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Briefing Paper

Taxing Banks Fairly

The cross-subsidisation at the heart of the 'free banking' model reduces tax revenue as it amounts to the payment of implicit, and thus non-taxable, interest in the form of waived bank service charges. The banks should thus be required to pay taxable, market related, interest. They could then recoup the costs of doing so through charges that relate to the cost of provision and usage of services, and ideally VAT would be charged; which is not the current practice due to the alleged complexity of doing so. Nevertheless, the Mirrlees (2010) review of the UK tax system recommends the VAT should be levied on financial services.

Penalty charges on customers drawing credit in excess of overdraft agreements should be allowed, but should relate to the costs to bank, and should not be disproportionate, or predatory, and designed to fund 'free banking'. Alternatively, the proposed utility regulator could require the banks to charge for financial services in relation to the costs of providing them, and the banks would then need to compensate customers by paying money market related interest rates to depositors. Additionally, a financial transaction tax (FTT) could be considered. Such a tax was originally proposed by James Tobin in relation to foreign exchange transactions, which he regarded as excessive and wasteful. Citing Keynes, Tobin suggests that a more general FTT might be appropriate for similar reasons, and Lord Turner, head of the FSA, seems supportive of this. There is also strong support for a FTT from EU

members, but strong opposition from other G.20 countries e.g. Canada, Australia and the UK. If it curbed 'over trading' or 'churning' and 'short termism', then it might be useful. Whether the revenues derived from it should be hypothecated to boost financial stability in some way, or not, is a matter for debate. It has been proposed that revenues raised, especially from foreign exchange transactions, could be used to fund aid aimed at 'Third World' poverty reduction, and as such it would become a 'Robin Hood' Tax. FTT is a potential substitute for VAT; especially if applied to financial transactions broadly defined. It could thus be used in place of VAT, if that indeed proves too difficult to implement for financial services.

It has frequently been argued that Capital Gains Tax (CGT) should be brought up to income tax levels, increasing revenue from hedge and private equity funds and reducing their competitive advantage. In its first budget on 20 June 2010, the coalition government did raise UK CGT from 18 percent to 28 percent for high earners, but it remains well below the higher 40 and 50 percent income tax levels. Legislation to raise US CGT from 15 percent towards the corporate and income tax level of 35 percent has also been under consideration. It should be noted that raising CGT may discourage trading, and so a FTT transaction tax may not be required. However, raising CGT might discourage investment.

More fundamentally, interest payments should arguably cease to be tax deductable in order to reduce the bias towards debt, as opposed to equity. This would also encourage the adoption of Islamic 'profit and loss sharing' banking principles and more widespread use of equity based venture capital. This could be applied generally, but bank dependent small businesses would object because of the current lack of financing alternatives, or just to banks; as a means of discouraging their massive 'leveraging' of their capital. It should also

be noted that pre-funded deposit insurance, with risk related premia, and risk related capital adequacy requirements, and also capital leverage and liquidity ratios, are effectively non-revenue raising 'taxes' on bank size and risk taking, and this needs to be taken into account when setting new special taxes on the large 'Too Big to Fail' (TBTF) banks. Special taxes were levied on large bonuses in the UK and elsewhere in 2010. Such taxes should be temporary, since prevention by the prudential regulators of 'excessive', risk inducing, bonuses should be replaced by better corporate governance of banks, making such special taxes redundant.

The UK coalition government is to levy a tax in 2011/12 on the difference between total bank liabilities and retail deposits plus core equity. This taxes both balance sheet size and reliance on wholesale funding, but not credit and other asset price risks, and so it is not equivalent to charging big banks risk related deposit insurance premia. Such levies are potentially unfair on international banks head quartered in the UK, such as HSBC and Standard Chartered, that do a substantial portion of their business outside the UK, particularly Asia, and so ideally the tax should be restricted to UK business activity. In 2010, the IMF reviewed various proposals for taxing big banks 'fairly' in order to assure they do not benefit from insurance at the taxpayers' expense.

Higher in-house, risk and leverage related, capital and in-house liquidity requirements are potentially more onerous than pooled deposit insurance, and are thus likely to restrict lending more. 'Polluter pays' taxes, such as the tax on banking dropped by President Obama's administration in 2010 in order to get the US Dodd-Frank Act approved, are an alternative means of attempting to discourage excessive risk taking. These force banks to pay as much as required, and for as long as it takes, to clear up the messes (recessions) they

create. If such a tax were credibly anticipated, excessive risk taking would indeed be contained.

In sum, the goal should be to achieve equal treatment of the large banks and the small banks; which can be allowed to fail if properly deposit insured. The risk related and pre-funded deposit insurance scheme operated by the Federal Deposit Insurance Corporation in the US works well for small banks. The way forward is to attempt to replicate it for big banks; which can be required to hold proportionately higher capital and liquid reserves than smaller banks in order to 'tax' their size and risk taking, but this would reduce their ability to lend. The principles of pooling in insurance suggest that an insurance fund is a better option. If big banks were required to pay ongoing special, rather than one-off, taxes, these could potentially be paid into a fund; but what would the fund be used for between crises? To fund public works, or to pay for adequate bank supervision, perhaps? The fund, would, however, need to be very large to cover all of the deposits of the large banks and so it might be better to use the funds raised to reduce the government's budget deficit. Taxpayers would then be called upon periodically to bail out the TBTF banks, if they are not to be broken up. Financial stability is a 'public good', however, and so taxpayers should contribute to its provision. Some combination of more in-bank insurance (capital and liquid asset holdings), *ex ante* special taxes on big banks, and *ex post* 'polluter pays' taxes seems appropriate. Getting the mix right is the job of regulators and politicians.

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