Prior to the 2008 financial crisis, few proposals were advanced to impose new taxes on financial institutions. However, in light of the adverse impact on government budgets of the ensuing recession, stimulus programs, and “bailouts,” policymakers in the United States and other countries began to question whether financial companies should be contributing more to government finances.

This development makes particularly useful the careful analysis in Taxation and Regulation of the Financial Sector, edited by Ruud de Mooij and Gaëtan Nicodème, a compilation of 15 papers prepared for a 2012 conference on financial sector taxation organized by CESifo. Bringing together insights of international experts in public finance and banking, the papers in this path-breaking volume include both theoretical and empirical research addressing the interplay between taxation and regulation of the financial sector. This review focuses on the papers that address tax issues.

Recognizing that readers may not have a background in both taxation and banking regulation, the editors authored the initial chapter to provide a helpful summary of recent bank regulatory and tax developments as well as a concise introduction to the papers that follow. On the regulatory front, bank supervision since 2008 has been strengthened in the United States (the Dodd-Frank Wall Street Reform and Consumer Protection Act), in Europe (Capital Requirements Directives III and IV), and globally (Basel III).

On the tax policy front, the G20 leaders in 2008 requested a report on “options countries have adopted or are considering as to 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” (International Monetary Fund (IMF), 2010, p. 4). In response, the IMF (2010) issued a report recommending two tax options: (1) a bank levy or financial stability contribution (FSC) on uninsured liabilities of financial institutions, to be used to pay for the cost of future financial crises, and (2) a financial
activities tax (FAT) on profits plus remuneration to raise additional revenue if desired. Notably, the IMF did not recommend adoption of a financial transactions tax (FTT), expressing concerns that a FTT does not target institutional attributes that give rise to systemic risk, cascades in business transactions, is vulnerable to avoidance through international transactions, reduces liquidity, and is capitalized into security prices with harmful effects on economic growth.

The editors count 15 European countries and South Korea as having some type of bank levy, like a FSC, and four countries with variants of a FAT. In addition, contrary to IMF recommendation, 11 EU member countries have been working on a common FTT for the last three years, with proponents pointing to the potential to raise revenue and reduce speculation. Under EU rules, nine countries are required for enhanced cooperation (a procedure under which a group of member states pursue common policies without involvement of the other EU countries); it is uncertain whether such consensus will be achieved, as Estonia pulled out last year and Belgium’s finance minister is opposed (Wishart, 2016).

The chapters in the volume are organized in three groups: (1) the interplay of taxation and regulation policies, (2) the design of taxes and regulations, and (3) evidence regarding the efficacy of taxation and regulation.

INTERPLAY OF TAXATION AND REGULATION

In the first group of chapters, Michael Devereux reviews the causes of the financial crisis, identifies four potential objectives for a new bank tax, and assesses the effectiveness of the FAT and bank levy options relative to these objectives. In Devereux’s view, the relevant policy objectives for a bank tax are: (1) to reflect the social cost of risky bank activities; (2) to recoup the budgetary cost of addressing the financial crisis; (3) to compensate for exemption of financial services from the EU value added tax (VAT); and (4) to fund a resolution mechanism to address future financial crises.

Devereux shows that a bank levy may induce banks to hold more capital (reducing risk, other things equal) but also to increase the riskiness of asset holdings. Thus, if the goal is to address the social costs of systemic risk, Devereux argues there is little role for tax remedies if regulatory deficiencies can be addressed directly. Supporting Devereux’s view, Pigouvian taxes often are difficult to implement in practice due to variations in marginal social cost among taxpayers and institutional constraints in tailoring tax rates accordingly (Fleischer, 2014). Moreover, a Pigouvian tax on systemic risk would be particularly challenging as accurate measurement of risk may not be possible before a financial crisis occurs.

If the goal is to recoup the costs of addressing the financial crisis, Devereux notes, these costs must be defined. In the United States, the financial sector has repaid with interest the loans received from government. That said, some might include the cost of the auto industry bailout or, more broadly, the 25 percentage point increase in U.S. public debt as a share of GDP since onset of the financial crisis.
From a fairness perspective, the burden of a compensatory bank tax seemingly should fall either on the shareholders and bank executives who benefited from risky lending behavior prior to the financial crisis or on the wider public who benefited from government stimulus spending. A priori, there is little reason to expect the incidence of a bank tax would correlate well with any of these fairness criteria (tax incidence is analyzed in Chapters 12 and 13).

The IMF has proposed a FAT as an alternative to the current exemption of financial services under most VATs. However, a FAT, unlike a well-functioning VAT, would cascade on financial services provided to business customers. Moreover, a FAT is not destination-based like the VAT, and would favor foreign over domestic financial services companies. As Devereux points out, there are less distortive ways to impose a VAT on financial services than the FAT (Merrill, 2011).

It also should be noted that the VAT exemption does not necessarily result in under-taxation. For services provided to business customers, the inability to recover VAT on purchases related to provision of these services results in over-taxation. Based on Eurostat data for 2000–2007, a PricewaterhouseCoopers (PwC) report found that the current VAT exemption system in the EU actually raised more revenue (due to nonrecoverable input VAT) than would full taxation of banking services in four of the eight years analyzed (PwC, 2011).

**DESIGN OF TAXATION AND REGULATION**

In Chapter 7, Ben Lockwood sheds new light on an optimal tax controversy, i.e., whether consumption taxes should be imposed on financial intermediation services (Auerbach and Gordon, 2002; Grubert and Mackie, 2000). Lockwood addresses this question using a dynamic general equilibrium framework in which there are consumption, income, and profit (rent) taxes and perfectly competitive financial intermediaries that transfer savings from households to firms at a cost of a fixed number of units of labor. If rents cannot be fully taxed, Lockwood shows that it is optimal to impose a capital income tax, which taxes rents indirectly. In this second-best setting, the government has two instruments (the capital income tax and the financial intermediation tax) to control one target, the intertemporal marginal rate of substitution, so the optimal tax is indeterminate. However, from a tax administration perspective, the simplest optimal tax structure would be to set the capital and financial intermediation taxes at a common rate that generally would differ from the optimal consumption tax rate.

Chapter 9, by Julia Lendvai, Rafal Raciborski, and Lukas Vogel, uses two related dynamic stochastic general equilibrium models to address the impact of an equity transaction tax (ETT). Financial frictions are introduced in the form of leverage constraints, and excess volatility occurs in these models due to “noise” traders whose sentiments depart from rational expectations as a result of exogenous shocks (Summers and Schleifer, 1990). An ETT is imposed only on noise traders — an unrealistic assumption that is intended as a best case scenario for evaluating the ETT.
The authors’ simulations illustrate the trade-off under an ETT between reduced noise trading and reduced economic output, which is estimated to be about 0.2 percent of GDP for an ETT that raises 0.1 percent of GDP in revenues. These results are based on a closed economy model and thus do not account for the possibility that an ETT would shift trading activity to foreign markets. If trading on foreign exchanges is untaxed, an ETT could result in substantial shifting. For example, in 1984 a tax on sale and purchase of equities in Sweden was introduced. By 1990, more than half of all Swedish trading had moved to London, and the tax was abolished in 1991 (European Commission, 2008).

EFFICACY OF TAXATION AND REGULATION

The third set of papers evaluate evidence for the efficacy of bank taxation and regulation. Chapter 11, by Ruud de Mooij, Michael Keen, and Masanori Orihara, explores the extent to which the bias for debt finance under an income tax affects bank leverage and, in turn, how bank leverage affects the probability of a systemic banking crisis. Based on individual and national bank data for 82 countries, the authors find a significant relationship between statutory tax rates and bank leverage. Further, the authors demonstrate that the probability of systemic banking crises increases with bank leverage. Combining these two empirical findings, the chapter simulates the impact of tax policies intended to reduce bank leverage on the probability of a bank crisis and the associated loss of economic output.

The tax policies considered in Chapter 11 are (1) a 10-point reduction in the corporate income tax rate, (2) an allowance for corporate equity (ACE), and (3) a 10-percent levy on bank liabilities net of insured deposits. For banks with an initial debt-to-asset ratio of 96 percent, the simulated four-year cumulative expected output gain ranges from 0.1 to 3.0 percent for the bank levy, 0.2 to 9.9 percent for the corporate rate cut, and 0.6 to 13.3 percent for ACE.

Recognizing the revenue cost of a lower corporate rate or an ACE (even if limited to banks), the authors suggest that bank levies at rates higher than are presently imposed may be justified by the benefits of systemic risk reduction. In view of the higher capital requirements under Basel III, the authors acknowledge that the potential welfare gain from bank levies is unclear. It also should be noted that bank levies, unlike Basel III, are not internationally coordinated, and thus may create competitive disadvantages in countries where they are imposed.

Differing from the prior literature, Chapter 12, by Gunther Carpelle-Blancard and Olena Havrylchyk, finds little evidence that corporate taxes on European banks are passed through to customers in the form of increased net interest margins, even in less competitive banking markets. Their results are based on effective tax rates calculated from financial statement data and a generalized method of moments estimation strategy to address endogeneity. It is not clear whether the authors construct the effective tax rate using cash tax, current provision for tax, or the total tax provision including deferred taxes.
Timothy Goodspeed in Chapter 13 finds that, unlike in the manufacturing sector, corporate taxes do not reduce wages in the financial sector. The author reaches this conclusion on the basis of individual wage data by industry and state, controlling for age, gender, education, race, and right-to-work laws, and utilizing variations in state bank (statutory) tax rates. The author notes several possible explanations for this result, including possible passthrough of corporate taxes by banks in the form of higher net interest margins (contrary to the results in Chapter 12), and particular characteristics of the banking industry, such as market power and labor mobility.

CONCLUSION

In sum, the impressive body of research in these papers makes an uneasy case for imposing selective taxes on financial intermediaries. In the reviewer’s opinion, the best case for taxation is to internalize the social costs of systemic risk; however, in light of the existing bank regulatory system, it is unclear why an additional policy instrument is needed or would be more effective than addressing directly any regulatory deficiencies. Also, it is doubtful that tax and banking rules — under the aegis of different government agencies — could be coordinated effectively to achieve the desired policy outcomes. Finally, bank regulation may be preferable to selective taxation due to important institutional considerations, including more effective international coordination of bank regulations, the greater flexibility granted to bank regulators to adjust policies to market conditions, and the deeper industry knowledge of bank regulators.

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REFERENCES


