



## The potential of financial transaction taxes for development financing

Difficulties in raising sufficient resources to finance internationally agreed development goals and global objectives, such as combating climate change, have led the quest for new and innovative sources of development finance. As described in the United Nations *World Economic and Social Survey 2012: In Search of New Development Finance*, existing innovative financing initiatives have thus far raised limited resources and have been mainly confined to the health sector. However, the *Survey* highlights the potential of proposals such as taxes on the financial sector, which could raise substantial additional resources for international assistance. These include taxes levied on a range of financial activities, including currency transactions.

As proposed, a financial transaction tax (FTT) or a currency transaction tax (CTT) would be part of an international agreement by which Governments pledge to jointly implement such a tax and earmark (all or part of) the proceeds for international development cooperation.

### Growing support for an FTT... but will the revenues be as large as estimated?

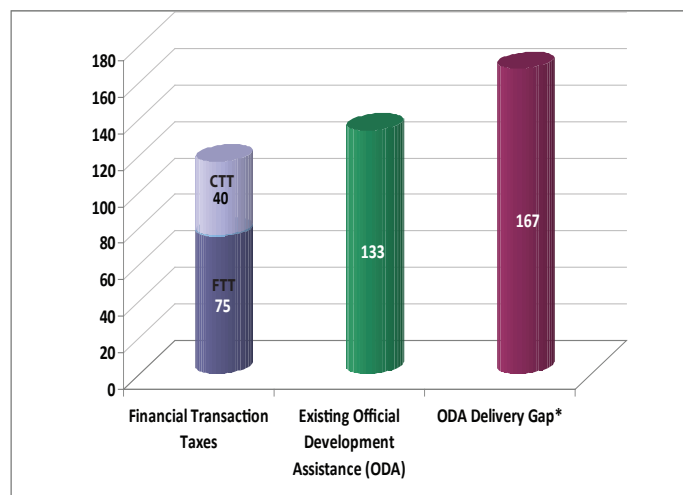
While there has been a plethora of proposals for taxing financial activity dating back to the 1930s, support for these mechanisms has increased in recent years. In November of 2011, France, then the Chair of the Group of Twenty (G20), put the FTT on the agenda of the G20 Leaders Summit in Cannes, and in May of 2012, the European Parliament voted in favour of such a tax. The growing support of governments for an FTT has, in part, been a response to intensifying international advocacy efforts by civil society organizations in search of additional development financing. Advocates across development sectors—from climate financing to education and agriculture – have understandably sought to tap these new mechanisms to meet their individual priorities.

Nonetheless, there is no clear estimate of how much revenue an FTT would raise, or how much of the revenues would be set aside for development cooperation. Estimates of the potential vary widely, in part because expected revenues depend on assumptions made on the

depth and breadth of the taxes. Estimates of the potential revenue from a CTT have been as high as \$400 billion per year, with estimates of broad based FTT as high as \$1 trillion per year—an amount that is a multiple of existing official development assistance (ODA). However, these large estimates generally do not sufficiently account for the potential adverse impact of the tax on the volume of trading, as higher costs associated with the tax will likely lead to fewer transactions. In general, banks that make markets in financial products earn profits from large volumes of financial market trades, with low profit margins on each trade. Because of this, even a relatively small tax can have a significant impact on trading margins and thus on the number of transactions. For example, it is estimated that increasing a CTT from one half of a “basis point” (0.005 per cent) to one basis point (0.01 per cent) would lower volume to the extent that total revenues from the tax would stay constant or even fall with the higher tax.

According to the *Survey*, realistic estimates of a tiny CTT put the revenue yield of a tax of one half of a basis point on all trading in four major currencies (the dollar, euro, yen and sterling) at \$40 billion per year. A tax on a wider range of financial transactions, such as equity trades, bonds and derivatives, could raise more resources. It is estimated that the proposed European FTT will raise approximately \$75 billion annually. The participation of

Figure 1. Potential revenue of a limited financial and currency transactions taxes relative to ODA disbursements and commitments (billions of United States dollars per annum)



Source: United Nations MDG Gap Task Force Report 2012 and United Nations World Economic and Social Survey 2012.

\*The ODA delivery gap is the difference between existing ODA and agreed upon UN targets (at 0.7 per cent of donor country national income).

the United States and other countries would obviously increase the revenue potential, but, to date, the United States has not been supportive of any form of FTT. Nonetheless, even when limited to Europe, as shown in the figure, an FTT and CTT have the potential to make a significant contribution to global financing needs, with estimated annual revenues nearly as large as existing annual flows of traditional ODA, even though — with the indicated scope — it would be insufficient to make up for the delivery gap between existing ODA and the agreed upon United Nations target (of 0.7 per cent of donor country national income). An FTT and CTT should therefore be viewed as additional to existing ODA, and not as substitutes for it.

## Double dividend taxation

There are several benefits of an FTT, which make it a particularly attractive complement to other forms of international financing. First, while a tiny tax would have minimal impact on transactions by non-financial customers, it would likely reduce the profitability and thus the volume of computer-operated high-frequency trades, such as proved so disruptive to the functioning of the United States equity market in the “flash crash” of 2010. There is already concern that such high-frequency trading threatens to exacerbate volatility in major foreign-exchange markets. Second, the tax would fall on a sector that is not yet heavily taxed. Indeed, financial transactions are exempt from the value-added tax (VAT) of the European Union. In addition, the FTT is a progressive tax inasmuch as poor people engage in relatively few transactions with financial institutions and the rich engage in many.

A concern voiced regarding imposition of an FTT is that it might reduce economic growth. This concern was, for example, raised in discussions on the proposed European financial transaction tax. However, recently revised estimates of the growth impact by the European Commission suggest that, if anything, such impact would be extremely small. Some independent studies have even argued that the proposed FTT could stimulate economic activity because there would be less financial market volatility.

## International agreements are necessary

While the potential is clear, it is not obvious that the revenues from financial and currency transaction taxes would become available for development cooperation. European Governments, for instance, who have agreed to the idea of introducing a concerted financial transaction tax, have not agreed on using the proceeds *for development*. Rather, they seem to be set to use the tax to finance a

shared financial safety net. Although, in theory, individual countries might allocate a portion of their taxes for international development, experience has shown that countries are unlikely to do so to a significant degree without a separate international political agreement.

## The way forward

There is a clear need for additional resources to address global needs. At the same time, the financial sector is severely undertaxed compared to other economic sectors. In addition, to the extent that the financial sector has benefited significantly from globalization, there is a view that revenues from taxing finance should be used to address global concerns. In particular, a CTT, which taxes international transactions, is by its nature a tax on financial market internationalization. In addition to countries appropriating a portion of taxes on domestic financial market transactions to international development, the international community should look to the implementation of a CTT to be allocated exclusively towards development and global needs, such as combating climate change.

This makes sense from an international public finance perspective: a small tax on currency transactions, which are largely undertaken by the wealthy, would serve the global public good of more stably currency markets and that of more equitable and sustainable global development. International forms of taxation are more than fitting in an increasingly globalized world.

In sum, financial and currency transaction taxes are technically feasible and economically sensible. They could readily provide the means of meeting global development financing needs. International agreement is urgently needed to enable implementation of these taxes, which should play an important role in financing sustainable development goals as part of the post-2015 development agenda. ■

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