Researchers skeptical about bank taxes, regulations still needed

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Taxes on executive bonuses, financial transactions and excess profits are a few of the taxes proposed or enacted to punish banks for their role in the recent financial crisis, but most of these ideas have shortcomings, says a University of Michigan economist.

"A number of potentially complicated and ambitious new taxes on the financial sector are currently being discussed," said Joel Slemrod, professor of economics and the Paul W. McCracken Professor of Business Economics and Public Policy at Michigan's Ross School of Business. "While the recent financial crisis shows how important it is to consider whether such instruments might help to improve incentives, reform efforts should not unduly focus on the exotic and new at the expense of the familiar and old.

"Addressing undesirable incentives within the existing income tax may be as or more important as creating new tax instruments."

Slemrod and colleagues Douglas Shackelford of the University of North Carolina's Kenan-Flagler Business School and Daniel Shaviro of the New York University Law School examine the role of taxation in the financial sector in a new study published this month in the *National Tax Journal*.

They say that even if fairly well-designed tax instruments are adopted, the key incentive problem that gave rise to the financial crisis—excessive risk-taking by firms and managers that did not face the

entire downside—will likely remain.

As a result, government regulation of the banking and finance industry will continue to be necessary, the researchers say.

"Expected social harm, other than the purely pecuniary to the government as insurer, is multidimensional and difficult to measure," Slemrod said. "And even that pecuniary harm cannot be measured entirely accurately through a risk-adjusted fee. Thus, the classic tax-or-regulation debate is surely beside the point with respect to financial institutions, because regulation of the financial sector both is not going away and should not."

Slemrod and colleagues say, however, that new tax instruments might conceivably be part of the regulatory response to lessons learned about how to reduce the chance of future crises—despite some skepticism regarding their efficacy.

Proponents of a financial transactions tax, for example, say it would increase the costs of financial asset transactions, thereby reducing speculative and technical trading that increases financial markets' volatility and susceptibility to bubbles. The researchers say, however, that little evidence exists to support the claim that an increase in transaction costs generally improves market functioning.

"The efficiency cost is likely to be high relative to the revenue raised, given the lack of any good evidence that it improves incentives or addresses externalities in any clearly identifiable respect," Slemrod said. "The allure of its low rate relative to revenue potential is illusory, and its incidence is uncertain."

A tax on bonuses of bank executives, if applied retroactively, could be effective as a retributive penalty if collected from employees rather than

firms (i.e., shareholders), the researchers say. However, future recurring taxes on bonuses is an invitation to avoidance, given the difficulty of ascertaining and monitoring what part of compensation is, in fact, a bonus.

Another proposal, a graduated tax on the uninsured bank liabilities of large financial institutions, would potentially provide a socially desirable disincentive for risky investments backed by less stable funding, Slemrod and colleagues say. But such a tax would likely be borne by shareholders and other stakeholders of these large banks. Also, if the revenues are to be set aside in a special fund for future bailouts, questions abound about how and when to make use of such a fund.

Finally, the researchers say that a tax on financial firms' profits in excess of a normal return has potential appeal, but its merits remain uncertain and imposing such a tax would also pose various design challenges, including whether and how to apply it to what are essentially financial firms nestled inside larger companies outside the purview of the recognized financial sector.

"Multiple motives underlie the recent flurry of proposals to levy new taxes on financial institutions or their transactions—a desire for retribution from those deemed to have caused or profited from the recent crisis, a desire to align private incentives with the social cost of activities so as to reduce the likelihood of future crises, and a desire to raise revenue to offset the government fiscal imbalances exacerbated by the cost of dealing with the financial crisis and subsequent recession," Slemrod said.

"Economic analysis can clarify what design elements are more likely to achieve which goals, is relevant for ascertaining whether the burden of new taxes will actually fall on those intended to bear the burden, and—political rhetoric aside—cautions that burdens are not borne by

legal entities such as corporations, but by people."

Provided by University of Michigan

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