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Taxing Finance

by Toby Sanger

The financial and economic crisis has led to a long overdue re-evaluation of the role, regulation and taxation of the financial industry around the world.

The IMF estimated that the crisis would cost G20 countries over $1 trillion in increased deficits; costs citizens are now paying for through public spending cuts, austerity measures and consumption tax increases. This alone is a good reason for the unprecedented interest in introducing new taxes on banking and the finance industry. Despite this, the commitment by G20 leaders at their September 2009 summit that the "financial sector should make a fair and substantial contribution" towards paying for some of the costs of the crisis remains unfulfilled.

Following strong advocacy by civil society and labour organisations, a significant advance was made in June 2011 when the European Commission recommended a European financial transactions tax be introduced by 2018 at the latest. It estimated this would generate €37 billion (US$52 billion) a year to fund the European Union's budget activities.

Beyond paying for some of the costs of the crisis, there are also a number of other compelling reasons for increasing taxation of the financial sector.

Financial sector is too big

Whether considered from a critical political economy or a more conventional neo-liberal perspective, there is broader recognition that the financial sector has grown "too big" for the good of the economy, as a recent IMF report suggested. Finance is an intermediary industry, and doesn't directly produce products with end-use values for people, so it can divert resources from other more productive areas. Excessive salaries and bonuses paid to engineering graduates to create new financial products and derivatives instead of working to meet more fundamental needs reflects the human resources side of this equation.

Tax changes have provided large benefits and preferences for finance

Major tax changes introduced over the past decades inspired by supply-side economics provided large benefits to the financial sector and to highly-compensated individuals in the industry. These include: preferential tax rates for capital gains and investment income, increasing dependence on consumption-based value-added taxes (which largely exempt financial services), cuts to corporate taxes, reductions in higher income tax rates, as well as the growing use of tax havens.

Reducing incentives for excessive risk-taking

Even from a micro-economic efficiency approach, there is recognition that tax changes increase incentives for short-term speculation and excessive risk-taking in the financial sector, as the IMF and the European Commission have acknowledged. Bankruptcy and limited liability laws have limited downside risk for corporations for centuries. Following the financial crisis, there is also more focus on the damage caused to the entire economy by systemically risky activities, with the implicit public guarantee for "too big to fail" financial corporations.

Some have argued that the exponential growth of trading in financial derivatives — futures, options, swaps, etc. — has magnified financial instability instead of reducing volatility as they were supposed to. The value of financial derivatives outstanding now amounts to over ten times the value of annual global economic output. Clearly much of this involves investments designed to increase profit through leverage and risky speculation instead of hedging to insure underlying investments against economic fluctuations.

There's been little effort to contain or control this. Financial derivatives have been largely unregulated; unlike transactions for most other goods and services, only a few countries apply taxes to a broad range, let alone any financial transactions; the growth in derivatives, hedge funds, private equity and increasing use of secretive tax havens has not only siphoned revenues from national governments, but also made them more vulnerable to the power of financial capital.

There should be little surprise that pressure exerted by popular groups for new taxes on finance, such as the Robin Hood Tax campaign, is now being supported by many politicians and political leaders from different sides of the political spectrum. The common appeal for international development, anti-poverty, economists and political activists is that new taxes on finance could not just to help pay for the costs of the crisis and provide funding for global social and environmental needs, but also to tame the financial industry and help prevent further financial crises.

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The leading group on innovative financing for development has endorsed financial or currency transactions taxes at low rates to raise revenues at the global level to fight poverty and climate change. Proponents estimate that a broad-based tax at 0.05% on all financial transactions could generate US$200 to $600 billion a year in revenues globally — significant funding for global development and environmental priorities.

The idea of special taxes on banks and financial transactions is neither new nor speculative. In 1936, John Maynard Keynes wrote in his General Theory that "the introduction of a substantial government transfer tax on all transactions might prove to be the most serviceable reform available, with a view towards mitigating the predominance of speculation over enterprise in the United States."

Nobel-prize winning economist James Tobin applied Keynes' idea when he proposed an international tax on currency transactions "to throw sand in the wheels" of international finance, reduce speculation and cushion exchange rate fluctuations after the Bretton Woods monetary system broke down in 1972.

Many countries already have long-standing and effective taxes on certain financial transactions. The UK's Stamp Duty tax, which includes a 0.5% tax on most equity transactions, has been in existence since 1694 and raises over US$5 billion in revenues annually. Switzerland also levies a tax on transactions of stocks and bonds. China levies a tax on trading in stocks, and adjusts the rate depending on how much they want to cool down or stimulate their stock market. Taiwan not only taxes transactions of stock and bonds, but a tax at a lower rate on transactions of financial derivatives such as options and futures. Other countries have financial transactions taxes, although a number have been eliminated since the 1990s.

Given this experience, there is no question that financial transactions taxes are not only feasible, but can be effective and raise decent amounts of revenue at a low administrative cost without much economic disruption. The greater interest now is in even broader-based taxes to also cover currencies and financial derivatives. Because much of this trading is global and highly mobile, financial transactions taxes in these areas would be much more effective if established through global or multi-lateral agreements.

Of the US$600 billion figure for a 0.05% tax on all financial transactions, about 80% is estimated to come from trading in derivatives. However, there is considerable uncertainty about the impact of a tax on trading on different types of derivatives and therefore on how much revenue would be raised. With a tax based on the notional value of the derivative contract, in some cases even a small tax rate could exceed the value of the actual premium paid. A global FTT might not raise US$600 billion a year and cure all the ills of the global economy, but it could certainly raise significant sums while improving the functioning of the economy. There is solid research showing that a tax at a rate of 0.005% just on transactions of major global currencies could generate over US$30 billion annually at a low administrative cost with little impact on markets. The G20 and other countries should join with the European Commission proposal to establish broader-based financial transactions taxes at the international level, but agree to direct half the funds generated to international development and climate justice priorities.

There's also no reason why national governments can't proceed with increasing other taxes on finance. There's a strong argument for *Financial Activities Taxes* to compensate for the broad exemption of financial services from most national value-added tax systems. As proposed by the IMF, a 5% tax on profits and compensation in the financial sector would form a good proxy for value-added by the industry and could generate approximately significant revenues in many countries.

Tax preferences that have provided disproportionate benefits to the financial industry and even increased the incentives for speculative behaviour should also be eliminated. These include reduced tax rates for capital gains, stock options and other forms of financial investment income. There's also solid justification for a higher corporate tax rate on bank and large financial sector firms given the implicit guarantee governments provide to rescue them from failure.

These tax changes will not fix all problems with finance, nor will they eliminate speculation and generate all the revenues we need for global poverty and environmental challenges. But at a time when governments have reacted to the financial crisis by penalizing people with cuts to public spending, increasing taxes on finance would not only be much fairer but also better for the health of the economy.

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Further reading

Toby Sanger (April 2011), *Fair Shares: How Banks, Brokers and the Financial Industry Can Pay Fairer Taxes*, Canadian Centre for Policy Alternatives,
http://www.policyalternatives.ca/publications/reports/fair-shares

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