

In a report for the G20 leaked in April, the International Monetary Fund (IMF) proposed not one, but two, new taxes on banks. Reaction around the world has been mixed, but there is enough support in principle – including from both parties in the UK's new coalition – to suggest that we should take these proposals seriously.

Why introduce new taxes on banks?

A starting point to understand the proposals is to ask why we need new taxes on banks and other financial companies. The IMF suggests two reasons, which it links with its two proposed taxes.



New bank taxes, NEW WORLD ORDER?

Michael Devereux assesses the IMF's recently-revealed proposals

The first is that governments need to build an insurance fund that would be available to bail out a defaulting bank or other financial company in the event that it defaults. The second reason is that a defaulting bank would impose costs on other financial companies, and the world at large, which extend well beyond those to the shareholders and creditors of the failed bank. And so banks should make a contribution to 'reflect the wider fiscal and economic costs of financial crises'.

Consider the insurance fund argument. Building an explicit insurance fund of course increases the problem of moral hazard in the financial sector, but let us leave that to one side. Instead, consider what would be a reasonable insurance premium for each financial company to pay.

A typical insurance premium reflects the probability that an insurance payment will need to be made, and the size of the payment if it is made. It costs more to insure a Ferrari than a Ford Fiesta for both these reasons.

But financial services are heavily regulated. In principle, regulators should be concerned with the probability that a financial company will default. If regulators were successful, then the probability of default would be low for all companies, and it would also be similar among companies. In this case, insurance premiums need not vary according to the risk of default, but only according to the size of the expected payout in the event of default. It would be as if the government enforced speed limits so effectively that driving a Ferrari was no riskier than driving a Fiesta.

The Financial Stability Contribution

So what does the IMF propose as a form of insurance premium? Its proposal of a 'Financial Stability Contribution' (FSC) is very similar to the tax that President Obama recently proposed for the USA: a levy on financial companies' non-insured liabilities.

This is presumably meant to reflect both the risk and the size of the company.

And of course, other things being equal, higher borrowing and less equity capital would make a financial company riskier. But other things are not equal. In particular, regulatory capital requirements typically depend on the risk of a bank's asset position – the riskier the bank's asset structure, the more equity capital the bank will be required to hold.

Paradoxically, the FSC could exacerbate the risk of banks' lending. A levy on non-insured liabilities would tend to increase the incentives for banks to hold more equity capital. Such a levy would therefore tend to relax the regulatory capital requirement, and so could permit banks to hold riskier assets. The tax would effectively distort risk-taking patterns without necessarily reducing the amount of risk taken by banks.

More generally, economists have long debated the merits of regulation as against taxes as a tool for controlling behaviour by those who impose costs on the rest of us. The classic example economists have studied is environmental

pollution: should polluters face a quota on the extent of their polluting, or is a better approach to tax it?

In the context of banks at least, taxes are a weak form of control. Suppose that the policymaker believes that a bank should have a capital ratio of 10%. A regulator can effectively insist on this ratio. A tax policymaker has to work out a suitable tax base and rate that would be just enough to induce the bank to reach 10%. Further, since the same tax would apply to everyone, we have to hope not only that the rate and base chosen are correct, but that all banks will respond in the same way.

The IMF position appears to be that it is unrealistic to expect regulation to prevent all defaults – and so an insurance fund will be needed where regulation fails. On the face of it, it seems sensible – as the IMF argues – to harmonise any new tax with the regulatory system. But if the insurance premium a bank pays is supposed to reflect that bank's risk in the presence of regulation, then actually there is an argument for the reverse: a bank will need a bail-out only when regulation fails. Of course, if the IMF can really design such a remarkable levy that it reasonably reflects the probability of default in the presence of strict regulation, then perhaps its officials should be given regulation to look after as well.

The tax and regulatory systems are anything but harmonised at present. We have a corporation tax system that favours debt finance over equity finance, and a regulatory system that attempts to control the use of debt finance. But the way that debt is defined is different. In the case of the regulatory system there is a clear reason for the regulation that can guide policy: to reduce the probability of default. In the case of tax, economists have long argued that there is no reason to treat debt and equity differently. The IMF agrees – it is scathing about relief for interest payments under existing tax systems, citing research that the financial sector has lower effective corporate tax rates than any other sector.

So the FSC falls down on two key criteria. It is not the best way of inducing banks to take less risk. And it does not necessarily reflect the risk of a bank in the presence of regulation. So if we are to have an additional tax on banks, then perhaps a better approach is to aim for a more neutral tax base.

One option would be for a form of excess profits tax. The idea is that relief would be given for the 'normal' return to capital, comprising interest payments on debt finance and a measure of the opportunity cost of finance for equity. If relief is given for all forms of finance, then the tax base would be reduced to that profit over and above the minimum required rate of return – excess profit. In principle at least, such a tax would be neutral since it corresponds to what companies aim to maximise – profits after allowing for a minimum return to the providers of finance. This means that such a tax should have no effect on a company's behaviour: there would be no gains in moderating banks' behaviour, but also no loss from getting it wrong.

One objection to this line of argument might be that the high returns earned by banks and other financial companies on their activities are not all returned to the bank's shareholders, but are instead partly captured by employees in the form of high salaries and bonuses. If paying a bonus reduces the tax on excess profit, then there would be an incentive to increase remuneration.

The Financial Activities Tax

The IMF's second proposal neatly avoids this problem. The 'Financial Activities Tax' (FAT) is based on the sum of financial companies' excess profits and remuneration. This makes it very similar to another well-known tax: value added tax. Although the form in which VAT is collected is quite different, the tax base of value added is exactly equal to the sum of excess profit and remuneration, just like the FAT. In fact, the IMF points out that a FAT could be justified on the grounds that the financial sector is not generally subject to VAT.

There is certainly something in this argument. The financial sector does complain about having to pay VAT on inputs that cannot be set against VAT charged on sales. But this cost is likely to be passed on in higher prices to customers, just as output VAT is. Research indicates that more VAT would be raised if the tax could be extended fully to the financial sector. But attempts to extend VAT to the financial sector have not been very successful to date – so a FAT might be an alternative.

The main reason for not imposing VAT on banks is that it is very hard to do so in practice. The FAT would get around some

of the problems of VAT, but raises many others. The IMF report leaves many important problems of implementation to one side.

International coordination

But one problem of implementation is key: how to treat profits earned abroad. Only last year the UK reformed its corporation tax regime to exempt profits earned abroad from UK tax. But as a result, the distinction between profits located in the UK and elsewhere has become even more important.

Given the relative mobility of financial transactions, both the FSC and the FAT would need to prevent the tax base being easily shifted to countries that do not introduce these taxes, or which do so at a very low rate. The approach that President Obama proposed was to tax all banks operating in the USA, plus the foreign subsidiaries of all US banks. Introduced on a unilateral basis, the idea was that US banks could not escape US tax simply by shifting activities out of the US.

But US banks have operations in the UK and other G20 countries. If the UK followed a similar approach, then a London subsidiary of a US bank would be taxed twice, as would a US subsidiary of a UK bank. That is presumably not what Obama or the IMF have in mind. The twin problems of preventing both tax shifting and double taxation can only be solved by international coordination.

The world does not have a very encouraging history of multilateral tax coordination. There have been agreements on VAT rates, notably in the EU, and also on trade taxes – though the experience in recent years is not a promising sign for international cooperation on bank taxes. So to introduce even one, let alone two, new taxes on banks in G20 countries, and possibly elsewhere, would require an unprecedented level of international coordination.

As such, the stakes are high. If such a level of coordination comes to pass, then the world really will have changed. If G20 governments successfully introduce new taxes on banks, they may feel sufficiently emboldened to start to tackle the much broader and much needed overhaul of the international taxation of all companies.

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