US trading volumes, and other nations impose a trading tax as well. Hong Kong's FTT raises revenue equivalent to 1.7% of GDP, and Taiwan sees average revenue of 0.78% of GDP. But in Sweden and Germany, which imposed large-scale FTTs in the 1980s and 1990s, capital and trading fled to other locales. Sweden's tax shut down 50% of its trading, while Germany's one-year experiment resulted in a 33% decline in volumes. Pros and cons accrue to an expanded FTT, and discussions about coordinating the taxes continue among the G7 and G20 countries.

About the Author

Aaron Klein is a fellow at the Brookings Institution and its policy director on regulation and markets.