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Taxing Financial Activities: an Ongoing Debate

Taxing financial activities: even though this idea has been popular for quite a while now, it has also been considered to be iconoclastic. It was rejected by most experts who considered that it would be impossible to make such an idea work. They feared that if such a tax was set up, it would increase transaction costs and thereby reduce liquidity while accentuate market volatility. The 2007-2010 crisis has resolutely changed the mind-set. Whilst obstacles certainly remain huge and such plans are considered controversial, the debate is clearly ongoing.

In this Letter we examine how well grounded a tax on financial activities would be. It is not merely a question of punishing bankers, or financial markets, or even of truly reducing asset price volatility. It would be better to use some regulatory instruments to do that. The main objective of the tax should be to raise funds. Some people think that funds raised by the tax should be used to finance activities considered to be "socially useful". However, it is highly unlikely that this solution would be chosen. Most of the existing taxes aim at replenishing resolution funds which can be drawn from in times of crises, while the more ambitious plans are aimed at feeding state budgets.

A change of paradigm

The idea of taxing financial activities – particularly transactions on the foreign exchange market and the stock market - can be attributed to John Maynard Keynes in 1936[1], but it is now associated with James Tobin[2] who suggested, in 1972, throwing "a few grains of sand in the wheels of international finance". Popular in public opinion, especially in France, for a long time this proposal remained confined to alternative movements such as Attac. Economists showed barely any interest in the idea, not to mention enthusiasm.[3] Standard financial theory is based on a model of markets in which agents are supposed to be perfectly rational and financial markets efficient; speculation is a stabilising factor and prices reflect the fundamental value of assets. No boom or crash in view. Within this framework, the only effects of a tax would be to increase transaction costs, distort prices and reduce liquidity, which would amplify volatility. This reasoning is, in fact, only partially verified by empirical studies: the link between the rise in transaction costs and volatility appear either positive or null.[4] Whichever the case, until the crisis, everything was done to promote liquidity

1. J.M. Keynes (1936), "General Theory of Employment, Interest Rates and Money", NY: Harcourt Brace & World.
2. James Tobin is known to the general public for his project on foreign exchange transactions tax but he is, above all, a leading macro-economist. In 1981, he received the Nobel Prize in Economics. J. Tobin (1978), "A Proposal for International Monetary Reform", *Eastern Economic Journal*, 4(3-4), 153–159.
3. Nevertheless, let us quote two illustrious counter-examples: Joseph Stiglitz (Nobel Prize in Economics in 2001 for his works on asymmetric information) and Lawrence Summers (Secretary of the Treasury under the Clinton administration and Director of the National Economic Council under the Obama administration) who expressed themselves as being in favour of a tax in an edition of the *Journal of Financial Services Research* published in 1989.
4. See, for example, R. Roll (1989), "Price Volatility, International Market Links, and Their Implications for Regulatory Policies", *Journal of Financial Services Research*, 3, 211-46; H. Hau (2006), "The Role of Transaction Costs for Financial Volatility: Evidence from the Paris Bourse", *Journal of the European Economic Association*, 4(4), 862-890. For a survey, see Th. Matheson (2010), "Taxing Financial Transactions: Issues and Evidence", *IMF Working Paper*.

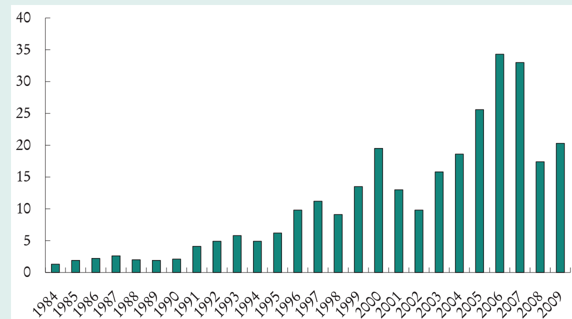
Box 1 – Should bonuses be taxed?

Amongst the stormiest debates which have followed the financial crisis, the one about bonuses occupies a prime spot. There is indeed something shocking both about the amounts in play (several tens of millions of dollars per year for the best performing traders – or the luckiest) and the circumstances: the same banks who have called on governments for help have not stopped awarding their employees spectacular bonuses (see graph 1).

Basically, the problem is that bonuses encourage excessive risk taking*. Should they therefore be taxed? France and the United Kingdom jointly announced, at the end of 2009, plans to introduce an exceptional tax on the bonuses of bankers. The aim was to force the banks to be more moderate in awarding them. But the banks preferred to pay the tax rather than give up paying the bonuses. In fact, the objective was not particularly clear. This tax does not solve the issue of the asymmetry of the bonuses (the fact that the traders are only incentivised for profits and not penalised for losses: "heads the trader wins, tails the bank – or worse the taxpayer – looses").

And if the aim is to reduce income inequalities, action should not merely be limited to bankers, but should involve all high incomes (see for instance the proposals of introducing a 80% marginal tax rate on all annual incomes in excess of 1m).

Grap 1 – The Wall Street bonuses since 1984



Source: OSC, authors' calculations.

* I.-H. Cheng, H. Hong & J.A. Scheinkman (2010), "Yesterday's Heroes: Compensation and Creative Risk-Taking", NBER Working Paper No. 16176.

which, it was thought, improved market efficiency and made market more resilient. Today, the approach is less black and white. An increase in liquidity is certainly a good thing, but only up to a point; one can even wonder if the markets are not too liquid. It has been established that investors have a tendency to carry out too many transactions.[5] Moreover, a large part of short term instability seems to be generated by the transactions themselves.[6]

Calls for a major overhaul of the paradigm have thus multiplied since the crisis. Tax plans are once again order of the day supported by new arguments which are receiving increasing attention. The idea is no longer to use the tax for regulatory purposes, to limit speculation or market volatility. There are other more efficient instruments for that (strengthening prudential standards, limiting access to certain markets and/or to certain operators, splitting up activities *etc.*). Today, the aim of the tax can be simply expressed: to collect funds. The debate no longer revolves around the question of a tax's possible effect on volatility, it bears more on:

• the tax base – should bonuses (see box 1), profits, balance sheets, off-balance sheet accounts, solely risky undertakings, foreign exchange transactions or all financial transactions be taxed?

• the rate – beyond what rate can it have an undesirable effect?

• the scope – does the project require international cooperation or can it be implemented on a national or regional basis? Should banks or all financial intermediaries be taxed?

• the assignment of the taxation product – should the income be assigned to an insurance fund, to be handled as any other fiscal receipt or should it be used to finance development projects?

A tax to prevent crises

To prevent the taxpayers from being the last but indispensable resort in the event of bank failure, we might consider the creation of a crisis resolution fund which could be drawn on in a case of failure of one of the contributors. This is the IMF's idea when it argues in favour of a "Financial Stability Contribution".[7] Such a fund would be fed by a fee paid by financial intermediaries for the financial sector. These resolution funds would make up the insurance from which depositors in the majority of countries benefit.

With regard to the tax's scope, as finance is globalised, an international system would be best. Ideally, this tax base should vary along the risks the institutions represent to the financial system, both for reasons of equity and incentives.

To date, this proposal has not been echoed around very much. The Europeans are rather more in favour (Sweden and Germany have already set up a similar fund at a national level), but they are encountering opposition within the G20, from Canada, for example, which considers that good regulation is enough, and from several emerging countries whose banking sectors were comparatively spared by the latest crisis.

5. See, for instance, T. Odean (1999), "Do Investors Trade Too Much?", *American Economic Review*, 89(5), 1279-1298.
6. In particular, high frequency trading (with orders passed in the millisecond), which represents up to 70% of transactions on the stock markets, is capable of causing abrupt variations in price as witnessed by the "flash crash" of May 2010, when the Dow Jones index plunged by 1,000 points in barely a few minutes, before bouncing back just as quickly.
7. IMF, "A fair and substantial contribution by the financial sector", Final Report for the G20, June 2010.

A value added tax to contain the financial sector

One option, supported by France, the United Kingdom and the United States amongst others, could be to tax financial activities in view of replenishing public finance, depleted by the crisis. This tax would be complementary to the previous one.

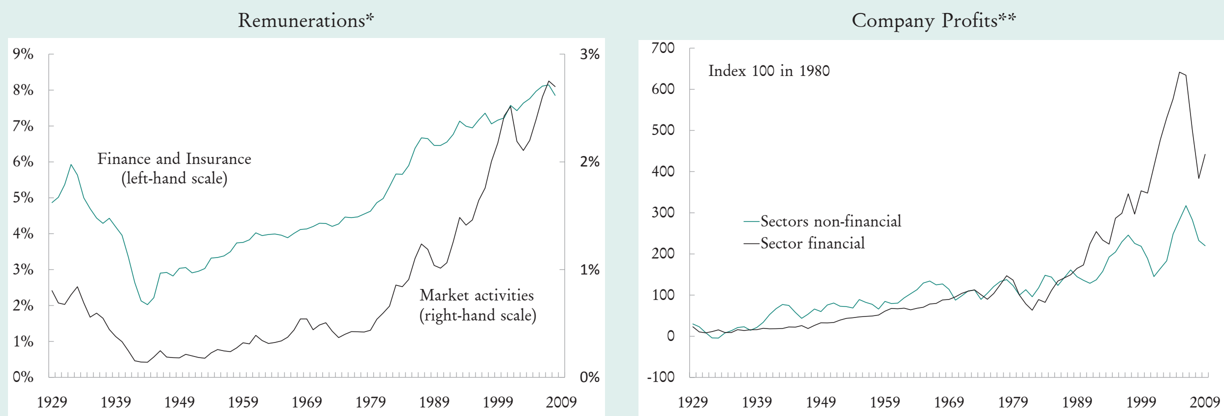
The IMF considers that this tax base, dubbed the *Financial Activities Tax* (FAT), could be made up of profit or remunerations from the banks. The idea would be to impose a tax on the value added, as financial services mainly do not have to pay VAT. In fact, this idea was not thought up yesterday.[8] There are already compensatory taxes in several countries, like the tax on salaries in France applied to the banks (and generally

Box 2 – A disproportionate financial sphere?

In August 2009, Lord Adair Turner, chairman of the Financial Services Authority (FSA), was one of the first to denounce the excessive weight of the financial sector. At the same time, he vigorously relaunched the debate on the taxing of financial activities.

In the United States, a country for which we have reliable data over a long period of time (see graph 2), the financial sector contracted strongly after the 1929 crisis. Immediately after the Second World War, its share in the grand total of remunerations in respect of all sectors, just about exceeded 2%. Since then, it has grown continually, with an acceleration since the 1980's, representing up to 8% of the total amount of remunerations before the crisis. There has been an even greater contrast in respect of profits. Since the end of the 1980's, profits have increased twice as fast in the financial sector than in other sectors.

Graph 2 – The weight of the financial sector in the United States since 1929



Note: * Remunerations in the "Finance and insurance" sector and the "Market activities" sub-sector (Transactions on stocks and shares and raw materials, Investments) in percentage terms of salaries in all sectors. ** Real profits of companies.
Source: *Bureau of Economic Analysis* (NIPA, Sections 1 & 6). Authors' calculation.

For Philippon (2009), this growth is due to the needs for finance, which also grew until the end of the 1990's; beyond that, it seems that the growth has been excessive. Moreover, it is likely that this growth has been spurred by the financial deregulation. As Johnson and Kwak (2010) emphasise, the growth in profits has been accompanied by finance's ever increasing intellectual and political influence, which has led to deregulation.* Actually, the governments saw financial activities as a first choice specialisation in the international division of labour. Confronted with relocations of manufacturing industries, finance offered a high value added activity, synonymous with very well paid jobs, high fiscal receipts and non polluting! The crisis has clearly shown that growth in the financial sector was not without problems. A country with an extreme specialisation is dangerously exposed to shocks: this argument is valid for all sectors, but it resonates all the more for financial activities due to the systemic risk. In addition, growth in the financial sector can have perverse effects. Salaries are so high that they attract some of the most brilliant brains, often to the detriment of other sectors**. The financial sector has also contributed to the increase in income inequality.***

* Th. Philippon (2009), "The Evolution of the US Financial Industry from 1860 to 2007", *Working paper*, NYU Stern School of Business. S. Johnson & J. Kwak (2010), 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown, Pantheon. See G. Capelle-Blancard & Y. Tadjeddine (2010), "The Impact of the 2007-10 Crisis on the Geography of Finance", *CEPII Working Paper*, No. 2010-16, août.

** For example Goldin and Katz (2008) show that Harvard alumni who work in the financial sector earn, all things equal, almost three times more than the others. In addidion, 15% of those who got their degree in 1990 work in the financial industry 15 years later. This is three times more than the 70's alumni. C. Goldin & L. Katz (2008), "Transitions: Career and Family Life Cycles of the Educational Elite", *American Economic Review,* 98(2): 263-269.

*** See for United States S.N. Kaplan & J. Rauh (2007), "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?", NBER *Working Paper* No. 13270. For United Kingdom, B. Bell & J. Van Reenen (2010), "Bankers' Pay and Extreme Wage Inequality in the UK", *Working Paper*, Centre for Economic Performance, London School of Economics.

8. H. Huizenga (2002), A European VAT on financial services?, *Economic Policy*, 17(35), 497-534.

to companies who pay little VAT). Basically, it would be a question of generalising this system.
Such a tax is also justified by the desire to claw back a part of the profit enjoyed by the financial[9] sector. During the last decades, this sector has seen a sharp growth (see box 2) which it is hoped can be contained.
In fact, an alternative would be to tax the banks beyond a certain level of profitability. In addition this would help discouraging the most risky behaviours. This last option is consistent with the idea that the banks' contribution is merely the fair counterpart of the negative "externalities" related to the systemic risk. Actually, this amounts applying the "polluter pays" principle to financial activities.
According to the IMF, the tax base of the FAT in France would be 3.3% of the GDP if the country decides to tax all of the profits and remunerations, 0.9% if profits and 1/8 of the remunerations are chosen (which roughly corresponds to the difference in remuneration between the finance sector and other sectors), and 0.8% if the excess profitability of the sector is chosen (as compared with a financial profitability of 15%). For the United Kingdom, the base would obviously be larger (6.1%, 2.7% and 1.1% respectively) taking into account the importance of the City for the British economy.

A tax on financial transactions to finance development aid

Although the IMF is in favour of a financial activities tax, it does not support the idea of a tax on financial transactions, for the reasons that it does not target the more dangerous activities in terms of financial stability and may it may further distort matters. Nevertheless, such a tax also has its merits: as the tax base is very large, the revenue would be significant. A tax on financial transactions to the order of 0.05% (assuming a drop of 65% in transaction volumes) would, for example, allow Europe collect fiscal income of around 1.6% of the GDP.[10]

Thus, the idea continues to make headway. France, for example, promotes the idea of setting up an international tax on foreign exchange transactions, the rate of which would be very low and the product would be assigned to development aid. Inspired by the solution defended by Attac, this idea was taken up in September 2010 by Nicolas Sarkozy at the United Nations rostrum. The reasoning is similar to that for the tax on airline tickets which is used to finance the fight against Aids. This project has little chance of success due to opposition from the Americans who are hostile to any new international bureaucracy.

Taxing financial activities: a double dividend?

Finally, the debate on taxing financial activities is best served by including it in a wider debate on fiscal reform. The banks never miss the opportunity of reminding that a new tax on their activities would inevitably lead to an increase in the costs of finance and consequently may damage growth. Nevertheless, in practice the effect is not so certain. There is a large consensus amongst economists that value added taxes or a taxes on profits – like the FAT – are both effective and economically neutral, something which is far from being the case for numerous existing taxes. A change over in the structure of mandatory contributions to alleviate the taxes causing the greatest distortion could well be considered.
Taxing financial transactions is undoubtedly not the panacea. But, it is more than just a damp squib[11]. The idea of a system made up of various taxes with different objectives makes perfect sense.

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9. Hence perhaps the acronym FAT which means fat or greasy in English.
10. Schulmeister (2009), "A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal", *WIFO Working papers* No. 344.
11. See P. Honohan & S. Yoder (2009), "Financial Transactions Tax: Panacea, Threat, or Damp Squib?", Working document, Trinity College Dublin.
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