FOUNDATION FOR EUROPEAN PROGRESSIVE STUDIES
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IMF consultation on Financial Sector Taxation

Document prepared by FEPS
for the Europeans for Financial Reform campaign
of the Global Progressive Forum

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January 2010

1. Rationale for a financial transaction tax?

"The globalization of financial markets has given financial capital an unfair advantage over other sources of taxation. A tax on financial transactions would redress the balance", G. Soros (2001)[1]

"*How governments handle the burden-sharing between Wall Street and Main Street will determine social cohesion, financial-market stability, -and political leaders-' reputations for years to come*", P. Steinbrück (2009) [2]

When some economists assess that the roots of the crisis lie as much in structural causes as in the loose regulatory framework of the financial sector, characterised by **global imbalances** and deregulated markets, one must have in mind that one of the most important imbalances in global economic activity is an **hyper-inflated financial sector**. Financial transactions volumes have increased drastically to reach 70 times world GDP in 2007, when this ratio was only 15,3 in 1990.

On the other hand, another structural imbalance fed the over-development of financial markets, namely a decrease in the share of wages in GDP and an increase in profits. These profits were invested in financial activities, resulting in low growth and unemployment[3].

In a cumulative effect, **short term speculation**, considered at least as "*socially useless*", can in fact produce persistent destabilising and unsustainable long term deviations, identified as financial bubbles. In addition, empirical evidences suggest that the economic crisis was deepened by the instability of stock prices, exchange rates and commodity prices.

This is in fact hardly surprising given that it has never been demonstrated that the economic system, independently of any external intervention, could produce an acceptable social order. Nobody has been able to show that the economy, through the intermediation of the markets alone, could reach a state of rest satisfying individual desires. The rhetoric on

[1] "Open Societies, Sovereignty, and International Terrorism", available at http://www.asiasociety.org/business-economics/development/george-soros-open-societiessovereignty-and-international-terrorism

[2] "The case for a Global Financial Transaction Tax", *Project Syndicate*, available at http://www.project-syndicate.org/commentary/steinbruck1/English

[3] Stiglitz & Fitoussi (2009), "The ways out of the crisis and the building of a more cohesive world", available at http://www.feps-europe.eu/fileadmin/downloads/political_economy/090528_StiglitzFitoussi_Gn.pdf

the necessity to liberalise markets has therefore to be interpreted as ideology. As rightly emphasised by Soros: "*Instead of a tendency towards equilibrium, financial markets have a tendency to develop bubbles. Bubbles are not irrational: it pays to join the crowd, at least for a while. So regulators cannot count on the market to correct its excesses*"[4]

In this respect, one must be intellectually careful in stressing the need for a financial transaction tax. The tax should not be designed in order only to grasp temporary negative externalities in some markets[5]. Indeed, the problem at stake is **to limit globally financial transactions**, in order to decrease their relative profitability compared with real sectors productive activities and consequently, their destabilising effects. From an history of economic thought point of view Keynes did not recommend a financial transaction tax for reasons of market failure.

Moreover, it is necessary to stress that financial investors make an extensive use of **leverage techniques**. Taxing financial transactions should also have an impact on the relative profitability of the financial sector, and should give even **more credit to the stabilising effect** of the implementation of a financial transaction tax. It would also allow a decrease in the level of debt and therefore of the risks of occurrence of new bubbles.

Indeed, based on his famous portrayal of the functioning of financial markets as a **beauty contest**, he states: "*It is rare, one is told, for an American to invest, as many Englishmen still do, "for income"; and he will not readily purchase an investment except in the hope of capital appreciation. This is only another way of saying that, when he purchases an investment, the American is attaching his hopes, not so much to its prospective yield, as to a favourable change in the conventional basis of valuation, (...). Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino,* ***the job is likely to be ill-done****. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism (...).The introduction of*

[4] G. Soros, "Do not ignore the need for financial reform", Financial Times, 25th October 2009, available at http://www.georgesoros.com/articles-essays/entry/do_not_ignore_the_need_for_financial_reform/

[5] Darvas & Weizsäcker (2010), "Financial transaction tax: small is beautiful", European parliament, DG for internal policies, Policy department A: Economic and scientific policies.

*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*”[6].

It is on the basis of the **intrinsic instability** of financial markets that a financial transacion tax is needed. It is the very same reason which implies that it must be levied **on all types of financial transactions**. Only such measures could be able to lead to more stable, and therefore sustainable, growth path. Indeed, it could limit **globally the weight of the financial markets** in our economies, while making **more expensive speculative**, **socially useless**, activities.

A financial transaction tax should allow **a fairer burden-sharing** of the crisis and permit the economy to follow a much more stable and sustainable growth path, through a **change in investors' behaviours**. Finally, a financial transaction tax of 0.05% could yield revenue of about 1% of nominal world GDP per year and create a **future permanent revenue from the financial sector to the real economy.**

Therefore, when the G20 leaders tasked the IMF “*to prepare a report for our next meeting with regard to the range of options countries have adopted or are considering as **to how the financial sector could make a fair and substantial contribution** toward paying for any burdens associated with government interventions to repair the banking system*”, one must state that this process has to be **redistributive**, through fiscal policies and financial regulation.

In this respect, Obama's reforms in regulating and taxing financial institutions stand in a remarkable coherence and are **the right things to do**. Indeed, last year, the Obama's administration stated that the $700 billion financial-bailout bill contained a provision requiring the US president to submit legislation to “**recoup**” **from the financial-services industry** any eventual shortfall in the Troubled Asset Relief Programme, or TARP. Consequently, it is necessary for the Obama's administration **to tax banks, insurance companies and brokerages**

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[6] Keynes (1936), *General Theory of Employment, Interest and Money*, Chapter 12, available at http://www.marxists.org/reference/subject/economics/keynes/general-theory/

with more than $50 billion in assets[7] and to propose to ensure that **no bank or financial institution that contains a bank will own, invest in or sponsor a hedge fund or a private equity fund, or proprietary trading operations unrelated to serving customers for its own profit, and to put limits on the excessive growth of the market share of liabilities at the largest financial firms**: "*My resolve to reform the system is only strengthened when I see a return to old practices at some of the very firms fighting reform; and when I see record profits at some of the very firms claiming that they cannot lend more to small business, cannot keep credit card rates low, and cannot refund taxpayers for the bailout. It is exactly this kind of irresponsibility that makes clear reform is necessary*"[8].

2. The functioning of a financial transaction tax:

It cannot be acceptable that the benefits of success in this sector are reaped by the few but the costs of its failure are borne by all of us", G. Brown (2009)[9]

In the recent discussion the financial transaction tax and the Tobin tax have often been confused. However, there is a difference. Whereas the Tobin proposal refers to currency transactions (i.e. changing money from one currency to another) the financial transaction tax envisages a much broader tax base. It would tax transactions of all kinds of financial assets.

Such a tax must be general, and implemented in a coordinated and manageable manner.

However, the financial transaction tax should be implemented first **in order to limit technical trading**. In this respect, following Schulmeister (2009)[10], a financial transaction tax should be levied on all spot transactions on exchanges, derivatives transactions on exchanges and

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[7] "Fact sheet Financial Crisis Responsibility Fee", US Department of the Treasury , 14th July 2010, available at http://www.ustreas.gov/press/releases/tg506.htm

[8] "President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers", The White House, Office of the Press release, 21st January 2010, available at http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e

[9] Available at http://www.bloomberg.com/apps/news?pid=20601068&sid=aEbwLvzaLk04 and http://www.ft.com/cms/s/0/a6ccb1d4-cc9a-11de-8e30-00144feabdc0.html

[10] Schulmeister (2009), "A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal", Österreichisches Institut für Wirtschaftsforschung, available at http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/WP_2009_344$.PDF

OTC transactions. Practically, the exchanges debit the buyer and the seller of each transaction with 50% of the tax. Such a global tax seems more attractive than a specific transaction tax for at least two reasons. First, a general tax **does not discriminate** against specific types of markets. Second, due to the enormous volume of the tax base **the tax rate could be very small** and yet, the tax receipts would be considerable.

3. How much would a global financial transaction raise?

"*I believe the transaction tax still has a great deal of merit…[It would have] really minimal impact on the transaction, but a tremendous impact on helping us meet our needs*" N. Pelosi (2009)[11]

As stated by many commentators arguing for a global financial transaction tax, governments, especially in developed countries, are experiencing huge public deficits as a result of massive financial institutions. Moreover, any economic crisis inevitably leads to a worsening of public finances, given that governments spend more on social expenditures with less resources at their disposal. In this respect, Schulmeister & al. (2008)[12] estimates that **a tax rate of 0.05% on all financial transactions in the world** (spot transactions on exchanges, derivatives transactions on exchanges and OTC transactions) would yield between **1% and 2,4% of world GDP** (for the year 2007) depending on the reduction in transaction volumes after the implementation of a global financial transaction tax.

A transaction tax would provide governments and/or supranational organisations with considerable revenues which could be used for the achievement of policy goals, particularly on the supranational level (e.g., to finance global public goods like development aid or to strengthen the financial base of the EU). This revenue aspect played only a minor role in the original Tobin tax proposal, however, it received increasing attention in recent discussions[13].

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[11] Available at http://www.reuters.com/article/idUSTRE5B24J520091203

[12] Schulmeister, Schratzenstaller & Picek (2008), "A General Financial Transaction Tax: Motives, Revenues, Feasibility and Effects", Österreichisches Institut für Wirtschaftsforschung, available at http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/S_2008_FINANCIAL_TRANSACTION_TAX_31819$.PDF

[13] See Landau report (2004) on Innovative development funding solutions commissioned by President Jacques Chirac, available at www.cttcampaigns.info/documents/fr/landau_en/Landau1.pdf; Jetin & Denys (2005), "Ready for implementation – Technical and legal aspects of a currency transaction tax and its implementation

4. A step-wise approach:

A general taxation of financial asset transactions in all major economies can only be the final stage in the process of implementing a financial transaction tax. The first stage could be the implementation of a tax levied only on spot and derivatives transactions on organized exchanges in some major EU economies. In fact, it would be sufficient if only the UK and Germany implemented such a tax (roughly 97% of all transactions on exchanges in the EU are carried out in these two countries).

However, most politicians who have recently supported the idea of a financial transaction tax have argued that such a tax would only work if it were implemented globally. **This is not true, as the existence of such taxes in several countries proves**. The most prominent example is the British "Stamp Duty." This is a relatively high tax of 0,5% which is levied on the nominal price of any purchase of shares of UK companies. This means that a foreign purchaser has to pay the tax. The tax is also levied on purchases of shares of British firms outside the UK. If the asset is transferred to a clearance service or converted to paper, which avoids the Stamp Duty, an "exit charge" of 1.5% has to be paid. The revenue in 2006 was approximately 5 billion euro. The duty has not lead to tax evasion and the weakening of the City of London. In fact, in big financial marketplaces, actors benefit from network externalities (i.e. important partners in proximity, infrastructure etc.). As long as the tax rate does not exceed the costs of relocation, financial institutions would rather pay the tax than move to another location.

In the group of countries reviewed by the WIFO study, 7 out of 27 EU member states as well as Switzerland and Japan currently have a capital duty with a tax rate of up to 1% (which is the upper limit in the EU). Austria, which has abolished its stock exchange turnover tax in 2000, levies a capital duty of 1% only. Germany no longer has any financial transaction taxes. Within the EU, it is striking that only four out of 15 old member countries, but nine out of 12 new member countries do not impose any tax on financial transactions.

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in the EU", World Economy, Ecology and Development (WEED), available at http://www2.weed-online.org/uploads/CTT_Ready_for_Implementation.pdf

Moreover, *"the extreme concentration of transactions on organized exchanges in Europe (only 6% are spot transactions, 94% refer to futures and options) clearly shows that network externalities of well-established market places are the most important factor for their success. This in turn implies that an FTT of 0.05% or even only 0.01% will not induce any considerable "emigration""*[14].

An HM Revenue & Customs study[15] selected examples of countries using some form of financial transaction tax :

	Equity Transactions	Derivatives	Corporate Bonds	Government Bonds	Currency Transactions	Consumer Account Transactions	Consumer Credit Transactions
Argentina	✓	✓	✓	✓		✓	
Belgium	✓		✓	✓	✓[1]		
Brazil	✓		✓	✓	4		
Chile						✓[2]	✓[2]
China	✓						
France	✓				✓[1]		
Hong Kong	✓						
India	✓				3		
South Korea	✓		✓				
United Kingdom	✓						
United States	✓						

1) Established in legislation although only comes into effect if all EU countries introduce a currency transactions tax
2) Rate temporarily reduced to 0% for 2009
3) Recently removed tax on cash withdrawals
4) CPMF was not renewed in 2007

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[14] Schulmeister, Schratzenstaller & Picek (2008), "A General Financial Transaction Tax: Motives, Revenues, Feasibility and Effects", Österreichisches Institut für Wirtschaftsforschung, available at http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/S_2008_FINANCIAL_TRANSACTION_TAX_31819$.PDF

[15] Shome (2009), "Financial Transaction Taxes", International Tax Dialogue Global Conference, HM Revenue & Customs.

5. Counter-arguments: addressing speculators' behaviours

"Some financial activities which proliferated over the last ten years were ***'socially useless'****, and some parts of the system were swollen beyond their optimal size. And if you disagree with that, you have a bone of contention not only with me, but with the Chairman of the British Bankers' Association, Stephen Green, who has said exactly the same thing in very similar words, when he argued that 'in recent years,* ***banks have chased short-term profits by introducing complex products of no real use to humanity'****, and when he recognised that 'some parts of our industry have become overblown*", A. Turner (2009)[16]

"The pattern of asset price dynamics as a sequence of very short-term runs which accumulate to "bull markets" or "bear markets" and, hence, to long swings around the fundamental equilibrium suggests that ***the cumulative effects of increasingly short-term transactions are rather destabilizing than stabilizing****. The growing importance of technical trading systems in financial markets might contribute significantly to this pattern of price dynamics. This seems plausible for at least two reasons. First, technical trading strengthens and lengthens persistent price runs. Second, technical trading is increasingly based on high frequency (intraday) data*"
Schulmeister & al. (2009)[17]

In the 1990's and early 2000's, before the global financial crisis, it was widely believed that trading and volatility would facilitate risk management and dispersion, better price discovery and moving faster to market equilibriums[18]. In this context, transaction taxes or such equivalents as capital controls were believed to have negative effects on price discovery, volatility, and liquidity and lead to a reduction in the informational efficiency of markets[19]. As a result, financial transaction volumes have increased dramatically in recent years: in 2007, total turnover for the main spot and derivatives markers as a ration of world GDP amounted to almost 70 times the world GDP.

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[16] Mansion speech, 22nd September 2009, available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0922_at.shtml

[17] Schulmeister, Schratzenstaller & Picek (2008), "A General Financial Transaction Tax: Motives, Revenues, Feasibility and Effects", Österreichisches Institut für Wirtschaftsforschung, available at http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/S_2008_FINANCIAL_TRANSACTION_TAX_31819$.PDF

[18] For a summary of IMF and OECD positions, see TUAC (2009) "The introduction of an International financial Transaction tax", available at http://www.tuac.org/fr/public/e-docs/00/00/05/D0/document_doc.phtml

[19] Securities Transaction Taxes and Financial Markets, by K. Habermeier and A. Kirilenko, IMF working paper, May 2001.

However, there is a general consensus that financial transaction taxes cause **a fall in asset prices and a fall in the long-term number of financial transactions**[20]. Nevertheless, there seems to be a debate on whether the implementation of a financial transaction tax would increase or decrease price volatility. Nevertheless, as rightly emphasised by Schulmeister & al. (2008) the concept of volatility can be seen in different manners, and to answer to this question would need more research.

Moreover, the implementation of a financial transaction inevitably makes **free-market ideologues** raise a series of arguments against it. However, it must be stressed that we consider that the economy is always in "**traverse**" i.e. **in a state of disequilibrium**. In this process, the functioning of the price system, independently of any external intervention, cannot be considered systematically as a good guide for a sustainable and optimal allocation of capital in the economy. The following are some arguments against a financial transaction tax:

1. *The high transaction volumes in modern financial markets reflect the liquidity necessary for the price discovery process and, hence, for facilitating and smoothing the movements of asset prices towards their fundamental equilibria*.

Short term speculation, whatever its impact on the real economy, produces long-swings in asset prices with no regard their to fundamentals. In this respect, speculation is harmful to the price discovery process. This kind of deviation leads investors to transfer capital towards sectors with no real concerns regarding their link to the real economy. These kinds of behaviour lead to an unsustainable allocation of resources in the economy.

2. *A great deal of short-term transactions is related to hedging and, hence, to the distribution of risk*.

[20] Share prices fall by 0.2% and transaction volumes fall by 1.65% for every 1% increase in transactions costs (Jackson & O'Donnell, 1985); in UK, Those shares with the highest turnover rate (effectively incur the highest Stamp Duty on share transactions) demonstrated the greatest price decrease in response to changes in Stamp Duty rate (Bond, Hawkins & Klemm, 2004); Kiefer (1990) estimates for the US that the introduction of a broad-based securities transaction tax of 0.5% might decrease trading volume by 8%. For China, *Baltagi – Li – Li* (2006) find that an increase of the Chinese stamp tax rate by 0.2 percentage points reduces trading volume by one third.

Financial investors do not invest in the sector they expect to be the most rentable but in the sector they expect others to think is the most rentable. In other words they have at least mimetic ways of assessing the expected profitability of an investment. As a result all financial investors **have the same diversification strategy**. In this respect, the process of diversifying risk does not work because all the actors have the same portfolio. On the contrary, it seems possible to state that such a belief leads to the appearance of **systemic risk**.

3. *Speculation is an indispensable component of both, the price discovery process as well as the distribution of risks. As part of the former, speculation is essentially stabilizing, i.e., it moves asset prices smoothly and quickly to their equilibria*.

"*Instead of a tendency towards equilibrium, financial markets have a tendency to develop bubbles. Bubbles are not irrational: it pays to join the crowd, at least for a while. So regulators cannot count on the market to correct its excesses*"[21]

4. *Any increase in transaction costs, e.g. due to an FTT, will cause liquidity to decline which in turn will increase the short-term volatility of asset prices.*

A uniform tax per transaction increases the costs of speculative trades, thus making it more costly to carry out short term transactions. Hence, a transaction tax would have a stabilizing effect on asset prices and would thereby improve the overall macroeconomic performance: "*To put it differently: Any (expected) profit from trend-following (technical) trading is reduced by a general FTT. This reduction will be the bigger the smaller is the average difference between the buy price and the sell price, i. e., the higher is the "speed" of trading. As short term trading becomes less attractive, price runs will become less pronounced. This effect will in turn reduce the attractiveness of technical trading based on (ultra-)high frequency data (often fully "automated systems"). Since long-term appreciation (depreciation) trends are the*

[21] G. Soros, "Do not ignore the need for financial reform", Financial Times, 25th October 2009, available at http://www.georgesoros.com/articles-essays/entry/do_not_ignore_the_need_for_financial_reform/

result of upward (downward) runs lasting longer than countermovements, a general FTT would dampen the "long swings" of asset prices"[22].

In any case, the increase in derivatives trading is fairly too much to be accounted for by hedging activities. The overall transaction volumes stems from technical trading since this practice uses data of ever higher frequencies. At the same time, technical trading seems unrelated to fundamentals. Moreover, since a general financial transaction tax makes transaction costs the more costly the shorter the time horizon is, it will specifically dampen technical trading. In this respect, the counter-argument stating that a financial transaction tax would **limit market efficiency is just wrong**. Indeed, technical trading i.e. speculation, does not play the role liberal economists expect it to play. Instead of being a tool for price discovery and risk diversification, it culminated in producing long-swings in asset prices, **unrelated to their fundamentals**. In this respect, it is hardly conceivable to consider that prices reflect all the information. The global deregulation of financial markets did not allow a better and more sustainable allocation of resources, on the contrary, it lead to the regular formation of financial bubbles.

In this respect a financial transaction tax represents the opportunity to **curb socially useless speculative behaviours** and stabilise our economic growth path.

6. Technical feasibility:

IMF managing director D. Strauss-Kahn said that "*a simplistic Tobin tax was impossible for technical reasons*" and added that "*any **new tax should be levied on all asset classes** – not merely foreign exchange – and would be based on the gross value of the assets, thereby helping to discourage the creation of asset bubbles*"[23].

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[22]Schulmeister, Schratzenstaller & Picek (2008), "A General Financial Transaction Tax: Motives, Revenues, Feasibility and Effects", Österreichisches Institut für Wirtschaftsforschung, available at http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/S_2008_FINANCIAL_TRANSACTION_TAX_31819$.PDF

[23] Tax Justice Network (2009), "Financial Transactions Taxes: new task forces", available at http://taxjustice.blogspot.com/2009/10/financial-transactions-taxes-new-task.html

In fact, technically, the financial transaction tax can be levied easily and at very low costs. All transactions at the stock exchanges are captured by electronic platforms. A simple electronic tag would automatically transfer the tax to the relevant tax office[24]: "*it is increasingly easy to implement. The greater centralisation and automisation of the exchanges' and banks' clearing and settlements systems – as well as the greater standardisation that will imply far more derivatives transactions settled on exchanges after the financial crisis – make the collection of such a tax much easier. It also makes avoidance of payment more difficult and less desirable, as the established settlements system would offer safety for such transactions*"[25].

Finally, one has to mention that a low financial transaction tax rate necessitates low interest rates and therefore stands in coherence with the prolongation of stimulus packages and that the implementation of a low financial transaction would curb, partially at least, what we considered to be the roots of the current crisis.

7. Summing up:

The recent financial and economic crisis has been characterised by economic imbalances. The most important and primordial imbalance is the overdevelopment of the financial sector with respect to the real economy. Moreover, it has been argued that one of the sources for the development of financial activities was the decrease in the share of wages in GDP. However, one can verify that the last ten or twenty years have been characterised by soft growth and a rise in unemployment. Indeed, financial investors were not interested in investing in the real economy when, through the use of different financial techniques, financial investments could yield a profit rate (return on equity) of 20% or 30%. However, it has been argued that such disconnected returns were only possible thanks to short term trading or speculation. In this respect they have been treated as socially useless activities. As this paper tried to show, short term speculation produces long term swings in asset prices, unrelated to their fundamentals, and hence, favours an inefficient allocation of resources in the economy.

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[24] Kapoor (2009), "Financial transaction tax – The taxes of the future" FEPS, available at http://www.feps-europe.eu/fileadmin/downloads/political_economy/090907_FEPS_Kapoor_tax.pdf

[25] Griffith-Jones (2009), "Now let's tax transactions", *The Guardian*, 7th December.

Moreover, mimetic behaviours on financial markets lead investors to act in the same manner in their diversification strategy. Therefore, not only was the allocation of resources inefficient, it was also unsustainable given the systemic nature of financial markets.

In this respect, the implementation of a financial transaction tax represents the opportunity to stabilise our economies by both enhancing a fairer sharing of the burden of the crisis, and limiting socially useless activities. It would also create the possibility of future permanent revenue from the financial sector to the real economy.

Europeans for Financial Reform

Europeans for Financial Reform is a coalition of progressive forces, ranging from NGOs to Trade Unions, citizens, academics and progressive politicians, that have come together to spearhead a campaign for real reform in our banking and financial system.

Partners: The Global Progressive Forum, CES/ETUC, CIS/ITUC, Solidar, UniGlobalUnion, FEPS, IGMetall, Unite, IUF/UITA/IUL, SOMO, Socialist Mutual Benefit Society, DGB, FGTB/ABVV, CNCD, AK, ÖGB, CEVEA, TUC, UNITE.