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# Financial Sector Taxes

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## Financial Sector Taxes

### Main points

Reported profits and bonus payments in the UK financial sector could be as high as £90 billion in 2011. These will be subject to corporation tax, income tax and national insurance contributions, perhaps totalling over £20 billion – but the sector could pay more. Measures to reduce tax avoidance, a levy on financial institutions, taxes on profits and bonuses or financial transactions taxes could raise further funds - perhaps up to £20 billion - to build an insurance fund for use in any future financial collapse and to fight poverty and climate change.

It is difficult to assess the ultimate distributional effects of taxes on financial institutions and financial transactions, but all the evidence suggests they would be highly progressive (unlike, for example, an increase in VAT). The initial incidence of FTTs, for example, would fall disproportionately on high-frequency traders – hedge funds and investment banks' proprietary trading desks. Hedge funds will largely pass any extra taxes onto their customers – primarily wealthy individuals. Banks will also endeavour to pass the tax on, but it is likely that their employees will share the burden with their shareholders.

## Introduction

The purpose of this paper is two-fold:

1. to assess the scope for the UK's financial institutions to pay an additional £20 billion annually in tax revenues in order to provide funds that could be used to fight poverty and climate change; and
2. to examine the distributional impact of such taxes.

## Financial sector profits and corporate tax

In 2007-08, according to corporation tax statistics, banking, finance and insurance industries in the UK made gross trading profits of £58.2 billion. After allowing for other income and for deductions and capital allowances, their income chargeable to tax was £61.0 billion and they paid £13.1 billion in corporation tax. Profits were down 3 per cent on the previous year, but income chargeable to tax was up 10 per cent and corporation tax paid was up 13 per cent.

Table 1: UK corporation tax, 2007-08

	Gross trading profits (£ million)	Income chargeable to tax (£ million)	Tax payable (£ million)	Average tax rate (tax as a percentage of income)
Agriculture and fisheries	1,358	979	230	23
Energy, water supply	36,915	23,638	7,051	30
Manufacturing	40,819	31,115	5,043	16
Construction	15,016	11,091	2,622	24
Distribution and repairs	32,345	22,254	5,367	24
Hotels and catering	4,538	2,332	601	26
Transport and communication	16,313	4,016	1,024	26
<b>Banking, finance and insurance</b>	<b>58,234</b>	<b>61,003</b>	<b>13,104</b>	<b>21</b>
Business services	52,829	55,126	10,388	19
Other services	11,266	6,004	1,449	24
All industries <sup>1</sup>	276,272	225,905	47,731	21

Source: HM Revenue and Customs (2009a)

Gross trading profits of the banking, finance and insurance industry in 2007-08 were 21 per cent of total UK profits. Because these industries have relatively high non-trading income and relatively low capital allowances (compared to, say, manufacturing industries, which spend relatively more on capital equipment), their income chargeable to tax was a higher proportion of the total, at 27 per cent. Unsurprisingly, they were also responsible for 27 per cent of corporation tax paid in 2007-08. The average tax rate paid by banking, finance and insurance industries – 21 per cent – was in line with the UK average.

<sup>1</sup> Includes industries not classified

The latest results from three of the UK's largest banks (two part-owned by taxpayers) suggest profitability is recovering as the economy emerges from recession. Lloyds and RBS both recorded large losses for 2009, at £6.3 billion and £3.6 billion respectively, but have subsequently reported an improved performance in the first quarter of 2010, with Lloyds unexpectedly returning to profit. Meanwhile, Barclays recorded profits of £11.6 billion in 2009, although this included £6.3 billion from the sale of its BGI fund management arm.

Barclays' figures also provide some perspective on the performance of different parts of the bank<sup>2</sup>. Excluding the one-off proceeds of the sale of its fund management company, profits in 2009 were split roughly equally between its investment banking operation, Barclay Capital, which made £2.5 billion, and its commercial and retail banking operations, which made £2.8 billion. Bonus payments for 2009 were £2.7 billion and the 23,000 staff working in Barclays Capital received bonuses averaging £95,000 – or £2.2 billion in aggregate. This left just £0.5 billion for those in the rest of the bank.

Banks in other countries have also reported big increases in profits this year. In the US, for example, the six biggest bank holding companies recorded total profits of \$18.7 billion in the first quarter, including \$3.3 billion at JP Morgan, \$3.5 billion at Goldman Sachs and \$4.4 billion at Citigroup. This was their most profitable quarter since the spring of 2007 – just before the US housing market began to collapse. Gains were concentrated in the banks' investment banking operations, which accounted for 80 per cent of revenue at Goldman Sachs and 44 per cent at Morgan Stanley, while the investment bank at JP Morgan produced more than two-thirds of its overall profit<sup>3</sup>.

### The corporate tax gap

An in-depth investigation into the 'corporate tax gap' – the amount of tax companies in the UK are avoiding – for *The Guardian* in 2008 and 2009 concluded that it was impossible to say how big the gap may be<sup>4</sup>. The investigators reported an HM Revenue and Customs estimate that the gap was between £3.7 billion and £13 billion in 2005 but noted that HMRC have subsequently refused to release updated estimates. They also said that a Commons public accounts committee estimate put the gap at £8.5 billion. *The Guardian's* reporters went through the accounts of all the UK's FTSE 100 companies for 2004 to 2007 and collated their profits and tax bills. They found that the tax paid by banks was between 20 and 26 per cent of their pre-tax profits, compared to a standard tax rate of 30 per cent. This did not put them out of line with non-financial companies. However, two non-bank financial companies in the FTSE 100 only paid 14 per cent of their pre-tax profits in tax.

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<sup>2</sup> <http://group.barclays.com/Investor-Relations/Financial-results-and-publications/Results-announcements?tab=1225803114897>

<sup>3</sup> [http://money.cnn.com/2010/04/21/news/companies/bigbanks\\_profits.fortune/index.htm](http://money.cnn.com/2010/04/21/news/companies/bigbanks_profits.fortune/index.htm)

<sup>4</sup> <http://www.guardian.co.uk/business/series/tax-gap>

Table 2: Tax paid as a percentage of pre-tax profit, 2004-2007

Company	Tax (%)
Barclays	22
HBOS	20
HSBC	21
Lloyds TSB	20
Man	14
RBS	23
Schroders	14
Standard Chartered	26

Source: *The Guardian*

*The Guardian* also reported ways in which many companies, including Barclays, seek to reduce their tax bills. For example, some companies, though none of the major banks, have sought to escape the UK's tax net altogether by establishing head offices in Ireland. These include one financial firm in the FTSE 250: Henderson Global Investors.

Hedge funds are more likely to have their official base in the Cayman Islands and are extremely secretive about their accounts. This makes it very hard to say anything about the scale of their profits. The successful ones are, though, less reluctant to talk about their returns, which has enabled the press to estimate the remuneration of some of the leading figures in the industry. It is thought that the top 25 earning hedge fund managers in 2009 (all based in the US) earned \$25.3 billion<sup>5</sup>.

Elsewhere, it has been suggested that a range of measures to clamp down on corporate tax avoidance, including a crack down on tax havens, country-by-country reporting and the adoption of binding codes of conduct by banks, could raise existing revenues from financial institutions by 50 per cent, or an extra US\$60 billion, worldwide, with the incidence falling mainly on banks themselves (Tax Research LLP, 2010, p.7). Up to one-sixth of this amount – US\$10 billion or £7 billion - might be paid by UK banks.

### **The outlook for banks' profits**

At the optimistic end of the scale are McKinsey, who in January 2008 forecast a doubling of global banking profits between 2006 and 2016<sup>6</sup> (though that prediction was, of course, made when the financial collapse was in its infancy).

More recently, analysts at a UK fund management company forecast large rises in British banks' profits over the next three years, as impairment charges (writing off bad debts) fall<sup>7</sup>. British banks<sup>8</sup> lost £2 billion in 2009, according to their annual

<sup>5</sup> <http://www.nytimes.com/2010/04/01/business/01hedge.html>

<sup>6</sup> [http://www.mckinseyquarterly.com/Whats\\_in\\_store\\_for\\_global\\_banking\\_2095](http://www.mckinseyquarterly.com/Whats_in_store_for_global_banking_2095)

<sup>7</sup> <http://www.moneymovesmarkets.com/journal/2010/3/22/uk-bank-profits-recovery-likely-to-generate-tax-payer-gain.html>

<sup>8</sup> Santander UK, Barclays, Bradford & Bingley lending, HSBC Bank, Lloyds, Northern Rock and RBS

results. This comprised record underlying net income of £51 billion offset by impairment charges of £53 billion. However, impairments are already contracting rapidly and are likely to continue to do so (unless the economy falls back into recession). Based on the experience of the last two recessions, the analysts believe impairments will fall from £53 billion in 2009 to between £8 billion and £25 billion in 2012. They add:

‘On the conservative assumption of no further increase in underlying net income from its 2009 level of £51 billion, this would imply a recovery in profits after charges to £11-22 billion in 2010, £19-36 billion in 2011 and £26-43 billion in 2012. In other words, **profits could surpass their 2007 peak of £31 billion as early as 2011.**’ (emphasis added)

A pessimist, on the other hand, might point to the continuing crisis in the euro-zone, banks’ large holdings of euro-zone government debt and the recent increase in inter-bank lending rates as signs that the banking system is not yet out of the woods as far as the fall-out from the Great Recession is concerned. Increased regulation may also hold back profit margins in some areas. So, while the central case is for a strong recovery in banks’ profits.

### Bonuses

In 2008-09, the UK financial sector paid incentive payments totalling £9.6 billion, according to official data from the Office for National Statistics.

Table 3: Annual pay – incentives, United Kingdom, 2008-09

	Number of jobs (000s)	Mean incentive payment (£)	Total incentive payments (£ million)
Financial service activities, except insurance and pension funding <sup>9</sup>	524	6,965	3,650
Insurance, reinsurance and pension funding	130	5,977	780
Activities auxiliary to financial services and insurance activities <sup>10</sup>	299	17,232	5,150
<b>Total – Financial and insurance activities</b>	<b>953</b>	<b>10,054</b>	<b>9,580</b>

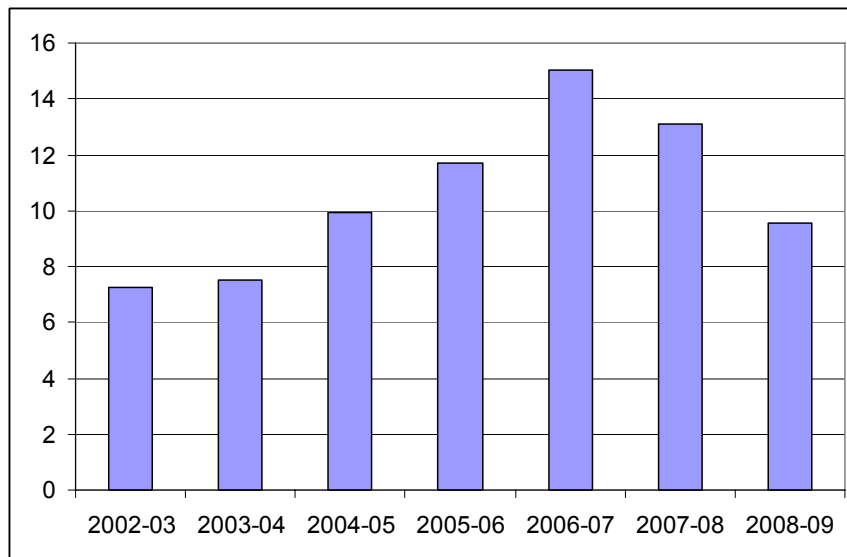
Source: Office for National Statistics (2009)

Incentive payments in 2008-09 were down 27 per cent from 2007-08 and were 36 per cent lower than in their peak year of 2006-07, largely as a result of bonuses in the banking sector falling by more than a half.

<sup>9</sup> Mainly banking

<sup>10</sup> Includes hedge funds and other fund management activities

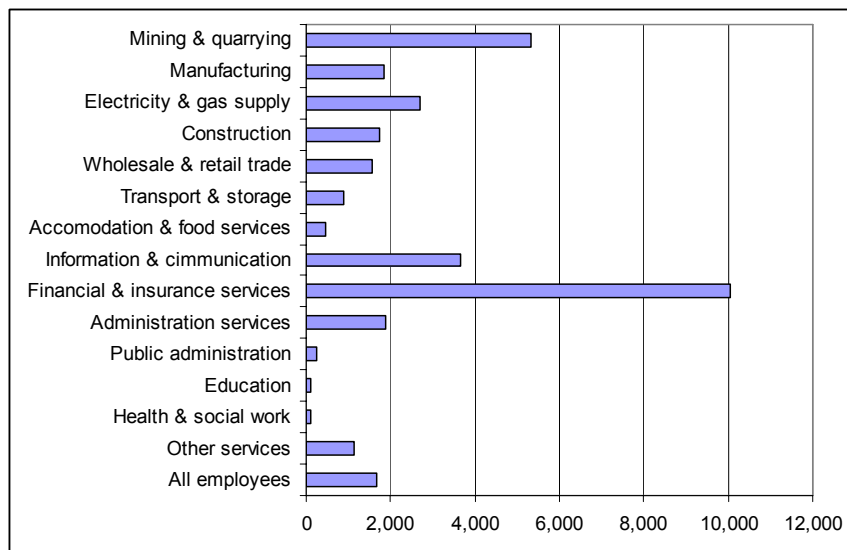
Chart 1: Annual pay – total incentives – financial and insurance activities (£ billion)



Source: Office for National Statistics (2009)

Total incentive payments across all UK industries in 2008-09 were £31.4 billion, so the financial sector accounted for 31 per cent of bonus payments made in the UK in that year, despite accounting for only 5 per cent of the workforce<sup>11</sup>. Or, to put it another way, the average bonus in the financial sector (£10,054) was over eight times larger than the average bonus in the rest of the economy (£1,220).

Chart 2: Annual pay – average incentive, 2008-09 (£)



Source: Office for National Statistics (2009)

<sup>11</sup> When bonuses peaked in the financial sector in 2006-07, they represented 39 per cent of all bonuses paid in the UK.



## The outlook for bonuses

The Centre for Economics and Business Research (CEBR) recently estimated that bonuses in the City increased by 50 per cent between 2008-09 and 2009-10, from £4.0 billion to £6.0 billion and they forecast a further increase to £6.8 billion in 2010-11<sup>12</sup>. These increases reflect a pick-up in profitability and a rise in the number of employees. The CEBR's figures cover only a sub-set of total bonuses paid in the financial sector, but they will include the financial institutions (banks) – and the bonus payments – most badly hit by the financial collapse. Payments in the rest of the financial sector will not have grown so rapidly.

Bonuses for 'activities auxiliary to financial services and insurance activities' were already at a record level in 2008-09, but if the jump in the remuneration of the leading US hedge fund managers is any guide they are likely to have reached new highs in 2009. Bonuses at insurance companies and pension funds are largely linked to investment performance and sales, which are in turn correlated with the level of financial markets, particularly the equity market. They should, therefore, have recovered somewhat but are unlikely to be back to their peak level for a few years. Table 4 shows some estimates of bonus payments in 2009, 2010 and 2011.

Table 4: Bonus payments in the UK financial sector, £ billion

	Financial service activities, except insurance and pension funding	Insurance, reinsurance and pension funding, except compulsory social security	Activities auxiliary to financial services and insurance activities	<b>Total – Financial and insurance activities</b>
2002-03	3,790	710	2,740	7,240
2003-04	4,050	650	2,830	7,530
2004-05	4,040	790	5,130	9,960
2005-06	6,270	880	4,550	11,700
2006-07	9,640	820	4,580	15,040
2007-08	7,530	880	4,720	13,130
2008-09	3,650	780	5,150	9,580
2009-10 (e)	5,500	800	6,000	12,300
2010-11 (f)	6,200	825	6,500	13,525
2011-12 (f)	7,000	850	7,000	14,850

Source: Office for National Statistics (2009)

Overall, bonus payments in the financial sector may have been £12.3 billion in 2009-10 and they could increase to around £13.5 billion in 2010-11 and almost £15 billion in 2011-12.

<sup>12</sup>

<http://www.cebr.com/Resources/CEBR/Press%20Releases/London%20and%20the%20City%20Prospects%20Press%20Release%2022%20April%202010%20City%20Bonuses.pdf>

## The risk of an exodus from the City

There have been concerns that increasing the tax on some financial workers' bonuses – through the introduction of a 50p tax rate – would lead to an exodus of people, and even whole companies, from the UK to countries with lower tax rates. Terry Smith, head of Tullett Prebon, a City broker, famously said in December 2009 that he would allow any of the company's 950 London-based staff to move overseas before the 50p tax rate came into force. *The Guardian* reported on 14 April that so far 'none ... have taken him up on the offer'<sup>13</sup>. This may, in part, be due to a court ruling in February, which has been interpreted as meaning that a person will continue to be liable to pay UK tax unless they have severed **all** links with the UK – including moving their family out of the country with them and selling all their UK property – and that they might still be liable if they eventually move back to the UK<sup>14</sup>.

There has also been no exodus of hedge fund managers from London according to Hedge Fund Review, which reported on 21 May: 'Hedge fund managers still happy with US and UK'<sup>15</sup>. Hedge fund assets under management in the UK dropped very slightly from 12.6 per cent of the total at the end of 2008 to 12.2 per cent at the end of 2009 but such a small change could easily be the result of poor relative performance or sales, rather than a drop in the number of managers.

## Could the financial sector in the UK pay £20 billion more in tax?

The financial sector's income chargeable to tax could reach £75 billion in 2011 – 25 per cent higher than in 2007-08 - and bonus payments could be £15 billion in the same year; a total of £90 billion. These profits and bonuses will be subject to corporation tax, income tax and national insurance contributions. Corporation tax payments would be around £15 billion, assuming an average rate paid of 20 per cent, but if firms carry forward losses, actual revenues could be lower. Income tax might be around £6 billion (depending on what proportion of the bonuses is subject to the 50p tax rate) and national insurance contributions another £2 billion – so up to £23 billion in total. Net of tax profits and bonuses would, therefore, be at least £67 billion.

If a range of measures were implemented to reduce tax avoidance by banks, up to £7 billion more might be raised. This would increase total tax and national insurance contributions on profits and bonuses to around £30 billion and reduce net of tax profits and bonuses to around £60 billion.

To achieve an extra £20 billion in tax revenues in total, a further £13 billion at least would have to be raised. This could be done in a variety of ways, for example through a levy on financial institutions, through special taxes on profits and pay in

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<sup>13</sup> <http://www.guardian.co.uk/business/2010/apr/14/terry-smith-tullett-prebon-pay>

<sup>14</sup> <http://business.timesonline.co.uk/tol/business/law/article7029806.ece>

<sup>15</sup> <http://www.hedgefundsreview.com/hedge-funds-review/news/1649862/hedge-fund-managers-happy-us-uk>

the financial sector or through financial transactions taxes. Although financial transaction taxes might be the best option in pure revenue-raising terms, because they are extremely hard to avoid, the Government – and the IMF – favour the other two options. The Conservatives prefer a levy on the total liabilities of banks; the Liberal Democrats support a tax on profits.

Ultimately, though, the method of taxing financial institutions is secondary to the amount of money that is to be raised. Whatever, methods of tax are agreed, the important point is that a recovery in profits and continued high bonuses mean there is the potential to raise up to £20 billion from the financial sector that could be used to help fight poverty and climate change.

### The IMF's proposals

Leaders of the G20 countries asked the IMF to prepare a report looking at how the financial sector might pay towards the cost of government intervention to prop up the banking system in the last three years. The IMF's interim report was leaked in April 2010. It proposes two new taxes on financial institutions:

1. A financial stability contribution (FSC). This would be a levy paid by all financial institutions, initially at a flat rate but eventually at a variable rate according to their riskiness and their contribution to systemic risk in the financial system. Money raised by the levy would either be placed in a special fund or incorporated into general government revenues (it makes no difference which in practice, if the special fund invests solely in government debt). Based on historical experience, the IMF thinks the fund would have to be equivalent to between 2 and 4 per cent of GDP. The UK, with its relatively large financial sector, would presumably need a fund at the top end of this range – 4 per cent of GDP, or £59 billion at current prices. If the fund were to build up over ten years, therefore, the FSC would have to raise around £6 billion a year in the UK; if over five years, then £12 billion a year.
2. A financial activities tax (FAT). This would be a levy on the sum of profits and remuneration of financial institutions. The FAT could be levied on all remuneration and profits, in which case it would be roughly equivalent to a value-added tax. Or it could be levied only on excess profits and bonuses (excess returns) in the financial sector. The IMF does not suggest what might be the appropriate amount of money to be raised through a FAT beyond saying that it could cover 'any further contribution from the financial sector that is desired'. The report does, though, give an illustration of the effect of a very low rate of FAT: 'in the UK ... a 2 percent FAT (with all salaries included in the base), might raise about 0.1-0.2 percent of GDP' (IMF, 2010, p.19). This is equivalent to £1½ to £3 billion, though the upper end of this range would only be achieved if the financial sector returned to its size, relative to the rest of the economy, just before the crash in 2007.

Financial transaction taxes are considered in the IMF's report as a third option and are not ruled out completely. It says 'The FTT should not be dismissed on grounds of administrative practicality' (IMF, 2010, p.15). Even so, it underestimates the

simplicity of the collection of FTTs relative to the new levies that it proposes. The FSC, for example, requires detailed information on the composition of financial institutions' balance sheets and difficult judgements to be made about their relative riskiness and contribution to systemic risk. This is far from a trivial task, as the failure of the authorities to be aware of the level of systemic risk in 2007 and 2008 illustrates. Similarly, if the FAT is to be levied on *excess* returns in the financial sector, how are these to be defined? There is also scope for avoidance if the levies are not applied in all financial centres or if financial institutions can find ways around them (whereas FTTs are hard to avoid if they are collected through central clearing houses).

However, it is clear the IMF is less keen on FTTs than on the FSC and the FAT. This view needs to be understood in the context of the question the IMF was posed: how should the financial system contribute to the bill for bailing out the banking system? In this context, the FSC makes perfect sense. Unlike the FSC, for example, the application of FTTs does not take any account of the relative riskiness of financial institutions.

Rather than comparing FSCs, FATs and FTTs as alternatives, it is better to see them as complementary and designed for different purposes. The FSC is designed to finance an 'insurance fund' to pay for a future bail out of the financial system, even though the very existence of such a fund could increase moral hazard (that is, it could encourage financial institutions to take bigger risks knowing funds are available to rescue them). Presumably, once sufficient funds are raised, and assuming there is no financial crisis in the next decade, the FSC will have served its purpose and could be abolished (although it is more likely that governments will see it as a source of revenue for other purposes). The case for a FAT and for FTTs is that they would provide funds that can be used to reduce poverty and mitigate climate change.

### **Financial Transaction Taxes**

The concept of Financial Transactions Taxes (FTTs) is not a new one. Its history goes back to Keynes, who thought that a tax on transactions in the equity market would discourage speculators, who were simply engaged in a contest to predict each others behaviour, and so allow share prices to reflect the views of long-term investors about profits and other economic fundamentals. It was revived in the 1970s, in a different form, by James Tobin, an American economics professor who proposed a small tax on all transactions in international currency markets in order to curb excessive fluctuations in exchange rates. Echoing Keynes, Tobin argued his tax would force participants in the foreign exchange market to give greater weight to long-term fundamental factors and pay less attention to speculative opportunities. His idea, which became known as the 'Tobin Tax', was for a levy of 0.5 per cent on all foreign exchange transactions.

The imposition of FTTs would not be an innovation; they already exist in a number of countries. Anyone purchasing UK shares pays a tax on the transaction known as

Stamp Duty Reserve Tax (or stamp duty for short) at a rate of 0.5 per cent<sup>16</sup>. In 2008-09, revenue from stamp duty on share purchases was £3.2 billion<sup>17</sup> (HMRC, 2009b).

In recent years, there have been calls for a broader range of taxes on financial transactions, to cover shares, bonds, currencies and all types of derivative instruments. Pollin et al (2003, pp.542-3), for example, set out a structure for a comprehensive set of taxes:

Shares:	0.5 per cent
Bonds:	0.01 per cent for each year until the bond's maturity
Futures:	0.02 per cent of the notional value of the underlying asset
Options:	0.5 per cent of the premium paid for the option
Interest Rate Swaps:	0.02 per cent for each year until maturity of the agreement

The rationale for FTTs has also been expanded. While Keynes and Tobin proposed them simply as a means of discouraging speculation, FTTs are now widely seen as a new source of general tax revenue or, more specifically, as a way of raising funds that could be used to fight world poverty and pay for climate change mitigation in developing countries.

The pros and cons of FTTs have been set out elsewhere - see, for example, Schulmeister (2009), Baker (2008) and Halifax Initiative (2010). This next part of this paper focuses on their distributional effect. FTTs have been presented as 'taxes on banks' or 'taxes on bankers' and have been popularised as 'Robin Hood Taxes'; the clear implication being that they will take money from the rich in developed countries so that it can be given to the poor in the developing world. But little attention has been paid to the distributional effect of FTTs, and how it might compare to that of, for example, an increase in the National Insurance contribution rate or in the standard rate of VAT.

### **The distributional effects of increases in National Insurance contributions and VAT**

The last Labour Government was planning to increase the main rate of National Insurance contributions for employees, from 11 per cent to 12 per cent, with effect from April 2011, while at the same time increasing the starting rate at which contributions are paid by £570. It also planned to increase employers' National Insurance contributions by 1 percentage point, from 12.8 to 13.8 per cent. These changes to employee and employer rates would together increase revenues by about £8 billion.

During the general election campaign, the Conservatives proposed scrapping all planned increases in National Insurance contributions. However, it appears that the new Liberal Democrat-Conservative Government will go ahead with the increase in contribution rates for employees (raising revenues of just under £4 billion), while

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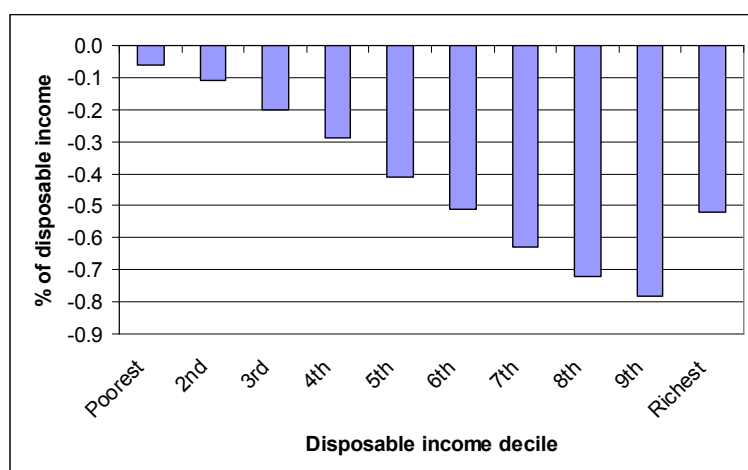
<sup>16</sup> The rate was 1 per cent before 1974, 2 per cent between 1974 and 1984 and 1 per cent between 1984 and 1986 (Bond et al, 2004, p.4).

<sup>17</sup> This was down significantly from £4.2 billion in 2007-08 due to sharply lower share prices.

cancelling the increase for employers, though this will not be confirmed until the new Chancellor of the Exchequer delivers his first budget on 22 June.

The distributional effects of increasing National Insurance contribution rates for employees are shown in Figure 3<sup>18</sup>. This is clearly a progressive tax change – those earning higher incomes, apart from those in the very top decile, lose proportionately more than those on lower incomes.

Figure 3: Distributional effect of an increase in employees' National Insurance contributions to 12 per cent



None of the major political parties proposed an increase in VAT during the general election campaign, but they did not rule one out either. A number of economists have suggested the task of reducing the government's budget deficit will prove so difficult that VAT will have to increase, if not in the June 2010 'emergency budget', then in the 2011 budget. A figure of 20 per cent for the standard rate of VAT is widely talked about, though probably as much because it is a convenient round number as for any other reason<sup>19</sup>. If the standard rate of VAT were to be increased from 17.5 per cent to 20 per cent, revenues would go up by £11.3 billion in 2011-12.

VAT is 'regressive – meaning that the burden of the tax falls much more heavily on low earnings households than it does on those with higher income' (Murphy, 2009). This is because those on lower incomes consume a higher percentage of their income and have less left over for savings compared to those on higher incomes.

<sup>18</sup> These figures, and those in Figure 4, were derived from ippr's Tax-Benefit Model

<sup>19</sup> A BBC survey of 28 economists who advise HM Treasury found that 24 of them thought VAT would increase during the current parliament, with 17 expecting the standard rate to go up to 20 per cent before the end of 2011.

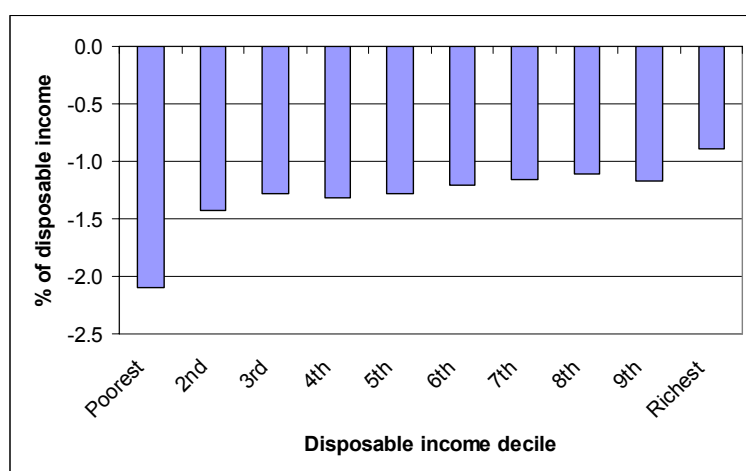
Table 5: VAT as a percentage of disposable income, 2007-08

All households	Quintile groups of all households				
	Bottom	Second	Third	Fourth	Top
7.4	12.1	8.4	8.0	7.4	5.9

Source: Barnard (2009, p.60)

The regressive nature of VAT is confirmed when the distributional effects of an increase in VAT are modelled (Figure 2). The biggest losers, relative to disposable income, are households in the lowest income deciles.

Figure 4: Distributional effect of an increase in VAT to 20 per cent



This means that poorer areas of the country – parts of northern England and Scotland for example - will be more affected by any increase in VAT, while in richer areas, like London, the poorest would be making a larger proportional contribution compared to the richer residents.

### The incidence of Financial Transactions Taxes

Calculating the distributional effects of changes in National Insurance contribution rates or in VAT is relatively straightforward; doing the same for FTTs is much more complex.

The first incidence of FTTs falls on those who trade in the financial instruments affected by the tax, so, potentially, financial institutions, pension and life insurance funds, investment funds, companies and individuals. Its precise incidence will be determined by the markets covered by the tax, the rate at which it is applied and the amounts of trading done in each market by these various groups.

Unfortunately, there is no recognised single source of data setting out who trades in financial markets. Even if there were, it would only be of limited use because trading is often carried out by agents on behalf of investors. The data would tell us about the agents, but the tax would be paid by the underlying investors.

There are, though, data showing ownership of UK shares, and, excluding overseas investors, insurance companies, pension funds and individuals are the largest holders.

Table 6: Beneficial ownership of UK shares, 2008

	£ billion	Per cent owned
Rest of world	481.1	41.5
Insurance companies	154.9	13.4
Pension funds	148.8	12.8
Individuals	117.8	10.2
Other financial institutions	115.3	10.0
Banks	40.6	3.5
Private non-financial companies	34.7	3.0
Investment trusts	22.1	1.9
Unit trusts	21.3	1.8
Public sector	13.0	1.1
Charities	8.7	0.8
Total	1,158.4	100.0

Source: Office for National Statistics (2010)

But insurance companies, pension funds and individuals trade relatively infrequently and so will pay a lower share of stamp duty than the size of their holdings suggests.

Hedge funds and investment banks' proprietary trading desks<sup>20</sup>, on the other hand, while they tend not to be long-term holders of shares, trade very frequently and they will pay a higher proportion of FTTs. The same is likely to be true of bond markets and even more so of derivative markets. The following figures, taken from Kapoor (2010, pp.6-7), illustrate the dominance of hedge funds and other high frequency traders such as proprietary trading desks in key markets:

- High frequency traders account for 70 per cent of US equity market trading volume and 30 to 50 per cent of UK trading volume.
- High frequency traders account for 50 per cent of US futures market volume and 25 per cent of foreign exchange volume.
- Hedge funds account for up to 87 per cent of trading volume at the Chicago Mercantile Exchange.
- Hedge funds account for 90 per cent of the volume in convertible bonds, almost 90 per cent in distressed debt and 30 per cent in high yield debt.
- Hedge funds account for more than 60 per cent of trading volume in the credit default swap market and between 55 and 60 per cent of transactions in leverage loans.

This suggests that the first incidence of FTTs will fall heavily on high frequency traders.

<sup>20</sup> Where employees of a bank trade in financial markets on the bank's own account



The same conclusion can be inferred from other data. Global turnover in foreign exchange and derivative markets has rocketed in recent years. Data from the Bank for International Settlements (BIS) show turnover in spot foreign exchange markets increased at an annual rate of 7 per cent between 1998 and 2007, while turnover in over-the-counter derivatives rose by 14 per cent and in exchange-traded derivatives by 18 per cent over the same period (for comparison, OECD GDP increased by 5 per cent a year).

Table 7: Global market turnover, daily averages in April, \$ billion

	1998	2001	2004	2007
Spot foreign exchange transactions	568	387	631	1,005
Over-the-counter derivatives	1,265	1,385	2,420	4,198
Exchange-traded derivatives	1,382	2,198	4,547	6,173

Source: BIS (2007)

Turnover in these three markets (assuming 250 trading days in the year) was equivalent to 73 times OECD GDP in 2007, compared to 33 times in 1998. There is little doubt that the scale of this increase was the result of the growth in hedge funds and proprietary trading over the same period. HedgeFund Intelligence estimates that global assets managed by hedge funds increased almost six-fold from \$450 billion in 2000 to \$2,650 billion in 2007 (though they have subsequently fallen back to \$1,850 billion in 2009)<sup>21</sup>.

Knowing where the initial incidence of FTTs might fall is, however, only the first step to understanding where their final incidence will be. We also need to understand how hedge funds and banks will react to the imposition of FTTs.

The case of hedge funds is relatively simple. If FTTs were applied to the trading of a hedge fund, they would lower the fund's return. In this instance, therefore, the bulk of the final incidence of the tax would be paid by the fund's customers, although lower returns would also mean lower income for the hedge fund, so its profits, and the salaries and bonuses of its employees would also be lower. Hedge funds are notoriously secretive about their customer base, but most of their assets are drawn from the wealthiest individuals in society. Other investors, particularly pension funds, have increased their investments in hedge funds in recent years, but their exposure is relatively small. A survey by Mercer – an investment consulting business – found that UK pension funds had only 7 per cent of their assets invested in all types of non-traditional assets (i.e. other than shares, bonds and UK property) in 2010 (Mercer, 2010). This includes hedge funds, but also private equity, commodities, overseas property and infrastructure. The same survey in 2008 found only 5.2 per cent of pension funds had exposure to funds of hedge funds<sup>22</sup> and just 2.0 per cent to individual hedge funds (Mercer, 2008).

<sup>21</sup> See <http://www.hedgefundintelligence.com/Article/2455359/Issue/74948/Global-hedge-fund-assets-rebound-to-just-over-18-trillion.html?Task=Report>

<sup>22</sup> That is funds which invest in a number of hedge funds so as to spread risk

The reaction of banks is more complex (see Tax Research LLP (2010) for a theoretical discussion of whether banks ever pay tax). Essentially, they have three options:

1. They can increase their fees and charges to offset the effect of the tax. This might include just fees and charges for the products affected by the tax, or it could also include other fees and charges<sup>23</sup>. In this case, the tax would be paid by the banks' customers.
2. They can cut their costs to offset the effect of the tax. While a small part of this might involve trying to cut non-wage costs (effectively passing the tax on to their suppliers), the bulk of the costs of banks are salaries and bonuses. In this case, the tax would be paid by bank employees.
3. If they could do neither of the above, they would have to pay the tax out of their profits. This would lead to lower dividend payments, lower retained earnings and a lower value for the bank. In this case, the tax would be paid by the banks' shareholders.

In practice, banks would try to increase fees and charges and to reduce costs first. The extent to which they could do so would be determined by the competitiveness of the markets in which they operate. The more competition there is among banks to provide services, the less likely it is that they would be able to increase fees and charges. And the smaller the aggregate pool of qualified employees they can draw on, the less likely it is that they would be able to cut salary and bonus costs. Banks themselves have argued in other contexts that there is a high degree of competition between them (although as a result of the financial crisis there are fewer institutions and so less competition now) and that there is a small pool of qualified employees (hence the need to pay large bonuses). This would suggest the largest burden of the tax, as it applied to banks, would fall on profits and thus on shareholders. However, banks' employees would not escape. The bonus payments of senior staff are invariably linked to profits, and so would be lower as a result of the imposition of FTTs. And it is hard to believe that, if proprietary trading became less profitable for banks as a result of the imposition of FTTs, the staff engaged in these activities would be unaffected. More likely, there would be fewer of them and their pay would be lower.

What can we say, therefore, about the distributional effects of introducing a comprehensive set of FTTs in the UK? First, equity transactions are already taxed through stamp duty, so the additional taxes would be paid on trading in bonds, currencies and various derivative instruments. Second, the initial incidence of these taxes would fall mainly on high frequency traders, such as hedge funds and investment bank proprietary trading desks, though 'traditional investors' such as pension funds, insurance companies and individuals will also pay a proportion. Third, the final incidence would be concentrated on investors in hedge funds, bank shareholders, and employees in investment banks, particularly those involved in proprietary trading or whose remuneration is linked to bank profits.

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<sup>23</sup> This means, in theory, FTTs could result in, say, lower interest rates for savings accounts. However, since the bulk of the burden of FTTs would fall on investment banking operations, any move to split retail and investment banking would greatly limit this risk.

While the first two groups include pension and insurance funds, which means the burden of FTTs would be spread around society to some extent (through reduced benefits or higher contributions and payments), they also include the wealthiest – and the highest earners – in society. Few but the very wealthiest are able to invest in hedge funds. Furthermore, high earners are likely to have bigger pension pots and more life insurance than lower earners. It seems clear, therefore, that the distributional effects of FTTs would be highly progressive – and much more progressive than either an increase in National Insurance contributions or an increase in VAT.

Economists at the IMF, however, are not convinced. In their recent report, they argue: 'It is far from obvious that the incidence [of FTTs] would fall mainly on either the better-off or financial sector rents.' (IMF, 2010, pp.16-7). However, the report does not present any arguments as to why the final incidence of FTTs would be mainly on final consumers rather than profits in the financial sector. And, it ignores completely the fact that the 'final consumers' of hedge funds are, largely, the 'better-off'.

Assessing the ultimate incidence of other types of tax on financial institutions, such as a FSC or a FAT, is similarly complex, depending on whether financial institutions can pass the tax on to their customers. The IMF appears to believe that a FAT would be borne largely by the financial institutions, in the form of lower profits, and by their employees, in the form of lower remuneration, rather than by their customers. If so, it too would be a relatively progressive tax.

So, while it may not be completely accurate to describe FTTs as taxes on banks, or on bankers, because some of their burden would be passed on, it is reasonable to describe them as 'Robin Hood Taxes'. Their incidence would fall disproportionately on high earners and the wealthiest in society.

### **The revenue potential of Financial Transactions Taxes**

There have been a number of attempts to estimate the revenues that might accrue from FTTs. Baker et al (2009) calculate that the particular set of taxes proposed by Pollin et al (see page 11) would have raised between \$177 billion (if trading volumes were reduced by 50 per cent as a result of the new taxes) and \$354 billion (if there was no effect on volumes) in 2008, in the US alone. This is the equivalent of between 1.2 and 2.4 per cent of global GDP. These are gross estimates. The net effects would be smaller because lower incomes and profits would mean reduced revenues from income and corporation taxes. Given existing income and corporate tax structures in the major economies, net revenues from FTTs would be at least 70 per cent of gross revenues (Kapoor, 2010, p.11). So in this case, net revenues would be between 0.8 and 1.7 per cent of GDP (equivalent to £12 billion to £24 billion in the UK, including existing revenues from stamp duty on share purchases).

The most comprehensive attempt to estimate potential revenues from FTTs has been undertaken by Schulmeister et al (2008). Using data from the Bank for

International Settlements and the World Federation of Exchanges, they calculated hypothetical transaction tax receipts for a number of major economies, and for the world as a whole, based on different tax rates and assumptions about their effect on trading volumes. Their analysis suggests that revenues in the UK could be between 2.5 and 12.7 per cent of GDP – far higher than in any other country due to the UK’s exceptionally large financial sector. The full results of their analysis for the UK are reproduced in Table 8.

Table 8: Hypothetical transaction tax receipts in the UK (% of GDP)

Tax rate	Market	Receipts (% of GDP)		
		Reduction in transaction volume <sup>24</sup>		
		Low	Medium	High
0.01%	Equities	0.03	0.03	0.03
	Bonds	0.01	0.01	0.01
	Exchange-traded derivatives	1.56	1.37	1.17
	Over the counter derivatives	1.70	1.49	1.28
	Total	3.31	2.90	2.50
0.05%	Equities	0.16	0.15	0.15
	Bonds	0.07	0.07	0.07
	Exchange-traded derivatives	3.92	2.94	1.50
	Over the counter derivatives	4.25	3.19	1.60
	Total	8.40	6.35	3.30
0.1%	Equities	0.30	0.29	0.27
	Bonds	0.14	0.13	0.12
	Exchange-traded derivatives	5.88	3.94	1.99
	Over the counter derivatives	6.38	4.25	2.13
	Total	12.70	8.61	4.52

Source: Schulmeister et al (2008, p.51)

Nominal GDP in the UK will be around £1,475 billion in 2010. Schulmeister et al’s calculations suggest, therefore, that an FTT set at a rate of just 0.01 per cent (but retaining stamp duty at 0.5 per cent for equity purchases) would raise gross revenues of £36 billion, even if there is a large effect on transaction volumes. After allowing for the effect on other tax revenues, the net increase in revenues would be around £25 billion. This is a little more than twice the revenue that would be raised by increasing VAT to 20 per cent.

If Schulmeister et al’s numbers are right, therefore, it would be possible to use half the net revenues raised by imposing an FTT in the UK at just 0.01 per cent to avoid an increase in VAT to 20 per cent, so replacing a regressive tax proposal with a highly progressive one. (Alternatively, the planned increase in National Insurance contributions could be abandoned with some money left over to further reduce the deficit.) The other half of the revenues could be used to reduce global poverty and

<sup>24</sup> The assumed reductions vary across markets.

pay for climate change mitigation in developing countries, as long advocated by supporters of FTTs.

### Options for taxing financial institutions

Clearly some consideration needs to be given to the possible cumulative effects of introducing a FSC, a FAT and, possibly, FTTs all at roughly the same time? What is the total burden that can reasonably be placed on financial institutions' shareholders, employees and customers?

The scale of any FSC is likely to be defined by the amount needed to insure against future risk to the stability of the financial system. The IMF's analysis suggests that an FSC in the UK would need to raise between £6 billion and £12 billion annually, depending on how quickly the insurance fund was to be built up.

The IMF is vaguer about revenues from the FAT, which will depend on the rate applied and the share of financial services in the UK economy. Assuming a share of 6.6 per cent (the average between 2000 and 2007), and a low rate FAT of 2 per cent, revenues from the FAT in 2010 would be close to £2 billion. Alternatively, applying FAT at the current standard rate of VAT, 17.5 per cent, would raise £17 billion<sup>25</sup>. Where in this range the FAT was set would depend, in part, on whether a broad-based FTT was also introduced. If it was, a relatively low rate of FAT might be needed, at least initially. If it were not, a higher rate of FAT would be appropriate to ensure sufficient funds were raised from the financial sector in total, to reflect the damage done to the economy by the financial crisis and to provide the funds needed to help fight poverty and climate change.

If an FTT of 0.01 per cent were imposed, this would raise around £36 billion - or £25 billion after allowing for reduced revenues from other taxes. This is equivalent to 1.7 per cent of GDP, which might be deemed too high right now, given the fragile state of the UK economy. But the FTT could be introduced at an initial rate of 0.005 per cent, when the extra net tax revenue might be £13 billion (just under 1 per cent of GDP). The rate of FTT could then be increased when the economy is stronger. Alternatively, a more complex structure of FTTs could be brought in, applying different rates in different markets to raise a similar amount in total.

### Concluding thoughts

The new Liberal Democrat-Conservative Government is likely to increase National Insurance contributions for employees from April 2011. It may increase the standard rate of VAT too, perhaps to 20 per cent. The change in National Insurance contributions will be a progressive move, but increasing VAT is regressive (because people on lower incomes spend proportionately more of their income).

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<sup>25</sup> Most activity of the financial services industry in the UK is VAT-exempt, though some other countries do charge VAT on the sector.

It is impossible to be precise about the ultimate distributional effects of taxes on financial institutions and financial transactions, but all the evidence suggests they would be highly progressive. The initial incidence of FTTs, for example, would fall disproportionately on high-frequency traders – hedge funds and investment banks' proprietary trading desks. Hedge funds will largely pass the tax onto their customers – primarily wealthy individuals. Banks will also endeavour to pass any new taxes on, but it is likely that their employees will share the burden with their shareholders.

The IMF is proposing two new levies – a Financial Stability Contribution (FSC) and a Financial Activities Tax (FAT) – as a way for the financial system to pay for the costs of bailing out the banks in 2008, to raise funds in case another bailout is needed in the future and to boost revenues in general. These should not be seen as alternatives to FTTs, which are designed to raise funds for very different purposes: to reduce poverty and pay for measures to mitigate climate change. However, consideration should be given to the total amount of revenue that it is reasonable to raise from three new taxes all brought in at roughly the same time.

If the FSC is levied to raise annual revenues equal to 0.4 per cent of GDP in the UK, as suggested by the IMF, it would be reasonable to introduce either a FAT at a relatively high rate or a FAT at a lower rate and a broad-based FTT at an initial rate of just 0.005 per cent at the same time. Unlike the FSC, the revenues from these taxes could be used to fight poverty and climate change. After allowing for reduced revenues from other taxes (as a result of lower incomes and profits), the net increase in revenues from all three taxes could be around £20 billion or 1.3 per cent of GDP.

If between one half and two-thirds of this extra revenue comes from the financial sector (with the rest being passed on to customers), and measures are taken to reduce tax avoidance, then total additional tax revenues from financial institutions could be between £15 billion and £20 billion.

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