TAXING THE FINANCIAL SECTOR
RECENT ISSUES AND DEVELOPMENTS

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G20 asked the Fund to report on:

"...how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system."

Report and background papers at http://www.imf.org/external/np/seminars/eng/2010/paris/pdf/090110.pdf

Objectives

- Ensure financial sector pays for any direct fiscal support
  - Focus on dealing with future failures/crises

- Reduce probability and costliness of failures
  - Improved resolution mechanism key: not bail out
  - Corrective taxation? What relative roles tax and regulation? Capital surcharge or systemic risk tax?

With an eye also to:

- Ease of implementation, recognizing differences in countries' experiences and priorities
- Enabling, if desired, a contribution to reflect wider fiscal and economic costs

- Addressing existing tax distortions
  - Interest costs are deductible but costs of equity finance are not: Excess leverage?
  - VAT exemption of financial services, so final consumers under-taxed, businesses over-taxed: On balance, financial sector too big?
- Taking account of/improving interactions tax and regulatory systems

Financial Stability Contribution (FSC)

- Resolution (which does not mean bailout!!!!) requires upfront resources—perhaps 2-5 percent GDP (more where financial sector larger), and credit line...

  ...for which the sector should pay, like any cost of doing business

- Some ex post recovery may also be needed...

  ...but sole reliance problematic: countercyclical, survivor bias, maybe adverse incentive effects

Design issues for an FSC

- Fund or general revenues?

  – Makes no substantive difference if fund would hold government debt: gross public debt higher with a fund, but net debt the same

  – Issues then: Is moral hazard likely to be greater with a fund? Will money in general revenue be ‘wasted’?

- Base and rate structure

  – Focus on liabilities side (excluding e.g. tier one capital, credit for deposit insurance paid): that’s where the resolution costs arise, and to avoid duplication with Basel risk-weighted assets

  – Adjust rate for aspects of systemicness (interconnectedness, size,...), perhaps not initially

- Perimeter
  – Broad, as all gain from enhanced financial stability

FTT, FAT

Financial Transactions Taxes (FTT)

- Many different forms—bank debit, securities, foreign exchange—and many already exist

- Seems appealing in terms of broad base and low rate—but that's only good if the base is right: general principle not to tax intermediates

- Some see corrective case for FTT to address excess short-term trading, but
  - Not clear if transaction tax would reduce volatility
  - Not well-targeted to systemic risks/financing resolution mechanism

- Incidence—not clear will be as proponents often suggest, but e.g. increased cost of equity finance

- Avoidance issues—contracts in differences etc

Financial Activities Tax (FAT)

A tax on the sum of profits and remuneration

Variants:

- ‘FAT1’: Include all remuneration, and define ‘profits’ as only returns in excess of normal

  Rationale: As a tax on value added, might help fix under-taxation of financial services under VAT

  – Origin based? Credit for business users?

- ‘FAT2’: Profits plus ‘high’ remuneration

  Rationale: Tax on rents to owners and managers

  - Hard to distinguish rent element of remuneration; coordination issues
  - Where are rents from? Bailout subsidy?

- ‘FAT3’: Returns to equity above some rate well above normal, and very high remuneration

  Rationale: Discourage risk-taking

Fund Recommendations

- FSC linked to resolution scheme, plus FAT if wider contribution to costs needed
- International cooperation helpful—some leveling of playing field though risk-adjustment
- Don’t forget pre-existing tax distortions
  - E.g. Allowance for Corporate Equity (ACE), with deduction for nominal return to equity?
  - FAT?
- Holistic approach to tax and regulation

What has been done?

- UK, Germany, Austria, Sweden,...: Tax liabilities less insured deposits and Tier 1 capital
  – Rates in order of 4-7 basis points; some to a fund

- On assets side: France

- Bonus taxes: UK, France (both temporary), Italy (permanent)

- European Commission:
  —Proposes network of resolution funds
  —Impact studies underway for FAT and FTT

Concluding

- Wide diversity of views and circumstances mean adoption of ‘bank taxes’ has been piecemeal—but the experiment has now started
- Increased attention to pre-existing problems is encouraging
- Still much to learn about comparative advantage tax and regulatory measures in supporting financial stability