The Nation.

Published on *The Nation* (http://www.thenation.com)

No Free Ride for Finance

Dean Baker | May 11, 2011

There is growing momentum in the United States and Europe for increasing taxation on the financial industry. On April 13, the Congressional Progressive Caucus put out a People's Budget that explicitly called for taxing trades of derivatives and foreign exchange transactions. In March the European Parliament voted in support of a financial transaction tax by a margin of more than 4 to 1. Even though the financial industry is too powerful to allow any new taxation at the national level in the United States, there is a real possibility of new taxes on the sector at the state level.

The best way to tax the financial sector would be through a financial transaction or financial speculation tax (FST). Such a tax (e.g., 0.25 percent on each side of a stock trade) would impose a modest cost on normal financial dealings. In most cases, it would just raise the cost of a trade back to where it was twenty or twenty-five years ago, when the United States already had a deep and well-developed capital market. For those engaged in rapid trading, however, a financial transaction tax would impose a heavy cost. This would discourage many types of short-term trading strategies, leading investors to focus more on longer-term trades—which, in turn, could help reorient the focus of the financial sector to its economic purpose.

While the financial industry has the political clout to prevent a serious tax from being imposed at the national level, that doesn't necessarily mean that it can escape better taxation. A financial transaction tax would be difficult to impose at the state level, but last year the International Monetary Fund suggested a viable alternative: a financial activities tax (FAT).

A FAT is essentially a value-added tax that would be applied to wages and profits in the financial sector. Countries around the world have extensive experience with value-added taxes. In Europe, they rival income taxes as the primary source of revenue for national governments. So the concept of the FAT is nothing new, even though this sort of value-added tax has not previously been applied to the financial industry.

The IMF argued for the merits of the FAT for the same reasons that many progressives support financial transaction taxes. It views the financial sector as being bloated with rent-seeking behavior that offers no benefit to the productive economy. A FAT would help to shrink the financial sector down to size while pulling away some of the industry's vast profits.

Although a FAT would not directly target speculative trading the way a transaction tax would, it would likely be easier to enforce, and in the United States it could be imposed at the state level. All but the smallest FST would send the bulk of trading into neighboring states. With current technology, even Wall Street would lose much of its business to trading platforms in New Jersey if it faced anything beyond a very minimal tax.

However, banks, brokerage houses and insurers will not abandon their business in a state simply because of a modest tax. Much of this activity is location-specific. Financial firms will want to keep their markets even if the profits are somewhat smaller following the imposition of a tax.

And a FAT can raise a substantial amount of money. If a 5 percent FAT had been imposed on the entire financial industry in 2010—the IMF used that rate in a recent report to the G-20—it would have raised more than $115 billion nationwide, an amount that would have covered almost two-thirds of the states' budget shortfalls.

If FATs become widely instituted across states, they will help reduce the profits and weaken the power of the financial industry. This will also show that the industry is a potential source of considerable tax revenue, a fact that has somehow been absent in the budget discussions in Washington.

For these reasons, the industry can be counted on to do everything in its power to oppose state-level FATs. But if one state can go first and show the substantial revenue dividend that such a tax can yield, other states will likely follow.

Willie Sutton was right when he said that banks are where the money is. That's because they have taken it from us. Progressives must find ways to give the money back to people.

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