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# Briefing Paper

## The 'Mirrlees Review' and 'free' banking

Financial services are exempt from Value Added Tax (VAT) in the UK and the EU because of the difficulty of applying it to them. Nevertheless, the November 2010 'Mirrlees Review' of the UK tax system recommended extending VAT to financial services, noting that New Zealand had made progress in this area. Traditionally, the revenue of retail banks comes from the difference between the rates charged for loans and paid on deposits, but over time, and particularly as banks have diversified into 'investment banking', fee income, which can easily be subjected to VAT, has increased substantially. The problem is in attributing the revenue from the interest rate differential, and this is where 'proxy' taxes can be considered. One possibility is to rely more extensively on 'Stamp Duties', which are currently levied on share and house sales, or on a financial transaction ('Tobin') tax. The Mirrlees Review concludes that transactions based levies create inefficiencies and should be replaced with VAT. However, Sir James Tobin, a 'Nobel' Economics prize-winner, and Lord Turner (Chairman of the Financial Services Authority), have both argued that much of the trading in financial instruments is of little social or economic value. The June 2010 IMF report for the G-20 favours taxation of financial services using a 'Financial Activities Tax' (FAT) levied on the sum of a bank's profits and bonuses above and beyond standard Corporation (profits) Taxation. It notes that the sum of a bank's profits and bonus pool is effectively gross 'value added' and should be taxed accordingly, at least until a VAT can be devised and implemented. There is thus a case for supplementing the current UK government's Bank Levy with an additional ongoing levy on bonus payments, as the previous UK government did in 2009 in a 'one-off' measure. The aim would be to discourage 'excessive' bonus payments and to raise revenue. The Labour government's levy was better at the latter than the former, but bank responses might be different if the tax was made permanent pending VAT introduction.

With a VAT on financial services, tax revenue could be further raised by ending ‘free-banking’; which involves substantial cross-subsidisation of high transaction volume, low balance, current account users (‘young professionals’), by low volume, high balance users (‘old widows’), and penalty charges well in excess of costs to the banks on people who frequently overdraw (‘the poor’). It is thus inefficient and unfair and it also involves implicit tax avoidance.  Fees are waived and interest paid on deposits is kept below market rates. The unpaid fees for services used are essentially implicit interest payments that are not taxable, and less tax is payable on the correspondingly lower explicit interest payments.  If banks were be required to charge fees conformable with the costs of providing payment services, they would be able to pay higher interest on deposits and the usage and operation of the payment systems would be more efficient. With VAT, higher fees and higher interest would generate more government revenue.

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March 2011