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Fair Shares

How Banks, Brokers and the Financial Industry Can Pay Fairer Taxes

Toby Sanger

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Toby Sanger is a CCPA research associate and senior economist with the Canadian Union of Public Employees. He previously worked as principal economic policy advisor to the Ontario Minister of Finance and as chief economist for the Yukon government. He is responsible for the views expressed in this paper as well as for any errors or omissions. This report is a condensed and updated version of a longer paper on this topic available from the author upon request.

Fair Shares

How Banks, Brokers and the Financial Industry Can Pay Fairer Taxes

Summary

In the wake of the financial and economic crisis, many industrialized countries have taken steps to have their banks and financial sectors make a "fair and substantial contribution" to pay for some of the costs of the crisis.

European countries have — either individually or collectively — introduced taxes on financial sector bonuses, levies on bank balance sheets, endorsed a Financial Activities Tax, and pledged to consider introducing additional financial transactions taxes. The European Parliament has moved forward with proposals to introduce a financial transactions tax at the European level.

In contrast, the Harper government engaged in intense lobbying to prevent world leaders from agreeing on introducing new taxes on banks at the Toronto G20 Summit last June. Finance Minister Flaherty argued that Canada would not impose "excessive, arbitrary, or punitive" regulations or taxes on its financial sector. It is now attempting to convince Canadians to support its plan for further corporate income tax cuts.

This report argues that instead of being "excessively, arbitrarily or punitively" taxed, Canada's financial industry has benefited significantly from tax preferences and recent tax cuts.

A leading bank analyst has estimated that Canada's top banks will have $40 billion in excess cash by the end of 2012. This amount is equivalent to the sum of all federal and provincial government deficits currently projected for the 2012–13 year. At the same time, federal and provincial governments are cutting program spending to pay for the approximately $300 billion in increased debt they expect to incur following the financial and economic crisis.

Is the banking and financial sector fairly taxed?

Canada's banking and financial sector has been consistently highly profitable. Corporations in the finance sector enjoyed an average 23% profit margin during the past decade compared to a 7% average profit margin for firms in non-financial industries. Profits of Canada's big five banks reached $19.4 billion in 2010 and are expected to rise by another 15–20% again in 2011.

Canada's financial sector has been the greatest beneficiary of recent corporate income tax cuts. Cuts in corporate income tax rates since

2000 have provided a benefit to the finance and insurance industry worth approximately $4 billion a year in 2010 in comparison to the tax rate that applied in 2001. Further corporate income tax cuts planned will help to increase the value of this benefit to an estimated $6.1 billion a year by 2012.

The financial sector has also benefited from the broad exemption of financial services from sales taxes, as well as from preferred tax rates applied to capital gains taxes and stock options.

In total, the value of these tax preferences and recent tax cuts — exemption from the federal GST, cuts to federal and provincial corporate income tax, and preferential tax rates for capital gains and stock options — now adds up to approximately $11 billion a year for Canada's financial sector and is projected to reach $15 billion a year in 2014.

Since 2000, financial sector stocks have enjoyed an extraordinary 5.7% higher annual return than non-financial stocks. As a result, Canada's financial sector makes from 20% to 30% of the capitalization of the Toronto Stock Exchange, double its share in the 1970s.

Canada's financial sector is nearing the 8% share of the economy that it reached in the U.S. before the financial crisis. Our financial industry has been growing at twice the pace of the economy as a whole since 2001 and is almost double the relative size it was in 1980.

Corporate income tax rates have been cut steeply at both the federal and provincial level in Canada, from an average rate of 42.6% in 2000 to an average of 28% at the beginning of 2011. Further cuts planned by federal and provincial governments will bring the combined top corporate income tax rate down to 25% in most provinces by 2013. This year, Canada will have the lowest combined corporate income tax rate of all G7 countries.

The rationale for preferential tax rates on capital gains and cutting corporate tax rates was they were supposed to lead to higher rates of savings and higher rates of investment in the economy, thereby boosting economic growth and employment. However, overall rates of capital investment as a share of our economy have been largely stagnant since capital gains taxes and corporate income tax rates were reduced. Rates of business investment in machinery and equipment, a key driver of productivity, have actually declined.

These tax cuts helped fuel a major boom in stock markets and other asset markets, but this wasn't reflected in stronger growth of the economy. Instead of investing in productive physical capital, increasing amounts went to finance mergers, acquisitions, speculative investments and share buybacks. Even now, in the wake of the financial crisis, both financial and non-financial firms are using their excess profits and cash to finance buybacks of their shares instead of expansion of economic activity. Share buybacks raise stock prices, at least temporarily, often with the greatest benefit going to those who are paid in stock options such as the executives and managers who make those decisions.

Fair Tax Alternatives

Other countries already have or are considering special taxes on their financial sectors, including different forms of Financial Transactions Taxes or a Financial Activities Tax on financial sector profits and remuneration, as the International Monetary Fund recently proposed.

This study shows that any of these three alternatives — a *Financial Activities Tax*, a *Financial Transactions Tax*, or eliminating tax loopholes restoring corporate tax rates — could contribute to restoring tax fairness and raising many billions in revenues for Canadian governments.

The government's first priority should be to establish a fairer tax system and broaden the base by:

- **Introducing a *Financial Activities Tax (FAT)* on financial sector profits and**

remuneration to compensate for the relative under-taxation of the financial sector. In October 2010, the European Commission endorsed a 5% Financial Activities Tax at the European Union level. A 5% Canadian FAT tax would generate $4.5 billion this year.

- **Eliminating tax preferences for stock options and capital gains.** Eliminating preferential tax rates for corporate capital gains and stock options would increase federal revenues by an estimated $3.9 billion this year, with an estimated $1 billion of that from the finance and insurance sector.
- **Reversing corporate tax cuts.** Restoring the federal corporate income tax rate to 21% for the finance and insurance industry (the rate that applied from 2004 to 2007) instead of cutting it to 15% by next year as the federal government plans would increase federal revenues by an estimated $2.4 billion in 2012–13.

These three measures could take effect in a very short time. Combined, they could generate well over $10 billion a year. These measures should be accompanied by stronger regulations over bank fees to ensure that costs are not simply passed onto consumers.

Following these domestic measures, the Canadian government should work with — and not against — other leading nations to introduce financial transactions taxes at an international level.

Introduction

In the wake of the financial crisis, many industrialized countries have taken steps to have their banks and financial sectors make a "fair and substantial contribution" to pay for some of the costs of the crisis — as the leaders of G20 countries agreed at their Pittsburgh Summit in September 2009.

In particular, European countries have — either individually or collectively — introduced taxes on financial sector bonuses, levies on bank balance sheets, endorsed a Financial Activities Tax, and pledged to consider introducing additional financial transactions taxes. Bills before the U.S. Congress and Senate propose to introduce both bank levies and financial transactions taxes, and the Obama administration pledged to introduce a "financial crisis responsibility fee." The European Parliament has moved forward with proposals to introduce a financial transactions tax at the European level.

The Canadian government stands in stark contrast. The Harper government lobbied intensely to prevent world leaders from agreeing to introduce new taxes on banks at the G20 Summit in Toronto last June. Finance Minister Flaherty forcefully argued that Canada would not impose "excessive, arbitrary, or punitive" regulations or taxes on its financial sector. These efforts were successful. It is now campaigning to convince Canadians to support its plan for further corporate income tax cuts. Additional corporate tax cuts planned past 2010 will reduce federal revenues by an estimated $5 billion to $6 billion by 2013.

Canadian banks and the finance industry have been the greatest beneficiaries of corporate tax cuts over the past decade and they also stand to gain the most from further corporate income tax cuts planned by federal and provincial governments.

The financial sector also benefits significantly from other tax preferences and exemptions, including reduced tax rates on capital gains and

stock options, and an exemption for most financial services from value-added taxes such as the GST and provincial sales taxes.

In fact, these benefits are so significant that a leading bank analyst has estimated Canada's top banks will have $40 billion in excess cash by the end of 2012. To put this in perspective, this amount is equivalent to the sum of all federal and provincial government deficits currently projected for 2012–13. At the same time, federal and provincial governments are cutting program spending to pay for the approximately $300 billion in increased debt they expect to incur as a result of the financial and economic crisis.

The Canadian government may have had some good reasons for opposing an international bank levy, but it hasn't provided any convincing reasons for opposing other types of taxes on banks — such as those proposed by the International Monetary Fund (IMF), the European Commission (EC), and other international organizations — and instead is proceeding with further corporate income tax cuts that will substantially *reduce* their tax contribution.

The issue may be confusing because a number of different taxes or "levies" have been proposed:

- Bank levies or *Financial Stability Contributions* as a form of insurance premium to rescue failing financial institutions;
- *Financial Transactions Taxes* on a wide range of financial transactions, and
- *Financial Activities Taxes* and special taxes on financial sector profits and compensation.

Beyond the debate over introducing levies on banks to deal with future bank failures, there are some very good reasons to introduce other types of new taxes on banks and other financial institutions at the national and international level.

Reports recently published by the IMF, the EC, and others have thoroughly examined proposals for new forms of taxation on the financial sector. A recent report by the European Commission outlines the three main policy goals for these new taxes:

- ***Taxes could enhance the efficiency and stability of financial markets and reduce their volatility and the harmful effects of excessive risk-taking*** *which can create negative externalities for the rest of the economy. In particular, the financial sector might be too large and take too much risk due to actual or expected state support (resulting in moral hazard), information asymmetries and remuneration structures which together with macroeconomic developments contributed to the recent crisis.*
- *The financial sector has been particularly profitable in the last two decades and there is a desire to* ***ensure that the financial sector makes a fair and substantial contribution to public finances****.*
- *The financial sector is seen to bear a major responsibility in the occurrence and extent of the crisis.* ***The financial sector could therefore contribute via increased or new taxes to fiscal consolidation in the aftermath of the crisis****. These additional taxes could also be justified by the fact that the sector received substantial government support during the recent crisis and not all of it might be recouped.*[1]

In addition, many international aid organizations and experts have proposed that taxes on international financial transactions could play a major role in raising funds to reduce world poverty and fight climate change. These new taxes are appealing because they could meet more than one of these goals at the same time, providing potential double or triple economic dividends.

However, there has been no considered analysis published by Canadian governments, policy

institutes, academics or others of how these different tax proposals might apply to Canada beyond the media attention prior to the Toronto G20 Summit.[2]

This paper attempts to fill some of this void by considering:

- Is Canada's financial sector fairly taxed; to what degree has it benefited from recent tax cuts and preferences; and are these tax preferences and cuts justified?
- How much will the recent financial and economic crisis cost in fiscal and economic terms?
- Is there a role for increased revenue from the financial sector to pay for some of these costs — and for new taxes to help prevent future crises by enhancing the efficiency and stability of financial markets?
- How much revenue could some of the proposed new taxes on the financial sector generate in Canada?

Briefly, the paper argues:

Instead of being "excessively, arbitrarily or punitively" taxed, Canada's financial industry has benefited significantly from tax preferences and recent tax cuts.

There is little evidence that these tax preferences and cuts have had a positive economic impact beyond their benefits to the finance industry and its shareholders. Canada's financial industry enjoys some of the lowest tax rates of G7 countries and has continued to grow rapidly. It now represents a 70% larger share of Canada's economy and stock market than it did 30 years ago. Employment in finance and insurance has grown at a rate of 2.6% a year, but still represents less than 6% of total private sector employment in Canada. As noted in a recent IMF report, as a result of tax preferences, "the financial sector may be under-taxed and hence perhaps 'too big'" for the health of the economy. The Bank for International Settlements has also recently raised concerns that the growing size of the financial industry may increase financial instability.

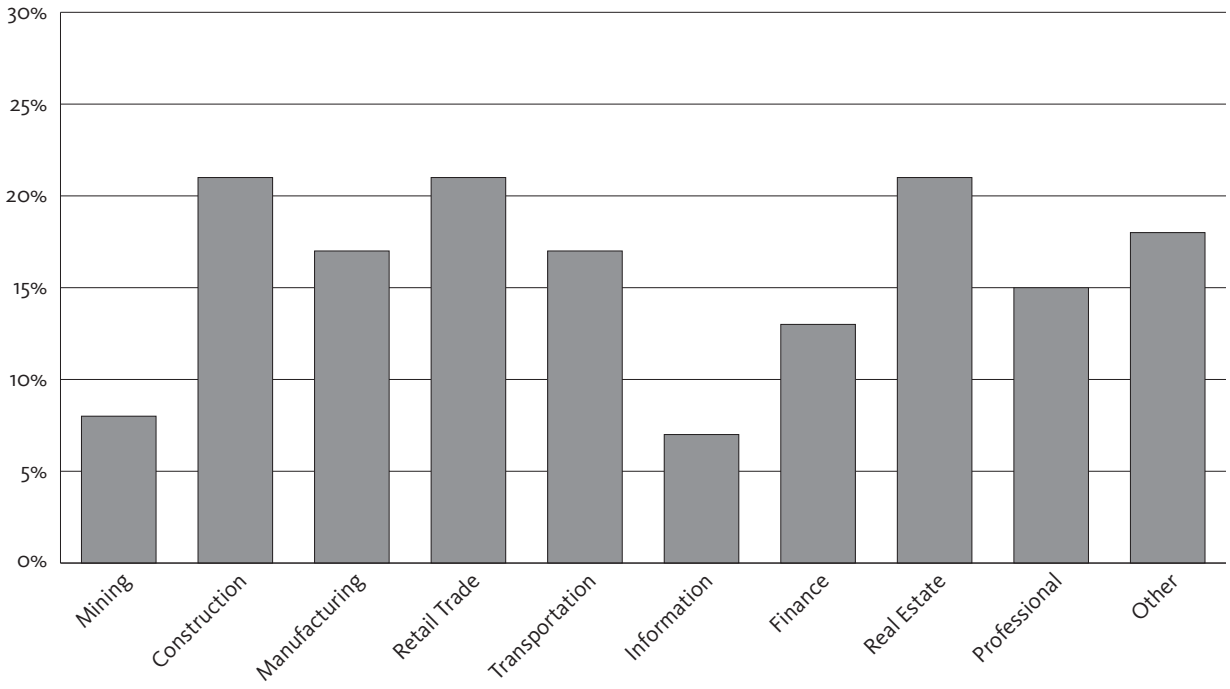
The costs to the Canadian economy and public finances of the recent financial crisis are large and will be long-lasting. It is expected that federal and provincial debts will increase by over $300 billion — or $9,000 per person — over the 2008–15 period. Canadian governments are focusing almost entirely on spending cuts and increases in consumption taxes to tackle these deficits and not considering tax increases on the finance sector.

Meanwhile, a number of other countries are introducing new taxes on the finance industry to pay for some of the costs of the financial crisis, make their tax systems more fair and reduce incentives for excessive risk-taking — thereby contributing to the prevention of future financial crises.

Of the three main proposals:

- *Bank levies* are problematic and inappropriate for Canada, as the federal government has argued. Their objectives of curbing risky behaviour could be better met by stronger regulation.
- A *Financial Activities Tax* on finance sector profits and compensation has a strong "fair tax" rationale because it would eliminate one of the tax preferences the industry enjoys. At a rate of 5% (similar to the GST), it could generate over $4.5 billion in revenues annually.
- *Financial Transactions Taxes* are feasible and can generate significant revenues without causing much economic disruption. A transactions tax at a rate of 0.5% on domestically traded stocks in Canada would raise an estimated $3.5 billion a year. However, a tax on transactions of currencies and financial derivatives would be much more effective at a global level.

FIGURE 1 **Average Effective Corporate Tax Rates For Canadian Multinationals By Industry**



SOURCE Markle and Shackelford, 2010. Effective tax rate calculated as current tax expense/pre-tax income for 2003 to 2007.

- Other fair tax reforms to eliminate tax preferences and restore corporate tax rates could result in a more equitable tax system, enhance economic stability and generate significant revenues.

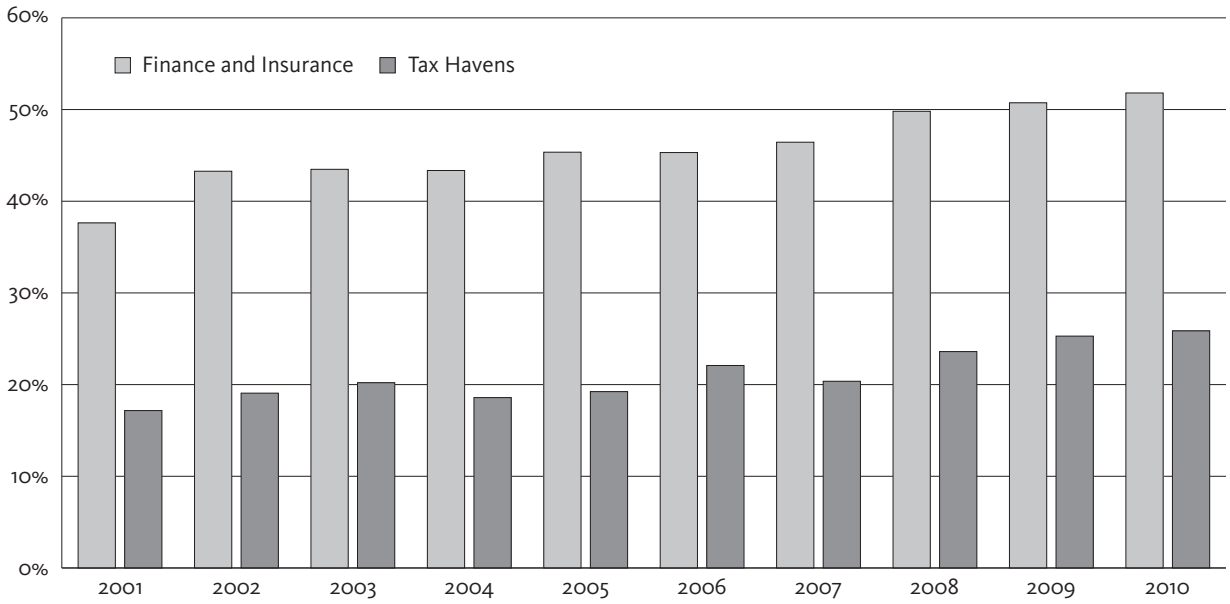
Is the Banking and Financial Sector Fairly Taxed?

Canada's banking and financial sector has been consistently highly profitable. Banks and the broader financial sector continued to register high profits all through the recent financial and economic crisis. Corporations in the finance sector enjoyed an average 23% profit margin during the past decade compared to a 7% average profit margin for firms in non-financial industries. Profits of Canada's big five banks reached $19.4 billion in 2010 and are expected to rise by another 15% to 20% in 2011.

Together with its higher profits have come higher taxes. The Canadian Bankers Association reports that the big six banks paid over $4.6 billion in federal and provincial income taxes and $2.9 billion in other capital, sales, payroll, and property taxes on their net profits of $18.7 billion in 2009. Statistics Canada figures show the banking and finance industries generally pay higher rates of effective corporate income taxes than most other industries. While the general statutory corporate income tax rate is the same for all industries, the large size and consistently high profitability of Canadian banks and other financial sector corporations means that they don't benefit as much from prior year losses and small business deductions to reduce their taxes.

However, Statistics Canada's numbers only report on income and tax declared domestically by the financial sector. A recent study by Kevin Markle and Douglas Shackelford, the most comprehensive international analysis of firm-level

FIGURE 2 **Canadian Direct Investment Abroad** Share Going to Finance Industry and to Tax Havens



SOURCE Statscan CANSIM tables 376-0038 and 376-0051

income taxes, found that the financial industry benefited from one of the lowest effective tax rates of all industries worldwide.[3] Only the mining and information technology industries have a consistently lower effective tax rate (Figure 1). This study calculated the effective corporate income tax rate on Canadian finance industry multinationals at 13% (see Figure 1). This is one of the lowest among the countries considered, higher only than Switzerland (12%), Sweden (11%) and tax havens such as the Cayman Islands (5%).

This discrepancy can be explained by the fact that Statistics Canada figures are based on income and taxes paid by banks and the finance industry in Canada, while the Markle and Shackelford study looks at the worldwide tax rates for multinational businesses. More than half of all Canada's direct investment abroad is through the finance and insurance sector, and over 25% of all Canadian direct investment abroad goes to countries considered tax havens (Figure 2). It has been estimated that Canada's big five banks reduced their Canadian taxes by an average of more than $1 billion a year through their activities in tax havens and by $2.4 billion just in 2007.[4]

Our analysis shows that Canada's financial sector has also been the greatest beneficiary of recent corporate income tax cuts. As Table 1 shows, reductions in effective corporate income tax rates since 2001 have provided a benefit to the finance and insurance industry worth approximately $4 billion a year in 2010. Further corporate income tax cuts planned will increase the value of this benefit to an estimated $6.1 billion a year by 2012. The financial sector has also benefited, directly and indirectly, from reductions in the preferential tax rates that apply to capital gains and to stock options.

The Canadian banking and finance sector has been able to achieve high profits partly because of its industrial structure — with a few large banks dominating — and because it is well-protected through regulations and an implicit "too big to fail" guarantee from the federal government. Thanks to our stronger regulation, no Canadian banks failed during the recent financial crisis,

TABLE 1 **Banking, Finance and Insurance Industry Corporate Income Taxes and Tax Savings**
Taxable income, corporate income taxes and income tax savings for Canada 2003–13 (millions)

	Actuals								
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Banking and other depository credit intermediation taxable income ($millions)	6,133	6,031	20,001	14,940	10,743	12,749	10,061	6,115	16,934
Federal and provincial income taxes ($millions)	2,576	2,497	7,120	5,020	3,642	4,118	3,139	1,981	4,674
Effective combined income tax rate (%)	42.0%	41.4%	35.6%	33.6%	33.9%	32.3%	31.2%	32.4%	27.6%
Annual tax savings vs 2001 tax rate ($millions)		36	1,280	1,255	870	1,237	1,087	587	2,438
Cumulative tax savings from 2002 ($millions)		36	1,316	2,571	3,441	4,678	5,765	6,352	8,790

	Actuals								
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Total finance & insurance industry taxable income ($millions)	15,731	15,374	33,916	31,308	30,152	33,118	30,493	26,231	37,042
Federal and provincial income taxes ($millions)	6,465	6,057	12,040	10,707	10,614	11,426	10,673	8,630	11,298
Effective combined income tax rate (%)	41.1%	39.4%	35.5%	34.2%	35.2%	34.5%	35.0%	32.9%	30.5%
Annual tax savings vs 2001 tax rate ($millions)		261	1,899	2,160	1,779	2,186	1,860	2,151	3,926
Cumulative tax savings from 2002 ($millions)		261	2,161	4,321	6,100	8,286	10,146	12,297	16,223
Federal/Ontario statutory corporate income tax rate	42.1%	38.6%	36.6%	36.1%	36.1%	36.1%	36.1%	33.5%	33.0%
Weighted average of provincial corporate income tax rates								32.2%	31.8%

SOURCE FOR ACTUAL DATA Statistics Canada *Financial and Taxation Statistics for Enterprises 2009*, http://www.statcan.gc.ca/pub/61-219-x/61-219-x2009000-eng.htm
For the period 2010 to 2013, taxable income is assumed to increase at the same rate as nominal GDP, based on the average forecast of private sector economic forecasters as reported by Finance Canada in December 2010.
Projected effective tax rates are based on planned reductions in the weighted average of federal and provincial general corporate income tax rates as of October 2010. These rates were weighted based on finance and insurance industry shares by province. Ontario's corporate tax rate has a significant impact as the province is home to over 50% of Canada's finance and insurance industry. As can be seen for the period from 2001 to 2008, there's a close relationship between this statutory rate and the effective rate for the finance and insurance industry.

but the federal government still provided up to $200 billion in a safety net to backstop Canada's financial industry, as well as extraordinary credit and financing arrangements through the Bank of Canada. This didn't amount to a budgetary expense, but it still constitutes an implicit subsidy for the financial sector, and particularly for the large banks.

This implicit guarantee and safety net from the government means large banks and financial institutions are able to take greater risks in the knowledge that they will be rescued and so will continue to play a dominant role in the industry and generate higher on-going profits. The value of this implicit guarantee can be calculated in different ways, but it amounts to many billions of dollars — with the long-run costs amounting to even more. For example, the U.S. Congressional Budget Office estimated the long-run costs of the earlier 1980s savings and loan bailout at $500 billion, or more than three times the short-run costs.[5]

There may be debate whether Canada's financial industry faces a relatively lower effective

TABLE 1 (CONTINUED) **Banking, Finance and Insurance Industry Corporate Income Taxes and Tax Savings**
Taxable income, corporate income taxes and income tax savings for Canada 2003–13 (millions)

		Projected		
	2010	**2011**	**2012**	**2013**
Banking and other depository credit intermediation taxable income ($millions)	17,916	18955	20,055	21,218
Federal and provincial income taxes ($millions)	5,437	5,332	5,286	5,508
Effective combined income tax rate (%)	30.3%	28.1%	26.4%	26.0%
Annual tax savings vs 2001 tax rate ($millions)	2,088	2,629	3,137	3,404
Cumulative tax savings from 2002 ($millions)	10,878	13,507	16,644	20,048

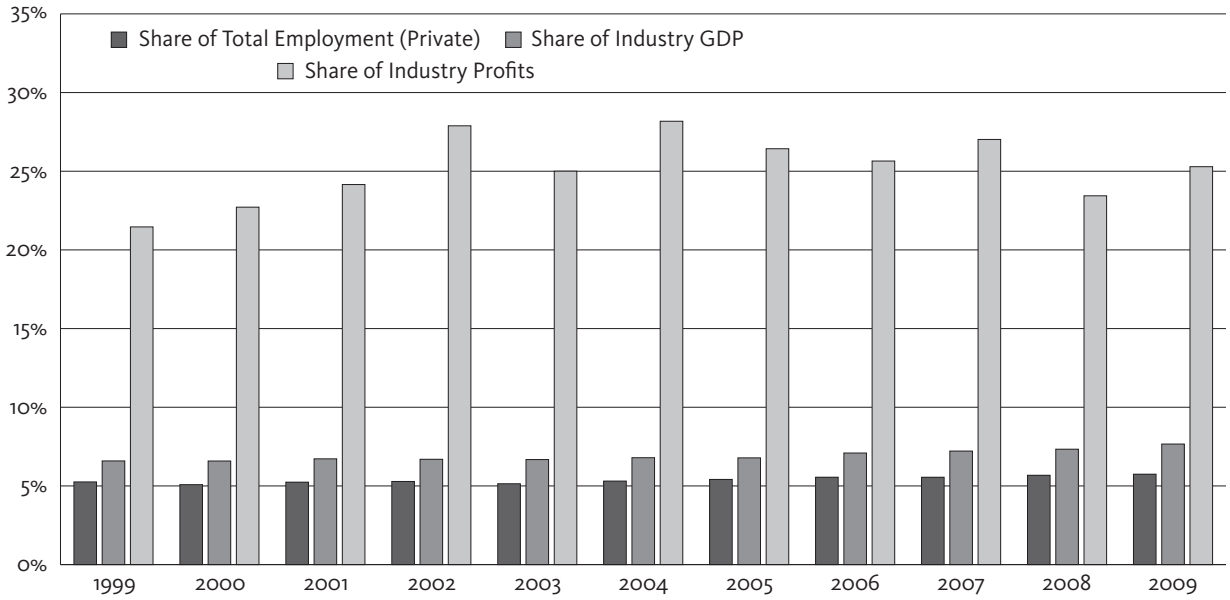
		Projected		
	2010	**2011**	**2012**	**2013**
Total finance & insurance industry taxable income ($millions)	39,190	40,993	43,084	45,238
Federal and provincial income taxes ($millions)	12,088	11,737	11,571	11,969
Effective combined income tax rate (%)	30.8%	28.6%	26.9%	26.5%
Annual tax savings vs 2001 tax rate ($millions)	4,019	5,111	6,137	6,624
Cumulative tax savings from 2002 ($millions)	20,242	25,353	31,490	38,114
Federal/Ontario statutory corporate income tax rate	30.0%	28.0%	26.0%	25.0%
Weighted average of provincial corporate income tax rates	30.2%	28.0%	26.2%	25.8%

corporate income tax rate and of the value and costs of the "too big to fail" guarantee. But there can be little debate that the financial sector as a whole benefits from the broad exemption of financial services from sales taxes, or that it has been a major beneficiary of reductions in corporate income tax rates and reductions in taxes applied to capital gains taxes and stock options.

Combined, the value of these tax preferences and recent tax cuts — exemption from the GST, cuts to federal and provincial corporate income tax, and preferential tax rates for capital gains and stock options — now adds up to approximately $11 billion a year for Canada's financial sector and is projected to reach $15 billion a year by 2014. (This doesn't include the additional benefit of cuts to federal and provincial capital taxes, which have reduced taxes paid by the industry by a further $1 billion.)

Consistently higher rates of profit have also been reflected in higher relative returns of financial stocks compared to non-financial stocks and a growing share of the financial sector in Canadian stock markets. Canadian financial sector stocks have enjoyed significantly higher returns than non-financial stocks in every decade except the 1980s. Since 2000, and the introduction of further tax changes highly beneficial to the financial sector, financial sector stocks have enjoyed an extraordinary 5.7% higher annual return than non-financial stocks. As a result, Canada's financial sector makes from 20% to 30% of the

FIGURE 3 **Finance and Insurance Industry Share of Total Industry Employment, GDP and Profits in Canada**



SOURCE Statistics Canada Labour Force Survey, National Accounts, and Financial and Tax Statistics for Enterprises

capitalization of the Toronto Stock Exchange, double its share in the 1970s.

The persistence of preferential tax provisions for the financial industry may be more understandable given the close connections between the senior ranks of government and banks in Canada. When former federal Environment Minister Jim Prentice resigned from politics to become vice-chair of CIBC, he joined a long list of former politicians and top bureaucrats who have since occupied the well-remunerated executive suites of Canada's banks. These include Kevin Lynch, former Clerk of the Privy Council and deputy minister of Finance, now vice-chair of BMO Financial Group; Frank McKenna, former Premier of New Brunswick and Ambassador to Washington, now vice-chair of TD Bank; former Finance Minister and Ambassador to Washington Michael Wilson, now chair of UBS Canada; former B.C. Finance Minister Carole Taylor, now on the board of TD Bank; and Tom Hockin, former Minister of State for Finance who subsequently became CEO of the Investment Funds Institute of Canada. While few would question their qualifications or integrity, one would be naïve to assume that their extensive connections — or the prospects of future employment opportunities for those now in government — have no impact on policy.

Is the Financial Industry Becoming Too Big?

While other countries have taken steps to increase taxes on and contain their financial sectors following the financial crisis, Canadian governments are moving in the opposite direction. Not only did the federal government campaign against an international agreement on bank levies at the June 2010 G8/G20 meeting in Toronto, but it and the Ontario government are actively promoting growth of the Canadian financial industry.[6]

Economic growth is generally considered to be a good thing. But many experts are now

questioning whether the financial sector is becoming too big. Finance is an intermediary industry which channels funds from lenders to borrowers while pooling and managing risk. A well-developed, competitive and well-regulated financial sector is critical for the growth of modern economies. However, since it doesn't create products with an end-use, an overgrown financial sector can be negative for the economy if it diverts resources from other more useful purposes — or if it contributes to increased volatility in the economy.

One of the foremost economic experts on the financial industry, Professor Thomas Philippon at Stern School of Business in New York, estimated that the U.S. financial sector was 15% larger than it should have been in 2007, after considering the demand for financial services and the need for investment by new firms.[7] His analysis of human capital and wages in the financial industry indicates that wages in the finance industry have been excessively high — by an average of 30% to 50% — in comparison with occupations involving similar skills and education in other private sector industries.[8] Similar analysis hasn't been published for Canada, but there are indications that our financial sector may also be growing too big.

Canada's financial sector recently reached the 8% share of GDP attained by the sector in the U.S. and is getting close to the 9.6% share it occupied in the U.K. on the eve of the financial crisis. Our financial industry has been growing at twice the pace of the economy as a whole since 2001 and is almost double the relative size it was in 1980. The market capitalization of Canada's financial industry as a share of the total stock market has also doubled in the past three decades and now well exceeds that of other major industrialized nations. In its latest annual report, the Bank for International Settlements raised concern about the growing size of the financial industry because of its higher degree of leverage and greater volatility than other industries.[9]

Even the IMF, normally one of the strongest defenders of the financial industry, recently acknowledged "the financial sector may be under-taxed and hence perhaps 'too big.'"[10] Despite record corporate profits and reductions to corporate income tax rates, business fixed investment has stagnated as a share of our economy, as increasing amounts have gone into more purely financial and speculative investments, mergers and acquisitions and share buybacks. These investments may have yielded high short-term returns, but they also come at a price: a diversion of funds from investment in more productive sectors of the economy as investors chase high short-term returns. To the extent that these are generated by speculative investments and asset bubbles, this can lead to greater volatility in the economy, with all the negative consequences that causes.

Before the recent financial crisis, it was thought that the rapid expansion of the financial sector and growth of different types of financial products such as derivatives resulted in greater economic stability. Even Ben Bernanke, chairman of the U.S. Federal Reserve gave a reassuring speech in 2004 about how this had helped lead to the "Great Moderation."[11] However, it is now understood that this represented a period of false calm before the storm of the financial crisis.

The question of whether the increased volume, speed and variety of financial transactions have increased financial volatility and economic uncertainty is hotly debated. There are different forms of volatility (e.g., short-term or long-term) and increased velocity can be positive or negative. At the micro-economic level of individual markets, an increased level of volume of transactions often leads to less volatility and short-term variation in prices, as many studies have shown.[12] At the same time, however, financial crises have become both more frequent and more painful in the last three decades.[13] What is causing this increased level of volatility at a macro level in the financial economy?

Eric Lascelles, Chief Economist for RBC Global Asset Management, recently concluded our economies are likely to suffer "ever more bubbles ever more quickly" as a result of the proliferation of derivatives, increased leverage and speculative trading strategies.[14]

What factors are most responsible for this increased volatility at a macro level in the financial economy? Is it the growth in financial transactions, and particularly of unregulated derivatives? Is it the relative growth of capital and of financial markets in relation to the rest of the economy? Is it increased leverage and increasingly speculative trading and risky strategies? All these factors appear to have played a role. There are many different proposals now being discussed for fixing these problems, including regulatory, administrative, market-based and tax approaches. This paper focuses on the main tax proposals, and each of the proposals aims more specifically at one or other of these factors.

Forms of Fairer Taxation on Banks and Financial Institutions

There are good reasons behind the growing momentum for new taxes on banks and financial institutions — beyond having the financial industry pay for some of the costs of the recent crisis — and these reasons also apply to Canada:

- Instead of being "excessive, arbitrary or punitive," tax changes over the past two decades in Canada have provided major benefits to the financial sector, amounting to an estimated $10 billion or more per year for the financial industry. These annual benefits are equivalent to approximately $300 per Canadian per year or $600 per taxpayer.
- Many commentators, including the IMF, now acknowledge that the financial sector has grown too big for the health of our economy, and stronger regulation and increased taxation are required to contain it.
- The exponential growth of financial markets, including of capital assets, transactions, and unregulated financial derivatives, has increased the volatility of financial markets, resulting in financial and economic crises.

There have been many proposals for different types of taxes on the financial sector. These proposals fall into three main categories:

- *Bank levies or Financial Stability Contributions* (FSC). These are special levies or taxes on the financial and banking industry intended to finance insurance-type resolution funds to rescue failing financial institutions and, in some cases, to repay governments for costs incurred as a result of bank failures in the recent financial crisis.
- *Financial Transactions Taxes:* Financial transactions taxes involve levying a small tax on each transaction of a financial security or asset. The idea of a financial transactions tax to curb speculation has been around since at least 1936, when it was proposed by John Maynard Keynes, and then popularized more broadly with the proposed "Tobin tax" on trade in foreign currencies. Most major industrialized countries, with the exception of Canada, have collected some sort of tax on the purchase or sale of financial securities *(see Table 5).*
- *Financial Activities Taxes:* Instead of taxing each transaction, a Financial Activities Tax (FAT) would tax the "value-added" of the financial sector to compensate for the exemption of most financial services from value-added taxes such as the GST. As proposed by the IMF, this could be simply done by applying a

separate tax to financial sector profits and remuneration, including bonuses, minus capital investment by the industry. A number of countries (and sub-national jurisdictions such as Quebec) already collect specific additional taxes on profits and/or remuneration from their financial sectors while others introduced special temporary taxes on bonuses and/or are increasing other rates of taxation on this sector.

- *Other Fair Tax Measures.* These can include eliminating tax preferences and increasing the corporate tax rate on the financial sector.

Each of these proposals should be considered in terms of how well they achieve one or more objectives:

- *Tax Fairness*: taxing the financial sector on a more equitable basis with other sectors.
- *Market and Economic Efficiency:* reducing the volatility of the economy at both a micro and macro level by reducing incentives for risky behaviour, reducing volatility in financial markets, preventing asset price bubbles, and constraining the size of the financial sector.
- *Public Revenue:* raising revenue in a more equitable manner, both to pay for the costs of the financial and economic crisis, and to provide funds to pay for other public programs.

No one tax can maximize the benefits for all of these objectives. For instance, if a tax were effective in curbing risky behaviour, revenue levels would probably not be maximized. At the same time, proponents expect each tax could at least partially achieve more than one of these goals.[15]

A side benefit of new taxes on the financial industry is that they can enhance the information financial authorities have about different types of financial transactions. This is particularly relevant for the large market in derivatives and over-the-counter trading and the lightly regulated shadow banking system. In this way, a small transactions tax can be seen as a natural complement to better regulation and oversight, rather than as a substitute for it.[16] Countries with transactions taxes have found that they have been useful for providing information about different financial markets.[17]

Bank Levies or Financial Stability Contributions

A Financial Stability Contribution (FSC) was first suggested by the IMF in the lead-up to the June 2010 G20 meeting in Toronto. As proposed, this would be a set levy on bank liabilities, with the revenue going to pay for the costs of government bailouts of banks and/or to set up a "resolution fund" that would be available to finance future bank failures.

Several countries have already proceeded with these types of bank levies, including Sweden and the U.K.[18] Similar bank levies, partly to pay for bailout costs already incurred, have also been proposed in Germany, the United States, and the European Union. The types of bank levies proposed, however, would seem to have little relevance for Canada. Our banking industry is dominated by just a few large banks that face tighter regulations than most other major industrialized countries. No major Canadian bank has gone bankrupt, with failures limited to smaller regional banks.

In terms of two of the goals outlined above — fairer taxation of the financial sector and raising revenue to pay for the costs of the crisis and other public programs — bank levies would not accomplish much because the revenues would be used within the sector to deal with future crises. Their main rationale in the Canadian context would be to improve market efficiency by levying a charge on riskier liabili-

ties. But even then, there is little agreement that they would reduce risk. Ultimately, it makes more sense to prevent large bank failures (and financial crises) through stronger regulation instead of taking false comfort in the existence of bank levy-financed resolution funds or contingent capital schemes. In this instance, the federal government had good reason to oppose an international agreement on introducing bank levies through the G20.

Financial Activities Tax

The idea of a Financial Activities Tax (FAT) was first proposed by the International Monetary Fund in a report prepared for G20 Finance Ministers in April 2010.[19] The proposal is for a special tax to be levied on financial industry profits and remuneration. This would compensate for the failure of most countries to adequately tax this sector through their value-added tax systems, such as the GST. As the IMF report states:

> With the inclusion of all remuneration, a FAT would effectively be a tax on value added and so would partially offset the risk of the sector becoming unduly large because of its favourable treatment under existing VATs.[20]

The IMF's main proposal ("FAT-1") is for a financial activities tax that would apply broadly to all wages and profits in the financial sector in cash-flow terms, with full expensing of investment and no deduction for financial costs. This would be closest to the base on which value-added taxes are charged.

The IMF also floated two other proposals: a "FAT-2" tax that would focus on economic "rents" in the sector (i.e., profits and compensation above the minimum required) and a "FAT-3" on an even narrower base of excess profits and remuneration above a certain rate. These were intended to target excessive risk-taking in the sector.

The broad-based FAT-1 is intended to compensate for the exemption of many financial services from value-added taxes. As such, it scores high on the objective of tax fairness. The FAT-2 and FAT-3 would have a narrower focus on profits and high incomes, and so could be more progressive, but they would generate less revenue and wouldn't compensate for the exemption of financial services from value-added taxes.

The FAT-1 proposal isn't focused on improving market and economic efficiency by preventing risky behaviour or reducing volatility in markets at a micro level. However, by increasing tax fairness on a sectoral basis, it could moderately improve economic efficiency at a macro level. The FAT-2 and FAT-3 proposals are focused on taxing higher compensation and higher profits in the financial sector, and so are intended to reduce the incentive to engage in some of the risky behaviour that result in these high rates of return. However, as with the proposed banking levy, it makes more sense to contain specific risky activities through direct regulation. It also makes more sense to eliminate existing tax preferences that encourage risky activities than to introduce new taxes intended to discourage them.

Of the three alternatives, the FAT-1 proposal — a broad-based tax on financial sector profits and compensation — is the preferred alternative, as it would be more effective at increasing tax fairness at a sectoral level by eliminating the tax preference that the financial sector enjoys through exemptions from the GST and from provincial value-added taxes such as Harmonized Sales Taxes. It would also generate considerably higher revenues than the other two alternatives.

The simplicity of the Financial Activities Tax proposal also has considerable appeal for governments. In its first budget of June 2010, the U.K.'s Conservative government announced it would introduce a Financial Activities Tax to take effect in 2011. In October, the European Commission endorsed a Financial Activities Tax at the European Union level, estimating it could gen-

TABLE 2 **Financial Activities Tax Base for Canada and Potential Revenues**

	Tax Base 2010	Revenues at 5% (= federal GST)
FAT1 Tax on Value Added of financial sector, including profits and remuneration, minus capital investment	$90 billion (~5.6% of GDP)	$4.5 billion
FAT2 Tax on Rents of financial sector: profits and excess remuneration (minus capital investment)	$35 billion (~2.2% of GDP)	$1.8 billion
FAT3 Tax on Risk: excess remuneration and profits.	$13 billion (~0.8% of GDP)	$0.64 billion

SOURCE IMF 2010a p. 139 for proportional tax base from the different tax proposals. The % shares of GDP are for 2005 and are applied to Canada's GDP for 2010. These are likely to be underestimates. Recent figures published by both the Bank for International Settlements and the European Community show that Canada's financial sector as a share of total value-added in the Canadian economy increased by 10% from 2005 to 2009. Accordingly, current annual revenues would likely be 10% higher.

erate €26 billion (or CDN$36 billion) in annual revenues at a rate of 5% for FAT-1, €11 billion for FAT-2, and €5 billion for FAT-3.[21]

Table 2, using similar calculations, provides an estimate of how much different types of Financial Activities Taxes could generate in annual revenues for Canada. Estimated revenues are significant: at a federal level, a FAT-1 tax at 5% (comparable to the GST) could generate $4.5 billion a year, an amount equal to 2% of total annual budgetary revenues and equivalent to 16% of annual GST revenues.

Financial Transactions Taxes

The idea of special taxes on banks and financial transactions is neither new nor speculative.

In 1936, John Maynard Keynes, considered the greatest economist of the 20th century, wrote in *The General Theory of Employment, Interest and Money*:

> The introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States.[22]

His proposal was largely for a tax on transactions of stocks on domestic financial markets. Much of the current interest in financial transactions taxes stems from a desire to use them to curb speculative and destabilizing activities on international financial markets, particularly in relation to financial derivatives and foreign currencies.

Keynes' idea was later adopted by Nobel prize-winning economist James Tobin, who proposed an international tax on currency transactions in 1972 after the Bretton Woods monetary system broke down and most of the Western world moved to fully floating exchange rates.

Tobin said his proposed transactions tax was intended to "throw sand in the wheels" of international money markets in order to reduce speculation and cushion exchange rate fluctuations.[23] Interest in the "Tobin tax" was revived in the 1990s in the aftermath of economic, financial and currency crises in Mexico, Russia, and Southeast Asia and speculation against the currencies of Sweden and the U.K. in 1992.

In March 1999, Canada's House of Commons passed a motion stating "That, in the opinion of the House, the government should enact a tax on financial transactions in concert with the international community." Finance Minister Paul Martin and most of the then-governing Liberal Party supported the opposition New Democratic Party in favour of the motion.

One of the most prominent examples of a financial transactions tax is the U.K.'s Stamp Duty and Stamp Duty Reserve Tax. This tax was first introduced in 1694 and generates over £3 billion (or over CDN$5 billion) in revenues annually at a rate of 0.5%. Many other countries, including major financial centres such as Switzerland and

China, also have significant taxes on financial transactions. In most cases these apply to transactions of stocks. The international mobility of the financial industry makes it more difficult to effectively tax transactions in financial derivatives or currencies at a national level.

Much of the current interest in international financial transactions taxes extends beyond currencies to cover transactions of derivatives and other financial instruments. The establishment of the Euro in 1999 eliminated currency speculation between most European countries, but there has been a massive increase of trading in — and the invention of — other types of financial products and instruments. In particular, there has been an explosion in the number and value of different types of financial derivatives traded around the world. Most trading in derivatives occurs through the over-the-counter market, which is almost entirely unregulated by financial authorities.

International development organizations including Oxfam, Save the Children, faith-based groups and environmental organizations are leading an international campaign to introduce broad-based financial transactions taxes. This campaign has a stronger focus on the international trade in currencies and derivatives. The goal is that a tax at a low rate could raise tens and perhaps hundreds of billions in revenues a year which could then be used to reduce poverty and fight climate change. Better control of these financial markets would also reduce speculation and economic instability, particularly for smaller vulnerable countries, and stem the flow of money from developing countries to tax havens, where much of the trading in derivatives and foreign exchange takes place.

Following the financial crisis this campaign has gained the support of leading politicians, including German Chancellor Angela Merkel and French President Nicolas Sarkozy. In March 2011, the European Parliament voted on a proposal to introduce a Europe-wide financial transactions tax. Sarkozy has also vowed to continue to push world leaders to agree on a financial transactions tax this year as France takes over the chair of the G20. The Leading Group on Innovative Financing for Development — an organization of over 60 countries, international organizations and the Gates Foundation — recently called for the an international tax on currency transactions.

How well could financial transactions taxes meet the three goals outlined above of tax fairness, economic efficiency and generating revenue? There is much debate on these issues.

There are different aspects of tax fairness. In general, financial transactions are not taxed while most other transactions for goods, services or labour are subject to tax at considerable rates. Even a tax at a very low rate could correct some of this imbalance. At the same time, there is legitimate concern that cascading transactions taxes would lead to high and varying effective rates for different financial activities or products. In some cases, this is the goal — to "throw sand in the wheels" of some financial markets — but in others it would be more effective to have taxes at different rates for different financial products, such as equities (or stocks), bonds, foreign exchange, options, futures, and other derivatives. A major appeal of a financial transactions tax applied to wealthy banks and the financial sector is its capacity to raise revenue for the world's poorest; that's why many proponents have called it the "Robin Hood Tax." Impacts on individual consumers could be contained by having an annual exemption and/or through stronger regulation of banking fees.

More debate centres on whether or not financial transactions taxes improve market and economic efficiency. Evidence has shown that transactions taxes probably don't reduce short-term market volatility of asset prices. However, proponents argue that they will reduce longer-term volatility and speculation and reduce the possibility of financial crises. At the very least, financial transactions taxes at the very low rates

proposed — no more than 0.5% on stocks and as low as 0.005% on foreign exchange — would have a small impact, except for those involved in high frequency trading.

A major attraction of financial transactions taxes is that they could potentially raise very significant revenues at the global level, a portion of which could then be used to reduce world poverty and fight climate change. Economists at the Austrian Institute of Economic Research estimate that a general financial transactions tax levied at a rate of 0.01% to 0.1% of all financial transactions globally could generate between $200 billion and $1 trillion a year, depending on how much it reduced transaction volumes.[24] These estimates may be overstated, given that much of the revenue is expected to come from derivative transactions and the revenues calculated appear to be based on notional values of the contracts rather than the premiums. However, the amounts generated globally would still be significant: a 0.1% transactions tax just on the spot transactions of stocks and bonds would generate close $100 billion a year globally. In the United States, it is estimated that a Financial Speculation Tax levied at different rates for different types of financial transactions could generate between $180 billion and $350 billion a year in revenues.[25] An expert report commissioned by the 63 member nations of the Leading Group on Innovative Financing for Development recently endorsed an international currency transactions tax to raise funds for international development. They estimate that such a tax levied at a rate of 0.005% would generate approximately $30 billion a year in revenues globally and cause little disruption to markets.[26]

There will be questions about how feasible financial transactions taxes can be in a world where financial capital is increasingly mobile. In Europe, countries with major international finance centres such as the U.K. and Switzerland have had successful and effective transactions tax systems in place for many years. These are levied at set standard rates, largely on transactions of equity shares and bonds in the case of the U.K., and on the issuance of capital shares in the case of Switzerland.[27] The amounts raised from existing financial transactions taxes are already significant. The U.K.'s Stamp Duty Reserve Tax generates over £3 billion (or over CDN$5 billion) in revenues annually at a rate of 0.5%, despite having a number of exemptions.[28] It is also levied on foreign transactions of shares in U.K.-based companies, so avoidance is more difficult, and provides exemptions for "market-makers" in order not to restrict market liquidity. Financial transactions taxes can also be very administratively efficient: centralized trading systems mean that the cost of collecting the tax is usually very low in relation to the revenues.

Also of particular interest are the systems in place in Taiwan, with its varying rates for different securities, and in China, which levies a duty on share transactions. China's system is unique in that the rate has often been adjusted by the authorities up and down as a mechanism to cool or revive the stock market. In this way, it is used not only as a passive measure to raise revenue and curb financial transactions, but also as an active measure to prevent asset bubbles from occurring in the stock market.[29]

Potential Revenues for Canada

How much revenue could similar transactions taxes generate at a domestic level in Canada? Table 3 provides estimated revenues for financial transactions taxes for Canada, using different rates for different types of securities.

A transactions tax at 0.5% on shares traded on the TSX would generate an estimated $3.5 billion a year in revenues, assuming it led to a 50% decline in transaction volumes and values. This is equivalent to a tax of $5 on a transaction worth $1,000. For comparison, a 0.1% tax (or $1 on a trade worth $1,000), as considered by the European Commission would generate ap-

TABLE 3 **Estimated Revenue from Financial Transactions Tax for Canada**

	Annual transactions (billions)	Revenue, assuming 50% reduction in trading volume (billions)
Stocks and Equities:	$1,414	
(tax rate at 0.5%)		$3.54
(tax rate at 0.1%, 20% reduction in trading)		$1.13
Bonds:	$8,223	$1.23
Government	$7,834	$1.17
Corporate	$389	$0.06
(tax rate of 0.01% per year to maturity)		
Foreign Exchange:	$14,600	$0.37
Spot	$4,570	$0.11
Forwards and FX Swaps	$10,035	$0.26
(tax rate of 0.005%)		
OTC Foreign exchange and interest rate derivatives	$11,300	$0.28
(tax rate of 0.005%)		

NOTES

EQUITIES TRADING The value of equities traded on the Toronto Stock Exchange averages over $5 billion a day, and over $1.4 trillion a year.[33] This volume understates the level of equity trading in Canada: new alternative trading systems, so called "dark pools" of capital, now take an estimated 25% of trades away from the TSX.[34]

BONDS The volume of trading in bonds in Canada is at higher levels than for equities, averaging approximately $160 billion a week or approximately $8 trillion a year, although over 90% of these involve transactions of government and crown corporation bonds.

FINANCIAL DERIVATIVES AND FOREIGN EXCHANGE Information about trading in financial derivatives comes from two main sources: derivatives traded on recognized exchanges (in Canada's case the Montreal Exchange) and derivatives that are traded "over-the-counter" directly between two parties. The Montreal Exchange doesn't provide much information about the value of derivatives traded on its exchange, but more information is available through the World Federation of Exchanges. The Bank of Canada surveys and publishes data on the value of transactions in over-the counter transactions in Canada every three years as part of the Bank for International Settlements' triennial survey. The latest survey was conducted in April 2010, and was reported in August 2010.[35] This latest survey reports that an average of $58.4 billion in traditional foreign exchange turnover occurred every day in Canada during April 2010, down by 2.3% from the previous survey in 2007. Trading in over-the-counter foreign exchange and interest rate derivatives averaged $45.2 billion a day in April 2010, up 82% from 2007. This adds up to more than $25 trillion in foreign exchange and over-the-counter derivatives turnover every year in Canada.[36]

proximately $1.1 billion a year, assuming it led to a 20% reduction in share volumes and values at that rate.

A transactions tax on trading in bonds at a low rate of 0.01% (1 basis point) per year to maturity could generate about $1.2 billion per year in Canada, if volumes declined by 50%.[30] However, most of this trading is in government bonds. Given the desire to maintain high levels of liquidity in the markets for these bonds, and the possibility that the transactions taxes would be reflected in higher borrowing costs, there's a good argument for excluding government securities from a transactions tax. In this case, revenues from bank and corporate bonds would amount to a much more modest $60 million a year.

While it is growing, the volume of trading in financial derivatives on Canadian exchanges remains relatively modest. A large share of the volume is in stock index and interest rate futures.[31] Based on 2009 trading values, a transactions tax on stock option and stock index premiums at the same 0.5% rate as the tax on stock transactions would only raise $6 million a year, assuming a 50% reduction in volumes. A tax on stock index futures at the lowest end of what Taiwan charges (0.01% on the contracted amount) would generate $22 million a year, also assuming a 50% reduction in volumes.

Much higher volumes of foreign exchange and derivatives are traded over the counter (OTC) directly through dealers. According to the latest survey of the Bank of Canada, there was an average of $58.4 billion in traditional foreign exchange turnover and an average of $45.2 billion in OTC foreign exchange and interest rate derivatives traded daily in Canada during April 2010. This adds up to more than $25 trillion every year in

Canada and suggests a transactions tax on such business at a rate of 0.005% (or $50 on every $1 million traded) could generate $650 million in revenues, assuming volumes decline by 50%.

However, trading in the foreign exchange and over-the-counter derivatives market can be highly mobile. According to the latest survey of the Bank for International Settlements, the value of transactions using the Canadian dollar is about twice the level of turnover occurring through Canadian dealers.[32] Accordingly, it makes much more sense to introduce a currency and interest rate derivatives transactions tax at a global level. Considering the share of the Canadian market as a portion of total global foreign exchange turnover, these revenue estimates are consistent with other estimates of global revenues from a currency transactions tax by Canadian expert Rodney Schmidt and the Leading Group on Innovative Financing for Development.

Other Fair Tax Alternatives

As noted above, Canada's financial sector has benefited considerably both from corporate income tax cuts made over the last decade and from a range of different tax loopholes and tax preferences.

The tax preferences include taxing stock options — which are a major component of executive pay — and income from capital gains at half the regular rate of tax that applies to employment and other income. These tax preferences provide direct benefits to finance sector firms and executives and also major indirect benefits for the sector by fuelling a boom in the stock and other financial markets.

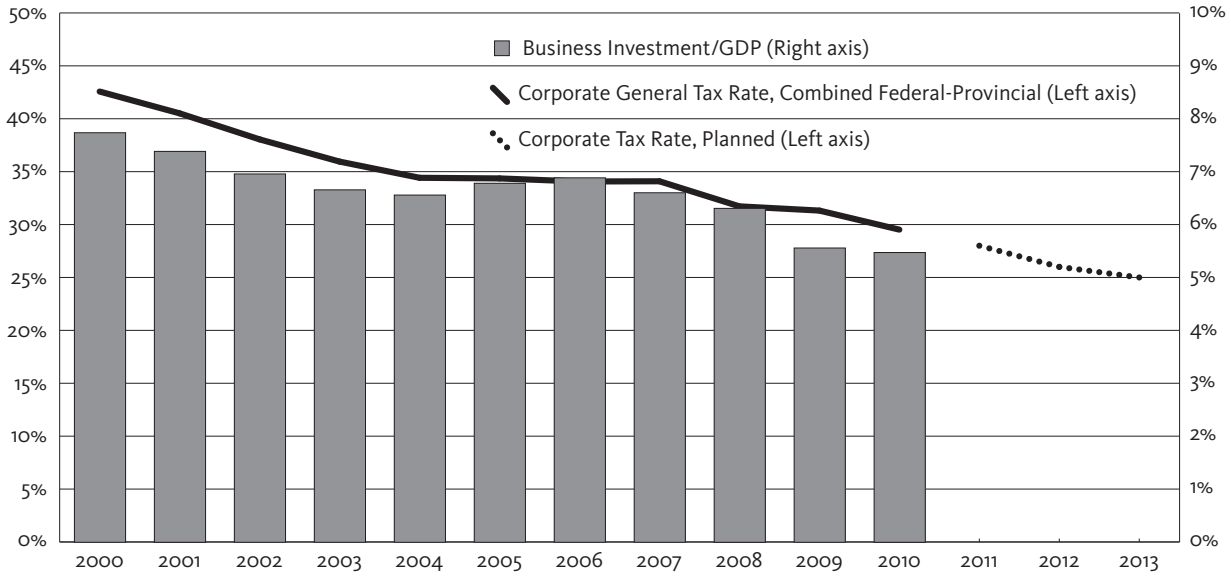
Lower capital gains tax rates especially benefited short-term investments. Since much of the revenue for the financial industry comes from transactions fees, such as on the buying and selling of shares or issuance of new securities, this more rapid turnover of investments increased revenues for the financial industry at an even faster rate.

The rationale for preferential tax rates on capital gains and lower corporate tax rates was they were supposed to lead to higher rates of savings and higher rates of investment in the economy, thereby boosting economic growth and employment.[37] However, overall rates of capital investment as a share of our economy have been largely stagnant since capital gains taxes and corporate income tax rates were reduced. There has been an increase in residential construction, but the rate of business investment in machinery and equipment, a key driver of productivity, has declined (see Figure 4).

The capital gains tax cuts helped fuel a major boom in stock markets and other asset markets, but this wasn't reflected in stronger growth of the economy. Instead of investing in productive physical capital, increasing amounts went to finance mergers, acquisitions, speculative investments, share buybacks, and growing surpluses of cash. Even now, shortly after the financial crisis, both financial and non-financial firms use their excess profits and cash to finance buybacks of their shares instead of expansion of economic activity. Share buybacks raise stock prices, at least temporarily, often with the greatest benefit going to those who are paid in stock options (and pay tax on these gains at half the normal rate), such as the executives and managers who make those decisions.[38]

Corporate income tax rates have been cut steeply at both the federal and provincial level in Canada from an average rate of 42.6% in 2000 down to an average of 28% at the beginning of 2011. Further cuts planned by federal and provincial governments will bring the combined top corporate income tax rate down to 25% in most provinces by 2013 — less than half the rate it was in 1981. This year, Canada will have the lowest combined corporate income tax rate of all G7 countries.

FIGURE 4 **Canadian Corporate Tax Rates and Business Investment In Machinery and Equipment**



SOURCE Statistics Canada National Economic Accounts (Table 384-0002), OECD tax database and federal and provincial budgets.

Cuts to corporate tax rates also lead to investment, profit and income shifting between jurisdictions and between types of income through forms of "beggar thy neighbour" tax competition as practiced by tax havens. Some advocates of corporate tax cuts claim the apparent increase in investment and profits that result from this represents an unleashing of entrepreneurial spirits and real economic activity, while others argue it represents a race to the bottom in which all but business interests lose out.

As the gap grows between corporate tax rates and personal income tax rates, it also leads to increased shifting of personal income to corporate income by business owners and others with the ability to do so. Within a few years, the combined top tax rate on corporate income in Canada will be close to 20 percentage points below the combined top tax rate on personal income. This will provide a powerful incentive to avoid taxes by sheltering personal income through corporate accounts.

Unless there are very strong and compelling reasons otherwise, the tax system should tax income from different sources at similar rates. In addition to being unfair, the current system encourages devoting enormous resources to tax planning and tax avoidance to take advantage of the differences in these tax rates. This diverts resources from more productive uses and leads to a further drain on public revenues.

As the recent financial crisis demonstrated, large banks and financial sector firms in Canada and elsewhere also benefit from an implicit "too big to fail" government guarantee that they will be bailed out if they face failure. This allows them to engage in riskier activities than they might otherwise — with often very damaging impacts on the broader economy. It can lead to a "Catch-22" situation where the discipline of market failure may be considered good on the basis of individual firms, but potentially very bad in terms of the overall economy. Canada's largely protected and oligopolistic banking structure appears to have resulted in greater market stabil-

ity, but also higher profit rates for the industry. Both these factors provide rationale for stronger regulation of the industry — including of the fees they charge — and/or higher corporate tax rates to retrieve some of the excessive profits they are able to gain and redistribute them to the public.

Potential Revenues

Restoring the federal corporate income tax rate to 21% for the finance and insurance industry (the rate that applied from 2004 to 2007) instead of cutting it to 15% next year as the Harper government plans would increase federal revenues by an estimated $2.4 billion in 2012–13. Restoring the rate to 18% would increase revenues by $1.2 billion from the financial sector. Reversing parallel provincial corporate income tax cuts would increase revenues by $685 million from the finance and insurance sector in Ontario alone.[39]

Eliminating preferential tax rates for corporate capital gains and stock options would increase federal revenues by even more: an estimated $3.9 billion this year, with approximately $1 billion of that from the finance and insurance sector.

Conclusions

In the wake of the financial crisis, other major countries are moving forward with proposals for new taxes on their banks and financial sectors. Their interests are three-fold:

- Ensure the financial sector makes a fair and substantial contribution to public finances.
- Enhance the efficiency and stability of financial markets and reduce their volatility and the harmful effects of excessive risk-taking.
- Ensure that the financial sector contributes to public revenues via increased or new taxes, given that it is considered to bear a major responsibility for the crisis and to have received substantial government support.

In addition, a number of policy groups, international aid and civil society organizations see financial transactions taxes as an appropriate potential source of funding to support the Millennium Development Goals and to combat climate change.

While other countries and the European Union are moving forward with new taxes on their financial sectors, there has been no serious consideration of the merits of these proposals within Canada. Canadian governments are relying almost entirely on spending cuts to tackle their deficits.

Canada faces similar fiscal challenges as these other countries and could also benefit from tax measures that would improve the functioning of our economy — and there's no doubt that federal and provincial governments could benefit from higher revenues. As other Canadians are paying for the costs of the financial crisis, Canada's under-taxed financial industry should also be required to pay its fair share.

This report shows that Canada's highly profitable financial sector has benefited very significantly from corporate tax cuts and tax preferences over the past decade. It also stands to gain more than any other sector from further cuts to corporate tax rates.

It's a cruel irony that, after an economic crisis that cost the public purse hundreds of billions of dollars, our governments are rewarding those who caused the crisis with an expanded financial safety net and lower taxes, but making individual Canadians pay for it with higher taxes and reduced social services.

A better alternative is to introduce a fairer tax system that increases revenues by eliminating or adjusting for the tax preferences and benefits that the finance sector has enjoyed. As this study has shown, any of three different measures — a *Financial Activities Tax*, a *Financial Transac-*

tions Tax, or eliminating tax loopholes and restoring corporate tax rates — could contribute to restoring tax fairness and raising many billions in revenues for Canadian governments.

The first priority of federal and provincial governments should be to establish a fairer tax system and broaden the base by:

- Introducing a *Financial Activities Tax* on financial sector profits and remuneration to compensate for the relative undertaxation of the financial sector;
- Eliminating tax preferences for stock options and capital gains; and
- Reversing recent and further cuts to corporate income tax rates.

These three sets of measures could all take effect in a very short time. Combined they could generate close to $15 billion in the coming fiscal year, rising to $20 billion by 2013–14, half of which would come from the finance and insurance sector. These measures should be combined with stronger regulations over bank fees to ensure that costs are not simply passed on to consumers.

Following these domestic measures, the Canadian government should work with — and not against — other leading nations to introduce financial transactions taxes at an international level. This could start with a 0.005% levy on foreign exchange transactions with the funds to be used for international development. This should then be followed with broader-based financial taxes on transactions of financial derivatives and other securities. The revenues raised from these measures would go a long way toward meeting Canada's international commitments to provide funding to reduce global poverty and fight climate change.

TABLE 4 **Value of selected tax preferences and new revenue sources for finance and insurance industry**
Includes both federal and provincial revenues ($millions)

Estimated value of tax preferences and tax cuts for finance and insurance industry ($millions)

	2010	2011	2012	2013
Exemption of financial services from GST and provincial sales taxes	4,540	4,749	4,991	5,241
Cuts to corporate income tax rate since 2002	4,019	5,111	6,137	6,624
For Finance and Insurance industry				
Preferential tax rate on stock options	247	272	299	329
Preferential corporate income tax rate on capital gains	1,497	1,647	1,811	1,992
Total value of above tax preferences and reductions	**10,303**	**11,779**	**13,238**	**14,186**

Estimated revenues from tax changes—federal and provincial governments ($millions)

	2010	2011	2012	2013
Financial Activities Tax at 5% on adjusted profits and compensation of finance and insurance industry ("FAT1")		4,749	4,991	5,241
Transactions tax at 0.5% for equity transactions		3,712	3,897	4,092
Retain corporate income taxes at 2009 rates *(revenues from finance and insurance industry only)*		1,947	2,908	3,393
Total potential revenues from above		**10,408**	**11,797**	**12,726**

TABLE 5 **Security Transactions Taxes in Selected Countries**

Country	Stocks	Bonds	Futures, Options, etc.	Other	Detail/Comments
Brazil	0.3% on stocks, 1.5% tax on equity issued abroad	1.5% tax on loans		0.38% on forex, 2% on capital inflows	Has a 5.28% tax on short-term foreign exchange (<90 days).
Canada	na	na	na	Na	
Chile		0.1–1.2%			
China	0.1–1.2%				Introduced in 1990, has been frequently adjusted to cool or stimulate market.
Colombia	1.5%	1.5%	1.5%		Introduced 2000.
Finland	1.6%				Asset transfer tax with exemptions.
France	[0.15–0.30%]				Abolished 2008.
Greece	0.6%	0.6%			
Hong Kong	0.3%				
India	0.25%		0.017% on premium		Local stamp duties may also apply
Indonesia	0.1%				Local stamp duties may apply.
Ireland	1.0%				On transfers and issues of new shares.
Italy	0.01–0.14% for off-exchange	0.25–2% on loan principal		Flat fee on issuance, 3% on purchase	
Japan				0.4% on trusts & mergers	Removed on shares 1999.
Russia		0.2% on new bonds		0.2% on new share issues	
Singapore	0.2%				Stamp duty, higher rates for other property
South Africa	0.25% of value				New shares excluded
South Korea	0.5% of value			0.1%–0.4% on capital formation	Shares in corporations & partnerships
Switzerland	0.15% domestic 0.30% foreign	0.06–0.12% on bond issues		1% on share issuance	
Taiwan	0.30%	0.10% corporate bond principal	0.1–0.6% on options; up to 0.06% on futures		
Turkey	0.1% initial fee 0.025% annual	0.6–0.75%		0.2% on stock issuance	
United Kingdom	0.5%		0.5%		
United States	0.0013% SEC				Plus state taxes per share.

SOURCES IMF 2010, European Commission 2010, Beitler 2010, information from national governments.

Notes

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15 For instance, if a targeted tax was 100% effective at curbing specific risky behaviours, such as smoking, it would not be effective at all in raising revenue.

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18 The U.K. bank levy was to be set at 0.04% of a bank's balance sheets, but already there are concerns that this rate may be cut. "George Osborne plans to cut levy on banks' balance sheets", *The Guardian* November 14, 2010 http://www.guardian.co.uk/business/2010/nov/14/bank-tax-cut-bonuses

19 This was subsequently published as the first chapter in IMF (2010a) along with another chapter specifically devoted to the Financial Activities Tax.

20 IMF (2010a) p. 20.

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27 See European Commission (2010a) for more details on the systems currently in place in European countries and in Taiwan; and Beitler, Daiana (2010). *Raising Revenue: A Review of Financial Transaction*

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29 Baltagi et al (2006) are very critical of China's securities transactions tax on the basis that increases in the rate significantly reduced trading volumes, led to little increase in revenues and increased market price variations. However, this criticism misinterprets the government's rationale for increasing the tax rate, which wasn't to raise revenues or to reduce price variation but to cool off stock market prices. Baltagi, Badi H. et al (2006) "Transaction tax and stock market behavior: evidence from an emerging market", *Empirical Economics* 31: 393–408 (2006).

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31 Data on the annual value and volume of these transactions are available from the World Federation of Exchanges http://www.world-exchanges.org/statistics/annual/2009/derivative-markets/derivatives. The Montreal Exchange reports that the notional value of trading in futures of the S&P Canada 60 index (SXF) tops $2 billion a day or $500 billion a year. By volume, trading in this SXF derivatives amounted to about 25% of the Montreal Exchange's trading in equity and ETF options and about 10% of the total trade by volume in equity, ETF, currency options and other derivatives. http://www.m-x.ca/f_stat_en/1009_stats_en.pdf

32 Turnover in the Canadian dollar amounted to 2.6% of the total global foreign exchange turnover with virtually all of this in exchange for the U.S. dollar, with about 2.3% of interest rate derivatives also denominated in Canadian dollars. Only 1.2% of global turnover in foreign exchange and 1.5% of global turnover in OTC interest rate derivatives occurred through Canadian dealers and exchanges. http://www.bis.org/publ/rpfx10.htm

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37 The tax rate for income from capital gains prior to 2000 had been 75% of the statutory rate that applies to other forms of income, but this reduced rate was in place to compensate for the fact that some of the increase in capital gains represented general inflationary increases. This was not the rationale for further cuts to capital gains taxes, as reductions in the rate of inflation would otherwise justify a higher, not lower, inclusion rate for income from capital gains.

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