



Briefing Note on a Financial Transaction Tax

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1. Introduction

The reasons put forward to introduce a financial transaction tax are many and varied. Some see this as an opportunity to make banks pay for the global financial crisis, others see it as a means to stymie financial speculation and others see it as a means to obtain money to fund global poverty relief. However, a financial transactions tax does not stand the test of policy scrutiny.

The Australia's Future Tax System (Henry) Review rejected the financial transaction tax option because it is an inefficient tax that would pose a risk to financial stability and impede economic activity. Indeed, a financial transaction tax would put the tax reform process in Australia into reverse. Stamp duty on share trading and financial institutions duty levied by the States were removed when the GST was introduced in 2000 because they were inefficient and imposed an unacceptable cost on the economy.

The International Monetary Fund (IMF) report to the G20 Ministers in June 2010 advised that there are better alternative means to a financial transaction tax to increase the responsibility placed on banks for the cost of any government intervention to repair the banking system. The IMF stated that "The argument that an FTT would cause little distortion because it would be levied at a very low rate on a very broad base is not persuasive".¹ It cautioned that the principles of public finance state that it is unwise to tax transactions between businesses.

There is no evidence that a financial transaction tax would reduce price volatility in financial markets but there are good reasons to believe that reduced liquidity may actually increase volatility. Moreover, a financial transaction tax does not discriminate between 'good' or stabilising and 'bad' or destabilising trading activity, so it harms the price discovery process that is vital for efficient resource allocation in the economy. A financial transaction tax would, however, stimulate socially useless and harmful tax avoidance activity.

A financial transaction tax would dramatically reduce activity on some key financial markets and would not meet its revenue objective, unless the target is set at a low level. Even then, there would be significant negative secondary revenue impacts for the Government as capital gains tax and income tax receipts would be adversely affected by reduced securities values and lower economic activity. The Commonwealth and State governments would also face higher funding costs for the debt they raise through the financial markets.

¹ A Fair and Substantial Contribution by the Financial Sector, Final Report for the G-20, June 2010.

2. Who Pays the Cost of the Tax?

2.1. A Tax on All Australian Investors

A financial transaction tax would reduce the value of shares and other securities held by all Australian investors. It would affect 'mum and dad' shareholders as well as institutional investors. 43% of the adult population, or 7.26 million people, own shares.²

An Australian tax on securities trading set at the minimum level proposed by the European Commission (EC) could reduce share prices by 2-3%.³ Based on data reported in the 2010 Share Ownership Study, this would impose a cost on the average individual share investor of around \$3,000-\$5,000 and a cost to the market as whole of \$25-\$40 billion.

In addition to this, investors would pay the financial transaction tax on all of their trades. Investors have become more active in managing their share portfolios with 43% stating in 2010 that they traded 4 times or more in the previous year. Individual share investors would incur the tax each time they trade. Transactions costs would be further increased by wider bid-offer spread; that is, the amount of value investors need to give up to complete a trade. These costs would also apply to other listed investments held by retail investors, such as property trusts, exchange traded funds, as well as unlisted marketable investments.

A financial transaction tax increases the cost of trading and both academic research and real market experience are unambiguous about the fact that higher trading costs reduce asset values. This is because investors who must pay higher costs to acquire or dispose of a security require a higher return from holding it, and thus are not willing to pay as much for it. Empirical research on overseas markets finds that the valuation premium placed on liquidity can be large. For example, the IMF has estimated using US data that a transaction tax of only *2 basis points* would initially lower stock values by roughly *1 per cent* and raise the cost of capital by *3 basis points*.⁴ The EC is proposing a minimum transaction tax of 10 basis points on securities.

² 39% of the Australian adult population own shares directly and others have indirect investments via unlisted managed funds – see 2010 Australian Share Ownership Study commissioned by the Australian Securities Exchange.

³ This estimate is derived using data from the 2010 Australian Share Ownership Study and applying the approach adopted in *Taxing Financial Transactions: Issues and Evidence*, Thornton Matheson, IMF Working Paper, September 2011.

⁴ This estimate is derived using the approach adopted in Matheson above.

Australia has a liquid equities market⁵, so the implication of international research is that the adverse impact of an Australian financial transaction tax on Australian investors would be significant.

Individual share ownership is less prevalent in Europe than in Australia, so the disadvantages suffered by ordinary investors from the imposition of a financial transaction tax is less of a problem for the EC than it would be for the Australian Government. For instance, the UK, Germany and Sweden all have share ownership rates that are less than half that of Australia's.

2.2. A Tax on Older Australians

A financial transaction tax would hit older Australians hardest amongst shareholders. As people move into retirement they typically have accumulated more financial wealth than the average person, as they prepare for retirement.

The 2010 Australian Share Ownership Study finds that the likelihood of share ownership increases with age. For example, 55% of Australians in the 55-64 age group own shares directly, compared to 28% in the 25-34 age group.⁶

Because older Australians hold relatively more financial assets, they are more exposed to a financial transaction tax due to increased trading costs and a reduction in the capital value of their tradable financial investments consequent to the introduction of the tax.

2.3. A Tax on Business

The corollary of the reduction in the value of traded securities is an increase in the cost of capital for Australian business. The more frequent a company's shares trade, the greater is the direct impact on their cost of capital. Academic research suggests that the impact would be significant, even for a tax set at the EC minimum level of 10 basis points.

For instance, IMF research using US data reports that a 10 basis point tax could increase the cost of capital by about 25 basis points.⁷ On a similar basis, the impact of this tax on Australian listed companies would be to increase their cost of capital by 10 basis points. The precise impact on the cost of finance for Australian business would need to be determined by more complex modelling that takes full account of behavioural changes that might result from the imposition of a cost on financial transactions. The cost could conceivably be higher.

⁵ The turnover ratio, or value of transactions/market capitalisation, on the ASX cash equities market was 0.97 in 2010-11.

⁶ See http://www.asx.com.au/documents/resources/2010_australian_share_ownership_study.pdf

⁷ See Matheson above.

The impact of the financial transaction tax would affect the cost of debt finance as well as equity finance. The effect would be both direct and indirect. The direct effect would probably be modest, as the Australian domestic corporate bond market is relatively small and primary market offerings would be exempt if an EC type transactions tax were adopted. However, the securities that are issued typically have a good turnover ratio, so the relative cost would be material for affected companies, although the precise cost is difficult to establish in the absence of further research.

Companies would likely encounter increased borrowing costs for their bank credit, as the cost of funds to banks would rise (see below). A financial transaction tax would also make it significantly more expensive for companies to manage their financial risks, including their exposure to interest rate and commodity price movements. Companies that trade internationally or obtain funds from international capital markets would also face the tax and higher charges for foreign exchange hedging facilities.

2.4. Upward Pressure on the Cost of Bank Finance

The costs of debt and equity funding are significant amongst a number of factors that influence the way banks set lending rates. A financial transaction tax would increase banks' funding costs in both respects. While some of the individual incremental cost components may be small, they could collectively be significant in terms of their economic impact.

Equity

The cost of equity in bank lending rates depends on a bank's amount of equity funding and the return it seeks on this funding. Different types of loans will have different amounts of equity allocated to them in accordance with their riskiness. Thus, for example, business loans require a greater share of equity capital than do home loans because it involves riskier lending. The amount of the equity cost in bank lending due to credit risk has increased since the global financial crisis.⁸ Moreover, the Basel III capital reforms will require a higher level of equity capital to be held to cover a bank's financial exposures (including credit, operational and market risk) – banks will be eventually required to have common equity equivalent to at least 7% of their risk weighted assets.

Against this backdrop, the higher cost of capital for business noted above will have a direct impact on Australian banks, especially as bank stocks are the more actively traded on the ASX. It is inevitable that these costs will feed into the cost of loan finance for households and business.

⁸ *The Effects of Funding Costs and Risk on Banks' Lending Rates*, Fabbro and Hack, Reserve Bank of Australia *Bulletin*, March 2011 estimate that the equity cost of funding business loans has risen since 2008 from around 120 basis points to 160 basis points.

Debt

Bonds are an important source of funding for Australian banks, accounting for around one-quarter of their liabilities. The indirect effect of a financial transactions tax on the economy, through a higher cost of bank loan finance to Australian households and business needs to be considered because banks on-lend the funds they raise on bond markets.

The Australian banks diversify their sources of funds by issuing bonds into a variety of markets and currencies. According to Reserve Bank data⁹, Australian banks and other financial corporations had \$182 billion on issue in domestic long debt issues in 2010. These securities trade in a liquid market with an estimated turnover ratio of more than 1.0.¹⁰ By implication having regard to the IMF research, an EC type transaction tax would increase bank funding costs by at least 10 basis points for their long term domestic securities funding, so the total effect on bank funding costs from this source could be of the order of a couple of basis points.¹¹

In addition to this amount, banks would incur a higher cost to hedge their interest rate risk on the exchange and OTC markets. This is because the EC type financial transaction tax is levied directly on derivatives transactions (at the rate of one basis point) and also because the price impact of establishing or unwinding a hedge through the interest rate derivatives markets would be higher in markets with substantially reduced turnover.

Australian banks issue larger amounts of debt on the international capital markets, most of which is issued in US dollars or Euros. Secondary market turnover of the securities issued offshore is not considered to be large and so it is less susceptible to the effect of a transaction tax that exempts primary issuance. However, the banks hedge almost all of their foreign currency bond issuance back into Australian dollars by undertaking interest rate and cross-currency swaps at the time of issuance, effectively raising Australian dollar funds.¹² An EC financial transaction tax will apply to derivatives transactions and also severely reduce liquidity in the markets, increasing the price impact of hedging transactions. This would increase the cost of overseas funding for banks, and while the amount of the net increase is difficult to determine without further research, it is likely to be at least several basis points.

⁹ Reserve Bank of Australia, statistical table D4; Debt Securities Outstanding - www.rba.gov.au/statistics/tables/xls/d04hist.xls

¹⁰ This assessment is made by reference to turnover in the *2011 Australian Financial Markets Report*, published by AFMA in October 2011.

¹¹ In addition, banks issued almost \$370 billion in short dated paper but this is predominantly a primary issuance market.

¹² RBA notes that cross-currency swaps are used to convert foreign currency payments into \$A payments. Interest rate swaps are often used to hedge semi-annual bond coupon against 3-month LIBOR, since cross-currency swaps are typically benchmarked to 3-month LIBOR.

2.5. A Tax on Labour

IMF research¹³ notes that, like the corporate income tax, the higher financing costs imposed by a financial transaction tax will in the long run fall more heavily on labour than on capital owners as the elasticity of the supply of capital increases. Thus, IMF advises that more efficient tax measures should be considered before a transaction tax is adopted.

The final incidence of corporate taxation was discussed at the recent Tax Forum in Canberra. Dr Ken Henry observed in his address to the Tax Forum that there is a strong consensus amongst tax academics that the incidence of the tax falls on labour in the case of a relatively small economy, like Australia's.

2.6. A Tax on the State and Territory Governments

Investors pay a premium for financial assets that have good liquidity features. Bonds issued by state governments in the 'semi-government' bond market are highly valued because they have strong market liquidity (turnover was almost \$600 billion in 2010-11, excluding repurchase agreements), which means investors can adjust their portfolios by buying and selling bonds at very low transactions costs, and interest rate risk can be efficiently hedged on the derivatives markets.

The semi-government bond market enables state and territory governments to fund their budgets and support infrastructure investment. The market has grown significantly in recent years and domestic long term bond issues were \$167 billion in aggregate at end-June.¹⁴ The state borrowing authorities have been successful in cultivating bond issues that have sufficient depth and liquidity to minimise their borrowing costs. By value, benchmark bonds account for at least 85 per cent of total issuance for all states and territories, except the ACT. The amount involved depends on the scale of each jurisdiction's borrowing requirement; for example, Victoria commits to maintaining benchmark bond lines at \$2.5 billion to \$3 billion, whereas the Northern Territory has 'institutional lines' with between \$300 million and \$500 million on issue. Typically, stocks on issue turnover, or change hands, several times a year.

An Australian financial transaction tax would disadvantage the states by increasing transactions costs and reducing liquidity in the market for their debt securities and, thus, increase their funding costs. Liquid lines of stock in the bond market trade at a notable premium to issues with the same credit rating that trade less frequently, so the impact on the states cost of borrowing from reduced market liquidity would likely be significant.

¹³ See Matheson above.

¹⁴ See *The Australian Semi-government Bond Market*, Lancaster and Dowling, Reserve Bank *Bulletin*, September 2011 for a description of the market.

Moreover, financial transaction taxes have a dampening effect on economic activity, which would also reduce the states' tax base.

An exemption from a financial transaction tax for the initial offering of bonds to the market by the states would not alleviate the higher cost of borrowing that would result from a less liquid market. Thus, it is apparent that the states could reasonably seek compensation from the Commonwealth Government for the adverse effects of a financial transaction tax, were it to be introduced at the Federal level.

2.7. Higher Commonwealth Government Funding Costs

The Commonwealth Government manages a significant debt portfolio and its bond issues constitute Australia's largest bond market; with turnover of \$690 billion recorded in 2010-11, with a turnover ratio of 4.3. The amount of Commonwealth Government securities outstanding was \$195 billion at end-June. Recognising the funding and broader economic benefits of an efficient government bond market, including the provision of a risk-free benchmark interest rate, the Government has contributed to the maintenance of a liquid market by careful and effective management of its debt program and related market facilities. The flexibility and efficiency of the bond market enabled the Government to raise finance to implement its macroeconomic support package in response to the global financial crisis.

For similar reasons to that outlined above for state government debt, a financial transaction tax at the level proposed by the EC would reduce market liquidity and the cost of hedging through derivatives like ASX24 government bond futures contracts would increase. The effect would be to make it more expensive for the Government to service its debt on an ongoing basis, at least in part offsetting the revenue it receives under the tax.

3. Implementation Issues

3.1. Business Mobility

It would be practically feasible for Australia to implement a financial transaction tax only if it were implemented at a global level. Even if the G20 countries were to agree to implement a uniform financial transaction tax, it would be necessary for all of Australia's regional competitors and other jurisdictions with capable and well-regulated financial sectors to implement the tax in order to avoid a significant loss of financial transactions business from Australia. Universal adoption of a financial transaction tax is very unlikely, as the economic and policy credentials of financial transaction tax are weak at best and jurisdictions like Singapore and New Zealand could well decide that it is not in their economic interests to impose the tax on their financial markets.

For instance, if Australia adopted a financial transaction tax but New Zealand did not, it is highly likely that a significant amount of financial markets business that presently takes place in Australia would in the future be done in New Zealand. This would lead to a loss of related income, employment and taxes in Australia.

International Evidence – The Swedish Experience

The international evidence is heavily weighted against a financial transaction tax and the Sweden experience presents a useful and well documented case study in this regard.

The Swedish government introduced a financial transaction tax on a variety of securities in 1987. The revenue directly generated by the tax fell well short of budget expectations, largely because local financial markets activity dropped sharply as it was switched overseas (especially to London). In addition, a consequent reduction in capital gains tax receipts almost entirely offset the revenue derived from equity transactions. Even a very low tax rate proved to be an inducement to move business to other markets. For example, during the first weeks of the tax on fixed interest securities, the volume of bond trading fell by 85% despite a very low tax rate (eg 3 basis points on 5-year bonds). The volume of futures trading fell by 98% and the options trading market disappeared.¹⁵ Consequently, the Swedish financial markets suffered significant harm in terms of their efficiency and effectiveness.

Reflecting on this outcome, the Riksbank (Swedish Central Bank) wrote to the European Commission in April 2011 counselling against a financial transaction tax and advising that it is not the optimal response to the aim of making the financial sector pay the cost of its negative externalities.

Business on financial markets that would be affected by a financial transaction tax is mobile to differing degrees. As the Financial Times noted in its editorial on 29 September, the City of London has a centuries old first mover advantage and a largely captive market for sterling equities financing that enables it to withstand stamp duty (with the benefit of important market maker relief). However, the market is still susceptible to competition from derivatives products; as noted in IMF research, the CFD market in the UK is stamp duty exempt and has grown significantly – estimated at 40% of market turnover in 2009. If a financial transaction tax was implemented in Australia at the minimum rates proposed in the EC, it is likely that some business currently conducted on the share market would similarly gravitate towards the CFD and equity derivatives markets.

In addition, markets for derivatives and especially new products would be more mobile and business would move to products or markets that do not incur a financial transaction tax liability. The process stimulated by response to the tax would beyond a certain point be reinforced by the attraction of transactions to the markets that exhibit good liquidity.

¹⁵ *Financial Transactions Taxes: The International Experience and the Lessons for Canada*, Marion Wrobel, June 1996, Government of Canada.

3.2. Practical Issues

It is operationally feasible to implement a financial transaction tax, especially in relation to business conducted through an exchange or clearing house but it is a difficult and expensive exercise and the costs to revenue ratio does not justify its implementation.

As discussed, in order to be effective the tax would have to apply globally – but there is no international uniformity or agreement on core concepts that underpin the tax. For example, the EC proposes to apply its tax to financial instruments and borrows the term "financial instrument" from the Markets in Financial Instruments Directive (MiFID) for this purpose. This MiFID concept does not exist in Australian law and generally the definition of key subsidiary products like derivatives vary between one jurisdiction and the next. Thus, the potential for a financial transaction tax to apply to different bases in different jurisdictions because of the difficulty in agreeing common concepts is a significant implementation problem.

Apart from this, different jurisdictions are at different stages in their economic and financial sector development. Therefore, they may not wish to apply a financial transaction tax at a common rate (the EC proposal recognises that rates may vary even within the EU) or apply it to the same base.

The Government's Tax Forum in Canberra highlighted the real challenge in an Australian context to get uniformity on state taxes. Getting agreement on the meaning of common terms is also an issue in negotiating bilateral international tax treaties. The global context for a financial transaction tax would have to be very carefully thought through and it would have to overcome very significant implementation challenges.

The implementation of a financial transaction tax along the lines proposed by the EC would impose high compliance costs on banks and other financial institutions. For a start, a large amount of financial market transactions do not currently pass through a central clearer or get recorded in a trade repository. Even if global initiatives in this area achieve their objectives, many customised financial market transactions will not in the future be dealt with through these facilities. Hence, the individual financial institutions would be collectors of the tax for many transactions and they would have to put in place the infrastructure to capture and record trades in a manner that would enable tax to be collected and the necessary tax compliance requirements to be met.

Additional complications arise with the joint and several liability that attaches to obligations under the EC's proposed financial transaction tax. This would require a detailed legal and counterparty risk analysis to be undertaken in respect of proposed dealings that would potentially be liable to the tax, which could be a complex and expensive exercise.

A further significant cost that would be imposed on taxpayers under the EC proposal is the obligation on company groups to collect tax on intra-group transactions. This approach is in contrast to the Australian income tax system and the GST, which permit corporate tax liabilities to be assessed on a group basis. This also contrasts with APRA's approach to bank prudential supervision that is focussed on group arrangements under its conglomerate rules. It also conflicts with the economic construct and operation of company groups. The economic costs of imposing a tax on intra-group transactions would be well in excess of normal tax compliance costs because the restrictive approach would impede the effective allocation of capital within a financial services group, reduce risk mitigation opportunities and impair the efficient management of financial and business risk at the group level.

3.3. A High Tax Relative to Margins in Australian Financial Markets

The EC's financial transaction tax would be set at a minimum rate of 10 basis points for securities transactions and 1 basis point for derivatives transactions. The expectation is that a tax at these levels will dramatically reduce turnover on financial markets – for instance the EC in its impact assessment accepts that derivatives turnover may fall by between 70 and 90 per cent. This is consistent with Sweden's experience in the late 1980s, as outlined above.

Margins on the Australian financial markets are tight reflecting a strong level of competition in the markets. Following on from Sweden's experience, Australia would be open to a similar sharp reduction in turnover if it were to introduce a financial transaction tax.

A financial transaction tax of at least 10 basis points would be a significant additional cost imposed on share investors in the context of a market bid-offer spread for S&P/ASX 200 Index securities of 22 basis points in 2010. Spreads on the government bond markets are much narrower and are typically less than 1 basis point for client trades, while repurchase agreements can be as tight as 1 basis point.

A financial transaction tax of 1 basis point would be very large relative to the bid-offer spread in the most active derivatives markets. Institutional OTC derivatives markets often record spreads in the 1-2 basis point range. The most actively traded interest rate futures contracts on ASX24 may trade on bid-offer spreads of 1 basis point or less. The ASX Index futures spread was 3 basis points in 2010.

The cost to market users would be much greater than the cost of the financial transaction tax, as bid-offer spreads widen as liquidity falls and the price impact of transactions increases.

4. Consistency with Other Government Policies

Well-designed tax reform can reinforce other government policies, such as promoting competition in banking, developing a retail bond market, lowering financial system risks, and enhancing Australia's competitiveness as a financial centre. A financial transaction tax would be marked down sharply against this benchmark.

4.1. Conflict with Bank Competition Policy

Financial markets generate significant competition for financial intermediaries, like banks, and they would be disadvantaged by the EC's financial transaction tax, which would be levied on securities transactions but would not apply to bank loans. The financial transaction tax would tilt business back towards bank credit intermediation and reduce the competition that debt and equity markets present to banks.

Business models, like securitisation, that rely on wholesale market funding to support consumer and business finance would be disadvantaged by the higher cost of funding on financial markets. The securitisation market was a new and highly effective source of competition for bank lenders from the mid-1990s until the global financial crisis. The growth of securitisation reflected the change in the composition of lenders in the mortgage market following the entry of mortgage originators, who relied predominantly on securitisation for funding. Thus, a financial transaction tax would in part frustrate the Government's policy to promote competition for the major banks by the regeneration of the home loan securitisation market. A financial transaction tax would in this way adversely affect the smaller participants like regional banks and some credit unions that would seek to rely on the securitisation market to develop their business offerings to their retail clients.

In a similar vein, a financial transaction tax would also run counter to the Government's current initiatives to develop a covered bond market for issues by Australian banks and also a retail bond market. While it would not prevent important progress being made in this area, it would limit its potential success to below that which would currently be achievable.

The corporate bond market is an alternative source of funds for large Australian corporates and, thus, provides competition to bank intermediated finance. Corporate bond issues have similar characteristics to syndicated loans, as they provide large amounts of finance, involve at least several financiers and may suit large companies.

The Government has stated that a vibrant domestic corporate bond market is critical to putting competitive pressure on bank lending rates to business, and to harnessing our national superannuation savings so we can domestically fund more productive investment in our economy, reducing our reliance on offshore wholesale funding

markets. A financial transaction tax would clearly inhibit development of the corporate bond market. It would also conflict with the Government's object to promote development of a retail bond market. Indeed, it would be inconsistent with the G20 Finance Ministers' agreement at their recent Paris meeting to support the development and deepening of local currency bond markets.

With respect to equity finance, companies seeking to raise finance for investment may tap the share market as an alternative to debt funding through bank loans or marketable securities. While the intrinsic properties of debt and equity differ in fundamental ways, from both an issuer and an investor perspective, they are imperfect substitutes that may have more or less relevance at different points in time. For example, listed companies were able to raise equity capital quickly and efficiently during the global financial crisis, when debt markets were constrained.

4.2. Conflict with Financial Market Stability Objectives

Turnover on financial markets may seem high relative to domestic and international economic transactions. Some promoters of a financial transaction tax offer this as evidence that speculation on financial markets needs to be constrained by a financial transaction tax. This claim does not stand up to scrutiny.

Trade in foreign exchange and derivatives are sometimes compared to the recorded level of international trade through imports and exports. This comparison is limited value as foreign exchange and derivative hedging transactions may relate to international trade flows, international investment flows or to the large stock of international investments outstanding. For example, an Australian fund manager that wished to purchase an exposure to the shares that comprise the Dow Jones index but wanted to avoid related foreign exchange risk could do so by also purchasing a US dollar hedge for their investment.

Another reason why financial transactions may seem unusually large is that their maturity may be quite short and positions get rolled over. For example, a \$10 million repurchase agreement position with a maturity of a week (which is common) would generate market turnover of \$520 million over the course of a year. In contrast, a one year bank loan for \$10 million would generate 'turnover' of \$10 million over the course of the year. Similarly, the rollover of derivatives positions over the course of a year will generate a high level of turnover but this of itself is not indicative of a high level of financial or systemic risk being generated.

Financial institutions face prudential limits determined by their regulators on the open FX and other financial exposures they hold. Therefore, if they receive a large commercial order for which they do not have an offsetting hedge, they must adjust their exposure by trading out of the position to restore the desired balance. A number of

other banks may pick up part of that exposure in the interbank market and they themselves may seek to trade out of some part of this risk in order to manage their own risk in a responsible manner. In this way, the risk initially taken on by the first bank is spread across banks in a manner that promotes equilibrium across the system.

These transactions may be supplemented by other connected financial transactions, such as multiple movements of collateral (including securities) as prices fluctuate to reduce financial risk over the course of an arrangement. These transactions may also be caught under a financial transaction tax.

From a financial system regulatory perspective, it is not desirable for a financial transaction tax to materially inhibit this risk allocation process. One implication of this process of sharing risk across the market is that even a 'small' tax would cascade across the market and distort risk allocation outcomes. Meanwhile, speculators betting on a significant change in a market price would not be deterred by the tax.

It is also relevant to note at this point that financial institutions globally are in the process of implementing changes to the infrastructure for OTC derivatives market, like centralised clearing of transactions. This is part of the G20 regulatory reform program to reduce systemic risk in financial markets. These reforms are complex and costly to implement but the expectation is that they will make a significant contribution to reducing the risk of financial instability. There is no place for a financial transaction tax within the framework of these reforms; rather, its introduction would threaten the economics of the new infrastructure being developed and be counterproductive to the reform objectives.

Some equity and foreign exchange dealers use algorithms to automatically hedge risk in their inventories or to clear positions in an efficient manner. Customers may also use trade execution management systems that seek to reduce the market price impact by breaking up trades into smaller amounts that are more easily absorbed by the market with a given level of liquidity. A variety of other participants including investment funds and proprietary traders use algorithms to engage in statistical arbitrage or other forms of technical trading. These are legitimate activities that assist the price discovery process.

Innovations like high frequency trading (HFT) have had a marked impact on the functioning of the markets in ways that could be seen as beneficial. The available academic evidence on equities markets is still developing but it suggests that HFT has actually increased liquidity and reduced bid-offer spreads. The Bank for International Settlements (BIS) has observed in respect of the FX market that HFT helps to distribute liquidity across the decentralised market, improving efficiency, and has narrowed

spreads.¹⁶ However, it also notes that the introduction of HFT to the market has affected the ecology of the FX market in ways that are not yet fully understood and that questions remain about HFT participants' willingness to provide liquidity on a sustained basis. These are matters for further research and it would be both pre-emptive and inefficient to use a financial transaction tax to stem trading activity on financial markets. Moreover, there is widespread concern that reducing liquidity through a transaction tax could be counterproductive and increase the risk of instability.

In accordance with the widely accepted principles of good regulation a determination would have to be made that HFT and algorithmic trading constitute a market failure of such nature that it warrants an additional regulatory response. An assessment of this type would take account of price filters and circuit breakers and other operational controls that have been or could be introduced to curtail any perceived risk to an orderly and efficient market. Any further measures should be designed and implemented to target the identified risks.

A financial transaction tax would be a substantially inferior option in this regard, as it would completely fail to discriminate between economically productive market transactions and speculation that may be unproductive. One of the themes on good tax design to emerge from the discussion on social taxes at the Tax Forum in Canberra was that a tax should specifically and cleanly attack only the targeted misbehaviour. A financial transaction tax fails this test, as it does not discriminate in its application.

4.3. Conflict with Bank Liquidity Regulation

The proposed financial transaction tax runs counter to the Government's and the G-20's measures to enhance the liquidity regulation of banks.

The Basel Committee on Banking Supervision announced its global framework for promoting stronger liquidity buffers at internationally active banking institutions in December 2010. This was followed by guidance from APRA and other national prudential regulators on the implementation of the Basel framework in their jurisdiction, with full implementation targeted for 2015.

The cornerstone of the new Basel framework is a requirement for banks to have sufficient high-quality liquid assets to survive an acute stress scenario lasting for one month. The bulk of high-quality liquid assets in most jurisdictions will take the form of holdings of marketable government debt – indeed; these are the only Australian assets that APRA recognises as being liquid at present.

The EC acknowledges that the introduction of a financial transaction tax will reduce liquidity in the market for securities, which include government debt securities and any

¹⁶ *High-frequency trading in the foreign exchange market*, BIS Report, September 2011.

other securities that bank regulators accept as being liquid assets for the purpose of the new Basel rules. Indeed, an objective of the EC tax is to reduce liquidity on certain financial markets. The tax would also adversely affect the market for repurchase agreements, which are a core instrument for balancing the liquidity of banks and other financial institutions and as such bring more stability into the financial market.

This all means that the intrinsic liquidity value of actively traded government securities will be reduced, which is distinctly unhelpful to achieving the objectives of the new Basel liquidity regime. Moreover, the imposition of a tax on securities transactions will inhibit attempts to develop existing and new securities markets so their turnover reaches the threshold at which they too might be considered to be a liquidity asset (and in Australia's case, hence, the tax will increase reliance on the Reserve Bank facility for liquidity).

5. Why the European Proposal is Not Relevant to Australia

The European Commission proposal for a financial transaction tax is founded on 3 objectives, none of which are applicable to Australia.

The Commission's Executive Summary defines the following general objectives for the proposed financial transaction tax:

1. Raising revenue and an adequate contribution from the financial sector;
2. Limiting undesirable market behaviour, thereby stabilising markets;
3. Ensuring the functioning of the Internal Market (avoid double taxation and distortion of competition).

Revenue raising

The EC cites the budgetary cost of supporting the financial sector during the financial crisis and the advantageous treatment of banks under the EU value added tax (VAT) regimes because of the exemption for financial services. These are not reasons to introduce a financial transaction tax in Australia.

First, Australia has not needed to inject funds into the banks or the financial sector more generally because our banking system remained sound throughout the crisis. This was due to a variety of factors including good management of the economy, effective financial regulation and sound business practices. Moreover, Australian banks and financial market participants have incurred significant costs, and will incur more into the future, in responding to the very comprehensive regulatory initiatives being implemented by G-20 governments, through BIS and IOSCO sponsored processes in many areas, to sharpen the focus of regulation and tighten control of risks generated by the financial system.

Second, one of the notable differences between the Australian GST and European VAT regimes is that Australia has much more extensive taxation of financial services, like brokerage and supply facilitation. Banking products like deposit taking and loans are exempt from both GST and VAT (ie they are input taxed) but these product lines would not be taxed under the EC's financial transaction tax either, so there is a poor alignment between the policy measures and the objectives. Moreover, recent research by the Australian Treasury has found that the finance and insurance industry pays tax at a higher level than the economy wide average tax rate.¹⁷ The financial sector accounts for 10% of GDP and provided 34% of company tax receipts in the period 2007-09.¹⁸ In addition, the financial sector pays Government levies to cover the cost of APRA regulation and AUSTRAC's supervision costs. The Government is also consulting on a proposal for a new levy on market participants to cover the cost of market supervision.

Third, as mentioned above, individual share ownership is much less prevalent in Europe than in Australia, so the disadvantages suffered by ordinary investors is less of a problem for the EC than it would be for the Australian Government.

Limiting undesirable market behaviour and thereby stabilising markets

The EC acknowledges in its impact statement that "the short term trading the STT is meant to eliminate is not proven to be detrimental to price discovery. Neither is there a clear link between short term trading and long-run cycles of asset mispricing (bubbles)". Hence, on the terms of its own analysis, there is not a clear case for action in respect of the EC objective. Moreover, the effect of domestic and global regulatory reform has been to greatly reduce risk within the financial system. As discussed above, the available academic evidence suggests that HFT has actually had beneficial impact on markets. This is consistent with our understanding of the Australian experience. Moreover, the global regulatory changes cited above significantly reduce risk within financial markets and the financial system. However, if there is a need to respond to the changing trading methods, then a financial transaction tax is a highly inferior policy option.

Ensuring the functioning of the EU Internal Market

This objective is internal to the EU and is not relevant to the Australian situation. However, the challenges the EU faces in reconciling and coordinating its internal tax policies can be taken as being indicative of the much greater challenge that would have to be overcome in implementing a financial transaction tax at a global level.

¹⁷ *Average rates of company tax across industries revisited*, Clark, Greagg and Leaver, Economic Roundup, Issue 2, 2011.

¹⁸ See ABS catalogue 5206.0 for sectoral GDP data and ATO's *Taxation Statistics 2008-09* for company tax data.

Australia has shown steadier judgment in managing the economy and supervising the banking and financial sector. The financial transaction tax is an example of where we should not follow the lead being suggested by the European Commission, as it will ultimately harm our financial sector and the economy.

Australia's closest competitors in the provision of financial services are in the Asia-Pacific region, so the risk to the Australian financial sector and economy are far greater from loss of business to other jurisdictions than European economies, whose neighbours would be covered by a financial transaction tax. An agreement on the imposition of a global financial transaction tax would require agreement from a large number of jurisdictions that are not represented at the G-20.

Issues for Developing Countries

The EC's proposal does not involve the allocation of funds generated under the tax to programs to assist developing countries, rather its purpose is to supplement national budgets and/or finance the EU. However, a global financial transaction tax would harm developing economies more by deterring development of their financial markets and the growth of liquidity in their financial systems. For instance, it would run counter to the Asian Development Bank's strategic initiative to develop bond markets in the region.

In addition, the Euro-zone countries would secure an international trade advantage, as a major part of their cross-border business transactions occur within the Euro-zone and, hence, technically would not be impacted by the introduction of a financial transaction tax that encompassed FX (this is because FX conversion is not necessary with a common currency and there is no related FX exposure to be managed). This is in contrast with Australia and other economies, including small developing economies, whose ordinary international trade would suffer an additional tax – including when they compete against for business with local firms in the Euro-zone area.
