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THE G20 AND NEW BANK TAXES

A BRIEFING NOTE

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The G20 meet later this week in Toronto. One of the issues they will consider, drawing on an IMF report, is the coordinated introduction of a tax on banks. This briefing note argues that the most effective way to do this is to introduce an excess profits tax on banks, instead of the tax on the liabilities of banks as implemented in Sweden and proposed by President Obama for the USA.

In summary:

- An excess profits tax would be designed to raise revenue without affecting banks' behaviour. Control of banks' activities would be left with the regulatory system, rather than through attempting to induce different behaviour through taxation.

- The most likely form of an excess profits tax is based on the ACE – an "allowance for corporate equity". The idea is that profits are subject to taxation only above the "normal" rate of return: that is after deducting the interest due on debt finance and a notional return for equity finance.

- The notional required rate of return for equity depends on the risk of default. If the government guarantees this tax relief, then the required rate of relief is the risk-free rate.

- Such a tax has been proposed as a form of corporation tax to apply to all companies. A form of this excess profits tax is currently used as a corporation tax in Belgium.

- This tax would be considerably more effective if it were applied in a coordinated way by G20 countries, and by other countries.

- Revenues may or may not be used as an insurance fund to support banks as required in the future.

- The main alternative to an excess profits tax is a tax on the liabilities of banks, as has been implemented in Sweden and proposed by President Obama for the USA.

- A levy on the balance sheet may increase the incentives for banks to hold more equity capital. However, this could be counter-productive, and actually exacerbate risk-taking. This is because it ignores the risk of the banks' assets. 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.

TAXING BANKS: A BRIEFING NOTE

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This briefing note sets out some of the issues likely to be considered in the IMF report discussed at the G20 meeting:

1. Why tax the financial sector more than other sectors?
2. A comparison of alternative forms of tax
3. International issues

1. **Why tax the financial sector more than other sectors?**

We comment on three possible reasons for introducing an additional tax.

a. To raise revenue to help reduce the fiscal deficit, and to offset the cost of bailouts?

- A new tax on banks or on their activities may not ultimately be borne by bank employees or shareholders. It may be passed on to others, for example, in higher prices charged to banks customers. Whether it is passed on depends on the form of the tax chosen.
- Given this, then purely from a revenue-raising perspective, there is less reason to target banks, as opposed to other companies and individuals that can afford to contribute more in tax.
- In any case, it will be necessary to define which financial companies would be subject to the new tax.

b. To induce banks to reduce excessive risk-taking?

- It is possible to identify several elements of bank actions that provoked excessive risk, including (a) engaging in excessively risky lending and financial innovation, (b) financing their activities with too little equity capital, and (c) agreeing contracts with employees which encouraged risk-taking.
- In principle a new tax could address one or more of these factors. Regulation of the financial sector, however, can also tackle these issues. Regulation may

not have been effective in the past, but it has some advantages over the use of taxes in attempting to moderate behaviour.

  i. Regulations can be applied directly, for example, in defining capital requirements. By contrast, to have the same effect, a tax would need to be designed and set at a level intended to indirectly induce banks to act in the desired way. Almost inevitably a tax would not have exactly the desired purpose, since the rate required to induce a particular change in behaviour in unknown.
  ii. Regulations can probably be changed and applied more quickly in response to changes in market conditions, compared to taxes.
  iii. Regulation and tax can, however, coexist. In this case, some harmonization between them would be an advantage. For example, until now, the distinction between debt and equity has differed for regulatory and tax purposes.

c. To provide explicit or implicit insurance in the event of a future crisis?

- With this aim, the tax would have two elements.
  i. The size of the tax should reflect the probability that the insured event happens, as with any normal insurance premium. This implies that the tax should be targeted towards the risk undertaken by the bank.
  ii. The revenue raised should be ring-fenced to be available as insurance payments (or bailouts) in the event of a future financial crisis.
- Providing explicit insurance in this way raises serious 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 is, that they will anyway be bailed out in the event of a crisis), then the problem of moral hazard exists anyway. In this case, the government may as well introduce a tax as a form of insurance premium, to cover any future bailout costs.

2. Two alternative forms of tax

The form of tax should reflect its aims. We begin with two options which reflect the aims set out above. We then briefly make comments on other options. Finally, we consider some international issues which are common to several of these options.

a. An excess profits tax

- An excess profits tax would be intended to raise revenue without affecting banks' behaviour. Revenues may or may not be used as an insurance fund.
- The idea would be to tax only profits over and above the rate of return required by the providers of finance. Such profits are commonly referred to as economic rent, or supernormal profit.
- This could be justified to the extent that bank profits are supported by the implicit guarantees and regulatory framework created by governments.
- The most likely form of an excess profits tax is 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.
- A tax of this form has been proposed as a replacement for a standard corporation tax, to be applied to all companies. In this case it is, however, more likely to be applied only to banks and some other financial companies in addition to the normal corporation tax.
- Because the tax is based only on excess profits, then it should not affect the behaviour of banks either in raising finance in different forms, or in their lending behaviour. Regulation would therefore continue to be required to control systemic risk.

b. A tax on risky investment, or on liabilities

Risky investment

- A key element of the financial crisis was that banks engaged in investment and financial innovation which proved to be riskier than expected. A tax targeted towards risky lending and risky assets in general could, in principle, reinforce regulation.
- 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. A 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. It would raise revenue. It would discourage riskier forms of assets. And it would be closely tied with the need for insurance – riskier assets implies greater risk of default, and hence a higher insurance premium (or, in this case, tax).

Liabilities

- Sweden introduced a "stability levy" in 2009 of 0.036% of bank liabilities, excluding equity capital and junior debt. The revenues will be earmarked to a fund which will be used for future bailouts of the financial sector.
- The US has proposed a similar tax based on uninsured borrowing by banks. The motivation is apparently to raise revenue to offset the cost of the financial bailouts, rather than to affect bank behaviour. By increasing the cost of borrowing, both taxes should tend to encourage banks to use more equity capital.
- Perotti and Suarez (2009) propose a similar tax, though based on the maturity of a bank's liabilities.[1] The underlying assumption is that the main problems creating the financial crisis were derived from banks' reliance on short-term, uninsured funding. Excessively small equity capital is also 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.

A potential conflict with regulations

- 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.

[1] See http://www.voxeu.org/index.php?q=node/4578.

3. Other possible forms of tax

a. A financial transactions (Tobin) tax

- Tobin originally proposed a tax at a very low rate on foreign exchange transactions as a way of reducing excessive price volatility in financial markets by discouraging trading. Whether such a tax would indeed reduce price volatility is open to question; there is empirical evidence that it has little effect on volatility.
- Such a tax is not targeted towards reducing excessive risk-taking by banks, and is not targeted as an insurance premium.
- Nevertheless, it is proposed that such a tax could raise significant revenue with minimal distortion to activities which have little social value. But note that:
    - i. If applied generally to specific transactions, then the tax would almost certainly be passed on to the bank's customers. It would not be borne by the bank's shareholders or employees.
    - ii. If the tax was successful in raising significant revenue, then there must be some indirect effect on the economy. Whoever bears the tax ultimately must be worse off, and this must affect their behaviour in terms of consumption, saving, and perhaps labour supply. The notion that it is possible to raise substantial amounts of revenue without any significant economic effects is misplaced.

b. An annual tax on bonuses

- It has been argued that one factor that caused excessive risk-taking by banks was the structure of compensation awarded to bank employees. High bonuses paid in good times, not offset by high penalties in bad times, are likely to encourage individuals to seek excessive risk.
- In principle, bonus systems can be structured such that they do not create incentives for excessive risk-taking. In general, appropriate bonus systems may play an important role in motivating employees. Taxing the use of bonuses as a general principle does not seem to be justified.
- A direct way to address the problem of harmful bonus systems would be to regulate the structure of compensation. This is likely to be more effective than a tax in reducing excessive risk-taking.
- If the bonus tax has the objective to raise revenue from bank employees in leading positions, a levy on all types of remuneration (including the fixed wage) beyond a certain wage level would seem more appropriate in the financial sector.
- As we have recently seen in the one-off tax imposed by the UK in 2009, a tax levied on the payment of bonuses may simply induce the bank to use even more capital to pay the gross cost of the bonuses, effectively passing on the cost of the tax to the bank's shareholders. This may raise revenue, but does not solve the problem of excessive risk-taking.

4. 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 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, Obama's 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.