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A Flat Rate Financial Transaction Tax to replace all taxes?

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Summary

In this paper I propose a very radical reform of the taxation system, in which a single flat rate financial transaction tax (FTT) is used to replace the vast majority of existing taxes (including VAT, income tax, taxes on profits...). Existing economic data indicates that a flat rate FTT of 1% would generate far more revenue than is currently generated by all existing taxes, and would allow governments to rapidly repay debts and restore programs of public expenditure as well as allowing resources to be allocated to globally important challenges such as third world development, climate change and health issues.

Preface

The ideas in this paper have developed over the last couple of months and followed some animated discussions with friends and family at our home near Toulouse during the month of August 2010. The starting point was a discussion with my godson Jeremy, who wants to be a trader. Questions like "where does the money to pay traders' bonuses come from?" led to a fascinating debate. I would like to thank all those involved for the stimulation. In September 2010, I visited Brazil, one of the few countries to have tried implementing a true Financial Transaction Tax. Unfortunately, in that case, introduction of an FTT was not associated with dropping the other conventional tax mechanisms, and in the end was seen as just another additional Tax. However, at least one Brazilian economist was pushing for the sort of single tax option that I propose here, although he limited his discussion to Brazil (Cintra 2009). But I believe that, in fact, the same scheme could be extended rapidly at a global level.

The present version of this document is very much work in progress. I hope very much to get feedback that will help develop the argumentation. Although I have tried to use the best economic data that I could find, I am certainly not an economist, and there may well be important issues that I have missed. However, as of today (27th October 2010), my main aim is to get the ideas into the public domain and to encourage a wide-ranging debate.

Introduction

The financial state of many countries is very serious. In the UK, the government has just announced a massive program of cuts in public expenditure that is expected to lead to the loss of at least half a million jobs in the public sector as well a major cutbacks in spending on welfare. The situations in Greece, Spain and the Irish Republic are all very serious, with reductions in pay and deep cuts in spending. The origin of these harsh cutbacks lies in the financial crisis in 2008 that led to a massive bail-out of the financial system involving an enormous injection of funds, funds that will have to be paid for by tax payers in the years and decades to come. Given the huge debts that many governments have to cope with, there are few people arguing for increases in taxes to cover the costs, with the consequence that most people assume that the only real option is massive cuts in public expenditure.

But are massive cuts the only option? In recent years, more and more people have been arguing in favour of some form of Financial Transaction Tax (FTT), of which the so-called Tobin tax is one of the most well known examples (for an up to date review see http://en.wikipedia.org/wiki/Financial_transaction_tax). For example, both Nicolas Sarkozy and Angela Merkel have recently been heard supporting such schemes, and they are by no means alone. When such schemes have been presented, they have almost invariably been talking about very low rates such as 0.005% - just enough to slow down the currently frenetic rate at which financial transactions are taking place in the world's financial markets. The amounts of tax revenue that would be generated might be enough to allow for the constitution of a fund to reduce the risk of global bank failures of the type seen in late 2008 (see for example, the proposals outlined in the report "Taxing Banks" (Murphy 2010)). However, so far, there has not been any real question of using this sort of financial transaction tax to replace other forms of tax revenue, and more specifically, the possibility of using an FTT based taxation system to solve the current crippling debt problems faced by many countries. One notable exception is Brazilian Economist Marcos Cintra (Cintra 2009), who has argued for many years that a Bank Transaction Tax could potentially replace other traditional forms of taxation.

In this paper, I will look at the arguments in favour of a radical reform of the current tax system in which all the main sources of taxation (VAT, income tax, taxes on profits etc) are replaced by a single flat rate Financial Transaction Tax that would apply to everyone, traders and consumers alike.

In order to assess the potential for generating revenue with a Financial Transaction Tax, it is clearly necessary to have detailed data on the total volume of financial transactions in the economy. One reputable source of information is the Bank for International Settlements (<http://www.bis.org>) that publishes regular reports on the financial activity in participating countries. The latest annual report, published in December 2009, provides details of financial transactions for the period from 2004 to 2008, based mainly on figures from a set of 13 representative countries. Table 1 provides a summary of the different types of transactions detailed in the report.

Together, these different financial transactions total nearly \$9000 trillion per year. Is this a realistic number for the 13 countries that are analysed in the report? One factor that is difficult to control reflects the fact that some values for trading could be counted twice when a transaction includes two different countries in the group. On the other hand, there are also a number of places in the report where the numbers are simple not

available, meaning that the actual value may be substantially higher. Even so, the values are very impressive. Financial transactions within the United States total over \$3500 trillion, followed by the UK with around \$2200 trillion and Germany with over \$1500 trillion. These very high values no doubt reflect the high levels of financial activity associated with Wall Street, the City of London and the Frankfurt Stock Exchange.

Country	Credit Transfers, Direct Debits, Card Payments & Cheques	Payments processed by selected interbank funds transfer systems	Value of executed trades	Value of contracts and transactions cleared	Value of delivery instructions processed	Grand Total USD billions	Tax Revenue USD billions	Ratio
United States	79,628.92	1,323,446.20	43,325.63	1,441,300.00	601,347.26	3,568,676.92	2524	1414
United Kingdom	155,422.30	153,603.39	nav	1,611,235.06	210,135.44	2,285,818.50	881	2595
Germany	107,956.81	327,332.72	173,981.72	712,447.46	91,402.05	1,521,077.57	1249	1218
Japan	30063.77	364,540.82	44,440.61	25,176.78	227,273.68	691,495.65	1429	484
France	34,197.53	157,921.04	7,244.86	27,176.76	196,439.04	457,176.76	1060	431
Belgium	6,754.28	40,921.92	872.31	1,092.00	376,592.48	432,987.27	180	2405
Italy	14,284.99	65,215.14	26,450.82	44,344.08	98,310.75	262,890.79	786	334
Canada	11,319.99	47,960.88	12,772.78	216.85	57,514.76	141,105.25	160	882
Netherlands	9,058.11	89,099.11	4,459.90	9,206.70	nav	120,881.93	292	414
Switzerland	3,993.25	53,595.22	383.33	1,564.28	16,286.53	79,815.86	138	578
Hong Kong	nav	33,985.84	2,273.56	4,370.10	7,683.81	48,313.31	31	1558
Sweden	1,872.59	21,060.75	nav	522.21	18,153.60	43,481.73	211	206
Singapore	630.91	12,081.68	273.22	273.22	881.68	14,771.62	19	777
Total	425,149.76	2,326,588.42	272,082.58	3,853,773.90	1,674,974.66	8,977,719.08	8960	1002

Table 1: Financial transactions for 13 selected countries (billions of USD) for the period 2004-8 (source <http://www.bis.org> "Statistics on payment and settlement systems in selected countries", published December 2009). The table also provides the average tax revenues for each country (source <http://www.wolframalpha.com/input/?i=Total+Tax+Receipts>), together with the ratio between transactions and tax revenue.

The table also includes a column with the total amount of tax revenue for each of the 13 countries. The top five countries for tax revenue are the USA (\$2524 bn), Japan (\$1429 bn), Germany (\$1249 billion), France (\$1060 billion) and the UK (\$881 billion), and the total tax receipts for the 13 countries adds up to \$8960 billion. The comparison between the two figures, namely the total value of all the financial transactions, and the total amount of tax is revealing, because it demonstrates that financial transactions currently exceed income for taxation by a factor of more than 1000. It follows that if a flat rate financial transaction tax was introduced at a level of just 0.1%, it would generate the same amount of revenue as all the other taxes combined!

Before discussing whether or not such a move is desirable, we need to ask whether the same sorts of ratios between the levels of financial transactions and tax income would apply outside of the 13 countries covered by the BIS report. According to the Wolfram database, even when we take the total tax receipts for all 231 countries in the world, we still only reach a total of \$13.78 trillion – about 50% more than the 13 countries on their own. The reason for this is that many of the other nations have relatively small economies, although it should not be forgotten that some major economies are not in the list – countries such as China, India and Brazil. It seems likely that if we included financial transactions for the other 218 countries, that the picture would remain similar. Indeed, given the very strong trading position of countries like China and India, and the

relatively low wages paid to their workers, it is even possible that the ratio between financial transactions and tax revenue could even exceed the value of 1000 seen for the 13 selected countries. As a consequence, it seems highly likely that an FTT well below 1% and possibly as low as 0.1% could generate as much revenue as all the other sources of taxation combined, even when applied globally.

Most discussions dealing with the possibility of introducing an FTT have steered clear of using values as high as 0.1%-1%. Typically, the values that have been proposed have been much smaller – for instance 0.005%. One argument for using such low values is based on fears that such a tax could seriously reduce the amount of trading and that this would not only reduce the amount of tax that could be derived, but could also have negative effects on the economy itself. There are several reasons for believing that this would not be a real problem. While it is likely that there would be some reduction in activity in key locations such as Wall Street, the City and the Frankfurt finance centres, it seems reasonable to suppose there is enough activity elsewhere in the economy to provide the necessary revenue. For example, a closer look at Table 1 suggests it is clear that even in countries that are not very strong players in global finance, an FTT of 1% would be plenty to allow existing taxation mechanisms to be replaced. Only one of the 13 countries would require an FTT above 0.3% and even that country (Sweden) which is well known to have a particularly strong social services and welfare arrangements, is still well under 1%.

To make the argument clearer, I will therefore work on the hypothesis that we could introduce a flat rate FTT of 1%, a value that in principle would generate 10 times as much revenue as existing taxation systems, and which would still generate very large amounts of revenue even if there was a severe reduction in the quantity of financial exchanges.

The choice of a 1% value is also interesting for another set of reasons. 1% is already substantially less than the transaction charges imposed by credit card companies for handling card payments. Thus, even if the credit card companies directly transferred the additional costs to consumers, this would have little direct impact on costs. Remember that the proposal would be to remove all other forms of taxation, including VAT, meaning that for many purchases the net effect of the move would be a reduction in prices of as much as 20%. 1% is also very close to the sorts of bank charges that most consumers have to pay every time that they transfer money between banks, and it has become increasingly common for banks to charge a flat rate fee of \$2 or more for withdrawing cash from a cash machine. Of course, many operators in the financial services industry are used to paying no fees whatsoever when performing a transaction, and this is indeed one of the reasons why traders (and their computers) will happily make literally hundreds of operations per second. There can be little doubt that such players will object strongly to the idea of having a transaction fee to pay for each operation, even at a modest rate of 1%. However, there is no obvious reason why, when banks charge ordinary consumers large transaction fees every time they transfer money from one place to the other, banks themselves should be able to avoid paying anything at all.

The argument that an FTT of 1% might cripple the economy seems completely fallacious. If the operation is really worth doing, it will be still worth doing even if 1% of the transaction was paid to the government. More to the point, since everyone would

have to pay the same fee, the system would allow for true competition within the financial markets. Furthermore, there have been numerous cases of transaction taxes for particular situations in the past that have clearly not resulted in disaster. One obvious example is the 0.5% Stamp Duty on purchases of shares, introduced in the UK in 1986 and has clearly not prevented the development of the financial services industry in that country.

In the rest of this paper, we will discuss some of the advantages and disadvantages of this radical change to the way government spending is financed. First, we will look at the basic question of how such a Flat Rate FTT might be implemented. Then we will examine some of the advantages of such a scheme.

Implementing a Flat Rate FTT

Until relatively recently, a Flat Rate FTT would have been technically very difficult to implement, but with the introduction of electronic banking the percentage of economic transactions that can be directly monitored through the banking system has become increasingly high. Importantly, imposing a levy on each transaction would be extremely simple to implement – far simpler than the vast majority of taxation methods that are normally used.

With the simplest implementation, the tax raised within a particular country would go directly to the government of that country. In the case of a transaction involving the transfer from one country to another, a simple solution would involve paying solution would be for each of the countries involved to receive half the amount raised. Thus, with a 1% FTT, the source country would receive 0.5% and the receiving country's government would receive the other 0.5%. However, as can be seen from Table 1, the concentration of financial activity in three major players (the US, the UK and Germany) means that these countries would benefit much more from such an arrangement. Various possibilities can be considered, such as diverting a substantial proportion of the excess revenue into an international fund. Nevertheless, it can be seen that in most countries, the level of FTT required to completely replace all the existing sources of tax revenue is always well below 1%.

Another important question would concern the situation where not all countries have implemented the Flat Rate FTT. It has been calculated that roughly 97% of all financial transactions occur within states that are part of the G20 group. As a consequence, if the G20 nations were all to implement the scheme, the percentage of financial transactions that would escape the tax would already be low. However, it is clearly important to discourage countries outside the G20 nations from gaining a competitive advantage by not implementing the scheme. This might be achieved by imposing a higher FTT rate (for example 2%) for all transactions towards a country that was not involved in the scheme. Obviously, the precise value of this charge could be fixed such that individuals would not be tempted to make such transactions.

One area of the economy that would clearly be difficult to integrate into the system would be those transactions involving cash, because it is obviously difficult if not impossible to keep track of transactions that do not pass via an electronic payment mechanism. However, given the relatively low transaction value being proposed (1%), it is likely that the vast majority of users will naturally prefer to use electronic means

rather than cash for reasons of security. Even today, it is often possible to obtain lower prices by paying cash rather than using a credit card. And yet this does not prevent people from preferring to use electronic payment. Carrying large amounts of cash around is clearly very risky, and this is even more obviously a problem with larger sums.

Nevertheless, it will clearly be important to encourage more people to opt for electronic payment rather than cash, and new methods including top-up cash cards and mobile phones are coming on stream that are likely to make the use of cash less and less common in the next few years. One additional mechanism that could potentially be used to discourage the use of cash could be to impose an additional surcharge for withdrawing cash from a cash dispenser. For example, suppose that the charge for withdrawing cash was 2% instead of the 1% charged for making an electronic transaction. This would no doubt substantially reduce the attractiveness of using cash for payments.

Advantages of a Flat Rate FTT.

In this section I will consider some of the key arguments for preferring a Flat Rate FTT mechanism over conventional taxation methods.

A Flat-Rate FTT is fair.

For many people, the most important characteristic of any tax system is that it has to be fair. Imposing a 1% tax on all financial transactions, irrespective of who is performing the transaction, is by definition fair in that it would affect everyone in exactly the same way, irrespective of who they are, where they live and what their income is. Compare this with the current system in which the average man in the street will typically have to pay VAT at around 20% on everything that they purchase whereas traders in the financial industry can freely buy and sell currencies, bonds, derivatives and so forth at essentially no cost whatsoever. In many places, the tax burden for the least well off in society can be even higher. In Brazil for example, the government has imposed a tax on locally produced goods such as sugar and coffee that can be 40-50%. Surely, on the grounds of simple natural justice, such a system is not defensible. The natural instincts of any right-minded person would surely favour a taxation system where particular groups are not given favourable treatment.

A Flat-Rate FTT is cheap to implement

As already mentioned, with the advent of electronic banking, the imposition of a flat rate FTT would be remarkably easy and also very cheap to implement. In the end, it only requires a small modification to the software used by the banks and clearing systems to handle the transactions. Furthermore, it is far easier to check the operation of a system because much of the necessary monitoring system is already in place. For example, the Bank for International Settlements already has a detailed record of the vast majority of transactions that are currently being made. The difference with more conventional taxation methods could not be more obvious. For example, conventional income tax is particularly onerous to implement and it has been calculated that 3-4% of all the revenue raised by income tax is wasted in collecting it. And where there is deliberate tax evasion, the costs rise to 7% or more (Cintra 2009). This is clearly money that is just being wasted in the current system, money that would be used far more efficiently under the proposed mechanism.

A Flat-Rate FTT would be virtually impossible to avoid

With conventional taxes based on income tax, VAT declarations and so on, a great deal of effort and investment is spent on trying to minimise taxation. Indeed, there is an entire industry built around advising clients about the best way to avoid paying tax. In the case of an FTT based system, this sort of tax avoidance would essentially disappear because there would be no practical way of avoiding the taxes. Furthermore, the effort that would need to be invested to avoid paying 1% on a transaction would rarely be worthwhile.

Removing conventional taxes would make tax-havens largely irrelevant

Replacing conventional taxes on company profits would make the existence of tax-havens irrelevant. Since companies would no longer need to pay tax on their profits, there would be little point in transferring funds to off-shore tax havens. Money is only of any use when it is used to purchase goods and services or to make investments. Having money in off-shore accounts would therefore be of little use and would probably become irrelevant.

A Flat-Rate FTT would provide a level playing field

Competition between companies would operate with a truly level playing field. In the current situation multinational corporations have an unfair advantage over locally based companies because they are able to use devious accounting procedures to avoid paying taxes involving complex investment schemes in which profits are circulated from one location to another in order to reduce the amount of tax paid. Such methods are clearly not an option for companies that are based in just one country. As a consequence one of the very positive spin-off effects of switching from a profits based taxation system to one that only depended on the level of financial transactions is that it would greatly reduce the huge disparities between different actors in the economy.

Other advantages related to the switch from conventional taxes

The abolition of taxes on profits would be a major incentive to the economy.

The current tax system actively discourages companies from making large profits since large profits are invariably followed by large tax bills (unless, of course, the company is able to take advantage of the numerous loop-holes that allow them to avoid paying the taxes). In contrast, with an FTT based tax system essentially all the profits that the company makes can be used to improve salaries, make investments and pay dividends to shareholders. This would surely provide a very strong boost to the economy by directly linking pay levels to the company's success. Indeed, for this reason, it is conceivable that even a single country acting independently to replace profit-based taxation with a transaction tax could benefit because of the added incentive for industry to move production to that country.

Increased incentives to short production supply chains

Value added taxes of the type used within the European Union are not only complex to implement – they also have additional disadvantages compared with a simple FTT based mechanism. When the production of a particular commodity involves a large number of different stages, VAT-based mechanisms mean that in the end the total amount of tax recovered does not change, irrespective of the number of production stages because at each stage, the producer can recover tax paid at earlier stage. Consider a farmer who

grows wheat, and who pays someone to harvest it, then sends the grain to the Miller to be ground into flour who then transports it to a Baker who uses it to make bread and who then transports it to a distributor who transports it to a supermarket where the consumer finally purchases it. The consumer will pay the basic rate of VAT, irrespective of the number of steps involved. In contrast, under the FTT based scheme, the 1% transaction fee will need to be paid at each step in the sequence, every time money is paid from one person to another. For foods that have a VAT rating of (say) 5%, the total amount of tax would only be more for an FTT based system if there were more than roughly 5 steps in the sequence. However, for many goods, the effective VAT rate is often 20% or more. This means that the cost of the goods would often be lower using an FTT based system.

But there is another positive feature of the system. Imagine the effect for goods that are produced locally with very short supply chains. For example, consider a farmer who grows his own crops, grinds the wheat to produce his own flour, bakes his own bread and transports the goods to a local market using his own transportation. In that case, only the final purchase of the bread at the market would be subject to tax with the result that the effective tax rate would drop to just 1%.

This sort of price advantage for locally produced goods would greatly reduce the tendency of supermarkets to supply goods that are flown in from the other side of the world (with all the ecological consequences involved) simply because the current VAT based taxation system fails to penalise long supply chains.

Increased incentives for local exchanges

A related positive spin-off of using an FTT based approach comes from the fact that one area of the economy that would not be subject to such taxes would be local exchange systems (L.E.TS. Local Exchange Trading System). These are locally initiated, democratically organised, not-for-profit community enterprises which provides a community information service and records transactions of members exchanging goods and services by using the currency of locally created LETS Credits. While some might claim that such systems would gain a competitive advantage relative to more conventional money-based systems, the abolition of excessive VAT rates and their replacement by a low 1% transaction tax would mean that the advantage would in any case be very slight. But, in any case, it could easily be argued that such systems have a number of highly desirable features including the increase in local collaboration between neighbours, which is politically very positive.

Perspectives

We have seen that, given the incredibly high levels of financial transactions within the world economy, even a modest financial transaction tax (between 0.1% and 1%) would be sufficient to completely eliminate the need for the conventional tax systems that concentrate on taxing income, profits and sales. Nevertheless, it is not because one could in principle eliminate all existing taxes that one should. For example, there are numerous taxes that have other functions beyond that of simply raising revenue for governments. For example, high taxes on tobacco and alcohol can easily be justified on health grounds, and likewise taxing petroleum products can also be useful for ecological arguments. Nevertheless, the vast majority of taxes are typically seen as a necessary evil and few people would oppose their abolition.

One of the critical factors that determine whether a level of taxation is deemed acceptable is the level of taxation. When up to 50% of income is taken in taxation, many people find this excessive, even (and perhaps particularly) when the person in question is a high earner. This is no doubt one of the reasons why right-wing conservative parties can easily convince voters that taxation is a bad thing. However, if we lived in a world where there was a flat rate 1% fee on all transactions, would it still be possible to argue that this is excessive? I believe that few people would have any objection to such a modest level of taxation, especially when they know that that money will be used for financing areas that are chosen by the government that they have voted for.

If we take a country like France, the data from table 1 imply that a 1% FTT would generate at least 4 times as much tax revenue as is currently achieved. This is a colossal amount of additional income, and it could be used to do things that currently seem totally inconceivable. For example, within a short time France would be able to repay the national debt and thus avoid paying the crippling interest charges that are currently eating up an increasingly large proportion of the nation's resources. But the government could also use these resources to pay decent levels of pensions to all their citizens, as well as providing improved levels of health care and education.

Obviously, one potential criticism is that since the FTT mechanism means that the bulk of the income would go to the developed G20 nations that account for much of the transactions in the economy. However, there would be no reason why a substantial proportion of the revenues could not be used for third world development and solving global problems like the development of renewable energy sources that are important for climate control. It seems likely that many people in rich countries would be happy to see a substantial proportion of the revenues diverted to such highly deserving projects. Of course, whether or not a particular country will make such contributions will depend directly on who has been elected to the government in that country.

In this respect, it is interesting to note although the proposition of replacing the existing tax system with a single flat rate FTT is a radical reform, it is not obvious whether the mechanism should be described as either left wing or right wing. Obviously, the idea of abolishing all income tax will only affect those already paying income tax. However, the removal of VAT would mean an immediate increase in the buying power of even the poorest members of society. At the other end, the abolition of taxes on company profits will presumably appeal to every pro-business lobby and defender of free enterprise.

So, who could possibly object to the proposal? For the vast majority of people, the effects will be clearly very positive. For anyone being paid a salary and using their income to pay for buying somewhere to live, food and clothes and leisure activities, the cost of the scheme will be just 2% of their income: 1% that would be deducted when their pay arrives on their bank account, and 1% again when they use that money to buy things or to move it to a savings scheme. This would be an immense improvement over the current situation where they may be paying 25% of the income to the government in the form of income tax, and paying 20% again when they buy things. There are of course a small number of people who would clearly lose out. They are the people who are currently buying and selling stocks, shares, and currency very regularly, and in the case of banks the traders who are using computer technology to buy and sell hundreds of times per second. They are the people who are being paid "obscene" bonuses for siphoning money out of the system.

Would the world be a worse place if this sort of frenetic gambling were reduced? Looking at the numbers generated by the Bank for International Settlements, it seems clear that although a substantial proportion of global financial trading involves this sort of speculative gambling, there is nevertheless a very large amount of trading that corresponds to the real economy and which involves trading of real products and services. This real economy would certainly survive even if the superfluous and risky speculative trading were to disappear.

It could be argued that in a world where the only transactions that take place are those that have some real utility, the economy would be much more closely matched to the real requirements of humanity.

How can we achieve this change?

It is clear that there is currently considerable opposition to the idea of a FTT from the banking industry, for obvious reasons. They will clearly have little reason to want to support a change to the tax system that would reduce their profitability. However, if the proposal goes beyond merely adding an extra tax to the already bewildering array of taxation mechanisms, to a radical reform in which the entire system changed, it is less clear that the opposition would be maintained. But even if there was resistance from within the financial and banking industries, the fact is that for the vast majority of the voting public the benefits would be enormous and direct. At a time when many people are facing redundancy and cuts in their pensions together with drastic cut backs in public services, a system that would allow up to \$100 trillion to be poured into government finances would probably be very popular. Currently, voters have not been offered the option, but it seems likely that the first political parties to include such radical tax reform in their policies would obtain massive support. Governments voted in with a very strong mandate to introduce such a scheme would be able to implement it even in the face of resistance from the financial sector.

In conclusion, I would call on all political parties, be they on the left or right wing of the political spectrum to seriously consider this proposal, that I believe could provide a simple and fair solution to many of the worlds problems.

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