LaRouche's proposed derivatives tax would solve budget crisis

by Richard Freeman

On March 9, Lyndon LaRouche intervened in the economic crisis to propose a plan that is as exquisitely simple and direct, as it is potentially effective in its execution: a sales or transaction tax on the turnover of "financial derivative" securities or financial instruments. Each time such a security or instrument is traded, he said, it should be taxed at 0.1% of its face value, or, as it is called in the derivatives trade, its notional principal amount.

No more than that simple "least action" step is needed.

The tax will raise between $60 and $80 billion in federal tax revenues in its first year of application. That is a very handsome sum for the U.S. government.

Although bankers will catalogue why the explosion in financial derivatives since 1986-87 is absolutely essential— "they hedge risk," "they make the markets more efficient" and so forth—their rationalization is *post hoc* nonsense. A financial derivative is a speculative, highly leveraged instrument, capturing interest rate or currency-related spreads. Rates of return on financial derivatives can vary from 10-15%, up to 2,000%, and even higher.

Taken as a whole, the financial derivatives market, orchestrated by financiers, operates with the vortical properties of a powerful hurricane. It is so huge and packs such a large momentum, that it sucks up the overwhelming majority of the capital and cash that enters or already exists in the economy. It makes a mockery of the idea that a nation exercises sovereign control over its credit policy. What good is a U.S. government policy to inject a few billion or even hundreds of billions of dollars of credit into the economy for jobs or other programs, when the financial derivatives market can overwhelm and counteract the effects? One hundred billion dollars is but one one-thousandth the size of the financial derivatives market. It is the financial derivatives market that organizes the overall geometry of, and thus significantly determines, how the U.S. credit system functions.

In his weekly "*EIR* Talks with Lyndon LaRouche" radio program on April 28, LaRouche told interviewer Melvin Klenetsky:

"This is *sucking the lifeblood*, in the same way that Michael Milken and his raiders were doing, who were stealing from people's pensions and so forth with junk bonds and these acquisitions. It's sucking the lifeblood out of industries, out of pensions, out of households—out of everything—out of our businesses, out of our farms. These people are thieves."

This vast market in the tens of trillions of dollars is international in scope, although 65% of financial derivatives trading occurs in the United States. But lawfully this international market must melt down. It will follow the path of every bubble in history since the tax-farming pyramiding schemes of the treasury of ancient Babylon and Imperial Rome up through A.D. 300, to the notorious John Law financial bubble in the eighteenth century. The violent effects of an explosion of the derivatives market bubble will far overshadow, the collapse of the leveraged buy-out bubble combined with the October 1987 stock market crash, liquidating one-third the value of the market within weeks, and the $350 billion expended since 1987 for the bailout of the commercial banks and savings and loan institutions.

Hence, LaRouche proposed that America re-assert sovereign control over its power of credit issuance through the transactions tax. The tax will also introduce transparency: Since each transaction to be taxed will be registered, the tax will act to identify the major players controlling the market. Such tax proposals have been made at earlier periods in the nation's history (see box, p. 36). The financiers fiercely resisted them, and usually prevailed. But this time, the stakes are immensely greater than ever before in history.

How the tax works

To understand how the tax will raise $60 to $80 billion in revenue, and how it will bring the derivatives market under control, let us examine the different kinds of derivatives markets that the tax will encounter, and how the tax will apply in each case. These instances simultaneously provide a useful bird's eye view of the incredible levels of deadly leverage at work. We will conclude by showing how the revenue from the tax is calculated.

Currently, the derivatives markets, and other financial markets, *pay zero percent sales tax on trades*. Most states apply a general sales tax of between 4.5 and 9.0¢ on the dollar; that is, a tax is assessed equal in value to between 4.5 and 9% of the value of the purchase (transaction) made at the store. Under the LaRouche tax proposal, each trade of a financial derivatives market instrument will be assessed a "sales" tax equaling just 0.1% of the value of the purchase, far less than the rate citizens pay every day. It is absurd and

dangerous to continuously raise the tax on Social Security and to apply an energy BTU tax, which will devastate every sector of the economy, while the transactions—as opposed to the realization of profit—of the financial derivatives market, which are harmful to the economy, go untaxed.

With a sense of poetic justice, the LaRouche tax will provide *reverse leverage*. As will be shown, the higher the leverage operating in a particular market, the more the LaRouche tax will bite. The less-leveraged markets, such as the stock-equity and the bond markets, which in normal times are helpful to an economy in supplying equity capital or debt for new capital formation and expansion, will be least affected. The tax will help return these markets to their true function.

Applications of the tax

As a simple example of the transaction tax, consider the case of an application of the tax to a stock. Take the random case of the oil giant, Amoco, which at the close of trading May 14 was worth $55.50 per share. A 0.1% transaction tax would add 5.6¢ to the cost of a share—less than half the value that Amoco stock moves every day in a quiet market. Let us take the case where someone is buying the Amoco stock through a broker. The brokerage commission would be 4 to 8¢ per share traded. The tax adds a small, but real impediment: It roughly doubles the per share cost of purchase to what the brokerage commission fee alone would cost. While the cost is not very large, representing 0.1%, it is important. It makes the purchaser less financially able to rapidly turn over trades in the stock, and makes him hold the stock a longer term for the dividend yield, rather than trading short term for its rapidly changing price.

Next, attention is turned to application of the tax to the futures market. The futures market has exploded, largely through the introduction of trading in financial instruments. All through the 1950s and 1960s, up until 1970, the volume of yearly trading of futures rarely exceeded 10 million contracts. By 1992, however, annual trading volume climbed to 289 million, 29 times the annual level of 1970. The futures market, valued at roughly $25 to $30 trillion, comprises the largest share of the dollar value of the entire U. S. derivatives market.

How the tax will function is illustrated by examining its practical application to two of the most powerfully destabilizing and leveraged of all futures contracts.

U.S. Treasury Bond future

Traded on the Chicago Board of Trade (CBOT), the U. S. Treasury Bond future is the single most widely traded futures contract instrument in the world. In 1992, a whopping 71,099,955 contracts in this future were traded. That figure represents one-quarter of all contracts of all types traded on the CBOT, which is the world's largest exchange. The notional principal value of the underlying bond of the U.S. Treasury Bond contract is $100,000. It is usually a bond of 15 years or longer maturity. The speculator buying this

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The John Law bubble gone mad

From LaRouche's March 9, 1993 proposal for a tax on derivatives:

The derivative bubble, by the very nature of these transactions, is a financial bubble in the tradition of the more primitive, more rudimentary, and far less dangerous bubbles of the eighteenth century such as the John Law bubble in France and the South Sea Island bubble in England in the same period of time. This is the John Law bubble gone mad. The vulnerability to the entire financial system, the chaos and destruction of actual physical processes of production, distribution, employment, and so forth is incalculable in potential, and therefore this thing must be brought under control promptly. . . .

The down side that would be argued from certain sources, apart from the wild free market monetarist maniacs, will be that the number of transactions related to any single initiating trade, can be enormous, can be over 100 individual transactions. Fine! Tax them all! "That's a big amount of paper," they will say. Fine! Tax them all! The burden of doing the paperwork will itself prevent you characters from ballooning this market in that way.

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contract does not pay $100,000, but only a fraction of that, which is called the "initial margin requirement." Margin requirements vary from contract to contract, but for this one, the initial margin required is $2,025. The leverage in this contract is the notional principal amount, or $100,000, divided by the margin bond requirement of $2,025. Thus the leverage is a spectacular 49 to 1.

Assume, for a moment, that the bond underlying this contract is a 15-year bond bearing an initial yield of 8%. Assume further that, during the first hour of trading, the interest rate on 15-year Treasury bonds fell marginally to 7.995%. As bond yields are inverse to prices, that would push up the price of the bond to $100,050. The speculator holding a U.S. Treasury Bond contract has made a $50 profit (to realize it, he must either take physical delivery of the bond, or sell the contract to someone). That $50 represents a rate of profit on the investor's original margin investment of $2,205, of 2.47%.

The reader may think that $50 is a very small return. Not at all.

First, speculators in these markets play with very large

volumes. A speculator may buy 100 contract units of U.S. Treasury bond futures on the CBOT, meaning that the profit realized in one hour of trading (less commissions, etc.) is $50×100, or $5,000.

Second, the actual rate of return placed on a daily or yearly level is huge. For example, were the speculator to continue to realize this 2.47% hourly rate of profit for a week, his rate of return would be above 85%. Who will invest in steel plants, which return about 5% per year, when spectacular rates of return can be made in the derivatives market in a week's worth of trading?

Now, if LaRouche's 0.1% transaction tax is levied to the $100,000 notional principal amount of the U.S. Treasury Bond contract that has been purchased, the tax would yield $100, and could be collected by the exchange. But, in this example, the tax is a necessary, unbridgeable hurdle: The speculator will pay more in tax ($100) than his profit ($50). The LaRouche tax makes the deal unprofitable. Just to break even to cover the cost of the transaction tax, the speculator would have to make $100 profit, which represents a rate of profit of 5% on this particular transaction. To go over breakeven, the speculator would have to make $150 or so, representing a 7.5% rate of profit on his investment. The chance that a Treasury bond will move up $150 in an hour is slim, although hardly impossible, especially in a manipulated market. But markets can turn very suddenly, as speculators very well know. In markets, in which the time it takes to transact a trade is measured in fractions of a second, a speculator can be severely burned if he is constrained to wait in the market long enough for it to realize a full 5-7.5% rate of return. If it doesn't in that time frame, the market jolts the other way, he is doomed. The threshold level for real or net profitability, introduced by the 0.1% transaction tax, will, like a surgical tool, slash trading in this market instrument by at least one-fifth to one-quarter of its volume, puncturing this market, and begining to dry it out: precisely as the tax is intended.

The stock index future

The other example is the Major Market Index (MMI), which is also traded on the Chicago Board of Trade. The MMI is an average of a basket of 20 leading stocks, such as AT&T, Du Pont, or Mobil, and is the favorite of the program traders. By using the MMI in the Chicago futures market, they can send the Dow Jones Industrial Average gyrating up and down. The MMI was one the chief culprits behind the October 1987 stock market crash. The notional principal of the underlying MMI contract is calculated by a formula, which is 500 times the MMI index's closing price. On May 13, the MMI index closed at $356.40, so the notional princi-

The history of the fight against derivatives

The fight to institute Lyndon LaRouche's proposal for a one-tenth of 1% tax on financial derivatives comes after intense warfare over this issue by many nations that were fighting to preserve their national sovereignty. In the United States, trading in options on agricultural commodities had been banned in 1936, and the ban was not officially lifted until 1983.

Farmers had opposed the highly destructive effect of options, one of the earliest forms of the derivative market, starting in the 1920s, long before they became as large as they are today; even then, farmers still exercised significant influence within the United States. In 1933, an attempt was made to manipulate the wheat futures market using options, which resulted in an opportunity for farmers to force the U.S. government to ban trading in these options. There were attempts to re-introduce trading in agricultural options during the 1970s, but the plan met with only limited success.

It was only in January 1983, when President Ronald Reagan signed the 1982 Futures Trading Act, that the ban was officially lifted. This was a major feature in the disastrous Reagan-era deregulation of the U.S. economy.

Contrary to the "free enterprise" argument that options markets are essential to agriculture, because they make the market more efficient, American agriculture has demonstrated its ability to function and thrive without options trading for the three and a half decades since the ban in 1936 through 1983.

Moreover, America had, for a short time, a small financial transaction tax, and the fight to impose a larger financial transaction tax was very intense in the late 1980s.

Throughout the 1950s and early 1960s, the United States had a low-rate transaction tax—called a stamp tax—on the issuance and transfer of stocks and debt. The tax was repealed in 1965.

Rumblings from Congress

However, in the late 1980s, the fight broke out more intensely for a transaction tax of a greater size. In 1987, Speaker of the House Jim Wright of Texas called for a transaction tax on the financial markets. Wright's proposal called for a 0.5% tax on both the seller and the buyer in the same transaction, thus, effectively, amounting 1%. For six months, there was a heated public debate over Wright's proposal. Wright was soon driven from office in what is generally agreed to be an overblown scandal. The

pal amount of the MMI futures contract was $178,200. The initial margin requirement that a speculator must commit to buy an MMI futures contract is only $5,400. The leverage built into this contract is 32 times.

Assume that the MMI index trades upward for the day by 25¢, which, multiplied by 500, per the formula, makes a profit on the contract of $125. However, the 0.1% transactions tax for the single trade in the Major Market Index will yield $172. Thus, once again, the tax level is higher than the anticipated profit. A trader in the MMI contract would have to make more than 3.2% on his margin investment to go over breakeven. Again, the trading volume of the market in this destructive contract will shrink.

A sizeable revenue

This is how the tax acts to exert reverse leverage. The higher the leverage of the transaction, as in the case of the U.S. Treasury Bond futures contract, the more bite the derivative tax takes, thereby shrinking the markets. In the case of stocks traded on the New York Stock Exchange, the effect is important, but less remarkable. The tax is applied in similar fashion to every section of financial derivatives markets, such as currency and interest-rate swaps held by the banks in the United States.

If one adds up the value of the annual transactions in all the diverse segments of the financial derivatives market—the many and varied derivatives in currencies, stocks, bonds, interst-rate futures, commodities, etc.—the sum of the notional principal value traded is between $80 and $100 trillion. A precise figure does not exist, in part because the different trading exchange and government regulatory bodies have not compiled figures for the different segments of the market—and do not want to—because it would expose how large the markets have become. It can be assumed that the tax will reduce trading volume and, in parallel, a roughly corresponding dollar volume, in all the financial and financial derivative markets by at least one-fifth to one-quarter. This reduction will occur within a matter of weeks of the application of the tax, so that the derivatives market against which the LaRouche tax can be applied will be reduced to a low of $60 trillion or a high of $80 trillion. A tax on this range of 0.1% range will yield $60-$80 billion in annual revenue. After the first year, because the tax is, in part, a "sin" tax, the tax revenue will be smaller. However, as every congressman and senator caught in the budget debate will admit, such a tax produces a very, very large revenue figure.

Most importantly, the tax harms nothing essential in the physical economy, while lancing a growing malignancy. It constitutes a crucial step toward restoring America's sovereignty.

Oct. 16-19, 1987 stock market crash confirmed Wright's warnings of the instability of the financial markets.

Also in the 1989-90 period, during discussion of the 1990 Budget Reconciliation Act, Sen. Lloyd Bentsen, then chairman of the Senate Finance Committee and now secretary of the treasury, raised a proposal for a transaction tax on selected financial instruments on the floor of the Senate.

In February 1990, partly in response to the furor over this issue, the Congressional Budget Office, in its report "Reducing the Deficit: Spending and Revenue Options," had a section on pages 388-89, entitled "Impose a 0.5% Tax on the Transfer of Securities." Its analysis of the tax reported that "the tax would have to be broad-based, applying to stocks, debt, options and trades by Americans on foreign exchanges."

What other nations have done

Various nations have taken action to tax and/or ban some of the instruments traded in the financial derivatives market, in an attempt to assert sovereign control over their national credit and finances.

• In 1986, the government of Sweden doubled its equity transaction tax, which is the tax on trade of stocks on the Swedish stock market. In 1989, Sweden extended the tax to futures and options trades. The effect of this new tax was to substantially reduce the trading of futures on Sweden's Stockholm market. Furthermore, the tax closed the Swedish Option and Future Exchange (SOFE) for two years. But in 1990, apparently under pressure from financiers, Sweden abolished the derivative tax, and trading in the derivatives market exploded, helping to deepen Sweden's financial problems.

• Until as late as 1989, the German government held firm and refused to legalize the trading of some financial derivatives within the country. As a result of pressure from the trading of German government bond futures in the London markets, amendments to Germany's gambling law in 1989 made changes and permitted retail participation in derivative markets, followed by the opening of Germany's first financial exchange, Deutsche Terminbörse in 1990.

• At present, derivative taxes are assessed in Finland, France, Hong Kong, and Japan. These countries assess a transaction tax on various securities at rates 3-6 times larger than the LaRouche-proposed tax. In France, the fee is only used to finance the annual budget for CMT, the French regulatory body for the futures and options markets. Once the CMT's budget requirement is met, the fee is no longer levied.—*Richard Freeman*