

# 1. Introduction

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Since the ‘Global, or Great, Financial Crisis’ (GFC) of 2007–2009, policy makers and regulators have been seeking the best approach to ‘taxing’ financial institutions and their activities in the financial markets. There are a number of ways of taxing banks, with the goals of improving their stability, and dissuading them from engaging in overly risky activities while also raising tax revenue. One way is through regulations and another is through imposing direct ‘fiscal’ taxes that raise revenues. Hitherto, regulations have been the dominant approach to ensuring the stability of banks and the banking sector. The post-crisis Basel III framework strengthens the minimum risk-related capital requirements outlined in Basel I and Basel II and also introduces new regulations in the form of bank liquidity requirements and bank leverage ratios.

Nevertheless, the big banks remain implicitly insured by taxpayers and can consequently raise funds more cheaply than less strategically important banks that are deemed not to be too big or too complex to be allowed to fail. This gives the big banks a competitive advantage and reinforces their dominance. In response to this,

systemically important financial institutions are increasingly required to hold supplementary capital as recommended by the Financial Stability Board (FSB, 2011), and attention is now turning to TLAC, the total loss absorbing capacity of banks and the banking system (Mullineux, 2014).

The GFC revealed problems with the regulatory approach to addressing externalities arising from excessive bank risk taking and from the 'too big (or complex) to fail' problem. A structural proposal to help solve the problem is to separate the investment and commercial banking activities of 'universal banks' within bank holding companies (BHCs) and to require them to operate as separately capitalized subsidiaries; with the aim of making it easier to let parts of the BHC fail while 'resolving' problems in the 'utility', or infrastructural, part of the bank, so that it can keep functioning without unduly disrupting payments systems and economic activity.

In the UK's Financial Services (Banking Reform) Act (2013), the 'ring fencing' of retail banking and some commercial banking, and thus the household and small business deposits, in line with the Independent Commission on Banking (ICB, 2011) and the Parliamentary Commission on Banking Standards (PCBS, 2013a) recommendations, was required to be implemented. Further, the UK's Prudential Regulatory Authority is to consider whether a US Volcker Rule (SEC, 2013), which limits the scope of the 'proprietary' trading and hedge fund business a

bank can undertake with the aim of restricting the risk to which bank deposits can be exposed, is appropriate for 'The City' in London. Meanwhile, the EU is still considering the Liikanen Report proposals (Liikanen Group, 2012) for a more limited separation of retail and investment banking than is now required in the UK. A less strict separation seems likely given the long tradition of universal banking in Germany and elsewhere in continental Europe.

The debate about the pros and cons of universal banking is ongoing. Calomiris (2013) argues strongly that there are significant economies of scale and scope in banking and also major benefits from the cross-border operation and competition of universal banks, while acknowledging that size matters and robust *internationally agreed* resolution regimes need to be implemented as a back-stop.

Nonetheless, we consider regulatory reforms to be moving in the right direction. Keeping in mind the usefulness of regulations to ensure financial stability, we argue that the aforementioned regulatory and structural measures should be augmented by (fiscal) taxation and also that a fair balance between regulation and fiscal taxation should be aspired to. We propose that Adam Smith's (1776) widely accepted 'principles' of fairness and efficiency in taxation should be used to balance the regulatory and fiscal taxation of banks (and other financial institutions), noting that

regulatory and fiscal taxes may potentially be interchangeable. The ultimate aim should be to tax banking activities, not just banks as variously defined in different countries and regionally regulated blocs, so as to include 'shadow banking' as well as mainstream banking.

In this report, we study how banks are regulated and taxed in a number of countries and analyse how they could be taxed to achieve a fair and efficient balance between regulatory and fiscal taxes. Additionally, we provide an overview of the taxation: of financial instrument trading (the Financial Transaction Tax, or FTT); of financial activities (the Financial Activities Tax, or FAT); and banking products and services using a Value Added Tax (VAT) or GST (Goods and Services Tax), as it is called in Australia and New Zealand.

We note that revenue from such taxes could be hypothecated in order to build 'bank resolution' and deposit guarantee funds, and also to finance bank supervisory authorities; which are normally funded out of general taxation or through levies on banks and other supervised financial institutions. Differential rates of taxation, like varying risk weights in the Basle risk-related capital adequacy requirements, might potentially be used to 'tax' risk taking at appropriate rates in order to promote financial stability and could be varied over time as a macro-prudential policy tool.

We support the elimination of the tax deductibility of the ‘expensing’ of interest on debt because current business tax rules encourage excessive debt issuance and favour debt over equity, which is in direct opposition to what bank regulations require, namely raising extra equity and reducing bank leverage to make banks safer. This in turn raises the question of whether tax deductibility of interest on debt should be removed from banks alone, as they are the licensed creators on credit.

We support the prevailing view that an FTT is economically inefficient because it reduces market trading volume and liquidity and increases volatility and the cost of capital for firms. This is especially the case if it is applied to the gross value at each stage of the settlement chain of a financial transaction – as initially proposed by the European Commission – unlike VAT; which is applicable at the end of the chain. The cumulative effect of charging each agent in a multi-step execution process can be substantial. An FTT may seem like a tax on banks and other financial institutions, but it is highly likely that a good proportion of the costs would be passed on to the end investors. A narrower and relatively low tax, such as the UK ‘stamp duty’ on equity sales (and house sales), is likely to be much less distortionary and now seems more likely to be adopted by the EU, or the Eurozone alone. It would however raise less revenue. But imposing an FTT on government bond sales would both

raise the cost of government funding and be detrimental to the 'repo market',<sup>1</sup> which underpins the interbank markets and thus liquidity in the banking system, and now forms the basis of central bank interest rate-setting operations.

The originally proposed EU FTT was applicable to other non-participating member countries and to third countries if they were counterparty to financial transaction trading in an FTT jurisdiction. Equity issuance is already relatively more costly than debt issuance due to the tax deductibility of interest, but not dividend payments, and UK-style stamp duty adds to the cost of selling equities. Nevertheless, we might support a suitably low stamp duty as a revenue raiser whose major benefit might be to serve as a 'Tobin Tax' (Tobin, 1978) discouraging wasteful over-trading of shares and 'short termism' by throwing 'sand in the wheels' of the stock market.

We further propose the removal of the exemption of financial services from VAT in order to achieve greater efficiency in taxation, as recommended in the Mirrlees Review (Mirrlees et al., 2010) for the UK and the Henry Report (Henry, 2010) for Australia. It would also discourage over-use of financial services and the elimination of the distortionary UK 'free banking' system, based on cross-subsidization, and promote efficiency in the payments system (Mullineux, 2012). Given the operational difficulties linked to the removal of exemption from VAT, the cash flow

method with Tax Collection Account proposed by Poddar and English (1997) is recommended.

We note the overlap between the UK Bank Levy (HM Treasury, 2010), which was initially designed to discourage reliance on wholesale money market funding in favour of retail deposits taking, but has increasingly been used to hit revenue-raising targets, and the proposed Basel III Liquidity Coverage Ratio (LCR). This should be rectified to eliminate double taxation. The best use of a bank levy, as proposed in the Eurozone, is to fund the build-up of a bank resolution and deposit insurance fund. Once the fund reaches a sufficient size, the levy should be phased out and replaced by a risk-related deposit insurance premium, as in the US, leaving banks' profits in the UK to be taxed in line with other companies once it is deemed that they have made a 'true and fair contribution' to the fiscal consolidation made necessary by the banking crisis and the major recession it precipitated.

Finally, we conclude that the proposed EU FTT is likely to reduce market liquidity while the proposed Basel III liquidity ratios (LCR and the Net Stable Funding Ratio) may also reduce money market liquidity because they require banks to hold more liquidity assets on their balance sheets. This may reduce the number of buyers in the market and could cause difficulties when many banks are seeking to sell liquid assets following a major adverse event. As with deposit insurance, the principle of pooling risks

should underpin liquidity insurance, and so ever larger liquidity reserves within banks should be mitigated by a redefinition of a modern fit-for-purpose lender-of-last-resort liquidity support regime operated by central banks. As with deposit insurance, the implicit premium implied by conditions of access to the facilities should be risk related, in line with the Bagehot (1873) principles that have been relaxed since the onset of the GFC and further undermined in the face of the Eurozone crisis. In other words, deposit insurance premiums and conditions for access to central bank liquidity insurance should 'tax' risk taking.

The remainder of this Arts and Humanities Research Council 'FinCris' project report for its 'Taxing Banks Fairly' workstream is organized as follows: Chapter 2 draws a comparison between bank regulation and taxation; Chapter 3 reviews the causes of the GFC; Chapter 4 describes the fiscal costs of the GFC; Chapter 5 provides an overview of existing taxation and related issues; Chapter 6 discusses the taxation of financial instruments; and Chapter 7 provides a conclusion and policy recommendations.

## **Note**

1. A repurchase agreement, or repo for short, is a type of short-term loan much used in the money markets, whereby the seller of a security agrees to buy it back at a specified price and time. The seller pays an interest

rate, called the repo rate, when buying back the securities (source: <http://lexicon.ft.com/Term?term=repurchase-agreement> (accessed 27 March 2015)).

