The G20 finance ministers meet later this week in Toronto. One of the issues they will consider, drawing on a new IMF report, is the coordinated introduction of one or more taxes on banks and other financial companies. The IMF has proposed two new taxes on banks and other financial companies, a “Financial Stability Contribution” and a “Financial Activities Tax”.

This briefing note sets out the rationale for considering new taxes on banks, describes the taxes proposed by the IMF, and comments on their likely effectiveness.

In summary:

- The “Financial Activities Tax” (FAT) is a combination of a tax on excess profits and a tax on remuneration. Combined, this amounts to a tax on value added. Since financial services are not typically subject to VAT (because identifying value added through the normal VAT invoice-credit method is technically difficult), the FAT could be seen as an alternative to the VAT.

- To the extent that the financial sector has grown too large due to the absence of VAT, then the FAT would tend to reduce the size of the sector relative to the rest of the economy.

- Combining both components of the FAT implies that the tax liability does not depend on whether gross profits are paid out to employees in bonuses or other remuneration or accrue to shareholders.

- The excess profits component would raise revenue without affecting banks’ behaviour, since it is targeted at what banks aim to maximize. However, the remuneration component will create an additional tax wedge on employment costs. As with a normal VAT, the tax may be passed on in higher prices to customers.
• The tax would not affect the risk-taking activities of banks. Control of banks’ risky activities would be left with the regulatory system, although it would also be affected by the “Financial Stability Contribution”, described below.

• The “Financial Stability Contribution” (FSC) is similar to the tax proposed by President Obama for the USA. It is a levy on the non-insured liabilities of financial companies. The IMF sees it as a form of insurance premium, with the premium (that is, the tax) paid being available to governments to create a fund for future financial sector bailouts.

• By providing explicit insurance, the FSC raises significant problems of moral hazard. If bank managers, owners, or creditors believe that they are insured against future failure due to excessive risk-taking, then they are more likely to undertake riskier behaviour. That would exacerbate the likelihood of a future financial crisis.

• On the other hand, if banks believe that they are already implicitly insured (that they will anyway be bailed out in the event of a crisis), then the problem of moral hazard exists anyway. In this case, governments may as well introduce a tax as a form of insurance premium, to cover any future bailout costs.

• Paradoxically, even apart from the moral hazard problem, the FSC could exacerbate risk-taking. A levy on non-insured liabilities may increase the incentives for banks to hold more equity capital. But regulatory capital requirements typically depend on the risk of a bank’s asset position. A tax that induced banks to hold more equity capital would relax this constraint, and could therefore permit banks to hold riskier assets. The tax would effectively distort risk-taking patterns without necessarily reducing the amount of risk taken by banks. In addition, it would increase the cost of using financial intermediation and may thus slow down economic recovery.

• For both taxes, the IMF report leaves many issues in the design of the tax unresolved. One important issue is the international scope of the tax as applied in any single country. Both taxes would be considerably more effective if they were applied in a coordinated way by G20 countries, and by other countries.
This briefing note sets out and comments on some of the issues considered in the recent IMF report which will be discussed at the G20 meeting.

We consider each of the IMF’s proposed taxes in turn.

a. **Financial Activities Tax (FAT)**

- The FAT consists of a tax on the value added of financial companies, which comprises two elements: a tax on excess profits tax and a tax on remuneration.

- This could be justified as an alternative to charging VAT. However, the comparison with VAT raises two important issues.
  
  - Would input VAT be deductible from the FAT? Financial companies are currently unable to claim relief for this input VAT, which therefore already represents a real charge on the banks. (The European Commission has proposed ways of dealing with this within VAT, but they have not yet been implemented).
  
  - A normal VAT charge would be passed on to customers through a higher price. This becomes input VAT for the business customer, which can then offset this against its own VAT charge. If the FAT charge is also passed on in higher prices, would a bank’s business customers be able to offset the FAT implicitly charged?

- The excess profits component of the tax would probably be based on the notion of the ACE – an “allowance for corporate equity”. The idea is that profits are subject to taxation only above the normal return. For debt finance, the normal return is simply the interest payment. For equity finance, it would be a notional return on the provision of equity finance. The tax base would therefore be profit after deducting interest payments and the notional return to equity finance.
The notional required rate of return depends in principle on the risk of default. In the simple case in which the government guarantees a tax relief based on the notional return, then it becomes risk-free, and the appropriate rate of relief is the risk-free rate.

An excess profits tax of this form has been proposed as a replacement for a standard corporation tax, to be applied to all companies. It is currently used in Belgium. However, the FAT appears to be intended to be levied on top of a normal corporation tax.

- The FAT has an advantage over a pure excess profits tax alone in that the base is very much larger. This means that a lower rate can be levied to raise a given amount of revenue. It also implies that paying out gross profits in the form of bonuses would not affect the overall tax liability. The tax is therefore neutral with respect to bonus payments.

- A pure excess profits tax should, however, be completely neutral in its effects. By contrast, a tax on total value added would not be neutral, and may be passed on to consumers in higher prices. However, because the tax is based only on excess profits and total remuneration, then it should not directly affect the ways in which banks either in raise finance, or invest. Even in the presence of the FSC, discussed below, regulation would therefore continue to be required to control systemic risk.

b. The “Financial Stability Contribution” (FSC)

The idea of the FSC is to levy a charge on financial companies to contribute to building up a fund to pay for financial support in the event of another financial crisis. The charge is therefore intended to be similar to an insurance premium: riskier companies should pay more tax. The measure of risk proposed is the proportion of the company’s assets funded by uninsured liabilities.

- The US has proposed a similar tax based on uninsured borrowing by banks. Sweden introduced a “stability levy” in 2009 of 0.036% of bank liabilities, excluding equity capital and junior debt. In the Swedish case, the revenues will also be earmarked to a fund which will be used for future bailouts of the financial sector.
- The motivation for the IMF proposal is to raise revenue to offset the cost of the financial bailouts, rather than to affect bank behaviour. But by increasing the cost of borrowing, both taxes should tend to encourage banks to use more equity capital.
- Excessively small equity capital is an important factor in determining the financial fragility of a bank. A tax on the main alternative form of finance therefore seems consistent with encouraging banks to use more equity capital.
Does the FSC appropriately account for risk?

- However, the tax does not completely identify the sources of risk of a financial company.
  - Perotti and Suarez (2009) propose a similar tax, though based on the maturity of a bank’s liabilities. The underlying assumption is that the main problems creating the financial crisis were derived from banks’ reliance on short-term, uninsured funding.
  - However, another key element of the financial crisis was that banks engaged in investment and financial innovation which proved to be riskier than expected. The FSC would not target risky lending and risky assets in general.
  - Regulatory capital requirements are based on the risk of the bank’s assets: a riskier investment policy generally triggers a requirement for higher equity capital. An alternative form of tax could be designed on a similar (preferably the same) basis. That is, a riskier investment policy could also trigger a higher tax liability. Such a tax seems consistent with all three of the possible aims above.

- A tax on either liabilities or assets, however, could generate a potential conflict with regulations.
  - Suppose that a bank’s existing lending policy and composition of assets means that regulations require it to have 10% of its liabilities in the form of equity capital. Now suppose that a new tax on borrowing by banks is introduced. This increases the incentive for banks to use equity capital. In turn, this may relax the constraint imposed by regulation. With a now higher equity capital induced by the presence of a tax, assets can become riskier while still complying with regulations. For example, suppose that after the introduction of the tax, equity capital becomes more attractive and the bank aims to hold 15% of its liabilities in that form. At this level of equity capital, the bank would be allowed to undertake riskier lending, commensurate with the higher equity capital.
  - A tax on risky lending would raise a similar issue. If a bank reduces risky lending to avoid a tax on these loans, regulations would allow the bank to reduce its equity, so that the overall riskiness of its operations may not change, or even increase.

C. International Issues

- A common element of the debate on taxes on banks has been the question of whether a tax would need to be introduced in a coordinated way across countries. In general, the answer to this question is yes.

- The location of lending, borrowing, and other financial transactions is typically difficult to define, and is very mobile as financial activities can be moved easily to

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offshore locations. In general this is a problem with most of the taxes described above. Even a tax on bonuses might induce bank employees to move, although they are probably less mobile than the funds that they control.

- For this reason, for example, the US proposals were designed to tax the worldwide activities of US-resident banks, as well as the US activities of non-resident banks. By taxing the worldwide activities of US banks, the administration aimed to prevent US banks from avoiding the tax simply by moving activities out of the USA. Co-ordination is then required, since, for example, many US banks have activities in the UK. Should they also be taxed by the UK government, implying double taxation? It would clearly be more appropriate for either the UK, or the US, but not both, to tax the UK activities of US banks. The same applies to the international activities of all banks.

- Similar considerations apply to the FAT, especially if it is intended as an alternative to a VAT. VAT is levied on a “destination-basis” – that is, in the residence of the final consumer – by zero-rating exports and taxing imports. If applied in the UK, then such a tax would only tax those financial services consumed by UK businesses and individuals. While the tax on transactions with these consumers would be hard to avoid, value added generated from other consumers would not be taxed in the UK.