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## Taxing financial transactions: the right thing to do when you owe $600bn a year and have lost control over global finance

by Pierre Habbard

For those who had placed some hope in the G20 process to start re-regulating global finance the result, so far, has been utterly disappointing. Governments and central banks have been as eager to bail out the bankers and take on their 'toxic assets' as they have been reluctant to move decisively on financial regulation. At every G20 Summit since the first one in November 2008 in Washington, we have been told that a revamped and enhanced Financial Stability Board (including the IMF, the OECD, the BIS and other key financial organisations) would lead the way with concrete deliverables to bring the focus of global finance back to the real economy. We have seen instead a long series of reports on what-went-wrong and "high level" principles and "guidance", but with no teeth when it comes to enforcement. If anything, these reports reveal the extent to which supervisory authorities are exposed to a "significant lack of information" on "where risks actually lie" (FSB & IMF 2009). They tell us that, two years into the crisis, the "current state of analysis limits the extent to which very precise guidance can be developed" (BIS, FSB & IMF 2009) and that "considerable work remains" (SSG 2009) in the areas of banks' internal controls and regulatory infrastructure.

At the G20 Summit in Pittsburgh (G20 2009) in September 2009 however, some hope emerged that at last something tangible could be agreed upon in the near future. G20 leaders called on the IMF to undertake research to determine a "fair and substantial contribution" that the financial sector could make to pay "for any burdens associated with government interventions to repair the banking system". They further asked the IMF "to strengthen its capacity to help its members cope with financial volatility, reducing the economic disruption from sudden swings in capital flows." Read together, the two mandates were seen as an opening to an old policy issue that had been long neglected by governments and international financial institutions: the creation of a global Financial Transaction Tax (FTT).

In its original proposal by James Tobin in the 1970s (TUAC 1995), the economic justification for an FTT starts with the acknowledgement of the harmful effects of short-term speculation producing strong and persistent deviations of asset prices from their theoretical equilibrium levels. Such "overshooting" in prices lead to speculative bubbles over the long run. A measured and controlled increase in transaction costs implied by an FTT (from 0,02% up to 0,5%) would slow down trading activities so as to align capital flows with economic fundamentals and the real economy, while freeing up new sources of financing for global public goods. Since then, the FTT has been developed in different ways by economists and civil society groups, each putting different weight on the twin objectives of curbing financial speculation and freeing up new sources to finance global public goods. In fact, some proposals had such a strong focus on financing for development that in most cases they explicitly excluded the initial objective of Tobin to curb speculation, targeting a minimalist tax rate of 0.005% to avoid "producing market distortions" (HILLMAN et al. 2007) or "disrupting the market" (SCHMIDT 2007).

Unlike in the pre-crisis literature, the FTT has now gained considerable traction, both as a financial stability instrument and as a solution for financing development. There is a strong case for this. Regarding financial stability, it would be hard to contest that at least part of the crisis we face today has been triggered by a speculative bubble in the derivatives markets and by global imbalances of current accounts between regions and within regions. As Stephan Schulmeister (SCHULMEISTER 2009) puts it, the size of the trading in derivative products is just much too big to be accounted for by its original purpose: to hedge against price volatility or credit default risk. On the revenue side, OECD governments still have to deliver on their past commitments to finance global public goods, including the Millennium Development Goals (MDG), but also on 'new' demands regarding climate change adaptation and mitigation measures for developing countries (the financing of which was a major contributory factor in the failure of the Copenhagen Summit). According to TUAC estimates (TUAC 2010), the global public good resource gap that would emerge would be in the range of $324-336bn per year between 2012 and 2017 ($156bn for financing climate change measures in developing countries, $168-180bn for Official Development Assistance to reach 0.7% of GNI).

To make matters worse, the very same OECD governments are running budget deficits at unprecedented levels as a result of the global crisis, including the bailing out of the banking sector. According to the OECD, the size of the fiscal consolidation that would be needed in the 2012-2017 period to bring deficits back to normal levels (below 2%) is projected at $300-370bn per year - on top of the above resource gap for public goods. Unsurprisingly, the OECD experts would want to fund this gap with cuts in public expenditure, "long overdue reforms" to public pensions and regressive tax reforms that

would hit working people front on. In the absence of new tax revenues, such a fiscal scenario would have working families pay twice for the crisis: first through rising unemployment and falling incomes and secondly as a result of cuts in public and social services.

Against this background – "heavily indebted rich countries" whose supervisory authorities have lost control over global finance – then surely now is the time to take the FTT option seriously. This is what many unions have been campaigning for, together with social movements, as seen in recent initiatives in the US, Europe and Asia. For its part, the TUAC has been working on a paper (TUAC 2010) on the parameters of a FTT together with the ITUC. Based on recent contributions by Dean Baker (BAKER et al 2009), Stephan Schulmeister (SCHULMEISTER 2009), and Bruno Jetin (JETIN 2009), the paper shows that an FTT could be designed with different rates per counterparty (large banks, other financial institutions including hedge funds, and non-financial corporations) and per market ('traditional' foreign exchange markets, exchange-traded derivatives, over-the-counter derivatives). Such a multi-tiered tax regime would help hit where it really hurts and target the counterparties (e.g. large banks and hedge funds) and transactions (e.g. derivative products) that are more prone to speculative trading than others. The revenues generated would be in the range of USD200-600bn per year if the tax is applied on a global scale.

Following the G20 summit in Pittsburgh, the IMF was quick to publicly dismiss the FTT (IMF 2009) as an option to be considered in the commissioned report (forthcoming, April 2010). The sceptical reaction of the IMF is not surprising. Ever since 1995, when the Tobin tax became a "global issue", the IMF has not seriously considered the issue. The main objections are with the negative impact that the reduction in trading volume would have on price volatility and market liquidity. Other objections relate to the potential transfer of the added transactions cost to "middle class investors", the opportunities for tax avoidance or the more economic theory textbook argument that tax should apply to value added, not to transactions. Dean Baker (BAKER 2010) has published a solid set of responses to those criticisms as has Stephan Schulmeister. Overall, the single most important aspect to keep in mind in considering the pros and cons of an FTT is the need to look at the specific problems associated with the FTT (in contrast to generic problems that would also be encountered by comparable regulatory options). IMF and OECD concerns about feasibility clearly belong to the latter category: yes, implementing an FTT would be complicated, but would it be more complicated to implement than an alternative solution that would deliver comparable financial stability and global public good financing? On that, the IMF has argued for the creation of a "global banking insurance scheme" as an alternative to an FTT. However the two instruments differ in terms of both revenues (which would not be available for public goods under an insurance scheme) and the handling of risk. Regarding the latter, the insurance scheme in fact would be more onerous for regulators than the FTT. A pre-requisite for any insurance scheme is the ability to price the risk associated with the banks' balance sheets, which in turn presupposes the ability of the insurer (the regulator) to conduct proper risk assessment of the insured (the banks) and to do so at reasonable costs. And yet it appears that such a basic requirement has become a step too far for financial authorities.

An FTT, unlike the insurance proposal, would provide governments with a powerful regulatory tool which would not depend on the ability of the supervisory authorities to price or assess risk. It would be no panacea for the much broader agenda on financial re-regulation, but it would offer government a 'low-cost' instrument for tackling volatility in asset prices and for downsizing the global banking industry, particularly at a time when the international financial supervisory framework is in tatters and will take a decade to reform. It would free up new sources of financing for global public goods at a time when public services and welfare are at threat.

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