Taxation and the Financial Sector
(by Shackelford, Shaviro, and Slemrod)

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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., from changes over time or national variation) - & no shortage of other prime suspects.

Extra gasoline on the floor when the “explosion” happened for other reasons?

Surely 2008 raises 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.
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” bets made good sense for managers (though not socially).

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


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 Pigouian 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 Pigouian 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 comfortably 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 raising transaction costs generally improves market functioning.

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.
Tax Proposal III: Levy to Fund Bailouts

Obama Admin: proposed 10-year, 0.15% levy on large firms’ non-FDIC liabilities. But no bank tax was enacted.

Again, charging firms for expected rescue costs is in principle a no-brainer economically – even if a non-starter politically.

Design issues would include (1) relevance of firm size, (2) what liabilities to include in the base, how to measure risk, (3) general revenues vs. resolution fund.

But U.S. “market” ideology – or is it just interest group dominance – now appears to reject such fundamental economic ideas as externalities and public goods.
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.

But the time for enacting any of this has probably passed …

… until the next crisis (which might be a lot worse).