

## **Innovative Finance Mechanisms: comparing Aviation Tax and Currency Transaction Tax**

### **Background**

It is clear that in the absence of forthcoming commitments from the largest economies such as the United States, Japan and Germany, the aggregate target of 0.7% of GDP of Overseas Development Assistance (ODA) flows will not be met in the near future. This underscores the urgent need to create additional ways of mobilising extra resources to help fund the Millennium Development Goals (MDGs).

This has led to a number of so-called 'innovative sources of financing' that have been suggested as a way of raising resources for development. The discussion has been gathering momentum with the International Financing Facility (IFF), the Aviation Tax (AT) and Currency Transaction Tax (CTT) emerging as the three front-runners with the broadest political and popular support.

The IFF does not itself raise any additional money for development but is a mechanism for frontloading the delivery of aid. On the other hand, the CTT and the AT are both capable of raising billions of dollars of predictable and stable new money for development.

### **Revenue potential**

The proposed CTT can be implemented as a small (0.005%-0.02%) stamp duty on currency transactions which now amount to \$475,000 billion per annum. Such a stamp duty can raise annual revenues of around \$30 billion. Implementation only across Europe can mobilise \$15- \$20 billion in revenue and if a stamp duty is levied only on sterling transactions in the UK would mobilise \$4-\$6 billion of new money.

Air passenger traffic has grown from 1,843 Passenger Kilometres Performed (PKPs) in 1991 to an estimated 3,300 PKPs in 2005 and air freight has registered similar growth. A small tax of the order of \$21 per metric tonne on aviation fuel (of all kinds) can mobilise \$6 billion - \$9 billion annually.

It is interesting to note that both currency transactions and air traffic are growing at a very fast rate though the growth in air passenger traffic grossly overestimates the growth in aviation fuel consumption (improving fuel efficiency means that this is less than growth in air traffic).

### **Political Popularity**

The financial services industry, which is responsible for an overwhelming majority of currency transactions, has been generating record levels of profits in the past few years with the two most profitable, Citibank and HSBC, posting more than \$30 billion of profits between them. The top banks, where the FX trading is concentrated, generate as much as \$40-\$50 billion annually from FX market operations alone. There is a widespread public perception that the earnings of banks are excessive and there is potentially a favourable political climate to rein in some of these profits.

The global airline industry is currently in a state of turmoil precipitated by a slump in air travel after the World Trade Centre bombings in 2001 and record high air fuel prices. For example, the International Air Transport Association, which represents most major international airlines, has forecast a range of \$5.5 billion losses to \$1.2 billion profit for its members in 2005. Its members have also reported aggregate losses of \$36 billion since 2001. It is likely that the imposition of any significant aviation tax is going to worsen the situation.

### **The incidence of tax**

Most transactions in the FX markets are conducted between banks themselves or with other large players in the financial services industry. Transactions with individuals (for overseas travel for example) constitute less than 0.1% of total transactions and trade related transactions amount to less than 10%. The bulk of the tax burden is thus likely to be borne by the financial services industry itself with some of the costs being passed on to trade related transactions. The financial services industry is disproportionately used by the richer segments of the society so the tax incidence is likely to be socially progressive and is unlikely to affect the majority of the population in any tangible way.

Many of the major airlines have been levying an air fuel surcharge to offset part of the higher fuel costs that they have had to bear because of the oil price spike seen in the past couple of years. Experts agree that any aviation tax is likely to be passed on in full to the millions of people who fly. Although it is true that wealthier people on average fly more than the less wealthy, a uniform aviation tax is likely to impact the budget segment in a proportionately greater way, disadvantaging the economically weaker segments of society.

### **Other taxes**

The FX market is currently one of the most loosely regulated financial markets and does not have any direct tax imposed on it. Other financial markets such as stock markets and bond markets already pay a transaction tax in many countries. In the UK, for example, a 0.5% stamp duty is levied on the purchase of stocks. This generates substantial revenues of more than \$7 billion every year. A stamp duty on currency transactions would be a natural extension of financial transaction taxes that exist in other markets.

While it is true that aviation fuel is very lightly taxed (or not at all) compared to other fuels such as motor fuel and gasoline, it is also true that the aviation industry is subject to a number of other taxes such as airplane passenger duty and the arrival or departure tax (or airport duties). In fact, taxes account for a significant proportion of the final price of air tickets. It is common for taxes to constitute more than 30% of the final price of an economy ticket in Europe and the proportion on budget tickets is even higher. Any kind of aviation tax would add to this burden. The three main types of aviation tax are a levy on Air Fuel (kerosene), or on Air Tickets or on Air Corridors.

### **Technical issues**

The CTT can be levied unilaterally on a currency basis. The tax can be collected in a cheap and efficient way at the point of settlement through either the Continuous Linked Settlement Bank (CLS Bank) or the gross settlement mechanisms that are run for all major currencies by their respective central banks. The fact that all FX transactions are electronic makes collection cheaper and evasion more difficult. Any tax that includes the Euro will need a consensus from all Euro area members, though countries such as the UK, Switzerland, Sweden, Norway and Denmark could implement a CTT unilaterally.

The main obstacle in levying an aviation fuel tax is the existence of an international treaty that explicitly forbids it. This dates back to the 1944 Chicago convention when driven by a desire to encourage air travel, still a nascent industry, an agreement not to tax aviation fuel was signed. The assembly of the International Civil Aviation Organization (ICAO), a UN body, which oversees international air traffic regulation, ruled out the introduction of any international tax on jet fuel until at least 2007. Another problem is that more than hundred bilateral air service agreements which exempt fuel used internationally from taxation would be extremely complicated to renegotiate in the absence of a broad international consensus. However, given the political will to overcome these legal hindrances, Air Fuel could be effectively taxed. In the interim, progress on an Air Ticket tax or on Air Corridors looks more feasible.

### **Conclusion**

On the basis of the above analysis it seems that there is a strong case for European leaders to concentrate on the implementation of a Currency Transaction Tax in the short term. The implementation of an Aviation Tax, if it is to apply a levy to airline fuel, is also a desirable goal but it seems that such an implementation is more realistic over a longer time horizon.