Generating Resources for Investment

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A key part of the discussion in Europe is how to urgently restore growth in a climate where financial markets are unwilling to finance sovereign debt of many countries at reasonable cost. A central issue is how best to design macroeconomic policies for this purpose. Complementary to this is how to mobilize resources to kick-start investment.

There is a great need for creative thinking, to achieve the latter. This can be done both by using existing and new instruments. I want to illustrate this by providing one important example of each.

Expanded role of the European Investment Bank

As regards expanding existing instruments, it seems important to significantly increase the lending capacity of the European Investment Bank (EIB). This could lead to a major increase in EIB lending, with a possible target of doubling EIB lending. This would have a major effect on expanding investment, jobs and output, with very small fiscal resources required to achieve this.

The EIB has already played an important role during the first phase of the global financial crisis, as it has increased significantly its lending within Europe in a counter-cyclical way, with far higher loans both to small and medium enterprises, as well as greater finance for major investments in infrastructure, especially for the green economy. This is to be welcomed. But as the European crisis continues, and as a major challenge is the restoration of growth , whilst private credit stagnates or even declines, an even greater role for the EIB seems highly desirable. This would help fund both long -term investment in infrastructure and help finance urgently needed working capital for small and medium enterprises, so as to support increase in jobs.

A key advantage of increasing lending by the EIB, and/or by national public development banks, is that with fairly limited public resources, a major increase of lending can be achieved, due to leverage. Capital is only a relatively small proportion of annual lending (for example the Basle capital adequacy ratio requires 8% of risk weighted assets), and only a small share of total capital is called up capital (actually paid in).

Thus a doubling of EIB capital could be achieved with only relatively small budget contributions, implying very small effect on budgetary deficits, whilst leading to a large increase in EIB lending. Indeed, in 2010 total called up capital of the EIB reached only Euro 11.6 billion; this allowed the EIB to lend within the EU almost Euro 63 billion in 2010, with additional lending to the enlargement countries. If the same ratios were maintained, a doubling of called up capital would represent an additional cost to EU countries of another Euro 11.6 billion (a very small sum if compared to the money spent by EU governments as a result of the crisis); it could however generate ADDITIONAL EIB lending of Euro 63 billion annually within the EU.

The ideal would be for all EU member governments to contribute to a significant increase in the EIB capital, which as discussed above, would have very low implications for actual called up capital, and thus for national budgets. However, should all EU governments not be willing to contribute to such an increase in capital, an EIB subsidiary could be created; this would be capitalized by an injection of capital by willing governments. Though the option of an increase of capital by all EU member governments would clearly be the best option, a separately capitalized subsidiary would be a very good second best.

Further leverage could be achieved if national development banks are created or expanded, and the EIB expands its current collaboration with national development banks. Currently the EIB is for example collaborating on financing long term offshore wind projects, jointly with the German development bank, KfW, and with private banks. Such co-financing could be considerably expanded.

More generally the lessons from successful development national development banks, such as KfW in Germany and BNDES in Brazil need to be learned for other European economies. These public banks provide much needed finance in sectors where market gaps or market failures normally exist due to for example important social externalities(such as in financing the green economy); furthermore, they have provide very valuable counter-cyclical finance in times of crises, and their positive counter-cyclical role has received increased recognition as a valuable one. They can provide essential finance for supporting a restructuring of economies, such as a transformation to a greener economy. In the case of Europe, an expanded EIB could achieve further leverage by co-financing with national development banks, to finance HIGH PRIORITY activities, particularly those which contribute to the green economy and to generating jobs

Financial transactions tax to fund additional investment

The European Parliament and EU finance ministers have been discussing the European Commission's proposal for a financial transactions tax (FTT) of 0.1% on bond and equity transactions and 0.01% on derivatives. This is projected by the European Commission to raise over Euro 55 billion annually, if implemented by all member countries. There seems to be growing support for such an initiative, which would be highly desirable.
Before the Great Contraction began in 2007, bankers had succeeded in painting FTTs as the concept of naïve idealists who knew little about the real workings of finance. This was quite a feat given that the idea had towering intellectual credentials. John Maynard Keynes had recommended it in his “General theory of employment, interest and money”, and a Nobel prize-winner, James Tobin, later developed it. Many leading economists, like Joseph Stiglitz, currently strongly endorse such a tax.

Before the financial crisis, rather than looking to “throw sand in the wheels of finance” (to use Tobin's phrase), the story propagated by the industry was that those wheels should spin

ever more quickly. We were told that the faster money moved, the more efficiently it would be allocated. Bankers and hedge-fund managers would grow super-rich, but that was a minor distraction because the economy would be stronger and jobs more plentiful.
That story has been shown as totally false by the financial crisis.

Dynamic economies

Today, FTTs are no longer ridiculed. How could they be? The world's most dynamic economies, including Brazil, South Korea and India, use them, Europe's most successful large economy, (Germany), along with eight other EU states, wants to adopt one, and last year approximately $38 billion (€29bn) was raised by FTTs in the 40 countries that have them. Since 1986 (and before in other forms), the UK government has unilaterally, without waiting for others to follow suit, levied a stamp duty reserve tax of 0.50% on transactions in UK equities. Despite not updating this tax to take into account derivatives and other innovations, it still raises around €3.8bn per year.

The reason why these FTTs work is that they are stamp duties on the transfer of ownership and not based on tax residence. If the transfer has not been 'stamped' and taxes paid, the transfer is not legally enforceable. Institutional investors who hold most assets around the world do not take risks with legal enforceability. Of the UK's receipts from its stamp duty reserve tax, 40% are paid by foreign residents. Far from sending taxpayers rushing for the exit, this tax gets more foreigners to pay it than any other.

A negative impact?

Having lost the argument on feasibility, the financial sector and their political friends are now vigorously opposing FTTs with ever more outlandish claims about their negative impact on the wider economy. They have latched on to very preliminary estimates by the European Commission that a 0.1% FTT on equities and bonds could reduce gross domestic product (GDP) by 1.7%, without waiting for the final analysis. In fact, as discussed below, it has been estimated that the proposed FTT would actually increase EU GDP.

In its latest iteration, the Commission's model takes into account that the overwhelming majority (85%) of investment comes from retained earnings or bank loans not subject to FTTs. Furthermore, as the Commission's analysis said from the start, the proposed FTTs would only apply to transactions between financial institutions and would not cover companies issuing new shares. Once these factors are taken into account, the Commission's model indicates that the estimated negative effect of FTT on GDP would fall to just 0.1%.
But this is not the complete story. It is necessary to add that the tax would fall most heavily on short-term holders of securities, such as high-frequency traders, hedge funds and bank proprietary trading desks. It would fall least on long-term holders such as pension funds, life-insurance companies and private equity firms. This would likely trigger a shift away from short-term trading in favour of long-term holding that will reduce misalignments in markets and their subsequent abrupt adjustments or crashes.

FTTs would therefore somewhat decrease the likelihood of future crises. Indeed, among those countries that were least affected by the crash, countries with FTTs were disproportionately represented. If we conservatively estimate that the probability of crisis would decrease by only 5% as a result of the FTT, which is very low, and we take into account that on average financial crises decrease gross domestic product (GDP) by around 7%, we would have a positive impact of +0.35% on European Union GDP due to smaller likelihood of future crisis. The total net effect of an FTT would be an estimated boost of Europe's GDP by +0.25%, not a reduction. A more detailed version of this analysis can be found in a recent report written for, and presented to, the European Parliament by the author of this background paper and by Avinash Persaud[1].

At a time when many European governments face large deficits, in large part as a result of bailing out the financial sector, or more broadly due to the crisis caused to an important extent by the financial sector, it seems reasonable to expect the financial sector to accept measures to help reduce the likelihood of future crises. The evidence is clear that an FTT adopted by all 27 EU states or by the 17 members of the euro-zone would help strengthen Europe's finances considerably- the European Commission estimates the tax would yield above Euro 55 billion annually, if adopted by all member states --and reduce the likelihood of crises.

In the short term, part of the FTT could be destined to fiscal consolidation; this could help reduce spreads on government borrowing, and help crowd in private investment. However, part of the additional tax could also be channelled to financing much needed public investment; in a context where the private sector lacks confidence for investing, as growth falters or is negative in many EU countries, public investment needs to play a catalyzing role to increase aggregate demand; Furthermore, such public investment can increase aggregate supply in the long term. Revenues from the FTT could even contribute to boost national contributions to the capital of the EIB, as discussed above, thus providing leverage and greater impact on growth and job creation by both the private and the public sector.
Indeed this may be a particularly reliable way of increasing investment in the short to medium term, as if the FTT was not implemented, the higher corporate earnings would not necessarily go to private investment due to poor growth expectations.

As the FTT would be one of the first internationally coordinated taxes, (though collected nationally), a proportion of its revenues should, possibly at a later stage once the European economy is on the path to recovery and growth, be earmarked to help finance the solutions to some of the world's most difficult international problems, such as poverty and inequality, as well as climate change. Therefore, an FTT could help foster somewhat fairer and more sustainable growth in Europe and globally.

[1] See the paper, 'Financial Transaction Taxes' by Stephany Griffith-Jones and Avinash Persaud, written for the European Parliament at http://policydialogue.org/publications/network_papers/financial_transaction_taxes/