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How to use a bank tax to make the financial system safer

Current approach boosts behaviour authorities wish to curb, write Mark Roe and Michael Tröge

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A tax on the balance sheets of big banks – first proposed by US President Barack Obama in 2010 but later shelved – is back on the political agenda. Last month Dave Camp, Republican chairman of the House of Representatives ways and means committee, put forward a proposal for tax reform that included a 0.035 per cent levy on bank assets more than $500bn. This would hit large institutions such as Bank of America, Citigroup and Goldman Sachs.

The aim of the Republican plan is to find tax revenue that could be used to offset cuts in income taxes on individuals. Mr Obama pitched his proposal as a way of raising money from US banks to help repay taxpayers who had to bail them out at the height of the crisis. Neither plan aims to make the financial system safer, and neither would. But with a few alterations, a balance-sheet tax could help strengthen the banks.

When financial institutions get into trouble, it is usually because they have borrowed too much, leaving them at risk of becoming insolvent if their assets decline in value. When banks have too much debt, losses can be crippling even if they are not very large. This is why regulators have been insisting that banks stop relying so heavily on debt financing, and instead build up a bigger cushion of loss-absorbing capital.

Mr Camp has missed an opportunity to back up regulatory action with a profit motive. His plan calls for a levy on banks' assets – that is, their claims on individuals and companies. Two banks that hold the same level of assets would pay the same amount of tax, even if one had taken on far more debt than the other. Much better to tax the banks' liabilities. A bank that relied heavily on debt financing – putting it at greater risk of insolvency – would then pay more than an institution with the same assets but a larger capital cushion. Such a measure would give banks a reason to curtail their own borrowing and increase their capital, as regulators have asked. It would make taxpayer bailouts and damaging financial crises less likely.

The current approach to taxing banks is perverse. It encourages precisely the kind of behaviour that supervisory authorities are trying to curb. Bank regulation requires banks to keep their equity above a specified level. Yet corporate taxation encourages the banks to use more debt and less equity.

This perversity comes from the fact that corporate tax is levied on the banks' profits. When a bank borrows money to finance its balance sheet, it incurs interest expenses that can be deducted against profits for tax purposes. The greater a bank's borrowings, the larger the interest payments and the lower its tax bill. Tax bank liabilities instead of profits, and you will disadvantage liabilities more and bank capital less. Making that change would encourage banks to be better capitalised and stronger.

A more ambitious plan would be to abolish corporate tax on banks altogether, replacing it with a tax on their liabilities. If the rate were set at 0.5 per cent, it would yield roughly the same revenue today as the current 34 per cent corporate tax, which could then be eliminated. Banks should not oppose that change as vociferously as they have opposed prudential regulation proposals, which they think go too far.

But while their tax bill would be the same size, the banks' incentives would change dramatically. They would see capital, rather than debt, as the form of financing that the tax system favours. They would have an incentive to keep bigger capital reserves, and less reason to fight capital regulation.

Until now, regulators have largely used command-and-control mechanisms to make banks safer: requiring them to have more capital, banning or reducing their riskiest activities, and punishing reckless behaviour after the fact. Banks understandably do not like regulators getting involved in their strategic decisions. They lobby against regulation and – if that fails – devise fiendishly complicated transactions to work around the rules. Aligning the incentives of banks and regulators with an innovative tax change could break this perverse incentive, and enhance financial stability.

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