Fiscal Affairs Department

‘BANK TAXES’ RATIONALE AND DESIGN ISSUES

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Outline

- What has happened
- What rationale for bank taxes
  - User fee
  - Pigovian
  - Third-best
- Conclusions

WHAT HAS HAPPENED

- Twelve EU countries (and Korea) now have some bank tax:
  - Bases differ, but core is often liabilities less equity and insured deposits
  - Some feed a fund (Cyprus, Germany, Sweden)
  - Several are progressive in size (Austria, Germany, Hungary, Portugal)
  - Some distinguish short-/long-term liabilities (UK)
  - Top rates vary from 4 to 8.8 basis points

- Bank levies still work in progress—e.g., need to invent new double tax arrangements
- Revenue fairly modest—average 0.2 percent of GDP
- What future?
  - A fad or here to stay? (Some are temporary)
  - More international coordination?
  - If so then, e.g., on what base?
- Key issue is—What purpose do/could they serve?

WHAT RATIONALE FOR BANK TAXES?

Three sets of concerns a ‘bank tax’ might help address:

- Ensure financial sector pays for direct support in future crises/failures— ‘user fee’ role

- Make failures/crises less likely/damaging— Pigovian role
  - But what link with regulation?

- Existing tax distortions (e.g., bias to debt) may be more costly than we thought– ‘Third best’ role

Slide 7

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m5 Could perhaps drop this slide - at least dlal with repetition this and "objectives" section
mkeen, 27/01/2012

User fee

- Equity concerns prominent in public debate
  - But who exactly is “the financial sector”?
- If aim just to raise revenue, use most efficient instrument
- Looking forward, a case to pay for improved resolution (stressed in IMF report)—a kind of user fee
  - Many design issues:
    - Fund or general revenue?
    - Perimeter?
    - Base?

Correcting externalities—‘Pigovian’ tax

- No shortage of possible financial sector inefficiencies
  - Though complex and less than fully understood

- Two kinds of externality to worry about when systemic institutions are in trouble:
  - Wide damage from unmitigated collapse: failure externality or
  - From providing whatever public support is needed to avoid disaster: a bailout externality

- Regulatory reform to address this underway—but what might a corrective tax on bank borrowing look like?

Work in progress, but

- At capital ratio of 6 percent, perhaps 50 basis points for bailout externality and 40 basis for failure externality (of 100% GDP)

Comparing taxation and regulation

Why, e.g., do we have capital requirements, not a tax on borrowing ?

- With full information, and if revenue is not an issue, the two are equivalent
- —but these are very restrictive conditions…

- Income effects—public or private buffers?
- Uncertainty
- Asymmetric information
- Institutional considerations

‘THIRD-BEST’—CORRECTING OTHER DISTORTIONS

- Tax deductibility of interest, but not return to equity, creates bias to debt finance

- Bank taxes can be seen as to some extent offsetting this
  - But rates are low

- Other ways to address the bias:
  - E.g., ‘Allowance for Corporate Equity’?
  - For all, or (first) for financial institutions ?

But do taxes actually affect banks' leverage?

Theory unclear as to whether more/less tax-responsive than non-financials

Empirically (14,000 banks, 82 countries, 2001-09):

- Tax *does* affect leverage—about as much as for non-financials
- Effects much smaller for large banks
  - But they have lower capital ratios, so a small tax effect can mean a big effect on probability of failure

CONCLUDING

- Diversity of bank taxes as notable as their rapid spread
- Little yet known of experience with them
- Here to stay?
- If yes, what improvements?