BANKING VS DEMOCRACY

how power shifted from parliament to the banking sector

PositiveMoney

CONTENTS

EXECUTIVE SUMMARY

This report asks if power has shifted from Westminster down the river to the City of London. What we find is a banking system that has more 'spending power' than the democratically elected government, no accountability to the people, and massive concentration of power in the hands of a few individuals.

However, the greatest concern is that government has surrendered one of its most important powers—the power to create money and control the money supply—to the private sector which has exploited this power to blow up housing bubbles and indirectly transfer wealth upwards and inwards, with disastrous results. There has been no democratic debate about this transfer of power, and no law actively sanctions the current set-up.

As the last few years have shown, the banking sector can have a serious negative impact on our lives. Leaving it with such a huge and unaccountable degree of power is no more likely to work in the best interests of society or democracy in the future than it has in the past.

CEDING THE POWER TO CREATE MONEY TO THE BANKING SECTOR

In the current system, banks create the vast majority of money in the UK, in the form of the electronic bank deposits that appear in your bank account. They create this money without regard to how much is needed for the economy and society as a whole to operate effectively, and they put over 90% of this money towards activities that do not contribute to the growth of the economy.

This power to create money causes inflation that insidiously transfers wealth from savers and those who hold their wealth in cash (i.e. the poor and those on medium incomes) to those who are rich enough to hold their wealth in other assets (such as property). Giving private sector banks a monopoly on the creation of money also means that whenever additional money is needed in the economy, only private banks can provide it. In effect the entire money supply must be rented from the banking sector, at great cost to the economy. This is a service that could be provided by the government at no cost to anyone.

The business model that permits banks to create money—so far from the popular perception of banks as simple intermediaries between savers and borrowers—is inherently unstable and will systematically require periodic taxpayer-funded bailouts. The cost of these bailouts diverts revenue from the activities that the government was elected to do, compromising its ability to fulfil its democratically mandated objectives.

Leaving this power to create money to the private sector creates a serious democratic deficit: a process that many would consider to be the sole prerogative of the state is in the hands of corporations who have no accountability to the wider public and whose interests are completely at odds with those of society as a whole.

OVERSTATING THE TRUE CONTRIBUTION OF THE BANKING SECTOR

Politicians and policy makers are misinformed about the true contribution of the banking sector because they are only shown the positive side of the sector's contribution to government finances, i.e. the taxes they pay.

The overall contribution of the UK banking sector to the Exchequer is about 6% of overall tax revenues. In the year that the banking sector paid its highest ever tax, the manufacturing sector paid over three times more.

Society is now acutely aware of the direct cost to the taxpayer of bailing out banks but less attention is directed to the hidden subsidies they benefit from, even in the good times. Firstly, because of both implicit and explicit government guarantees, when a bank borrows money it does so at an interest rate lower than it would be able to otherwise. Secondly, by giving up the power to create money the government forgoes an important source of revenue, which results in higher taxes, lower spending or a bigger national debt. Conversely, the banks benefit financially from the power to create money. These hidden subsidies more than outweigh any taxes paid by the banks.

NO ACCOUNTABILITY TO CUSTOMERS

Unlike pension funds, banks are not required to disclose how they will use their customers' money. As 97% of the UK's money supply is effectively held with banks, this allows them to allocate a larger sum of money than either the entire pension fund industry or the elected government itself. Consequently the UK economy is shaped by the investment priorities of the banking sector, rather than the priorities of society.

Just five banks hold 85% of the UK's money, and these five banks are steered by just 78 board members whose decisions shape the UK economy. This is a huge amount of power concentrated in very few hands, with next to no transparency or accountability to wider society.

THE CLOSE RELATIONSHIP BETWEEN BANKING & GOVERNMENT

It is impossible to know how much influence the financial sector has over policy but they certainly devote substantial resources to getting it. The financial sector makes large donations to political parties: the Conservative Party is 50% financed by donors associated with the financial industry, and it offers a 'backstage pass' to meet the Prime Minister in exchange for a £50,000 annual donation, raising the question of whether 'cash for access' is subverting the political process.

Lobbying is a fact of political life and only the most naïve politician would fail to take account of their naturally biased agenda. However, the resources of banking sector lobbyists far exceed those from other sectors and therefore the views of the banking industry may be drowning out those of civil society.

The close relationship between the banking sector and its chief regulator, the FSA, should be worrying, especially given the record of the last few years. The revolving door between the banks and their regulators revolves faster in the UK than in any country other than Switzerland and a former Prime Minister now consults for one of the world's largest investment banks, for a salary approximately 12 times more than he earned as Prime Minister.

POLICY IMPLICATIONS

A few economically simple changes to the banking system would return power back to the people and restore some level of democratic control over the economy. These changes are:

1. Make banks ask for permission from their customers before they lend out their money.
2. Make banks disclose how customers' money will be invested, so that members of the public can refuse to fund activities that they are not ethically comfortable with.
3. Remove the power to create money from the banks and return it to a democratically accountable body.

Making these changes would help redress the democratic deficit in banking and limit the ability of the banking sector to damage society. After the experience of the last few years, these are changes that urgently need to be made.

INTRODUCTION

Whenever major decisions are taken about the future of the UK, news cameras will be aimed at reporters standing in front of Parliament. But is Parliament really where the key decisions are being made today, or has power shifted down the river to London's financial sector, the City?

This report argues that, above and beyond their visibly effective lobbying activities and the periodic threats to 'up sticks' made in the press by bank chiefs and their representatives, the banking sector holds much greater powers; powers that are generally hidden by the complexities of money and economics. This report aims to bring these hidden powers out into the open and show that there is a serious and worrying democratic deficit in banking.

Chapter 1 explains how the power to create money—a power that most would assume is restricted to the Bank of England—has shifted almost exclusively to private sector banks as a result of the failure of successive governments to update legislation to take account of technological changes in banking. Not only has there been no democratic debate in Parliament to approve of this surrender of power to the banking sector but also the vast majority of the public (and most Members of Parliament) are completely unaware that the process of creating our nation's money has been privatised. An examination of the consequences of maintaining the status quo shows that doing so would be against the interests of society as a whole, since the current system limits and compromises the power of government to implement the objectives it was elected to achieve and therefore weakens democracy.

Chapter 2 discusses how the public and politicians are misinformed as to the real contribution of the banking sector. The debate usually focuses on the tax contribution of the banking sector, completely overlooking the hidden subsidies that banks receive in good times and the costs of banking crises in bad times. The banking sector has successfully promoted a perception that the UK's economy is powered by financial services and that the government depends on tax revenue from the City. In fact, the tax paid by the banking sector is dwarfed by that paid by the manufacturing sector, even at the best of times. Misconceptions and misleading information about the true contribution of the banking sector make it impossible for Members of Parliament to make well-informed decisions that will be in the public interest. The result is that the interests of banking are catered to rather than the interests of society as a whole.

Chapter 3 highlights the fact that 85% of the British public's money is held with just five banks, and that these banks are able to use this money with very little accountability to the public. This creates a situation where investment in the UK economy reflects not the interests of the public or society itself, but the interests of the senior decision-makers at the five largest banks. Given that the total gross lending of the banking sector in the run-up to the crisis far exceeded government spending, this means that the decision-makers in these banks have more 'spending power' to shape the UK economy than the government.

Chapter 4 takes a quick look at the intimate relationship that exists between government and the banking sector. Whilst lobbying is to be expected from any industry and cannot have seriously adverse effects as long as our elected representatives are well-informed and incorrupt, more worrying is the 'revolving door' between the City and the Financial Services Authority. There are serious questions about how the current network of relationships between politicians, regulators and bankers impacts on society and democracy.

Finally **Chapter 5** proposes some economically simple changes to the current model of banking that would redress the democratic deficit, giving members of the public more control over how their money is used and re-democratising the power to create money. Regulators and tighter regulation (as recommended by the Independent Commission on Banking) cannot be relied on to make the current banking system work in the interests of the general public; the banking system needs to be restructured so that it no longer poses a threat to society. We suggest that the changes outlined in this chapter would make the real contribution of the banking sector more transparent which would in turn help Members of Parliament to make better-informed decisions about whether and how the banking system should be reformed, in the interests of society as a whole.

1. A LICENCE TO PRINT MONEY

How the power to create money shifted from the democratic state to unaccountable corporations

If money is power, then having the ability to create money must be absolute power. So it should be of some concern that the power to create money has shifted from the state to a collection of private corporations that we commonly know as 'banks'. Over 97% of money in the UK today was created, electronically, by the private banking sector[1]. The other 3% was created by the state as the notes and coins that most of us have in our pockets.

The power to create money has been privatised. Whilst one agency of state (the police) spends time and resources hunting down criminals who print a few million in counterfeit notes each year, another agency of state (the Bank of England) is actively encouraging private corporations to create over £100 billion of new money each year in the form of the electronic bank deposits in our bank accounts.

How did banks acquire the power to create money and what is the impact on democracy?

When we speak of banks creating money, we do not mean that they have secret printing presses in their basements churning out £50 notes. The process by which they create money is perfectly legal and it occurs every time they make a loan. Almost all of the money in the economy was created by someone going into debt to a bank. In the words of Martin Wolf, chief economics editor of the Financial Times and a member of the Independent Commission on Banking:

> *"The essence of the contemporary monetary system is the creation of money, out of nothing, by private banks' often foolish lending."*
>
> *MARTIN WOLF, FINANCIAL TIMES, 9TH NOV 2010.*[2]

A detailed discussion of the differences between bank 'credit' and money is outside the scope of this guide[a] but the Bank of England itself is quite clear that it is the banks that create money:

> *"By far the largest role in creating broad money is played by the banking sector... When banks make loans they create additional deposits for those that have borrowed the money."*
>
> - BANK OF ENGLAND (2007)[3]

> *"...changes in the money stock primarily reflect developments in bank lending as new deposits are created."*
>
> - BANK OF ENGLAND (2007)[4]

HOW DO BANKS CREATE MONEY?

The common misconception of how banks work is that they take people's savings and lend them out in the form of loans. In this vision, banks merely operate as the middlemen between savers and borrowers but this is simply not what happens. When a bank makes a loan it does not take the money out of anyone else's account. Instead, it simply creates a new account for the customer and types a number into it.

> *"Subject only but crucially to confidence in their soundness, banks extend credit by simply increasing the borrowing customer's current account...That is, banks extend credit by creating money."*
>
> —PAUL TUCKER, DEPUTY GOVERNOR AT THE BANK OF ENGLAND AND MEMBER OF THE MONETARY POLICY COMMITTEE, 2007[5]

When a customer is approved for a loan (of say £1,000), she signs a contract with the bank obliging her to pay back £1,000 plus interest over a period of time. According to accounting conventions, the £1,000 loan can then be recorded as an asset of the bank. At the same time the bank opens an account for the customer and types £1,000 into it. As the bank owes the customer this money, it is recorded on the liabilities side of the bank's balance sheet. By this process, the bank has simultaneously created new money in the borrowing customer's account and a corresponding debt. The bank's new asset (the debt) balances out the new liability (the newly created money) so that in accounting terms, the books balance.

The customer now has £1,000 of new money to spend on whatever they choose. No money was taken out of anyone else's bank account. New money has been created out of nothing.

In the UK, over 97% of the entire money supply was created in this way and exists in the form of 'digital' money, numbers in the bank accounts of members of the public and businesses.

PRIVATISATION BY STEALTH?

Privatisation of any activity that is currently undertaken by the state will be subject to scrutiny and public debate—witness the discussion around attempts to privatise Royal Mail or the public hostility to any attempt to privatise (or 'marketize') parts of the NHS. Yet over the last 160 years, the power to create money has been effectively privatised with no debate in either civil society or Parliament. No law sanctions the current state of affairs. Successive governments have failed to consider this issue in any depth, with serious implications for the economy and for our democracy.

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a This issue is comprehensively addressed in "*Where Does Money Come From?",* a book published by the New Economics Foundation and co-authored by one of the authors of this report (Andrew Jackson) after examining over 500 documents from the Bank of England and other authorities

HOW DID WE GET TO THIS POINT?

It is common knowledge that anyone found printing their own bank notes can expect to find the police kicking down the door at two o'clock in the morning. However, it has only been illegal for individuals and companies to create their own £5 or £10 notes since 1844.

Prior to 1844, the state had a legal monopoly only over the creation of metal coins dating from the time when this had been the only form of money. But keeping lots of metal and carrying it around was inconvenient so customers would typically deposit their metal coins with the local jeweller or goldsmith who would have secure storage facilities. Eventually these goldsmiths started to focus more on holding money and valuables on behalf of customers rather than on actually working with gold, and thereby became the first bankers.

A customer depositing coins would be given a piece of paper stating the value of coins deposited. If the customer wanted to spend his money, he could take the piece of paper to the bank, get the coins back, and then spend them in the high street. However, the shopkeeper who received the coins would then most likely take them straight back to the bank. To avoid this hassle, shopkeepers would simply accept the paper receipts as payment instead. As long as the bank that issued the receipts was trusted, businesses and individuals would be happy to accept the receipts, safe in the knowledge that they would be able to get the coins out of the bank whenever they needed to.

Over time, the paper receipts came to be accepted as being as good as metal money. People effectively forgot that they were just a substitute for money and saw them as being equivalent to the coins.

The goldsmiths then noticed that the bulk of the coins placed in their vaults would be gathering dust, suggesting that they were never being taken out. In fact, only a small percentage of all the deposits were ever being claimed at any particular time. This opened up a profit opportunity—if the bank had £100 in the vault, but customers only ever withdrew a maximum of £10 on any one day, then the other £90 in the vault was effectively idle. The goldsmith

FIGURE 1: A PRIVATELY-ISSUED BANK NOTE

Note: After the 1844 Act was passed, it took a number of years before all private issuing of notes was phased out. This note is actually from 1889.

could lend out that extra £90 to borrowers. However, the borrowers again would choose to use the paper receipts as money rather than taking out the metal coins from the bank. This meant that the bank could issue paper receipts to other borrowers without necessarily needing to have many—or even any—coins in the vault. The banks had acquired the power to create a substitute for money which people would accept as being money. In effect, they had acquired the power to create money: perhaps this is when the goldsmiths became real bankers.

The profit potential drove bankers to over-issue their paper receipts and lend excessive amounts, creating masses of new paper money quite out of proportion to the actual quantity of state-issued metal money. As it always inevitably will, blowing up the money supply pushed up prices and destabilised the economy (of the many crises, particularly galling was the Bank of England having to borrow £2 million from France in 1839). In 1844, the Conservative government of the day, led by Sir Robert Peel, recognised that the problem was that they had allowed the power to create money to slip into irresponsible private hands and legislated to take back control over the creation of bank notes through the Bank Charter Act. This curtailed the private sector's right to print money (and eventually phased it out altogether), transferring this power to the Bank of England.

However, the 1844 Bank Charter Act only addressed the creation of paper bank notes. It did not refer to other substitutes for money. With growth in the use of cheques, the banks had found another substitute. When a cheque is used to make a payment, the actual cash is not withdrawn from the bank. Instead, the paying bank periodically communicates with the receiving bank to settle any net difference remaining between them once all customers' payments in both directions have been cancelled out against each other. This means that payments can be made even if the bank has only a fraction of the money that depositors believe they have in their accounts.

Following on in the spirit of financial innovation, after cheques came credit and debit cards, electronic fund transfers and internet banking. Cheques are now almost irrelevant as a means of payment but over 99% of payments[b] (by value) are made electronically.

Today the electronic numbers in your bank account do not represent real money. They simply give you a right to demand that the bank gives you the physical cash or makes an electronic payment on your behalf. In fact, if you and a lot of other customers demanded your money back at the same time—a bank run—it would soon become apparent that the bank does not actually have your money. For example, on the 31st of January 2007 banks held just £12.50 of real money (in the form of electronic money held at the Bank of England) for every £1000 shown in their customers' accounts.[c] Even among those who are aware that what banks do is more complicated than merely operating as middlemen between savers and borrowers, there is a widespread belief that banks are obliged to possess a sum corresponding to a significant fraction of their liabilities (their customers' deposits) in liquid assets, i.e. in cash or a form that can be rapidly converted into cash. In fact, such laws were emasculated in the 1980s in response to lobbying from the industry (although some effort is now being made to re-impose such rules in the aftermath of the crisis).

When a run starts (like the one on Northern Rock on the 14th September 2007) it becomes almost impossible to stop. Once the bank has paid out any

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b See Payments Systems Oversight Report, Bank of England, 2010. Whilst cash is still used for a significant proportion of transactions, when taken by the value of payments, electronic payments make up over 99% of all payments. This is because cash tends to be used for lower value payments – one electronic transfer of £250,000 to buy a house is equivalent to half a million people buying a newspaper or pint of milk with cash.

c On the 31st Jan 2007: M4 = £1491385 mil, Reserves held at the central banks = £18765mil. M4/reserves = 79.48. £1000/80 = £12.5. Source: BoE database, M4 code: LPMAUYM, Reserves code: LPMBL22 cash which it holds in the branch to individuals (and transferred all of its reserves to other banks) other depositors will have to wait for the bank to sell off its remaining assets before they see their money. And because the bank has to sell these assets quickly, it will find it hard to receive a fair price. Because of this it is unlikely the proceeds from these sales will cover the value of their deposits and other liabilities, and therefore most customers are likely to lose a large proportion of their savings. Because this type of personal ruin is a tragedy and, even more importantly, because one bank run is likely to lead to others (as confidence in the banking system falls through the floor) the government insures deposits, guaranteeing some level of payback in the event of bank failure. Thus, because the system is inherently unstable, and because almost all of our money exists on banks' balance sheets, the banking sector has to be underwritten and rescued by the taxpayer, all as a result of the failure of legislation to keep up with technology and financial innovation since 1844.

DEMOCRATIC QUESTIONS WE NEED TO ASK ABOUT MONEY

Before we consider the impact of allowing banks to create the nation's money, we need to be aware of a few key issues around money. To the best of our knowledge, these questions are never discussed in politics courses or the press even though they have profound implications for democracy.

Q1. WHO CREATES MONEY?

If the creator of money also benefits from creating it, then there will be a conflict of interest that drives them to create more. For example, if politicians could 'print' money to pay for all their manifesto pledges, it is unlikely that they would resist this temptation, regardless of the impact that creating such a large amount of money would have on society or the economy.

Since 1844 the state has held responsibility for creating coins and paper money. However, since then, this power has consolidated in the banking sector. Now over 97% of money is created electronically by the banks.

Banks create money by lending. The more loans they make, the more interest they collect and the more profit they make. As a result, banks directly benefit when they create money and have every incentive to increase the money supply. This is necessarily associated with an increase in the level of debt regardless of the impact this will have on the economy and society. Allowing banks to control money creation is unlikely to work in the public interest.

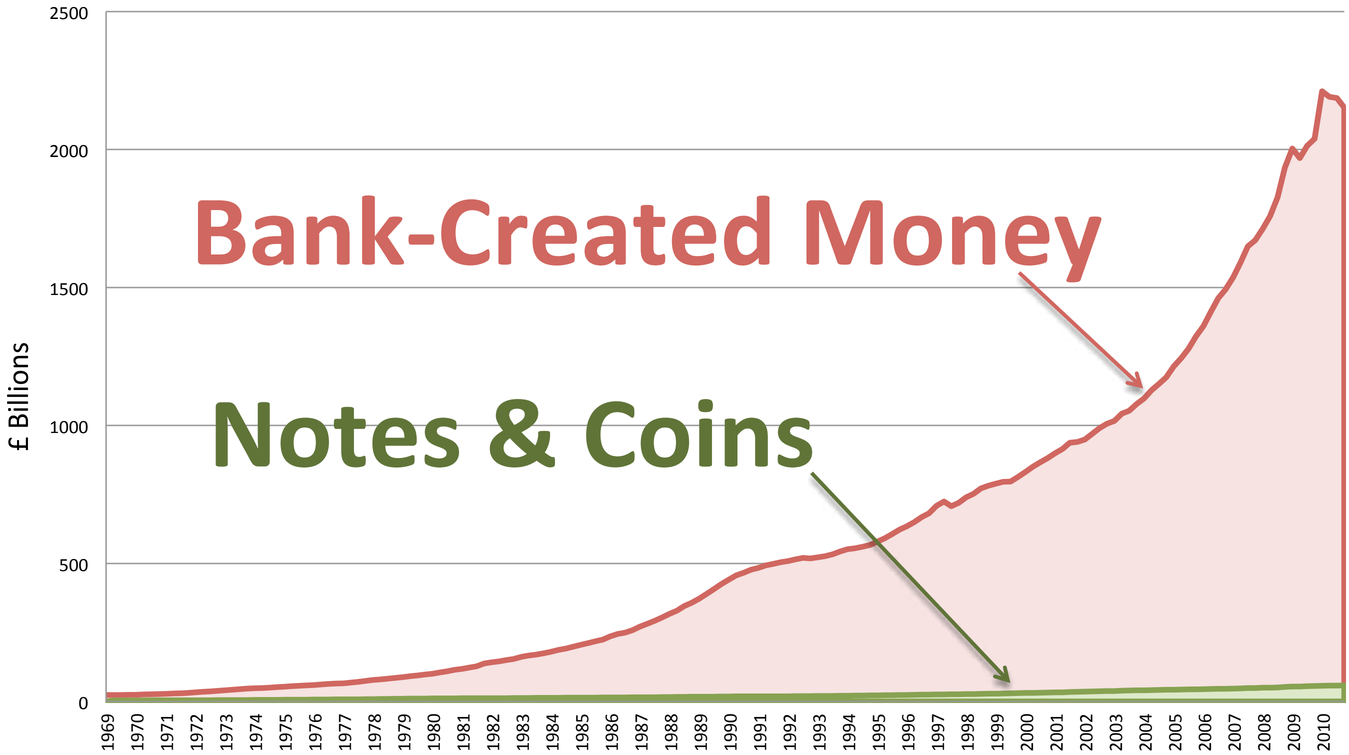
Q2. HOW MUCH DO THEY CREATE?

The amount of money that is created each year is critically important to the health of the economy and therefore the health of society as a whole. If the money supply increases too quickly it can cause inflation which reduces the value of people's savings. If the money supply stops growing or shrinks, the economy can seize up (a 'credit crunch') with significant rises in unemployment and poverty.

Between November 1982 and November 2006 the banking sector increased the money supply—by creating new money through lending—by an average of 10% a year.[6] As shown in Chart 1, overleaf, between November 2007 and November 2008, £258 billion of new money was created.[7] If government were to increase the money supply at this rate, it would be accused of following the policies of Zimbabwe, but because few people understand that banks create money via lending, this is completely overlooked.

This huge growth in the money supply is hardly surprising when we consider the incentives that banks have to increase their lending. In confident times, all of a banker's incentives push him to lend as much as possible: by lending more, they maximise short-term profits and, more specifically their own bonuses, commissions and prospects

CHART 1: MONEY CREATED BY BANKS VS GOVERNMENT



of promotion and profits. There is no reward for bankers who are prudent and choose not to lend or only lend judicious sums. In short, the supply of money into the economy depends on the confidence and incentives of bankers rather than what is best for society as a whole.

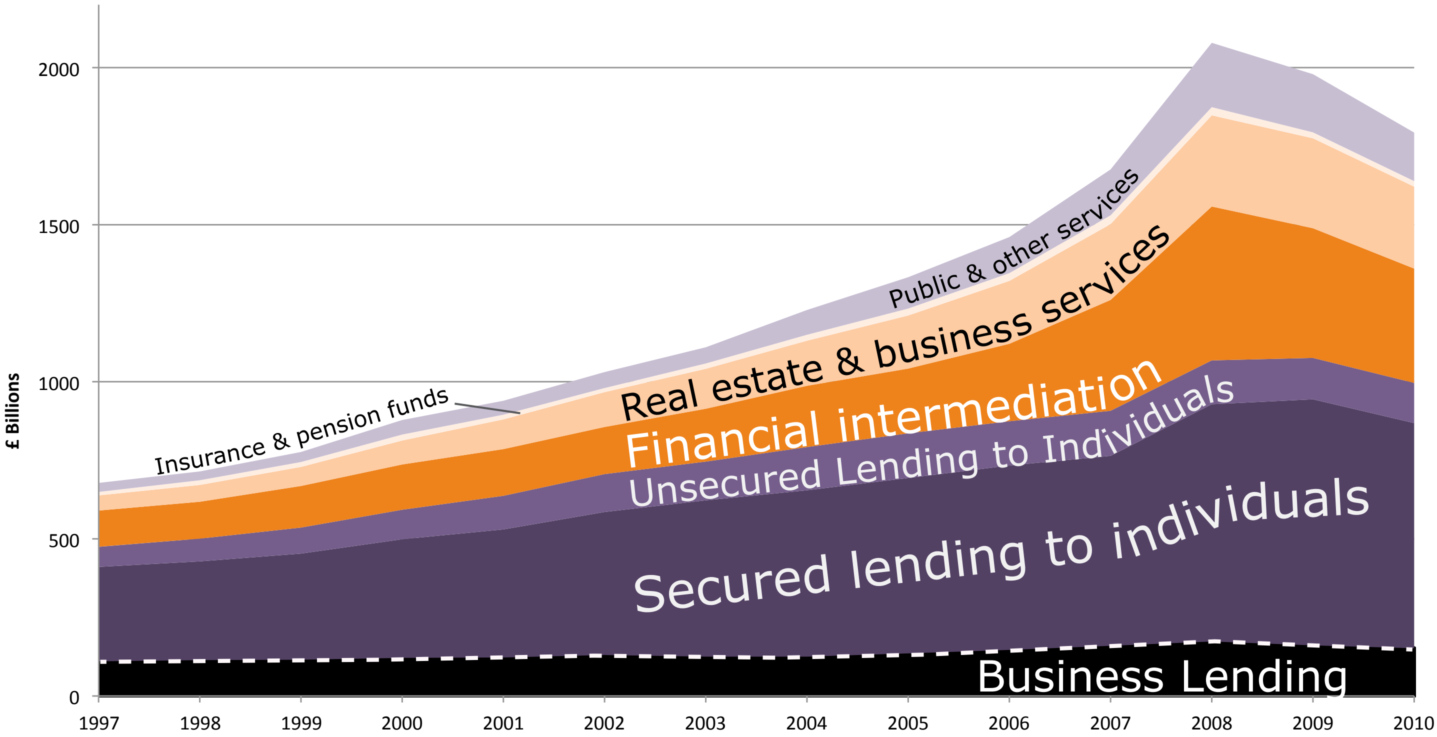
Q3. HOW DO THEY USE THE MONEY THEY CREATE?

When money is created, it can be put into the economy in two ways: it can either be spent in exchange for goods and services or lent out. When banks create money, they put most of it into the economy through lending. Exactly who this newly-created money is given to is crucial because it will determine the shape of the economy.

So do banks lend the right amount of money to parts of the economy that will create the greatest social benefit or create jobs? Unfortunately not, as their only interest is in maximising profits. Chart 2, overleaf, shows the last 13 years of lending in the UK, during which time there has been a massive increase in lending to unproductive sectors of the economy. Unproductive lending broadly refers to lending that does not increase the capacity of the economy: investing in machinery to make factories more efficient is productive investment whilst lending to buy existing property through mortgages is non-productive as it simply pushes up house prices without increasing production.

Over the decade leading up to the 2008 financial crisis, the amount of money lent out by banks tripled but this steep rise is largely accounted for by loans advanced for the purposes of buying property and for financial speculation. The amount dedicated to productive investment remained more or less constant throughout this period meaning that the proportion of the money supply that was dedicated to enhancing production steadily waned.

CHART 2: WHERE THE LENDING GOES...



(Source: Bank of England statistical database. Productive investment includes manufacturing, construction, communications, distribution, retail & wholesale)

CONSEQUENCES OF ALLOWING BANKS TO CREATE MONEY

1. CONSTRAINING THE CAPACITY OF GOVERNMENT

When governments give the right to create new money to banks, they lose an important source of revenue called 'seigniorage' which derives from the fact that it costs pennies to print a piece of paper that can be exchanged for £50 worth of goods and services. In the UK, the profits on creating paper money are paid over to the Treasury and can be used by the government to lower taxes and borrowing or raise spending. Between 2000 and 2009, seigniorage yielded nearly £18 billion[d] and in 2009 alone it was sufficient to pay the salaries of around 120,000 nurses.

Because the government has franchised out the right to create electronic money to banks, the government has lost the seigniorage upon the creation of the 97% of the money supply, a substantial sum. The £1.16 trillion of new money created by the banks over the last ten years could have been used to: pay off the national debt (which currently stands at around £977 billion[8]); invest in public transport, hospitals, schools or renewable energy; or exempt the poorest ten per cent of the population from tax.[e] Instead, it has been used by the

d Aggregated from Bank of England Annual reports, Issue Department Profit & Loss statement. The item that represents seigniorage is listed as 'Amount payable to HM Treasury'.

e The issued notes and coins are usually recalled as they begin to wear out. When this occurs they are sold back to the Bank of England at face value. Because of this, in the long run seigniorage only occurs on the increase in the supply of notes and coins, or on notes and coins that are removed from circulation and do not return to the central bank. America is the largest beneficiary of seigniorage, with recent estimates claiming 65 percent of all U.S. banknotes in circulation are outside the country ($580 billion) at the end of March 2009. The reasons for this are twofold, firstly the dollar is the international reserve currency, and is held in large quantities in the vaults of central banks. Secondly, many citizens distrust their banking sector to fuel a housing bubble that has made buying a home unaffordable for all but the very rich.

In addition to giving up this source of revenue that could have been used in the public interest, the current system also limits the capacity of government whenever taxpayer funds are diverted to rescue failing banks. As the last few years have proven, the business model that enables banks to create money is fundamentally unstable, requiring rescue by the government from time to time. When this happens, taxpayer funds are diverted from public spending and spent on salvaging failing corporations. This further reduces the power of government to do what it was democratically elected to do, weakening democracy in the process.

By handing the power to create money over to the banks, the government reduces its revenue, compromises its capacity to carry out the activities that it has been mandated to carry out and undermines the potential of the democratic system to change society for the better.

2. INFLATION & INTEREST: HIDDEN & UNDEMOCRATIC TAXES

Giving banks the power to create money results in two hidden and undemocratic 'taxes' being levied on the public.

The first of these 'taxes' is inflation, when increases in the amount of money in the economy feed through into higher prices. If the money supply is increased quickly then the new money pushes up prices, especially in housing (to where much of the new lending is destined), and people's savings buy less this year than they did last year.

In this way, inflation is said to be a hidden tax that invisibly transfers value and wealth from savers to borrowers.

Of course, it is now banks that create the vast majority of new money. They have increased the amount of money in the economy at an average of 10% a year between 1981 and 2007, (by lending) and pumped this money mainly into the housing market. As a result, house prices shot out of the reach of ordinary people, whereas those who got the 'first use' of the money (by borrowing first) received most of the benefit. Meanwhile those who were not already on the housing ladder became significantly poorer, in real terms, because the relative cost of housing doubled in just 10 years (between 1997 and 2007). Consequently, the inflation caused by allowing banks to create money is also effectively a 'tax' accruing to the banks (through their increased interest income on ever greater mortgages) and those who borrow early on (to buy property and other assets).

The second of these hidden taxes corresponds to interest. Because banks create 97% of the UK's money supply, essentially through making loans, the entire money supply is 'on loan' from the banking sector. For every pound created, somebody somewhere goes one pound into debt and starts paying interest on it. By virtue of their power to create money, banks have the right to collect interest on nearly every pound in existence.

A hidden tax collected by private corporations because they have a power that most people would consider—and believe—to be a prerogative of the state can hardly be considered democratic.

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own currency due to the potential for inflation (this is known as the dollarization of a country's currency). (Goldberg, 2010, '*Is the International Role of the Dollar Changing*?' Federal Reserve Bank of New York, Current Issues in Economics and Finance, volume 16, no. 1)

2. CONFUSED BY LARGE NUMBERS

How Politicians Are Misinformed As To The Real Contribution Of The Banking Sector

When government threatens to place regulations or restrictions on particular industries, a key consideration is the impact that the regulations will have on the level of tax raised by the sector. This issue is brought into sharp relief when the discussion turns to banking reform, with banks and bodies such as the British Bankers' Association keen to stress the impact that any regulation would have on the amount of tax paid by the industry. The implication is that the financial sector is 'the goose that lays the golden eggs', and that we should not to be too hasty in interfering with the way these firms do business.

However, the tax raised from the banking industry is only one side of the equation, the positive side; there are also costs associated with banking. Just as pollution is a cost to society of the oil industry, financial crises, debt and economic instability are costs to society of the banking industry. The most obvious and quantifiable of these is the direct cost of bailing out failed banks; less direct costs associated with the unemployment, lost production and lower growth that result from a banking crisis are not as easy to measure. Moreover, financial crises are not the only item on the negative side of the equation: the banking industry has long benefited from various subsidies which are often overlooked due to ignorance about how banks actually work.

If our democratically elected decision-makers are led to believe that the financial sector makes a bigger net contribution to the Exchequer than it actually does, then the decisions they make regarding banking reform will be distorted in favour of banks at the expense of society as a whole. This chapter aims to draw an accurate picture of what the banking sector actually contributes so that politicians and policy makers can make informed decisions.

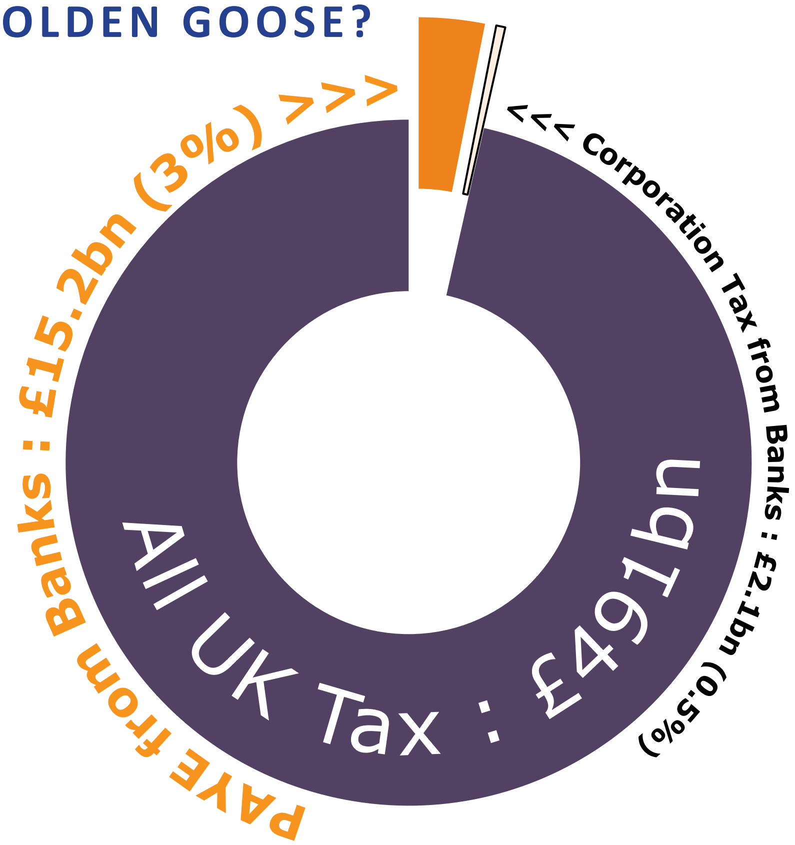
BENEFITS OF THE BANKING SECTOR

So is the banking sector really bankrolling the rest of the UK? How much tax are banks actually paying? Recent evidence on an individual bank's tax expenditures suggests that it may not be that much. For example, Barclays paid just £113m in UK corporation tax in 2009, yet earned £11.6bn in profits during the same period.[1] This translates as a tax rate of just 1%, even though the corporation tax rate in 2009 was 28%. Barclays would of course point out that it earned a large proportion of its profits overseas and so would not be eligible to pay the full 28%. Cynics might question the purpose of the 300+ subsidiary companies which Barclays has operating in tax havens throughout the world.[2]

But what of the banking sector as a whole? Chart 3, overleaf, details the banking sector's UK tax payments for the tax year 2009-2010. The government's total tax revenue was £490.6bn, of which only £2.1bn (less than half of one percent) came directly from the banks in the form of corporation tax. Another £15.2bn (3%) came from the banks' employees in the form of income tax and national insurance contributions. The other £473bn (97%) in taxes came from outside the banking sector. So, whilst contributing a modest percentage, the banking industry is hardly one of the biggest contributors to the government's coffers.

Banks have also faced a one-off payroll tax (commonly known as the 'bonus tax'), and will soon begin to face a yearly 'bank levy'. The payroll tax was a temporary one-off tax on bankers' bonuses, which totalled £2.3bn (net) in 2010-11. The bank levy, which is due as of 2011, is expected to raise £1.9bn in 2011-12, and £2.5bn a year from 2012-13, roughly equivalent to the revenue raised by airport taxes. However, whilst these amounts are not insignificant, they only add a fraction to the total tax bill banks will have to pay. It is worth noting that banks, unlike other industries, are exempt from paying VAT—an exemption that the Institute for Fiscal Studies has said is neither necessary nor logical.[3]

CHART 3: BANKING AS THE GOLDEN GOOSE?



Since the crisis, the banking sector has contributed less tax as its revenues were lower and its taxable income was reduced by large losses and write-downs. However, even when banks' tax payments were at their highest—£23.3bn in 2007-2008—they were still dwarfed by tax receipts from the manufacturing sector, which totalled £63.3bn in the same year.[4]

COSTS OF THE BANKING SECTOR

Perhaps the most obvious cost associated with the banking sector is that of the financial crisis, and taxpayer support to the banks. Although the government's guarantees to the banks at one point totalled £1.16 trillion, this amount is now down to £456.3 billion. Over the long term it has been suggested that the total direct cost to the taxpayer will be below £20 billion[5] and representatives of the banking industry have argued that the government may actually make a profit on the sale of partly nationalised banks. Viewed in this light, the financial crisis has not been that bad—in fact the tax revenue from the banking sector in 2009-10 alone may cover the bill. However, this conveniently ignores all the other costs of the financial crisis, such as the redundancies, unemployment, failed businesses and the massive rise in national debt that resulted from the recession. These costs far exceed any potential profit that the government might make on its 'investments' in RBS and Lloyds/HBOS. As Mervyn King, Governor of the Bank of England, pointed out in a recent speech:

"The loss of world output from the financial crisis is enormous, even though such a crisis might be considered a once in a generation, or even once in a century, event. It is not difficult to see that a crisis that reduces output by between 5% and 10% for a number of years, and occurs once every fifty years, amounts to an annual cost several multiples of the revenue that will be generated by the UK bank levy."[6]

Estimates as to these costs vary. However, with world GDP around 6.5% lower in 2009 than it would otherwise have been, lost output for the world economy could be as high as £2.5 trillion. In the UK, economic output in 2009 was about 10% lower than it would otherwise have been, corresponding to £140 billion in lost output or about £3,000 per adult. Moreover, low output is likely to persist with the present value of output losses for the world predicted to be anywhere between $60 trillion and $200 trillion and, in the UK, between £1.8 trillion and £7.4 trillion. For the banking sector to actually cover the costs of the crises it creates, it would need to pay a global levy of around $1.5 trillion a year[7], making the UK's £2.5 billion bank levy look trivial and completely disproportionate to the real costs of the banking system.

SUBSIDIES TO THE BANKS

"Modern financiers are now invoking other dubious claims to resist reforms that might limit the public subsidies they have enjoyed in the past. No one should blame them for that—indeed, we should not expect anything else, they are responding to incentives. But...the benefits to society, most obviously through greater financial stability, but also through factors such as higher tax revenue, are likely to swamp any change in the private costs faced by banks."

- SIR MERVYN KING, GOVERNOR OF THE BANK OF ENGLAND, 25TH OCTOBER 2010[8]

When judging the contribution of the banking sector via taxes, it is also important to take account of any subsidies that the banks may receive. Unlike subsidies to public transport or agriculture, the subsidies to the banking sector tend to be indirect and therefore 'hidden'.

One way in which banks are subsidised follows on from the fact that government considers them to be 'too big to fail'. Potential investors assume (either implicitly or explicitly) that the government will use taxpayer funds to prevent the bank going bust. This makes the investment safer—more or less risk-free—so big banks are able to borrow (from depositors and other banks) at lower interest rates than other firms that are otherwise just as much a risk. According to the Bank of England, this perceived government guarantee gave the banks collectively a subsidy of £59 billion a year between 2007 and 2009, with the big five banks accounting for more than 90% of this[9].

A further subsidy to the banking sector arises from allowing banks the power to create money when they make loans. Without this power, banks would have to attract deposits before they make loans. Furthermore, banks that wished to lend money would have to find depositors who would be happy to put their money into the equivalent of a 'time deposit' (a deposit that cannot be withdrawn for a certain period of time). Depositors would be likely to demand a higher interest rate on their savings to compensate them for this inconvenience, decreasing the profitability on any given loan. In their book 'Creating New Money' Huber and Robertson calculated that this special profit was worth £21bn in the year 2000. However, since then the UK's money supply has been more than doubled by private bank lending. As such, this 'special' profit is also likely to have more than doubled.[10]

OVERALL CONTRIBUTION OF THE BANKING SECTOR

So is the overall contribution of the banking sector actually positive? In 2009-10, the banking sector paid a total of £17.3 billion in taxes, the vast majority in payroll taxes (Chart 3). Whilst this "golden egg" may sound like a large sum, it actually accounted for less than 3% of the total tax take that year. The other side of the equation is effective subsidies and the costs of banking crises, which even Bank of England officials estimate to be well in excess of this amount. This is an expensive golden egg for the taxpayer.

Whilst this subsidy is not a direct transfer of funds from the Exchequer, without it the banks would not have returned a profit, and would certainly have been in no position to pay bonuses. The irony that bankers are the recipients of some of the most colossal subsidies at the same time as being among the most vociferous proponents of the virtues of the free market largely goes unremarked because their subsidies are so well hidden. As the Bank of England's Andrew Haldane states:

> *"Measures of the costs of crisis, or the implicit subsidy from the state, suggest banking pollution is a real and large social problem."*
> –*ANDREW HALDANE, MARCH 2010* [11]

Thus, banks contribute only a small proportion of the total tax take, receive massive subsidies, levy hidden taxes and periodically require bailing out at great expense to the taxpayer. A realistic appreciation of their real net contribution to the public purse might encourage MPs and policy makers to be bolder in reforming the banking sector with a view to reducing their subsidies and mitigating the threat they pose to the UK economy.

ARE THE BANKS' THREATS TO LEAVE CREDIBLE?

Any initiative to increase regulation on banks is usually met with an uproar from banks that they will be forced to move their headquarters abroad with catastrophic effects on tax take and business. That politicians and regulators routinely appear to be held hostage to implied threats to leave is testament to the unbalanced information available as to the contribution of the banking sector. But are the threats themselves even credible?

Calculations by the Independent Commission on Banking[12], show that the threats may in fact be empty. More than 50% of taxes from banking come from activities that would be 'hard to impossible' to carry out from abroad, such as retail and high street banking to UK customers. Another 27%-36% of the financial service tax contribution comes from "sticky" activities meaning that they could theoretically be moved abroad but only with considerable inconvenience. The activities that could easily be moved abroad only contribute 5% of all financial services tax contributions. Unless the level of regulation is extremely punitive, the banks are likely to find that leaving the UK does not make good business sense. In addition, it is highly likely that, with the emergence of new economic centres on other continents, a significant proportion of "unsticky" activities will relocate anyway. In short, threats that banks would leave the UK if regulations and reforms go 'too far too fast' should be taken with a handful of salt.

3. NOT IN OUR NAME

How Banks Use Our Money for Their Purposes

"Your pension represents your life-long savings and future financial security. You don't just have a right to know how that money is being used, but also a vested interest in finding out."

- FAIRPENSIONS

Do you know what your money is doing right now? Thanks to the work of campaigns like FairPensions, most individuals have at least some understanding that the money they pay into their pension is being invested in companies and corporations via the stock market, and may be funding activities that could be socially harmful. Campaigning in the 1990s ensured that the Pensions Act was amended to require the trustees of occupational pension schemes to disclose "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investment."[1]

However, there is currently much lower awareness or consciousness of how banks might be using our money; unlike pension funds, there is no requirement for your bank to tell you how your money will be used.

There is also widespread ignorance and confusion among the public about how banks actually work and what they do with the money we deposit with them. A poll conducted by ICM on behalf of the Cobden Centre found that 74% of the public thought that they were the legal owners of the money in their account.[2] In fact, all the money that you deposit into a bank account becomes the legal property of the bank, which means your bank is then free to use it as it sees fit.

Not only are customers unaware that any money they deposit into a bank is no longer legally theirs, a significant proportion do not even understand that the bank will use the money in their accounts to help fund loans and investments. When told that the bank does not just keep their money safe in its vaults but will put at least some of it at risk, 33% of people answered "This is wrong—I haven't given them permission to do so." [3]

This absence of any control by depositors over how banks use their money means that an environmentalist's deposits could be funding oil extraction and a pacifist's deposits could be funding arms manufacturers. It could be argued that environmentalists and activists should take care to bank ethically. However, when a third of the public believe that the money they put into the bank simply sits there waiting for them to return and reclaim it, then they are unlikely to have considered that they might be indirectly investing in arms or the destruction of the environment.

Of course no one is forced to open a bank account or to keep their money in it, and members of the public could refuse to fund banks' activities by simply refusing to have a bank account and dealing only in cash. However, it is almost impossible to live in the modern world without a bank account, and many employers will not pay salaries in cash. In this way people are effectively forced to fund the lending and investment decisions of banks, potentially against their own ethics and wishes.

THE PROBLEM, MULTIPLIED

The odd case of customers unknowingly funding something that is against their personal or ethical principles might be unfortunate. However, when we multiply this by 150 million bank accounts across the UK it reveals a huge democratic deficit in the banking system.[a]

In essence, we put our money into bank accounts, either for safekeeping or convenient access.[b] One-third of us is unaware that the money will even be used to fund loans or investments, and three-quarters of us still believe that we are the legal owners of this money. Despite this, banks are free to use our deposits for their own purposes, without either our explicit permission or having to disclose how the money will be used.

To understand the scale of this problem, in July 2011 households held a total of £1.2 trillion in deposits in bank accounts at UK banks.[4] This is funding that members of the public have provided to the banks which may then be used according to the wishes of the bank, with no accountability to the individuals who provided the deposits.

In contrast, the UK's pension funds are responsible for the investment of only two thirds as much, at around £0.8 trillion.[5] The law requires these pension funds to disclose the social, environmental and ethical considerations that guide their investments but does not require banks to do the same.

THE POWER TO SHAPE THE ECONOMY

We have seen that banks are able to use customers' money without any accountability to the customer and no law requires them to disclose how their customers' money will be used – banks use a customer's money according to the wishes of the bank rather than the wishes of the customer. Given that the vast majority of money in the UK is held with banks—less than 3% of the UK's money supply is now in the form of cash in people's pockets—this gives the banks direct control over 97% of the UK's money which they invest according to their own interests and priorities.[6]

The banks therefore have massive power to shape the UK economy. This power is even greater than that of democratically elected government, because the banking sector allocates more money via lending than the government allocates via public spending. In the five years running up to the start of the financial crisis, the banking sector's gross lending to households and individuals alone came to a total of £2.9 trillion whilst total government spending was less at £2.1 trillion. Because it is the

a The British Bankers' Association reports that its members operate over 150 million bank accounts (as of September 2011).

b The Cobden Centre Poll mentioned above found that 15% of people keep some of their money in current accounts for 'safekeeping', whilst 67% keep their money in current accounts for 'convenient access'.

banks that decide broadly where they will prioritise their lending (for example, on housing, personal loans, car finance or investment in small businesses), they can shape much of the spending and activity in the economy.

If this £2.9 trillion had been allocated by local bank managers who were in touch with small businesses and knew where the investment could be most productive, then banks having greater 'spending power' than government may not be a concern. After all, local bank managers are probably better connected to the needs of the real economy than distant and top-heavy government bureaucracies. But in reality this local connection to the real economy does not exist. The big decisions—about whether more money goes towards small businesses, renewable energy and socially beneficial projects, or towards mortgage lending, commercial real estate and other forms of speculation—are made by senior managers at the head offices of the banks.

In an economy with a large number of small banks, no one bank would have any control over the direction of the economy. However, in the UK the five largest banks (HSBC, Barclays, Santander, RBS, Lloyds) account for 85% of the current account market (2010), 61% of the savings account market (2010), 64% of the unsecured personal loan market (2009), 74% of the mortgage market (2009) and 84% of liquidity management services to small and medium-sized businesses (2008).[7] As of September 2011, these five banks have a total of 78 board members.[c] In other words, 78 individuals on the boards of the five largest banks choose (broadly) how much money to allocate to each sector of the UK economy. This gives 78 people the power to allocate more money than the UK government itself.

The force driving the board members of banks is the need to maximise profit for quarterly returns so it is hard to see how such an arrangement will ever lead to banks investing in a way that reflects the priorities of society as a whole. The experience of the last few years strongly suggests that it does not.

c RBS: 14 board members; Lloyds 12; HSBC 19; Santander 20; Barclays 13. Checked in September 2011.

4. IN BED TOGETHER

The Close Relationship Between Government and the Banking Sector

LOBBYING

"So amidst the worst recession for decades, and after unprecedented subsidy from the public purse, why are the bankers getting off so lightly? One answer lies in the vast network of financial lobbyists representing the sector."
– SPIN WATCH[1]

Lobbying can be defined as a legal activity through which an organisation seeks to obtain benefits, change regulations, or influence policy—in essence, it is an attempt to manipulate the democratic process via extra-electoral channels. This does not make lobbying undemocratic per se. It may actually improve the democratic process by giving policy makers a broader evidence base to make decisions on, and by giving those who will be most affected the chance to influence the decision. A House of Commons report on lobbying points to this when it states that 'Lobbying enhances democracy; but can also subvert it'.[2] Of course, one would hope that most MPs are intelligent enough to realise that an industry representative has a vested interest and that they would never take everything said by a lobbyist as unbiased fact.

However, concerns exist that lobbying may undermine democracy if disparities in resources give big business an unfair advantage. For example, of all submissions to the Independent Commission on Banking, 46% (by number of pages) came from banks or companies that earn substantial revenues from banks, meaning that the rest of society and the economy were heavily under-represented (relative to their contribution to the economy).[a] Many organisations with an interest in the impact of the banking system on society would simply not have had the staff time or budget to prepare a submission to the Commission.

In fact, even the perception that special interests wield power over policy makers could be enough to harm democracy, as public cynicism about the intentions of politicians—or the ability of politics to 'change anything'—leads to a decline in participation in the democratic process.

Financial firms are among the biggest spenders when it comes to lobbying. In the US, financial firms spent $5.1 billion dollars lobbying Congress in the decade that ended in 2008.[3]

Recent research from the IMF suggests that lobbying may have been a cause of the financial crisis. Firms that lobbied more were found to engage in greater risk-taking before the crisis and performed worse afterwards. One of the conclusions was that:

'The political influence of the financial industry can be a source of systemic risk. Therefore, it provides some support to the view that the prevention of future crises might require weakening political influence of the financial industry or closer monitoring of lobbying activities...' [4]

However, despite the potential for lobbying to have strongly negative effects, 'public affairs consultancies and in-house lobbyists are subject to virtually no regulation'.[5] No firms, including banks, are

a Of submissions to both stages of the Independent Commission on Banking's consultation process, banks, industry representatives and consultants to the banking sector contributed a total of 1200 pages (46%). Members of the public, think tanks, NGOs and civil society contributed a total of 1412 pages (54%). This excludes certain submissions that were untailored academic papers or extracts from books.

required to disclose the amounts of money that they spend on lobbying. Meetings with ministers often go un-minuted (or unrecorded entirely) and there is no record of who is meeting whom. The lack of even the most basic of information regarding lobbying by the banking sector is shocking when one considers that the banks have received unprecedented financial support from the taxpayer, as well as the fact that they have plunged the economy into the worst recession in decades.

FUNDING

Donations to political parties cause concerns similar to those that arise over lobbying, and are seen as a way to buy privileged access to decision-makers and influence over policy.

Fortunately, unlike in lobbying, there are rules and disclosure requirements surrounding the donation of money to political parties. This has resulted in a recent study by the Independent Bureau of Investigative Journalism uncovering that Conservative Party Central Office received more than 50% of its funding from individuals from the financial sector in 2010 (a total of £11.4 million, up from £2.7 million in 2005).[6] Individuals who pay a membership of at least £50,000 a year are entitled to join 'The Leader's Group', where 'Members are invited to join David Cameron and other senior figures from the Conservative Party at dinners, post-PMQ [Prime Minister's Questions] lunches, drinks receptions, election result events and important campaign launches'.[7] How many of these Leaders work in the financial sector is secret information. (The Labour Party has its 'One Thousand Club', which promises exclusive club events for donors who give more than £1,200, but does not openly promise access to the party leader or senior party figures).[8] Many will be uneasy with the idea that a small number of people who can afford £50,000 a year can buy access to the Prime Minister, an arrangement which does not help reassure the public that leading politicians represent society as a whole and the democratic system is working.

THE REVOLVING DOOR

The 'revolving door' between big business, government and the civil service is another method whereby firms try to gain influence.

People who have worked in a specific industry may take up a related job in government or the civil service. The concern is that, rather than working in the public's best interest, the individual may continue to make decisions that benefit their previous employers (whether consciously or simply through a natural tendency to sympathise with the plight of former employers rather than the more abstract or distant concerns of the rest of society).

On the other hand, an individual may move from a role in government or the civil service to industry. The concern here is that the individual will have special access through relationships they had previously cultivated as well as undue influence due to their knowledge of the inner workings of government.

The door between politics and the banking industry revolves particularly fast, especially when it comes to the Conservative party: eleven Tory MPs and peers have worked for Barclays (including Richard Bacon MP, Jesse Norman MP, former Chancellor Lord Lawson, Earl Howe, Francis Maude MP and Andrea Leadsom MP), eight have worked for NM Rothschild (including John Redwood MP, Mark Garnier MP, former Chancellor Lord Lamont and Jacob Rees-Mogg MP) and another four worked for

Lehman Bros (including Brooks Newmark MP and Lord Freeman).[9]

Not to be outdone, the most high profile movement from government to the financial sector has been from Labour: former Prime Minister Tony Blair recently took up a role as consultant/senior adviser to JP Morgan Chase & Co, for a reported salary of £2 million, and a concurrent position with Zurich Financial Services.[10] Other notable movements between the government sector and the banking industry include Howell James (former government chief press officer, now at Barclays), Dominic Morris (formerly director of the government's Digital Britain project, now at Lloyds), former MP Patricia Hewitt (on the Barclays advisory committee), Lord Digby Jones (UK minister for UK trade and investment 07-08, senior advisor to Barclays Capital 06-07), Sir David Arculus (was chairman of the Cabinet's Better Regulation Taskforce whilst a director at Barclays), Jonathon Powell (former Blair chief of staff, currently managing director of Morgan Stanley's Investment Banking division).[11]

The revolving door may lead to the regulatory authorities as well as politics. In the United Kingdom the agency tasked with regulating the financial industry is the Financial Services Authority (FSA). When individuals move from the private sector to the FSA, the concern is that rules will be altered or relaxed in order to benefit their previous employer. When FSA staff transfer to the private sector, the concern is that staff are being hired specifically in order to help circumvent regulations which they may have helped to design or enforce. There are numerous anecdotal stories of individuals from the FSA moving to private sector firms for salaries that were up to 10 times greater, working in the very areas that they were previously regulating.

Since July 2000, there have been 36 different members on the board of the FSA, including 26 with connections with the banking or financial industry at board or senior level either before or after working at the FSA. Nine actually continued to hold positions on the boards of financial corporations whilst working for the FSA, which would appear to be a blatant and worrying conflict of interest.

The most prominent examples of the revolving door come from the US—both the current and previous Treasury Secretary were chief executives of investment bank Goldman Sachs prior to their role in government. However, statistically the reality is that of all the countries in the world, only Switzerland had a greater proportion of regulators moving through the revolving door than the United Kingdom.[12]

This close relationship between the regulators and the regulated is widely acknowledged:

"It is a common phenomenon in all areas of regulation that regulators become 'captured' by the industry they regulate, meaning that they take on the objectives of management in the firms they regulate. They may thereby lose sight of the ultimate objectives of regulation. Regulatory capture is particularly serious in industries such as banking where there is a conflict of interest between the firms' objectives (to maximise profits) and the objectives of the regulator (to provide consumer protection and maintain systemic stability)."

- JOURNAL OF FINANCIAL STABILITY

And even the former European Commissioner for Internal Markets and Services highlights the problem:

"In the case of legislators, I am convinced that over the years there has been too much 'regulatory capture' by the sell side of the financial services market: Their lobbies have been strong and powerful."

- CHARLIE MCCREEVY, FORMER EUROPEAN COMMISSIONER FOR INTERNAL MARKETS & SERVICES

IS THE CLOSE RELATIONSHIP A HELP OR A HINDRANCE?

As much as the funding of political parties, lobbying and the various revolving doors appear to present potential conflicts of interest, this does not prove that anything untoward is occurring. Indeed, a case can be made that, by working for banks, MPs have gained an important and useful insight into one of Britain's biggest industries. And the knowledge acquired from working within an industry may help regulators to do their jobs more effectively.

However, certain facts stand out. The United Kingdom just experienced the most serious financial crisis since the 1930s which triggered a huge recession resulting in decreased growth and increased unemployment. In response to the crisis, the banking sector received unprecedented financial support from the taxpayer resulting in a massive increase in government debt. The increase in government debt has led to huge cuts to public services, reducing the ability of government to do the things that it was democratically elected to do.

The response of government to the financial crisis of the 1930s was to heavily regulate the financial sector. The regulations introduced were largely successful and led to several decades free of financial crises until they were stripped away over the last three decades as a result of lobbying and 'disaster myopia'—whereby regulators start to assume that a crisis won't happen simply because one hasn't happened for a long time. In contrast, the current crisis has led to no such increase in regulation. In fact, bar a one-off punitive tax on bankers' bonuses and a bank levy, little has changed despite widespread public anger, strident demands that something be done and the fact that the level of taxpayer support for the banking system is still greater than at any time in history. The recommendations of the Independent Commission on Banking go nowhere near as far as the changes made in the 1930s and implementation of the main measure prescribed to preclude future failures (the ring fencing of high street banking businesses from "casino" investment banking arms) will not be implemented to 2019. Whilst the exact reasons for inaction and delay are difficult to discern, any explanation must take stock of lobbying, the funding of political parties and the revolving door between private sector firms and the regulators.

5. SIMPLE SOLUTIONS

How we can democratise money and banking

Many of the problems discussed in the preceding chapters can be alleviated or solved with a few changes that are economically simple but politically challenging. The following suggestions may seem to be subtle changes to the structure of banking but they would have profound effects on democracy, as explained below.

SIMPLE CHANGE 1: SEPARATE RISKY MONEY FROM SAFE MONEY

A large part of the power of the banking sector comes from the fact that it is 'too big' and 'too systemic' to fail. Banks are allowed to operate a business model in which they can use all deposits from customers to fund risky loans or investments, with or without the permission of the depositor. Even though 33% of depositors believe that the bank *literally* keeps their money in the bank's safe, it is actually being used for speculation and risky lending.[1]

With this business model it is only a matter of time until a bank fails, and when this happens, the customers who believed that the bank was keeping their money 'safe' discover that they had actually been making a risky investment in a risky bank. This realisation would tend to lead to a run on all banks which would in turn bring down much of the banking system. To prevent this, the government has to offer a blanket guarantee that no bank customer will lose money as a result of a banking failure.[a] In effect, the government provides bank customers with a one-way bet: "Put your money into the bank; they'll do risky things with it, and if it goes badly, we'll use taxpayer's funds to give you your money back".

The implication for democracy is subtle but profound. If banks' risky investments were not underwritten by a promise to reimburse the customers of failed banks, then informed customers would demand a form of account where the bank promises not to put the money deposited at any risk. This would be a form of custodial account in which the money you deposit remains yours rather than becoming the legal property of the bank.

a Officially this government guarantee is run through the Financial Services Compensation Scheme, and stands at £85,000 per individual per institution. Implicitly the £85k is relatively meaningless; in the last crisis the guarantee was raised from £32k to £50k as soon as the panic started, and any serious run on the bank would see the guarantee become a blanket guarantee on all bank accounts, as happened in Ireland.

But by guaranteeing all customers' accounts, governments inadvertently ensure that any money a person pays into a bank account can be used by a bank for their own purposes. This massively increases the power of the banking sector to shape the economy and also gives them a substantial hidden subsidy.

We can address this by **requiring banks to provide two types of accounts:**

1. A **custodial account**, where any deposits would stay the legal property of the customer, and would not be available to the bank for their own use.
2. An **investment account**, in which the funds would be passed over to the bank so that the bank could lend or invest them

Making this change would allow customers (and in aggregate society) to make a conscious decision about how much of our money we wish to be used for risky investments and how much we would like to be kept *genuinely* safe. It would mean that only customers who opt to take the risk would face any risk of losing their funds. The government guarantee on savings accounts could then be withdrawn removing the hidden subsidy that banks receive from this guarantee. This would also reduce the subsidy that banks receive from being 'too big' or 'too systemic' to fail.

SIMPLE CHANGE 2: MAKE BANKS DISCLOSE HOW CUSTOMERS' MONEY WILL BE USED

The second simple change is to require banks to disclose to customers how their money will be used, at the point of investment. This does not require that grandmothers need to learn the intricacies of the stock market—it simply means that customers should be told the broad areas of investment in wich money will be invested. In other words, a bank would have to disclose whether the money you give it will be invested in say, the arms industry, or oil extraction, or renewable energy. Customers who didn't want to invest in these areas would be able to request other accounts, which would exclude those areas, or go to another bank.

Banks would argue against this proposal by suggesting that customers already have the freedom to go to, say, the Co-operative Bank which excludes certain investment areas, or Triodos, which only invests in projects with social and environmental benefits. However the reality is that the vast majority of the population has not given much thought to how banks use their money, primarily due to a lack of education (banking and personal finance is rarely discussed in schools, if at all). Ignorance of how the bank will use a customer's money does not mean the customer endorses the way that the bank actually uses their money. Requiring banks to 'come clean' with customers about how they'll be using their money will see a percentage of customers choosing not to fund certain socially harmful activities.

The longer-run impact of this change would be that the investment priorities of the banks would more closely start to resemble the investment priorities of society as a whole. These first two changes together mean that we as individuals, and in aggregate society as a whole, can choose how much risk we want and how we want our money to be used. This is a simple way of democratising money and invest-ment.

SIMPLE CHANGE 3: PROHIBIT THE CREATION OF MONEY BY PRIVATE SECTOR BANKS

To avoid a conflict of interest, it is vital that whoever creates money will not benefit from doing so, i.e. the decision on how much money is created must be separated from the decision on how the money is used.

As we have seen, in the current set-up, banks create money (via lending) and profit from doing so (via the interest they collect on loans). Consequently they have one-sided incentives to continue increasing the money supply, regardless of the needs of the wider economy and society. This has had disastrous results to date, and the financial health of the UK and global economy still appears to be deteriorating as a result of this intrinsic imbalance.

The power to create money must be taken away from the private banking sector and returned to a democratically accountable institution. This would involve updating legislation to make the power to create money a sole prerogative of the state (via the Bank of England). In effect, we would be updating the 1844 Bank Charter Act—just a few decades late.

The original purpose of the Act was to deprive the private sector of the power to create money. Financial innovations to exploit weaknesses in the design of the legislation ultimately defeated its essential goal but the importance of the underlying principle—that money should be created solely by the state—still holds today, as recognized by Mervyn King in a 2010 speech:

> *"…if banks undertake risky activities then it is highly dangerous to allow such 'gambling' to take place on the same balance sheet as is used to support the payments system, and other crucial parts of the financial infrastructure. And* ***eliminating fractional reserve banking [the business model that allows banks to create money] explicitly recognises that the pretence that risk-free deposits can be supported by risky assets is alchemy.*** *If there is a need for genuinely safe deposits the only way they can be provided, while ensuring costs and benefits are fully aligned, is to insist such deposits do not coexist with risky assets."* [2]
>
> *[OUR EMPHASIS AND ADDITION IN BRACKETS]*

Updating the 1844 Bank Charter Act to cover the electronic 'demand deposits' that appear in current accounts would remove the banks' power to create money and transfer it back to the state. This would have several important implications. Firstly, with a rationally determined supply of money, the boom-bust cycle would be dampened. In a more stable economic environment, less spending is required to counteract 'busts' and the government can focus on achieving its democratically mandated goals.

Secondly, with no risk to customers' deposits, there will no longer be a need for taxpayer-funded bailouts of the banking sector, again enhancing the government's capacity to pursue the ends for which it was elected by the people. This will also have the added benefit of removing the 'too big to fail' subsidy, making the true contribution of the banking sector more transparent so that more fully informed decisions can be taken on banking reform.

Thirdly, the government would also gain an additional source of revenue, as any newly created money would be credited to the Treasury's account before being spent into the economy. Where this new money is spent would be democratically decided by Parliament, and could be used either to increase spending or decrease taxes and/or borrowing.

CONCLUSION

We started by asking if power has shifted from Parliament down the river to the City of London. What we have found is a banking system that has more 'spending power' than the democratically elected government, no accountability to the public, and massive concentration of power in the hands of a few key individuals.

We have seen that politicians and policy makers are misinformed about the true contribution of the banking sector because they are only shown the positive side of the sector's contribution to government finances. Negligence of the massive costs to the exchequer associated with banking weakens the case for banking reforms that would be in the best interests of society as a whole.

The close relationship between the banking sector and its chief regulator, the FSA, should be worrying, especially given the record of the last few years. It may also undermine democracy to allow political parties to provide large donors with privileged access to government.

However, the greatest concern is that government has given one of its greatest powers – the power to create money and control the money supply – to the private sector, which has exploited this power to blow up housing bubbles and indirectly transfer wealth upwards and inwards, with disastrous results. There has been no democratic debate about this transfer of power, and no law actively sanctions the current set-up.

As the last few years have shown, the banking sector can have a serious negative impact on our lives. Leaving it with such a huge and unaccountable degree of power is no more likely to work in the best interests of society or democracy in the future than it has in the past.

A few economically simple changes to the banking system would return power back to the people and restore some level of democratic control over the economy. These changes are:

1. Make banks ask for permission from their customers before they lend out their money.
2. Make banks disclose how customers' money will be invested, so that members of the public can refuse to fund activities that they are not ethically comfortable with.
3. Remove the power to create money from the banks and return it to a democratically accountable body.

Making these changes would help redress the democratic deficit in banking and limit the ability of the banking sector to damage society. After the experience of the last few years, these are changes that urgently need to be made.

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