



NEWSLETTER

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Analysis**Global imbalances demand a global fiscal system**

Andrew Sheng*

The Global Financial Crisis (GFC) has shattered conventional wisdom about global governance. Governor of the Bank of England Mervyn King's dictum that global banking is global in life, but national in death, characterizes complex financial institutions that are larger than sovereign nations, are ineffectively regulated at national levels, and lack global laws. Their demise means that national governments have to pay for the global banks' mistakes, but ultimately the whole world pays in the form of higher inflation, taxation and lost jobs.

This Westphalian system of voluntary national cooperation in a highly interconnected and interdependent world is cracking at the seams.

The Group of 20 (G20) has improved the legitimacy of global governance, but the 'what to do' is confused by turf battles over who bears the loss and who will have control. It is useful to be reminded that the present fiscal trend of rising expenditure and tax cuts to rebuild excess consumption funded by excess leverage, despite limited global resources, is just a race to another crisis.

The world is caught in a collective action trap. The gaming nature of nation-states and private sector behaviour are such that there is the tendency of a race to the bottom. No country is able to tighten monetary policy alone for fear of inviting hot money that negates that policy. No country is able

to tighten financial regulation for fear of business migrating to other financial centres. No country is able to raise taxation for fear of massive tax arbitrage.

In hindsight, global imbalances were caused by the violation of the Triffin Dilemma writ large. The Triffin Dilemma states that the reserve currency central bank faces the dilemma of running monetary policy that is inconsistent with domestic needs. When the reserve currency country has excess consumption, its central bank should be running tighter monetary policy, but in a world of free capital flows, the efficacy of monetary policy is weakened. The trouble is that when all four reserve currency central banks are faced with rising fiscal deficits and massive financial engineering that pumped hidden leverage into the system, the systemically important countries collectively generated a global credit bubble that can only be financed by lower and lower interest rates.

The reality is that we now have a global economy without global monetary policy, global financial regulation or a global fiscal system.

In other words, excess consumption that ultimately feeds into global warming can only be controlled by hard budget constraints – current taxation, not future taxation. We are reminded of the effects of global climate change by recent typhoons, floods, earthquakes and droughts, as well as the estimate that biodiversity loss could cause as much as US\$2-5 trillion annually when the total cost of the current financial crisis is less than \$4 trillion.

Advocates of global governance reform suggest that the current problems can be solved through a global currency or a global

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EABER-SABER Conference on East and South Asian Economic Integration, February 2010. Canberra

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PAFTAD 33, October 6-8, Taipei.

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financial regulator. They forget that the pre-condition for global government action is a global fiscal system. The Euro-currency system has demonstrated unequivocally that a single currency cannot function without some form of fiscal compensation for those who suffer regionally from the consequences of monetary policy that may not suit local conditions. We cannot agree on a global fiscal system because so far all taxation is local.

But Lord Adair Turner of the UK Financial Services Authority has shown the way. Since the financial sector has become the 'perpetual prosperity machine' with massive moral hazard, Lord Turner is right in thinking that a 'Tobin tax' or a turnover tax is the first step in global fiscal reform.

A turnover tax offers many merits. First, it is a user-pay tax that is less regressive than other forms of taxation. It is akin to a gambling tax on socially negative activities.

Second, a turnover tax can be counter-cyclical, it can be increased or decreased depending on the level of speculative fever in the markets. When the risk of a bubble collapse rises, the tax rate can be increased to fund safety nets in the event of a crisis. It complements capital adequacy tools.

Third, a turnover tax can finance global public goods that currently have no other forms of financing.

Fourth, a turnover tax will reduce profits of financial institutions and hence their capacity to pay excessive bonuses that promote too much risk-taking at the expense of society.

Fifth, the turnover tax collection system will generate data on financial transactions which can help regulators monitor excessive speculation, market manipulation and insider trading that currently plagues effective global financial market supervision.

Of course the financial sector would object to any form of new tax. But those who prosper by public subsidy in the form of deposit guarantee and enjoy higher profits at public risk deserve to pay some tax. Those who argue for frictionless finance have created a windmill spinning at supersonic speed that

fractured the whole financial structure. A minimal turnover tax will stop infinite financial derivative layering that creates complexity, opacity and potential for systemic risks.

Just how much can governments raise from a turnover tax? Based on BIS Triennial Survey data in 2007, global annual value of foreign exchange turnover was roughly US\$800 trillion. Add another US\$101 trillion stock market trading based on the World Federation of Exchanges statistics would give total annual financial trading, excluding bonds and other over-the-counter transactions, of roughly US\$900 trillion. Using a turnover tax of 0.005 per cent would yield \$45 billion, roughly the aid pledged to Africa at a rate of US\$50 billion per annum.

Global public goods are currently funded by equity (voting quota for Bretton Wood institutions) or by direct national grants. These are not sustainable. We need a global tax to fund global public goods.

But for a turnover tax to work, it is vital that G20 agrees for all countries to impose a single, uniform rate of say, 0.005 per cent to avoid a race to the bottom from the onset. This would put into place the module of fiscal standardisation and tax mechanism that improves conditions for future coordination in monetary policy and financial regulation. The tax can be collected at the national level on a buyer-pays basis. The tax collected could be credited to a global fund, with a formula that would allow national governments to use part of the proceeds to resolve domestic crisis problems.

A global turnover tax can fund non-controversial global public goods, such as 'Education for All' initiatives, before moving to tackle other more controversial areas, such as funding to tackle climate change.

Global problems are a global tragedy of the commons. We cannot build a global fiscal system to tackle global problems overnight, but we must begin the debate

**Andrew Sheng, Adjunct Professor at University of Tsinghua, Beijing and University of Malaya, Kuala Lumpur.*

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