

Taxation and the Financial Sector

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Background

A looming global catastrophe ... Can we measure marginal social harm? ... Is international cooperation unachievable? ... Will tax-based solutions undermine economic growth? ...

But enough about global warming. Our topic here is the role of taxation in restructuring the financial sector post-2008 crisis.

Many of the same questions arise, however. And a key conceptual tool (Pigouvian taxation) can apply to both ...

... although much less developed to date for financial-sector than environmental issues, & conceptually trickier.

Agenda: look back (income tax & 2008, retributive responses), then forward (improve incentives, funding, recent proposals).

Looking backward: income tax

Most observers agree income tax not a big cause of 2008 crisis – although its fingerprints were all over the crime scene.

E.g., incentives for corporate debt financing, highly leveraged home ownership, managers' use of tax-rationalized derivatives to make & hide risky “heads we win, tails you lose” bets.

But hard to find causal links (e.g., tax changes over time, differences between countries' tax rules) - & no shortage of other prime suspects.

Still, 2008 may raise our estimate of the cost of tax distortions we already knew about – debt bias, home ownership, arbitrage problems in taxing capital income, financial institution rules.

Should “bad guys” have to pay up?

Making responsible entities/professions/individuals pay is a huge & salient political issue.

Jeffrey Sachs: FTT is a “Robin Hood” tax on “bankers brazenly smirking as they pocket large amounts of our money.”

Incidence problems: a tax “on” banks may be borne by new counter-parties, or at best would reach today’s SHs; a bonus tax may be borne by SHs rather than managers.

Politicians’ job differs from ours; they might need retributive rationales to sell taxes we’d evaluate on prospective grounds.

Looking forward: lessons of the financial crisis

Key cause: during credit boom + housing bubble, financial firms placed huge, highly leveraged bets against sector-wide decline in housing prices.

2 questions: Why did they make these bets, why did their losses have such huge systemic effects?

Incentive problems: “heads I win, tails you lose” may have made sense for SHs, & clearly did for managers.

Executive comp richly rewarded “fake alpha” – seemingly extra-normal returns, actually compensating for tail risk.

Easy to place (& hide) huge bets w/ derivatives – AAA-rated, firm’s downside limited, the manager’s even more so.

But so what?

Firms fail all the time. But for financial firms: (a) bigger social effects, (b) unique business risks (managers should be MORE cautious, not less), (c) harms radiate beyond counter-parties that can protect themselves contractually.

Banks provide liquidity by intermediating between depositors who want cash on demand & firms that want committed funds.

So even the best-run bank makes promises it can't all keep.

In normal conditions, capital adequacy is assured by the law of large numbers.

But not if anything prompts a run on the bank.

Bank runs

An externality among investors (race to the bank triggers a run on the bank). Cf. Keynes' "beauty contest" in reverse.

Can happen to the world's best-run bank – or not happen to fraudsters concealing huge losses (a la Madoff).

But no surer way to trigger than by suffering huge losses.

Even with just 1 financial firm (supplying global liquidity) & transparent finances, big externality problem: collapse destroys surplus from all transactions requiring liquidity.

Opaque finances & multiple firms w/ contagion potential (from counter-party risk, actual or assumed portfolio correlation) make the social problem a lot more complicated.

The Pigouvian perspective

Key externality: lost surplus from transactions that require liquidity. (If big enough, global recession or depression.)

Transmuted into a fiscal externality to TPs to the extent these harms are staved off by explicit (FDIC) or implicit (too big to fail) government insurance.

Suppose we could value the (net) negative externality for any investment choice by a financial firm.

Charge them the right Pigouvian tax (equaling marginal harm), & by definition they have the right incentives.

Alas, this is much more easily said than done!

Global warming vs. lost liquidity

Global carbon tax to address climate change: tough empirical problem, but comfortingly familiar theoretically.

And each carbon unit emitted is the same.

Financial instit'n externalities: not from any 1 output or activity.

Relevant aspects may include firm liquidity, solvency, riskiness, opacity, size or market share, interconnectedness, etc.

Even for a given investment choice, expected harm likely to be highly firm-specific, state-specific, etc.

Not limited to expected fiscal cost re. this firm unless no other harm (including via transmission effects to other firms).

Taxes AND, not OR, regulation

Hopelessness of setting a perfect Pigouvian tax confirms continuing need for regulatory command.

E.g., revised capital adequacy regulations will surely be of central importance.

But anything we *can* price could improve incentives, take pressure off the regs, allow use of firms' informational advantages (cf. cap & trade).

Risk-adjusted price for mandatory insurance coverage is a no-brainer (if done well enough), whether called a tax or a fee.

Note also the issue of size of the financial sector (e.g., from net subsidy, VAT- or income tax-exempt services, other).

Tax Proposal I: Financial Transactions Tax (FTT)

Tax base: securities sale prices; for derivatives, use notional value or spot price of reference security.

Rationales: huge revenue yield at low tax rate; discourage speculative & technical trading that (it's claimed) increase asset bubbles & market volatility.

First rationale is erroneous: compare “base-broadening” for an RST or VAT by taxing business-to-business sales.

Empirical literature to date appears not to support claim that higher transaction costs generally improves market functioning.

Tax Proposal II: Bonus Tax

U.K. & France: temporary high-rate taxes on bank bonuses, similar proposals in U.S.

Non-distorting if purely retrospective & not expected to recur.

If applied prospectively, note, e.g., difficulty of defining “bonus” & of how the definition relates to underlying concerns about excessive or ill-designed incentive compensation.

If meant to burden recipients not SHs, retrospective application and remission by the firm may ensure failure to meet this distributional aim.

Tax Proposal III: Levy to Fund Bailouts

Obama Admin: proposed 10-year, 0.15% levy on large firms' non-FDIC liabilities. Other U.S. proposals might either offset cost of 2008 bailouts or fund them for the future.

Germany & the U.K. may seek G-20 support for a bank levy on a similar base, but intended to have a risk-varying premium.

Potentially meritorious idea raises design issues, including (1) relevance of firm size, (2) what liabilities to include in the base, how to measure risk, (3) general revenues vs. resolution fund.

If a risk measure can address incentives, tax level should relate to marginal harm – not desired level of resolution fund.

Tax Proposal IV: Financial Activities Tax (FAT)

IMF 2010: proposes a new tax on financial firms' excess profits (over normal return, as determined with per-employee cap on deductible worker compensation). Cf. Kleinbard & Edgar 2010.

Rationales: excess profits are a proxy either for rents or for hidden tail risk, a la the run-up to 2008.

Absent the distinction between normal & excess profits, might also be a response to excess size of financial sector (e.g., from preferential treatment in other respects).

Implementation issues include application to non-financial firms' financial units – e.g., Ally Financial (formerly GMAC), GE Finance, GE Capital.

General guidelines & conclusions

A well-designed tax on financial institutions or activities should:

- (a) recognize the wide variety of activities in the sector,
- (b) be derivative-proof,
- (c) not depend on firm labels (e.g., “bank”),
- (d) address financial units in non-financial firms, and
- (e) be robust to imperfect international coordination.

Future research should:

- (a) sharpen our understanding of how to apply the Pigouvian framework, and
- (b) address the optimal coordination of financial sector regulation & corrective taxation.