A FISCAL EASING OF THE CRISIS IN THE EURO-ZONE

Jan Toporowski

All crises challenge the received ideas that validate, but do not inform, routine and unthinking behaviour, policy and decisions. Those who think use their imaginations to find new solutions to the urgent problems that beset us. Those who do not think reach back to the dogmas that comforted them in the past, in the hope of finding such comfort in a world that will not conform to old ideas.

After half a century of debate about perniciousness of state welfare and the odiousness of taxation, the present crisis appears as a crisis of state finances, soluble only by higher taxation of citizens, or lower welfare provision for them. The policy debate is caught up in a largely formal exchange between peddlers of austerity, who play on citizens' fears of debt, taxes and inflation, and 'Keynesians' who see no end to the possibilities of fiscal stimulus. In the process we have lost the insights into the incidence and effects of taxation and government expenditure that were common currency in the mid-twentieth century discussions on public finance.

In this situation therefore it is worth re-reading Kalecki's paper 'A Theory of Commodity, Income and Capital Taxation', published in 1937 in the *Economic Journal,* a short paper of remarkable clarity and reason. By 'commodity' taxation, Kalecki meant sales taxes, like the Value Added Taxes that are so widespread today. Kalecki argued that this simply redistributes income from those in employment to recipients of welfare payments and government employees. In the case of income tax, this also largely redistributes existing consumption. However, he showed that government expenditure financed by a tax on capital, because it is not paid out of income and has no effect on costs, would tend to raise incomes, employment and business investment. He concluded that ‘capital taxation is perhaps the best way to stimulate business and reduce unemployment. It has all the merits of financing the state expenditure by borrowing, but it is distinguished from borrowing by the advantage of the state not becoming indebted.’[1]

Kalecki was arguing about a tax on capital that is used to finance additional government expenditure. However, a tax on capital may also be used to repay government debt. An early advocate of this kind of financial operation was David Ricardo. In 1819, in speeches to the House of Commons, when he was a Member of Parliament, and in an article on ‘The Funding System’ which he wrote for the *Encyclopaedia Britannica*, Ricardo alluded to the benefits of taxing wealth in order to pay off the national debt. This would, in his view, stimulate business by making the wealthy more liquid (having their holdings of government debt exchanged for money)[2].

Similar arguments were made a century later, in Vienna, in a discussion between the veteran Austrian Marxist Otto Bauer and Joseph Schumpeter. In 1919 they were in a Socialist government that had inherited the responsibility for Austria’s war-time debts, in a country that had been hugely reduced by the Versailles and Trianon settlements, and whose economy had not only been correspondingly reduced, but also thrown by political circumstances into a state of chaos and depression. Bauer and Schumpeter, who were both in the Austrian Government’s Committee on Socialisation, were in agreement that the fiscal situation could be alleviated by a levy on bank capital. Bauer wanted to use the levy to drive the banks into insolvency, whereupon they would be taken over by the state. Because of the banks’ large

---

[1] *Collected Works of Michał Kalecki Volume I Capitalism Business Cycles and Full Employment* Edited by Jerzy Osiatyński, Oxford: The Clarendon press 1990, p. 325.

[2] *The Works and Correspondence of David Ricardo Volume IV Pamphlets and Papers 1815-1823* edited by Piero Sraffa and M.H. Dobb , Cambridge University Press 1951, pp. 196-197.

holdings of company stock, this would be an effective way of bringing Austrian business under state control, fulfilling the destiny that Hilferding and Lenin had prescribed for 'finance capital'.

Schumpeter, who had no enthusiasm for socialisation and appears to have been intriguing with conservative circles in Bavaria and Hungary to overthrow Soviet Governments in those countries, had other ideas. With the government in serious financial difficulties, he recommended that the capital levy be used to buy in War bonds, effectively cancelling them. In the end, the socialisation drive, and the capital levy that was to finance it, petered out in acrimonious parliamentary procedure.[3]

A Tax on 'Financialisation'

These historical considerations point to a simple and practical way of alleviating the crisis in Europe. This could be done by indebted government's imposing a small annual tax of 1 or 2 per cent on the balance sheets of all registered companies above some minimum size that would exclude small businesses. The tax would be in proportion to the total value of all assets or liabilities, with deductions for industrial or commercial assets and equipment. In effect the tax would fall mostly on financial intermediaries, and on non-financial companies holding financial assets. This would therefore be a tax on 'financialisation', that is on the financial balance sheets that have proliferated with credit innovation and deregulation.

The tax could be used by the Debt Management Offices of indebted governments to buy in, at full value, the government debt held by banks. This would support the government bond market, causing yields to fall in the market, and thereby easing financing pressure on

[3] Christian Seidl 'The Bauer-Schumpeter Controversy on Socialization' *History of Economic Ideas* II/1992/2, pp. 41-69. I am grateful to Riccardo Bellofiore who has made available to me his copy of this article.

governments. By concentrating buying on bonds of particular maturities, the fiscal authorities could manage the yield curve for government bonds. By improving the price and liquidity of government bonds, the tax and bond buy-back would improve the balance sheets of banks as well as the balance sheet of the government.

A number of possible objections may be easily shown to be groundless. First of all, it may be objected that this kind of tax would discourage the holding of government bonds. On the contrary, far from discouraging the holding of government bonds, the buy-back part of the scheme would actually encourage the holding of government bonds, because these would have a more assured liquidity and a higher value. If anything, the tax would discourage the holding of financial assets that are not liabilities of the government. But by allowing deductions for industrial and commercial assets, the tax would increase the incentive to invest in the real economy, as opposed to the financial markets.

A second objection is that the tax would be passed on to bank borrowers, and would thereby discourage financing for productive purposes. As previously mentioned, the greater inducement to invest of deductions for productive assets, would more than off-set this discouragement, since any increase in the cost of borrowing would not affect investment financed by drawing on reserves. In any case, strictly speaking such a tax could only affect banks' margin between deposit and lending rates. There is no convincing empirical evidence to show that this margin, let along the absolute cost of borrowing, affects investment in any way. Moreover, as financial assets and liabilities proliferate with financial development, more and more borrowing is done by banks themselves in the inter-bank market. If banks pass on the tax to their borrowers, they would increasingly be passing it on to each other and a growing proportion of this tax would be paid by financial intermediaries. In this way a tax on financial balance sheets would truly be a tax on 'financialisation'.

A third objection might be that such a tax would make financial intermediaries less liquid. On the contrary, it would make those intermediaries holding government bonds more liquid, because those bonds would be repaid. Those intermediaries that do not hold bonds that are bought back by the government, would of course be paying taxes and not receiving the liquidity benefits of having long-term bonds repaid. In effect the scheme would recycle intermediaries' own liquidity towards those banks holding government bonds. Insofar as this would stabilise government finances there would be social benefits in a scheme that improves government and bank balance sheets. In extreme cases, banks may have to reach into their reserves to pay the tax. But this should not affect their solvency as long as banks can borrow and lend among themselves and the central bank is prepared to accept non-government collateral.

A fourth objection is that the tax may be evaded. This is certainly true of taxes on profits where profits may be easily manipulated by transfer pricing, but also, with financial development, by management of debt liabilities, payments on which are treated as costs, rather than as taxable profits. However, it is less possible to do this with balance sheet totals. If anything, tax avoidance by debt management tends to increase the size of financial balance sheets. Some of the tax lost due to debt management could therefore be recouped by a balance sheet tax. Emigration is also less of a threat to balance sheets. A bank may transfer its country of domicile, as the Hong Kong and Shanghai Bank did in the early 1990s. But it cannot transfer its balance sheet unless it liquidates its business in a given country. As long as financial markets have the prospects of future profits, financial intermediaries will keep the balance sheets that they hope will capture those profits.

How it might work in Europe

A tax on financial balance sheets dedicated to buying in government bonds has the advantage that it can be applied within the European Monetary Union without changing the Maastricht Treaty, whose inflexible provisions contribute to the present revulsion against government debt. Governments within the European Monetary Union have Debt Management Offices within finance ministries that can, with national parliamentary authority, levy a balance sheet tax, handing over the proceeds of the tax to the DMO to use to buy in bonds issued by that office. No supranational fiscal authority would be required and many governments, including that of the UK, already impose taxes on bank balance sheets. But these are only a tiny fraction of the taxes that could be raised. The tax and buy-back scheme would have to operate at a national level, because it is only the national government that could buy back and cancel its own debt. A Europe-wide fiscal authority, taxing all financial balance sheets across Europe and buying in government bonds would be able to buy in governments bonds and then forgive them. But it is likely that depositors and shareholders of banks in a country with a low level of government debt would object to their financial balance sheets being taxed in order to cancel the debt of a more highly-indebted government of another country in the European Union. This political objection would not apply at a national level.

But there is another reason why a scheme like this is not only necessary, but essential to the future of Europe. When the monetary institutions for the European Union were being planned and established in the 1990s and at the turn of the century, it was believed that the only function of a central bank should be the conduct of monetary policy, and the issuing of money. The other functions of central banks were believed to be either unnecessary, in the case of the original function of central banks to manage government debt markets, or were transferred elsewhere, in the case bank regulation. The resulting institutional set-up means that Europe now has a central bank without a government, and governments without central banks. The function of managing government debt markets could be effectively recovered by extending the responsibilities of national debt management offices to include ensuring the liquidity of the secondary markets in government bonds. Indeed, it is most efficient for the institution that sells government bonds into the primary market to have responsibility for managing the secondary market, because that institution is best placed to cancel, on buying back, the bonds that it issues.

The European economy, and the institutions that are supposed to regulate it, are in a mess. A capital levy on financial balance sheets, used to buy back and cancel government debt, would not get Europe out of this mess. But it would buy time for more effective measures to be introduced, measures that are currently held back because of what has been made to look like a financial crisis of the state that need not be so critical. In the present circumstances, a financial balance sheet tax, should be welcomed by financial intermediaries and corporations as a small price to pay for improving the balance sheets of banks and governments.

Jan Toporowski is Professor of Economics and Finance at the School of Oriental and African Studies, University of London. His latest book *Michal Kalecki An Intellectual Biography Volume I Rendezvous in Cambridge 1899-1939*, is coming out in the summer from Palgrave.