

# Turning the financial sector from a **bad master** to a **good servant**. The role of regulation and taxation.



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The world experienced in 2008 the destructive power of an unregulated financial system. There has been much discussion in the aftermath of the financial crisis about how to protect the world economy from another such panic and its negative effects on the real economy. But there has been much less discussion about whether the financial system is actually serving the functions for which it was created, and whether the various proposals for reforming the regulation of the financial system are likely to lead to the financial system being more effective at achieving its core purposes.

In this paper, we intend to discuss the actual purpose of the financial system—the combination of financial institutions, financial markets, and governments as both regulator, market participant, and sponsor of financial institutions. Then we intend to review the course of post-crisis financial regulatory reform both in the United States and Europe, as well as the recent Basel 3 proposals to regulate banks internationally. We then pose the question, is the course of reform likely to leave us with a global financial system that is more or less effective at its core purposes? We finish by examining the issue of taxing the financial sector. We discuss financial sector taxation as a source of revenue and possibly as an additional way to mitigate negative externalities the financial system generates. The revenues generated by taxes on the financial system are one way of addressing that same system's failure to generate job-creating investment in the developed countries and to finance global public goods, such as financing development in poorer countries and mitigating climate change.

The financial system is mainly supposed to allocate resources in the form of savings to productive purposes in the form of investments. Some examples of recipients of investment are entrepreneurs with new projects, businesses needing working capital or seeking to expand, governments issuing public debt, and families needing to finance housing or education. The financial system should in doing so screen projects that seek capital, and invest only in those which are likely to be profitable on a risk adjusted basis. In a modern economy, financial markets also help investors manage both liquidity needs and insure against a variety of risks, both of which

**should facilitate investors being willing to invest in long term projects that entail a variety of risks.** (see IDEAS,2010)

This is the main purpose of the financial system. The financial system should not be treated as an end in itself, nor should the desire of participants in the financial system to enrich themselves be confused with the function of the financial system in the world's economy.

**The financial system is efficient when it performs all these functions satisfactorily without collapsing into crisis on a regular basis.** Its primary role of channeling resources from savers to real investors is a necessary condition for any economy to work, but modern financial sectors have evolved to offer more sophisticated financing and insurance products for agents who no longer operate with a regional/national perspective, but in globalized markets.

There are complicating factors in this simple description of the goals of a financial system. Among them are the problem of externalities, both positive and negative, including the need to finance public goods – investments that will generate large benefits that cannot be captured by the owners of the investment. And finally investors are not indifferent to both risk and return, time horizons and liquidity – some investors will be rationally risk averse, and some will seek returns even at the expense of incurring excessive risk. Then finally there are large problems associated with the fact that information is not cost-free and is asymmetric (Stiglitz and Weiss, 1981), as well as the fact that much information about the future is unavailable.

The problems inherent in financial markets manifested themselves in the real world in events like financial panics and prolonged difficulties in achieving adequate levels of investment in public goods like rural electrification. In response, modern societies actually allocate capital by a combination of capital markets, financial institutions, operating companies themselves, and governments both directly and indirectly through tax policy.

But in the runup to the financial crisis of 2008, there was a long period during which the role both of governments and of financial institutions in capital allocation shrank, and the role of private finance and specifically capital markets grew. Public policy in much of the developed world and the policies of the International Monetary Fund and the World Bank consciously encouraged this trend. Of course, the result was a world economy more vulnerable to a financial market panic, and an ensuing recession, than at any time since the Second World War. And of course, that was the moment when the panic came.

Much of the recent debate about financial reform has treated the financial system as an end in itself – so that the goal of financial reform is to stabilize and preserve the financial system. Naturally this is important, but it is clearly not enough. Ironically, some discussions have been focused on minimizing the threat the financial system poses to the real economy, as if minimizing systemic risk was the best we could do. Of course, returning to the post-WWII environment where financial busts did not pose a meaningful threat to economic growth is certainly a worthy goal, but it is not a sufficient one.

One of the reasons why the financial system is so hard to regulate is its extreme complexity and large size, especially in the Anglo Saxon world. A highly relevant, but not often asked, question is whether all this scale and complexity is necessary for satisfying the needs of the real economy. In fact, there have been simpler and smaller financial systems in the US and elsewhere in the past; even today, in the so called under developed world, certain aspects of the financial system may work better to channel efficiently resources from savings to productive investment.

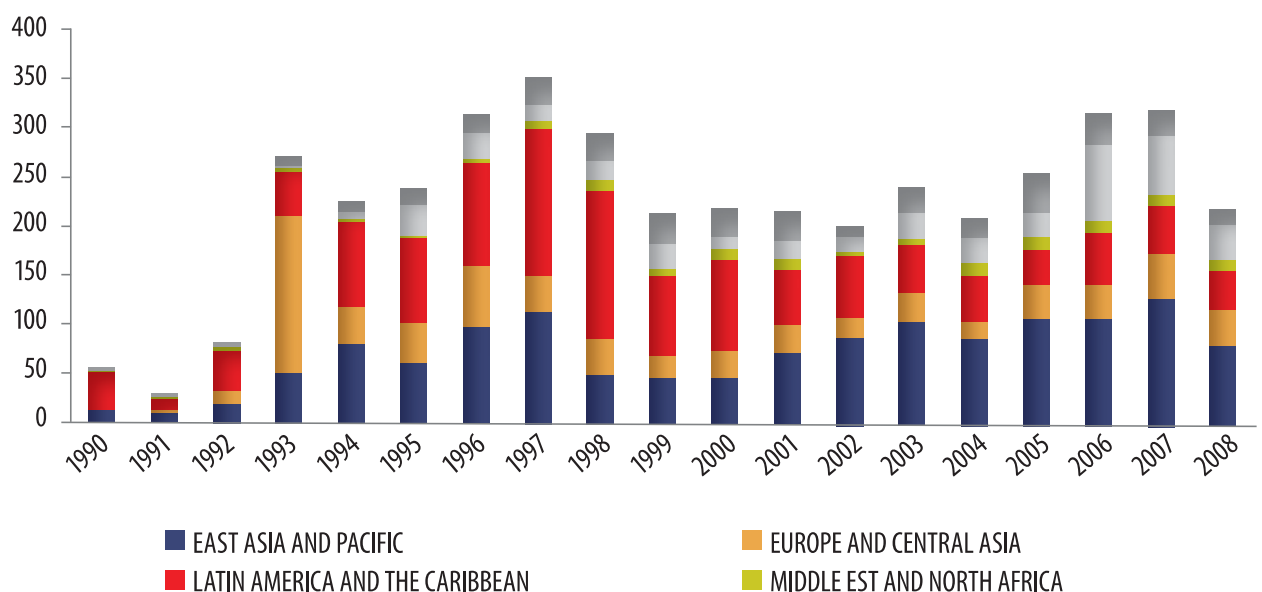
There is a wide consensus that some aspects of the increasing complexity of the world's financial system have been welfare-increasing. But critics rightly point out that the oversized financial sector that we have witnessed during the last decade - with financial activity, and their profits, growing at rates enormously bigger than those of real economies - is a signal that some parts of the financial system may be generating activities that are only marginally productive. Moreover, the destabilizing potential effects of some forms of financial trading for real economies need to be considered. As a result, the net effect of parts of the financial sector may be socially negative. As we have seen with the recent crisis, when the financial sector becomes a "threat to the sovereign" in making huge demands on public resources that then has knock-on effects for the state's capacity to provide welfare, we can talk about imbalanced priorities and raise the question of how to tax finance.

In particular, can we think of how to simplify and possibly even reduce (in some aspects, where there are large negative externalities) financial systems, to make them also easier to regulate, and less prone to financial crises, whilst more focussed on their real purposes, like providing sustainable credit for firms and households?

Consider the case of infrastructure on a global basis. Infrastructure plays a key role in promoting and sustaining economic growth and intraregional trade, especially but not only in developing countries. However, despite the significant progress in the development of infrastructure in most developing countries in recent years, investment has not kept pace with the demands placed on it by economic growth. This is particularly the case in East Asia. Recent estimates suggest that on average, Asia needs to invest about US\$ 750 billion per year in infrastructure during the period 2010 - 2020 to meet the strong growth of populations and economies. Approximately two-third of this amount will be earmarked as new investments, with the remaining third used for the maintenance of existing infrastructure assets.

As we can see in the Figure below, the private public investment in East Asia, at around \$70 billion in 2008 is well below the needed amounts. Also highly problematic is the fact that private public (PPI) investment in East Asia, and in the rest of the developing world fall after crises; as can be seen in the Figure above, PPI fell sharply in the wake of the East Asian crisis, and was very slow to recover previous levels; similarly we can see

**Private public investment in developing countries, by region (US \$ billions)**



Source: World Bank

how PPI has fallen for all developing regions since the 2007 crisis.

This latter fall is particularly sharp for low income countries, as we can see in the Table below, where PPI

### Private Public Investment in Low Income Countries (\$ US billion)

Low income	2006	2007	2008	2009
	\$ 8.9	\$12.0	\$10.1	\$0.6

– according to World Bank data –, fell from \$12 billion in 2007 to \$ 0.6 billion in 2009.

These trends show that firstly private investment in developing countries is insufficient, in relation to needs; secondly it is highly procyclical, in relation to crises.

In the United States, in the aftermath of the economic crisis and the rescue of the large financial institutions through the Troubled Asset Relief Program, there are continuing problems not just with infrastructure finance, but with the provision of commercial credit through the banking system generally. As can be seen in Table below, commercial and industrial bank credit is 18% below in June 2010 than it was in mid 2009; the fall for the

### U.S. Bank Commercial and Industrial Loans Outstanding Balances by Month

(\$ in 000s)	2008 Dec	2009 Mar	2009 Jun	2009 Sep	2009 Dec
All US Commercial Banks	\$ 1,618,600,000	\$1,563,500,000	\$ 1,503,700,000	\$1,561,800,000	\$1,316,000,000
% Change From June 09		97%	93%	104%	88%
Bank of America	\$ 188,845,918	\$ 193,463,760	\$ 191,710,309	\$ 171,587,276	\$ 165,589,221
JP Morgan	\$ 151,237,000	\$ 141,695,000	\$ 130,760,000	\$ 123,258,000	\$ 112,816,000
Citigroup	\$ 151,178,000	\$ 145,034,000	\$ 137,095,000	\$ 126,242,000	\$ 117,792,000
Wells Fargo	\$ 184,957,000	\$ 174,844,000	\$ 163,176,000	\$ 152,627,000	\$ 142,755,000
Total of 4 banks	\$ 676,217,918	\$ 655,036,760	\$ 622,741,309	\$ 573,714,276	\$ 538,952,221
% Change From Dec 08		97%	92%	85%	80%
% of Big Banks/Total	42%	42%	41%	37%	41%

*Federal Reserve National Information Center.<sup>1</sup>*

largest US banks is even higher, as it declined by 25% from December 2008.

The real measure of a successful financial system is, does it efficiently allocate capital to useful, wealth creating purposes? It is hard not to look at the record of the world's financial system over the last fifteen years and conclude anything other than that it failed this test. This is true whether the results are measured by simple returns to investors – who have suffered long term negative returns in some of the world's largest markets, or by the obvious waste of the trillions of dollars pumped into the developed world's housing bubble. But it is most true when one considers the investments not made – in the replacement of the developed

<sup>1</sup> The Federal Reserve System, Bank Hold Company Performance Reports, Federal Reserve National Information Center available at <http://www.fdic.gov/nicpubweb/nicweb/SearchForm.aspx>.

world's aging infrastructure, in basic infrastructure for the world's poor, and perhaps most tragically of all, in the energy technologies necessary to stop climate change,

In the remainder of this paper, we survey financial reform in the United States and Europe and measure it against both standards – has it addressed the causes of our continuing crisis, and are the reform measures that have been adopted or are under consideration likely to result in systems of capital allocation that are more likely to pass the more fundamental test of whether or not they allocate resources to productive purposes. We then examine in some detail the new Basel bank regulations proposed recently, as they will play an important role in shaping behaviour of banks in the future. In the final section we turn to financial transactions taxes, and especially the currency transactions levy.

## Regulation

### a. The United States and the Passage of the Dodd Frank Act

The one clear step toward re-regulation of global financial markets following the events of 2008 was the passage in the United States of the Dodd-Frank Act. This comprehensive legislation took a year to move through Congress, but, much to the surprise of many observers and lobbyists, it passed in a more robust form than it began, quite the reverse of the usual outcome of Washington's legislative process.

Several factors seem to explain greater strength of the US legislation compared to what has been accomplished in Europe, where the public discourse has been more aggressive than in the United States. Firstly, there was particularly strong coordinated lobbying effort on behalf of strong financial reform in the United States by trade unions, consumer and civil rights advocates, and a wide range of civil society organizations. This lobbying built on popular anger against the financial sector that was reflected for example in demonstrations and polling data. Much of the liberal media also backed the financial regulatory process. The trade union interest in systemic risk issues, arising out of the employment consequences of the financial crisis, had a particularly strong influence in ensuring regulatory and transparency progress on derivatives, on the establishment and nature of the systemic regulator and on the establishment and stronger features than would have been otherwise been achieved of the resolution authority.

In terms of the broader background, more progressive forces in U.S. politics were encouraged and became more assertive by the success of passing the U.S. health reform bill just as Congress took up financial reform.

Finally, there was the element of political structure and political leadership. The leadership provided by Senator Dodd and Congressman Frank at critical moments ensured that strong versions of the reform measures made it to the floors of Congress. Finally, and perhaps most importantly, the strong unitary executive structure of the U.S. system of government combined with President Obama's personal commitment to robust reform in a politically significant manner, particularly on aspects such as consumer protection.

#### **The Dodd Frank bill that resulted had the following key features:**

**Consumer protection** – the bill created an independent consumer financial protection bureau with a dedicated budget and close to universal jurisdiction over firms that sell consumer financial services. Recently,



President Obama appointed Harvard Law School Professor Elizabeth Warren to launch the new agency with the title of Assistant to the President for Consumer Affairs.

**Private Equity and Hedge Funds** – Dodd Frank requires that both private equity and hedge funds’ managers register with the SEC as investment advisors, subject to SEC issued rules for both disclosures and investor protection. In addition, Dodd-Frank creates the option that the Council of Regulators charged with overseeing systemic risk could find large hedge funds or private equity funds to be systemically risky, and require leverage limits or other systemic risk mitigation efforts be undertaken by the funds. Finally, the bill included a provision barring large banks from owning significant stakes in either leveraged buyout funds or in hedge funds

**Derivatives** – The Dodd-Frank bill ends the exemption from regulation granted to those who trade in derivatives in 2000. In its place are requirements to list over the counter derivatives with clearinghouses that will require parties post collateral to cover the risk of losses, and to list derivatives transactions with an exchange or exchange like entity that will provide pricing transparency. However, there are a number of exceptions to these requirements for commercial companies (end users) and others whose precise definition has been left up to the Commodities Futures Trading Commission.

**Corporate Governance** – The Dodd- Frank Act requires U.S. public companies to submit their executive pay packages for a shareholder advisory vote, as is also the case today in the United Kingdom. The Act also clearly grants the Securities and Exchange Commission the authority to require candidates for corporate boards nominated by significant long term shareholders to be included on management’s proxy card. Finally, and perhaps most surprisingly, the Act requires publically traded companies to disclose the ratio of the highest paid employee’s pay to that of the median worker at that company. The Securities and Exchange Commission has been left the task of deciding whether this ratio is company-wide or just with its U.S. workforce.

**Systemic Risk and Resolution Authority** – The Act created a Systemic Risk Council, tied to the Board of Governors of the Federal Reserve and chaired by the Secretary of the Treasury, with broad powers to regulate systemically significant institutions, including the power to set more stringent capital requirements, and bar systemically risky business activity. Under this system, the Federal Reserve is charged with doing annual stress tests of systemically significant institutions.

**Resolution Authority** – The Systemic Risk Council has the authority to place bank holding companies and other systemically significant financial institutions into a resolution process in which equity capital is eliminated, existing management is laid off, and there is a strong preference for haircutting bondholders. The resolution process would be run by the FDIC, who have the most experience in the US financial regulatory system in resolving weak financial institutions.

We summarize the main changes of this legislation in the matrix below, where we list why certain measures are desirable, which changes were initially envisioned by the administration (as reflected in their rhetoric) and what the final bill will actually do.

There is however a pattern that runs through the Dodd-Frank bill. The bill is the product of a struggle between two views of financial reform within the Democratic Party – first the view that the real problem was

that prudential regulators did not have broad enough powers to oversee and correct risky behavior. The second point of view was that there were structural problems within the financial system that had to be addressed – that simply giving prudential regulators universal jurisdiction was not going to for example resolve the problem of “too big to fail,” or that the big banks should not be allowed to own hedge funds no matter who was watching.

These tensions were ultimately addressed by Congress not addressing them, and instead asking regulators to involve the fundamental tensions in the bill. As a result, the real shape and force of Dodd-Frank remains unknown today, as the financial regulators begin the lengthy process of writing and adopting all the new rulemakings required by Dodd-Frank. The following table describes some of the key features of the Dodd-Frank bill that were left to the regulators to define.

Regulation of Wall Street	Desirable	Rhetoric of the administration	Reality
<b>Proprietary Trading of Banks</b> ( <i>Volcker rule</i> )	Needed in order to reduce interconnectedness due to funding strategies (repos) that rely on borrowing from other financial institutions and to prohibit speculation in institutions where taxpayer guarantees to protect depositors lower its cost and increase the incentive for risky behavior.	<i>In recent years, too many financial firms have put taxpayer money at risk by operating hedge funds and private equity funds ... When banks benefit from the safety net that taxpayers provide ... it is not appropriate for them to turn around and use that cheap money to trade for profit</i> (Obama, January 21 <sup>st</sup> 2010)	Rule has been adopted and other provisions will limit borrowing among financial institutions. However, the bill will allow banks to hold on to hedge fund and private equity funds equal to 3% of their tier 1 capital. Furthermore, regulators must distinguish between proprietary trading and trading for clients, which could lead to loopholes.
Transparency and Margins in the Derivatives Market ( <i>called Swaps market in the Legislation</i> )	Needed in order to increase systemic stability, as all sellers of derivatives (including nonbanks such as AIG) will have to hold capital in order to be able to cover their contractual obligations. Transparency is also needed to improve understanding of market activity by regulators and market participants.	<i>I will propose strong trading and mandatory clearing requirements, higher capital standards for systemically important market participants, real-time reporting of derivatives trades to regulators and the public and laws which will ensure that all loopholes are closed.</i> (Senator Blanche Lincoln, in a letter to Senator Cantwell et al.)	Transparency and margin requirements will be instituted for all derivatives which can be cleared through clearing houses. Those for which no clearing house can be established and those involving end-users will be exempted. Regulations covering who and what will fall under these categories will be established by rulemaking.

**Swap Trading by Banks**  
(Lincoln amendment)

Should be banned, in order to prohibit speculation by federally protected institutions, reduce interconnectedness and thereby reduce systemic risk.

*In my view, banks were never intended to perform these activities, which have been the single largest factor to these institutions growing so large that taxpayers had no choice but to bail them out in order to prevent total economic ruin.* (Senator Lincoln, May 5<sup>th</sup> 2010, press report)

Banks will be allowed to continue to conduct the majority of their derivatives business (such as foreign exchange and interest rate swaps) and hedge their own activities but they will have to push out to subsidiaries trading of non-investment grade entities, commodities, and credit-default swaps.

Capital Ratios

Capital adequacy ratios need to be increased and definitions of capital tightened in order to make banks more stable in the face of unexpected shocks. The problem of capital adequacy needs to be addressed in the context of market perceptions that large institutions enjoy an implicit government guarantee, by regulators adopting size based capital requirements.

In Pittsburgh, G20 Leaders noted the unique risk posed by Systemically Important Financial Institutions (SIFIs) highlighting that in addition to proposals to increase capital adequacy, for banks in general, the FSB should *propose . . . possible measures including more intensive supervision and specific additional capital, liquidity, and other prudential requirements.* (White House Press Secretary, June 27<sup>th</sup> 2010)

Some forms of hybrid capital will be phased out except for bank holding companies under \$15 billion in assets. BHCs will have to consolidate their capital ratios for their structure as a whole. Final regulation on how much new capital banks need to raise is pending (awaiting international agreements) but US regulators must issue rules establishing requirements to address risks arising from significant activity in derivatives, securitized products, financial guarantees, securities borrowing and lending and repos, and from asset and market concentrations. Regulators have the option of imposing size-based capital requirements.



**The problem of too big to fail**

Banks should be reduced in size in order to stop cheaper borrowing for banks which are deemed too big to fail and thus to avoid the high fiscal costs of rescuing huge banks which are engaging in too risky businesses.

Never again will the American Taxpayer be held hostage by a bank that is *Too big to fail*.  
(Obama, January 21<sup>st</sup> 2010)

The legislation does not require the break-up of big banks but the Financial Stability Oversight Council may require a systemically important company to take remedial actions, including selling assets, if 2/3<sup>ds</sup> of its members find that it poses a “grave threat” to financial stability. Further regulation regarding size might be imposed by regulators after impact studies. Mergers which result in holdings of more than 10% of financial assets by BHCs and financial holding companies will be prohibited after rulemaking by the Fed.

Even more fundamentally, the financial regulators and the Obama Administration face the challenge of whether or not to use the new resolution authority created by the Act to address the fate of a number of weak financial institutions kept alive by some combination of explicit government funds and implicit guarantees. While this question is most clearly posed by the state of Fannie Mae, Freddie Mac, and AIG, it is also relevant to the U.S.’s four largest banks, whose creditworthiness currently is in substantial part a function of their enjoying an implicit government guarantee.

**Moody’s: Uplift in Ratings From External Support<sup>2</sup>**

	Stand Alone Rating (Rating if no external support)	Actual Long Term Rating (adjusted due to external support)	Notches of Ratings Uplift Due to External Support
Bank of America NA	Baa2	Aa3	5
Citibank NA	Baa2	A1	4
JP Morgan Chase Bank NA	Aa3	Aa1	2
Wells Fargo Bank NA	A3	Aa2	4

<sup>2</sup> Moody’s.com - Moodys provides BFSR and Long-Term Rating and how the BFSR scale maps to the Long-Term Rating scale. Notches uplift from external support can be figured out from this.

### Fitch Ratings: Uplift in Ratings From External Support<sup>3</sup>

	Stand Alone Rating (Rating If no external support)	Minimum Rating For This Bank Due to External Support	Actual Long-Term Rating
Bank of America NA	C/D	A+	A+
Citibank NA	C/D	A+	A+
JP Morgan Chase NA	B	A+	AA-
Wells Fargo NA	B	A+	AA-

Because Dodd-Frank remains truly a work in progress, it is unclear whether it will ultimately lead to a U.S. financial system better able to transform savings into productive investment. That potential exists within the Act, but it may go unrealized. Ultimately, the effectiveness of Dodd-Frank may depend on the extent to which it is ultimately paired with other measures, such as changes to the tax codes, the restructuring of the housing finance system, and the creation of public or quasi-public investment vehicles in areas like infrastructure that will provide viable alternatives to a return to short term speculation, financial engineering, and yield chasing that have characterized U.S. financial markets over the last fifteen years.

#### **b. Europe makes progress, but somewhat less than US**

It seems more difficult to reach agreement in Europe on regulatory reform, as there is no federal state. Any regulation has to be negotiated by 27 member states, with different financial systems-both in their scale and in their characteristics. Above all, competition amongst EU member states to attract international investors and innovative financial products leads to national caveats in negotiations, which often create loopholes in prospective EU regulation (see also ETUC,2010).

In light of the limited progress made at the G20 on financial regulations, progress at the European level would be very important, as it is essential at least to have rigorous regulations at the supranational level of the European single market, to avoid a race to the bottom in the EU of looser financial regulations. European negotiations are more complicated because they take place in several levels:the more nationally oriented European Council, the very active more pro regulation European Parliament, and the European Commission. This makes the process slower and subject to bureaucratic delays, as well as to strong national and ideological contradictions; though lobbying by the financial sector seems less open and organized than in the US, it may in the end be more pervasive, as there are so many points of intervention where such lobbying can take place in Europe.

In Europe, valuable initiatives, such as that of the European parliament to regulate hedge funds and private equity - led by Poul Nyrup Rasmussen, President of the PES, gets not only diluted, but continuously postponed by the blocking tactics of the UK – where most of the European funds are hosted – the pressure from the US to avoid regulation for US funds in Europe and of course intense lobbying from hedge funds and private equity firms themselves.

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<sup>3</sup> Page 26, Fitch Ratings' "US Banking Quarterly 1010 - Financial Stability", June 2, 2010.

There are several areas where Europe seems well behind what the US is doing; one example is in relation to too big to fail, where Europe is largely silent, in contrast with the US, where the Volcker rule and the Kanjorski amendment gives federal regulators the power and responsibility to limit activities or even break up bigger banks if they pose a “grave risk” to the financial system. As ETUC suggests, caps on the size of the banks in relation to GDP, combined with a functional separation between investment banking and commercial banking seems very important also for Europe, as does forbidding deposit taking banks proprietary trading activities. It is to be seen to what extent the UK commission appointed for this purpose leads to meaningful changes in these areas.

However, there are important areas where the European Union seems to be making important progress, such as institutional issues, where a fairly ambitious pan-European financial regulatory architecture was approved. This architecture could become an important step forward that that would help develop common European rules for national regulators to implement. Three pan European Supervisory authorities for micro prudential supervision and regulation have been set up: one for banking, another for insurance and pensions and a third for securities and Markets. A European Systemic Risk Board has been set up for macro prudential regulation, which is due to start running in January 2011. The trade unions will be part of the Scientific Advisory Committee of the macro prudential regulator, thus providing diversity of stakeholders there, though they are no longer part of the Board, as was originally planned.

Another important development is that the European Parliament may request the European Council to declare an emergency for regulatory purposes. The legislation also contains elements such as the banning of certain financial products, consumer protection in financial markets, and binding mediation between national regulators in case of conflicts. Apparently the European regulators may in case of emergency – if national regulators do not act appropriately – impose binding decisions to national authorities. If national regulators do not comply, the European authorities can impose conditions directly on the financial institutions concerned. Finally, EU authorities will be equal partners in colleges of national supervisors.

### **c. Basel 3 proposals**

While both the U.S. government and the EU have been addressing comprehensive financial reform, a parallel international process has been underway addressing the particular problem of capital standards for banks in light of the shortcomings of Basel II revealed by the financial crisis. In September 2010, the 27 countries of the Basel Committee on Bank Supervision agreed in principle rather major changes to bank regulations, the so called *Basel 3*. Their aim is to strengthen banks so that “never again” a crisis like the 2007-2008 happens. The *Basel 3* initiatives appear to be quite substantially influenced, amongst others, by the critique of *Basel 2* levelled by Daniel Tarullo in his book *Banking on Basel*. Mr. Tarullo now serves as President Obama’s appointee to the Board of Governors of the Federal Reserve System, with particular responsibility for bank regulatory matters.

These *Basel 3* proposals have a number of positive elements, such as increasing risk weighted capital requirements, (though questions are rightly asked whether this increase is large enough and soon enough, see below), introducing a leverage ratio for solvency, an additional capital buffer and a countercyclical buffer (through dynamic provisioning based on expected losses) and introducing liquidity provisions.

However, a fundamental issue looms over *Basel 3*. Many of the provisions of *Basel 3* have effective dates far into the future. The reason for this, sometimes stated openly, sometimes not, is that banks and governments

are fearful that sound capital requirements, if imposed in the current economic situation, would lead to a further pullback in bank lending, and acting as a further drag on an already weak global economy. This approach is founded on the earlier refusal of a number of bank regulators in advanced countries, particularly the United States and Germany, to take a hard look at the asset side of their banks' balance sheets. The implementation schedule for *Basel 3* is unquestionably part of a broader strategy of forbearance, a strategy with unfortunate antecedents in the Japanese lost decade of the 1990's. The alternative approach would be to impose appropriate capital requirements now, and restructure and force to raise capital for banks that are too weak to function in their role of credit provider.

In what follows we analyze *Basel 3* measures in some detail and provide a critique. Firstly, are the increases of capital requirements enough, and will they be implemented soon enough? Most observers, even fairly conservative ones, think the answer is no to these questions, especially for banks with very risky assets. A more radical critique, which we discuss below, is whether focusing on risk weighted assets is the best approach, or will this lead to new forms of arbitrage? Also are the liquidity buffers well designed and sufficient? Will the new regulation deal properly with the problems that caused the previous crisis and even more whether the rules are dynamic enough to avoid systemic risk building up? Finally will better regulation of banks not cause financial activity to move even more to the so called shadow banking system if other activities are not properly regulated? Below we describe the main changes being suggested, and in a preliminary way offer an evaluation.

### 1. Raising core capital requirements- is it enough?

#### 2. What has been decided?

The **minimum common equity requirement** (the highest form of loss absorbing capital) is raised **from 2% to 4.5%**; **Tier 1 capital is raised from 4 to 6%**, while total tier 1 and 2 requirements will remain at 8%.

In addition, the definitions of Tier 1 and Tier 2 capital have been changed to raise the quality, consistency and transparency of the capital base. The goal is to make sure that banks have access to this capital at all times, and that the banks can stop paying any dividends on Tier 1 capital in case of crisis. Clearly, common equity and retained earnings most easily fit the definition of Tier 1 capital. The deduction of certain positions from core capital has also been made more restrictive. Banks will, for example, have to deduct good will and general intangibles from common equity rather than from tier 1 capital, as was the norm before *Basel 3*. This is effectively increasing the amount of common equity banks need to hold.

The cumulative effect of the two measures just described will mean that it will be significantly more expensive for banks to raise capital than it looks at first sight, i.e. that the mere numeric increases look far smaller than what *Basel 3* has actually done.

In addition, banks will need to hold a **capital conservation buffer of 2.5%**, designed to withstand future periods of stress. As a consequence, in calm times, banks should have 7% of common equity. **Banks are allowed to draw on the 2.5%**, buffer in times of crisis; however, the closer to the 4.5% core common equity they come, the smaller becomes their capacity for the distribution of dividends and bonuses among employees. The Basel Committee claims that in this way, regulators will effectively require retained earnings be used to increase common equity, rather than allowing banks to spend retained earnings on executive compensation.

The Basel agreement included in addition a number of less well detailed proposals, whose final shape remains to be resolved:

- **Countercyclical buffer of the range of 0 to 2.5% of common equity**, which will be implemented according to national circumstances, when there is excess credit growth in a country. Once introduced, it is above the 7% total equity requirement described above. The acceptance of the countercyclical buffer is a very positive step forward (see Griffith-Jones and Ocampo with Ortiz ,2009 for a discussion of the great need for countercyclical provisioning to help moderate booms and busts).One problem with implementation is that banks increasingly lend internationally, especially in countries in the EU. In order to prove more effective, such moves then would have to be accompanied by restraints for lending for foreign banks in these countries. This will be aided by the creation of EU wide regulatory institutions; also very important would be the adoption of greater emphasis on home country regulation, as advocated in the UN Stiglitz Commission Report (2009)
- **Non-risk based leverage ratio:** Behind the risk-based capital measures, there is a flat 3% Tier 1 capital requirement as a “back stop”, meaning a complement to the risk based approach. It implies a maximum leverage ratio of 1 to 33.33. The simple leverage ratio is based on high quality Tier 1 capital, with a 100% treatment of all exposures net of provisions, including some off balance sheet exposures. Test runs regarding this ratio will be starting from 2013, which will be evaluated in mid 2017 and put into pillar 1 requirement form (hopefully) by January 1<sup>st</sup> 2018.

Whilst introducing a leverage ratio, as a backstop to risk weighted exposures, (with the latter far more subject to regulatory arbitrage) is positive, given that excessive leverage was such a large part of the causes of the crisis, it could be asked why is the leverage ratio not the primary capital adequacy control tool ? Also very importantly, should leverage permitted not be lower as was initially proposed , proposal which was watered down due to the pressure of the banks ? And implemented sooner? In this respect, it is ironic to note that the Non-risk based leverage ratio in *Basel 3* of 3% is approximately the same leverage ratio that the U.S. Securities and Exchange Commission allowed the investment banks under its supervision to reach in 2005, a step for which the Commission has been intensely criticized. Three of those five firms failed, the other two converted themselves to bank holding companies so they could take advantage of Federal Reserve provided lending in the crisis.


The BIS and the Financial Stability Board are considering raising capital requirements for systemically important banks, where they are trying to determine the right size. For this reason, there is yet no number or a binding time plan.

### **Implementation:**

One of the key critiques of the *Basel 3* proposal is that they will be implemented far too slowly, with some not being in effect until 2022. The schedule is detailed below. The main reasons why this has been done is lobbying by the banking industry itself, and the fear by regulators that increasing capital and other requirements sooner could further curb banks willingness to lend, thus further undermining growth and jobs recovery. The



problem is that this current strategy is too risky, especially as many banks are currently perhaps weaker than the numbers show due to accounting manipulations on the asset side of their balance sheets. The risk of more banking problems occurring before the new rules kick in seems unacceptable. Therefore an alternative could be for regulators to push banks, especially those that are clearly undercapitalized, to raise fresh capital; this could be enforced, as Sharfstein and Stein (2010) suggest, by regulators forbidding dividend payments or limiting compensation until they did so.



**National implementation will begin by January 2013, by when these requirements will have to be implemented into national law.** That day minimum core equity requirements will be raised to 3.5%, tier 1 from 4 to 4.5%. On 1<sup>st</sup> of January 2015, the banks will have to meet the 4.5% common equity and the 6% tier 1. Regulatory adjustments, which will further increase the capacity of core equity to absorb losses (by e.g. limiting investments in other financial companies to 15%) will be phased in in 2018.

**The raising of the tier 1 capital from 4 to 6% will be phased in starting January 1<sup>st</sup> 2013 and will be reaching 6% by January 1<sup>st</sup> 2015.**

**The capital conservation buffer will be phased in from 2016 and reach 2.5% on January 1<sup>st</sup> 2019.** The same holds for the countercyclical buffer, where countries are urged to shorten the transition phase in case excessive credit growth is experienced.

**State capital injections will be phased out by 1<sup>st</sup> of January 2018. Instruments which will no longer qualify for tier 1 or tier 2 capital will be phased out through an annual 10% derecognition starting from January 2013 and ending December 2022.**

Disqualification of riskier forms of tier 1 capital will be recognized immediately in 2013. However, if they are issued by non-joint stock companies, recognized under national accounting law and national banking law, they will be exempt from this provision. This seems to be a response to the problems of German public banks.

### **Liquidity requirements: what is done?**

One of the most revolutionary aspects of *Basel 3* is its attempt to establish liquidity risk as an independent pillar of regulatory action and supervision, rather than treating it as a subsidiary problem to the risk of losses. *Basel 3* applies liquidity tests to internationally active banks on a consolidated basis. While their implementation is too slow and the measures themselves could be more robust, this direct approach to regulating liquidity is very positive. Problems of liquidity were central to the crisis, and in part were the result of previous regulation having practically abandoned liquidity regulation. Financial institutions, including banks, had extremely low liquidity ratios, which made them very vulnerable (see for example Darista and Griffith-Jones (2010) for the US).

**A liquidity coverage ratio is introduced, which will come into force on January 1<sup>st</sup> 2015. The Net stable funding ratio will be introduced by January 2018.** However, these standards might still be changed, in case unintended consequences occur over the observation period. Initially, implementation was planned earlier, but banks complained that the impact of these measures might be dramatic and therefore require more

intensive quantitative studies (s. e.g. Zentraler Kreditausschuss (2010)) justifying the delay. These two measures, if implemented, could have a very significant impact on large banks' business model, limiting the derivatives business of banks and their exposures to the wholesale funding market. In particular, this measure make make it difficult for banks to participate in the Asset-Backed Commercial Paper (ABCP) markets.

- **The liquidity coverage ratio** is defined as the sum of all liquid and high value assets a bank holds (weighted according to the quality and liquidity of assets) and the 30 day liquidity needs it might face, assuming a disaster scenario. This ratio has to be equal or bigger than 1. The rating of the quality and liquidity of assets will form part of the quantitative impact studies. Conservative approaches favor substantial discounts on corporate and covered bonds, letting only cash and state bonds have a 0% risk weighting. On the denominator side, credit and liquidity lines for small and medium sized enterprises and for banks and special purpose entities will be weighted with 100%. For Special Purpose Entities (SPEs), this proposal is intended to curb much of off-balance sheet activity, as it will not be profitable anymore for banks to engage in the credit arbitrage business by running SPE's and providing them with liquidity lines and other credit guarantees. On the other hand, the 100% risk weighting for credit lines for banks and SME's seems overly restrictive, and could damage lending to SMEs. Also, given that the current risk weighting measures are very restrictive for the more speculative and more profitable activities in the short term, there is the risk that after Quantitative Impact Studies, they will be severely watered down. If that occurred and yet the 100% weighting remained for credit for small and medium sized enterprises, the net result would tilt the financial system further away from financing the real economy.
- **The net stable funding ratio** is defined as a ratio of all available stable refinancing options over all the needed stable refinancing options over the course of one year. This ratio has to be equal to or bigger than one. This further seeks to minimize the liquidity mismatch in the banking sector, which proved so disastrous in the crisis. However, this might impact lending too much, so that recalibration will be needed. Liquidity lines are risk weighted, such that 10% of their value has to be available for the entire year. Other contractual commitments by the banks will have to be risk weighted by national regulators, which may reintroduce national regulatory competition.

Besides these two measures, *Basel 3* also provides 4 instruments to supervisors in order to measure the liquidity risks of banks. These are:

1. The contractual maturity mismatch
2. The concentration of funding- which aims at uncovering and potentially limiting the concentration of exposure to lenders,
3. The available unencumbered assets: how much can the bank refinance without trouble, and
4. Market related monitoring tools

With the help of these instruments, regulators hope they will be able to have a better understanding of the liquidity consequences if a bank is failing.

### **Criticism/ final evaluation**

Like its predecessors, *Basel 3* may be vulnerable to strategic behavior by the banks. And despite the obvious efforts to make the *Basel 3* rules less vulnerable to the banks' own risk management models than *Basel 2* was, *Basel 3* remains dependent on risk management models that may not be able to easily model the consequences of the interaction between the behavior of different actors in the financial system in a crisis.

As Felix Salmon points out in his blog on "*The biggest weakness of Basel III*", imposing risk weighted measures on assets is not only backward looking, but it induces a game in which banks increasingly take up risks which are not accounted for by the regulatory framework, *Since taking any additional measurable risk is now stigmatized, the game becomes how to increase returns without increasing measurable risk...*

This means that *Basel 3*, which is reacting to rampant regulatory arbitrage under *Basel 2*, which was a reaction to rampant regulatory arbitrage under *Basel 1* might again induce regulatory arbitrage (s. Blundell-Wignall and Atkinson 2010: 3). Banks may transform assets with high risk weighting into assets with low risk weighting, which, as in the case of AAA MBS can prove disastrous.

*This issue is about promises in the financial system. If regulations treat promises differently in different sectors, then with complete markets in credit, the promises will be transformed into those with the lowest capital charges... There is a massive incentive in financial markets to use "complete market" techniques to reconfigure credits as capital market instruments to avoid capital charges and reduce tax burdens for clients, thereby maximising returns for themselves and their customers. This will continue despite the proposed reforms.* (ibid: 5, 8)

This problem could be counteracted maybe, if the two measures of liquidity and capital ratios are actually supporting each other in order to stem excesses, i.e. if loading up on assets due to 0 risk weighting is actually limited by the liquidity requirements of banks, and in particular source of funding regulation. Also, as discussed above, if the leverage ratio were to be lower and more binding, as well as given a bigger regulatory role, this could help. How these factors will interact together thus has to be a focus for future research and study as well as monitoring by regulators, in order to determine how different elements can be adapted to each other to prevent excessive risk exposure due to regulatory arbitrage.

The two ratios, Liquidity Coverage and Net Stability Funding are particularly subject to modeling risk. The effectiveness of the two ratios at preventing crises will depend on the models used by regulators in order to determine liquidity behavior in these moments of crises. The ZKA has noted that the approach of penalizing illiquid investments will lead to more herding and concentration risks. This is so because these restrictions make certain business models unprofitable and thereby will lead to more intense competition in other segments. If these segments are impacted by a crisis, due to lower diversification, the whole banking sector will be affected.

Duttweiler (2010) also points out that the LCR and NSFR-approach well defines the period of one month (shock) and the period for one year (crisis). However, it is unclear how a bank will be able to renew its short term liquid assets if it is in a persistent liquidity crisis after the first 30 days.

Then there is the problem of off-balance sheet instruments. Many of the banks which looked well capitalized before the crisis suffered the biggest losses during the crisis. This was due to mispricing of securitized assets on balance sheets and due to off-balance sheet activities which were not sufficiently accounted for in core equity calculations. The historical impact of the crisis on core equity was substantial, and for several banks far above even what the new capital requirements could buffer. One approach to this problem is to instead of demanding impossible equity ratios, to reduce the sources of potential substantial sudden write downs in the system, by discouraging or forbidding more risky instruments. This is essentially the approach taken by the Dodd-Frank bill to a limited extent in barring large investments in proprietary trading by banks.

In this respect, *Basel 3* does go some way in the right direction. The liquidity coverage ratio and the net stability funding ratio, if enacted as such will limit the emission of ABCP-papers for credit arbitrage reasons and will thereby limit one of the most lethal instruments for banks before the crisis.



In general, *Basel 3* (like most regulation) is an ex-post regulation which cannot foresee future regulatory arbitrage. For this reason, stronger and especially faster mechanisms for responding to regulatory arbitrage need to be found (and are not part of *Basel 3*). Here we must recognize the irreducibly political nature of bank regulation. To the extent banks are allowed to become large enough to dominate the regulatory process itself, that process will never have the political independence to respond to regulatory arbitrage in anything other than a crisis environment.

During the run up to the financial crisis, regulatory arbitrage activities often involved the shadow banking sector. Thus, industry bodies, such as the ZKA for Germany, have rightly noted in response to *Basel 3* that the new regulations will increase the incentives for regulatory arbitrage, as they are imposing severe limitations on banks, while leaving other financial sectors untouched (e.g. money market funds).

The appropriate response should be a more robust form of increasing regulatory coverage that included all financial intermediaries and all financial instruments in an equivalent way in the same core capital requirements regime in order to avoid such asset-shifting (Darista and Griffith-jones, op.cit.; for more recent analysis see Blundell-Wignall and Atkinson (2010): 16f). This is not an easy task, but is essential. Both US and EU regulation are moving in this direction, but too slowly and not comprehensively enough.

The step of creating a systemic regulator, both in the US and in Europe, is an important move forward; however, the question is if they will be sufficiently strong and comprehensive? The further question is how much more should in the medium term the international institutional regulatory structure be coordinated, with a view towards the creation of a global financial regulator, as discussed in the *UN Stiglitz report*? Naturally issues of governance, eg participation of developing countries, and autonomy from financial interests, would be crucial here.

## **A fair contribution from the financial sector; the case for a financial / currency transactions tax**

The global financial crisis sparked a surge of interest in financial transactions taxes. Financial transaction taxes are a response to failures of the financial system to allocate resources productive in two ways – first by increasing resources for governments to invest in areas like infrastructure and education, and secondly, by creating incentives for financial markets and financial institutions to make productive investments rather than engaging in speculative market activity. Financial transaction taxes also are a way to discourage systemic risk and encourage financial stability, in the tradition of Keynes and Tobin. Finally, such taxes may, for example, improve transparency, which is good for financial stability, as was the case in Brazil during the bank transaction tax era.

For some time there have been various proposals for “innovative sources of financing” to meet the goal of official development assistance of the United Nations and help finance provision of global public goods. This received support in several UN summits since 2000. Some innovative sources have begun to be successfully adopted, such as a tax on airline tickets.

Proposals for financial taxes have received support in the UK – the world’s largest financial centre for foreign exchange transactions – from former Prime Minister Gordon Brown, and the head of financial regulation, Lord Adair Turner. Furthermore, the manifesto of the UK Liberal Democrats, now part of the Coalition Government, clearly endorsed such a tax, and its use for development and climate spending. The leaders of France and Germany have also given significant support to this idea, as has President Luiz Inácio Lula da Silva of Brazil. At

the recent UN Millenium Development Goals Summit, many leaders-and especially Heads of State José Luis Rodríguez Zapatero and Nicolas Sarkozy – gave clear support for such a tax. There has also been support in other European countries as well as Japan. In the US, the labor movement, led by the AFL CIO has given strong support to such taxes, as have prominent NGO's like Oxfam. In September, Ecofin (EU Finance Ministers) started discussion of a financial transactions tax.

The efforts to enact financial transaction taxes have received further support from recent expert reports. One such report was written by a group of experts at the request of a leading group of 60 nations sponsored by the United Nations, including the United Kingdom, France, Germany, Spain, Japan, Belgium, Brazil, and Chile, which concludes that a very small currency transactions tax, of 0.005% is the best option (TIFTD, 2010). The most recent paper of the IMF on the subject of financial transactions taxes, (IMF, (2010) recognizes that securities transactions taxes (STTs) exist in many countries and there is little evidence that they distort markets; it concludes that a low rate, less than 0.05%, broad based multilateral STT would raise considerable resources, whilst having modest impact on markets, beyond its impact on short term trading, especially linked to computer high frequency trading.

There are several important reasons for strong support for a tax on financial transactions. First, even a small tax (half a basis point, or 0.005%) applied only to foreign-exchange transactions of major currencies could generate a significant amount: more than \$30 billion annually (see Spratt, (2006); TIFTD, (2010), op cit). These resources are increasingly seen as critical at a time when the global crisis caused a significant increase in deficits and public debt levels in developed countries, and there is high unemployment in these countries. And this at a time when the crisis has also increased poverty in many developing countries, making it harder to meet the Millennium Development Goals (Ocampo, Griffith-Jones et al, (2010). In addition, governments around the world need additional resources to finance investments in developing countries to combat climate change, while the global financial crisis makes it less likely the private sector will finance such investments.

An added attraction of a tax on currency transactions is that a high proportion of such transactions are made by people of high income or by specialized financial agents, including hedge funds. Therefore the tax seems likely to be more progressive than other taxes. Possible disadvantages, argued by opponents of such a tax, like a reduction in liquidity, should not be relevant provided the tax is very small, as for example IMF reports have recognized. Indeed, such a tax would be far smaller than the commissions and spreads charged by financial institutions for such transactions.

A second reason is that, at the moment, political support for such a levy is relatively high, given the widespread perception that the behaviour of the financial sector has been one of the root causes of the crisis. The key question is whether the significant rhetorical and technical support will materialize into a political commitment. The recent financial regulatory reforms, especially in the US but increasingly in Europe, give ground for optimism that governments can be independent of financial interests, to act for the common good.

There is also a long tradition of taxing financial transactions nationally, including in the United Kingdom which has a stamp duty on all stock sales of 0.5%, or 100 times above the proposed tax to be applied to currency transactions. Not taxing currency markets, despite their large volume, is a real anomaly. (IDEAS, 2010).

It should be noted, moreover, that financial transaction taxes have a distinguished theoretical tradition. Since Pigou it has been recognized that there is a need to correct, through taxes, the difference between

public and private marginal benefits of economic activity generated by negative externalities. Keynes, in his *General Theory*, more specifically proposed a small tax on financial transactions to mitigate volatility generated by speculative excesses (Keynes, 1936). Nobel laureate James Tobin proposed in 1972 a tax on foreign-exchange transactions. Tobin (1996) explained that the proposal's aims were twofold: cause exchange rates to better reflect fundamental factors rather than short-term expectations, and expand autonomy of national macroeconomic policies. As such a tax could generate substantial resources, Tobin suggested they might be used for international purposes, such as development.

The *Tobin tax* as it came to be known, was supported by well-known economists of different persuasions (Jeffrey Frankel, Peter Kenen, Lawrence Summers, John Williamson and Nobel Prize winners Paul Krugman and Joseph Stiglitz, among others).

In recent years, proposals to create a tax on currency transactions (CTT) have varied, however, in relation to Tobin's initial suggestions (see, for example: Landau, (2004); I.F.T.D., op cit). **The CTT differs, therefore, from the Tobin tax, both in its purpose, which would be only to get additional resources, and in its amount, which would be much smaller to avoid distorting effects on the foreign exchange markets.**

Politicians in developed countries seemed more willing to support such a tax in the context of innovative financing for global public goods (GPGs) such as poverty reduction and mitigating, as well as adapting to, climate change. Overall, sectors of civil society switched to support for a lower tax to raise revenue for development and climate change. It was also assumed that ensuring financial stability should be achieved mainly by more precise instruments, such as financial regulation.

However, given the severity of the global financial crisis, and the central negative role the financial sector played in it, some studies (such as IDEAS, 2010) returned to the idea of currency or financial transactions taxes to help curb, together with regulation, massive negative externalities that the financial sector generates, as well as raising revenue for GPG.

Proposals to use taxes to help financial stability are especially influential in continental Europe (Schulmeister, (2009)) and progressive US circles (Baker et al, (2009)); they also tend to prefer a broader financial transactions tax on all financial activities.

Importantly, as a result of the collapse of Herstatt Bank in 1974 and its negative effects on international payments, regulators, central banks and private banks have taken measures to reduce risk in systems payments for foreign-exchange transactions. This has led to the establishment of the *Real Time Gross Settlements System*. This means that all transactions in foreign currencies are made in real time in a centralized manner. Supporting these activities, there are a number of institutions that have complete records of currency transactions. This makes it extremely easy and inexpensive to impose taxes on currency transactions. There is also a similar central global clearing system for derivatives transactions.

Ideally, such a tax would be done at the multilateral level (or, rather, for the major currencies), but studies show it could be applied to individual major currencies. Thus a coalition of the willing, eg the Leading Group of countries and/or the EU could move forward leading by example.

We will look at two recent reports on financial taxes, to illustrate different types of financial taxes, and their aims. The first was the mentioned report written by a Committee of Experts (including the coauthor of this article) at the request of a taskforce created by a leading group of governments (TIFTD, op cit). The second

report is written by IDEAS, a think tank close to the Spanish government and endorsed by Stiglitz, Sachs, Stern, Griffith-Jones and others. Whilst the first report focuses more on a small currency tax to finance development and climate change, the second focuses on larger and wider financial transactions taxes to both curb speculation and raise revenue.

### **a. The Taskforce on International Financial Transactions for Development Report**

The aim of the TIFTD Report is to address the vast shortfall in finance required to meet international development and environmental commitments. The global financial crisis and resulting fiscal consolidations, seriously undermined governments' ability to meet existing commitments.

This Report links the funding crisis directly to the "global solidarity dilemma". The growth of the global economy has not been matched with effective means to levy global economic activity to pay for global public goods.

Given the scale of the funding gap, financing will need to be on a large scale. The financial sector is the most appropriate point to levy such an innovative financing mechanism. The sector is intertwined with the globalized economy, and is a primary beneficiary of its growth. It is the most appropriate channel to redistribute some of the wealth of globalization towards provision of global public goods, to help those benefiting least from globalization.

The option this Report chooses as most desirable is the global currency transaction levy (CTL) on foreign-exchange transactions on all major currency markets at points of global settlement. Given existing infrastructure, it would be easy and cheap to implement, practically immediately. It could serve as a pilot (to be applied for 4-5 years); then if it worked well, it could be extended both in time and/or to other financial transactions.

Global collection mechanisms avoid the domestic revenue problem, as funds would go directly into a Global Solidarity Fund for development and mitigating climate change. A global CTL has challenges. Principally, the levy would need to be scaled so it did not lead to avoidance of centralized settlement. However, the report concludes this would not be difficult. First, currency transactions not going through centralized settlements could be non-enforceable legally if problems arose. Second, higher capital (or margin) requirements could be placed on transactions not going through central settlement.

### **b. The IDEAS Report**

The IDEAS Report argues that taxes, apart from being a source of revenue for the public sector, are an instrument for economic policies. The obligation to pay taxes provides governments with information about the volume of trade (large parts of financial transactions performed daily are completely unknown). Also, taxes are tools to create the right incentives to decrease the volume of transactions that generate more social costs than benefits.

The two main objectives for the suggested FTT are: promoting stability of the financial system; and obtain revenues to cover costs of the current economic crisis originated by financial causes, and/or provide funds for global public goods.

Three main objectives should be pursued in designing taxes on the financial sector, according to this report:

- 1. avoid negative externalities generated by the financial sector,**
- 2. put an end to the anomaly of having a large sector with no VAT; and**
- 3. obtain revenues.**

The IDEAS Report makes the important point that different taxes on the financial sector are not mutually exclusive: a combination of different types of taxes applied to the financial system could be used since they pursue different objectives, although the fiscal burden on the sector should be carefully considered.

Like the IFTD, the IDEAS Report argues that a global approach to financial taxes would be the right one: but, if this does not happen, it suggests the debate should continue at EU level.

### **c. Economic and political conclusions on taxing the financial sector**

Both these approaches to financial sector taxation should ideally be implemented multilaterally, as markets are global. However, if this is not politically feasible, it is technically possible to have it implemented by a group of countries – or a so-called coalition of the willing; examples could be the EU or the Leading Group of countries for Innovative Financing. Ideally the US, given its importance, would join such an initiative, but it is not essential. The lead may be taken by countries where the lobbying powers of the financial industry are relatively weaker (or where the financial sector is more enlightened) or counteracted best by other political forces, linked more to the real economy.

There could be a two pronged strategy; a CTL on currency transactions could be used mainly to fund global public goods, such as helping finance development and poverty reduction in the poorest countries, as well as investment in climate change mitigation in the developing world. Taxation on other financial transactions, (mainly domestic, which ideally but not necessarily be coordinated) would be used for domestic purposes, such as deficit reduction, but above all job creation and long term investment.

### **d. Overall Conclusion**

The financial crisis of 2008 and the global economic crisis that followed it led to a paradox. The rise of neo-liberal approaches to financial regulation over a generation had discredited mixed economy approaches to capital allocation, and led to a deep belief in policy makers in unregulated financial markets as efficient allocators of resources. A key consequence of this trend was skepticism about government intervention in the form either of subsidies, direct public investment or loans, or the use of tax policy to drive investments. It was thought that government was not efficient, and markets were.

In the crisis of 2008, governments intervened wholesale to prop up both financial institutions and financial markets that had demonstrably behaved in an astoundingly inefficient and destructive fashion. Instead of using the power of government to support investment for clear reasons related to the need to provide public goods, the power of government was used only to prop up financial markets and institutions largely because they were there. Clearly it was also the case that governments did not want to risk a repeat of the negative effects of financial sector collapse as occurred in the 1930s.

Financial reform and debates over financial sector taxation in the U.S., Europe, and on the international stage in processes like the *Basel 3* accord and the work of the Financial Stability Board represents an opportunity to ask, how can governments interact with private institutions and financial markets to lead to genuine wealth creation, so that financial markets are the helpful servants, and not the destructive masters of the world's real economies, and of democratic societies. In our survey of regulatory and tax initiatives, we have shown that a number of positive steps are either underway or being contemplated by governments, often under pressure from angry publics and mobilized labor movements and NGO's. But what is equally clear is that unless the

promise of the initial regulatory steps is realized and complimented with parallel tax reforms, it is likely that the financial system's capacity for regulatory arbitrage and political capture will set the stage for both continued failure on the part of the financial system to perform its proper role, and more crises to come. Though regulation and taxation are crucial, a more in-depth transformation of the financial sector to make it simpler and better suited to the needs of the real economy seems desirable

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